

FINAL EXAMINATION
GROUP II

SUGGESTED ANSWERS

May, 2012



The Institute of Chartered Accountants of India
(Set up by an Act of Parliament)
New Delhi

SUGGESTED ANSWERS TO QUESTIONS SET AT THE
FINAL EXAMINATION – GROUP II
MAY, 2012



BOARD OF STUDIES
THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA
(Set up by an Act of Parliament)

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Website	:	www.icaai.org
Department/Committee	:	Board of Studies
E-mail	:	bos@icaai.org
ISBN No.	:	978-81-8441-559-9
Price	:	₹ 40/-
Published by	:	The Publication Department on behalf of The Institute of Chartered Accountants of India, ICAI Bhawan, Post Box No. 7100, Indraprastha Marg, New Delhi- 110 002, India Typeset and designed at Board of Studies.
Printed by	:	Sahitya Bhawan Publications, Hospital Road, Agra 282 003 August/2012/13,000 Copies

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PAPER – 5 : ADVANCED MANAGEMENT ACCOUNTING

Question No.1. is compulsory.

Answer any **five** out of the remaining **six** questions

Working notes should form part of the answer.

No statistical or other table will be distributed along with this question paper.

Graph sheet will be provided to candidates along with this paper.

Question 1

- (a) A company has decided to launch a new product X which is, expected to have demand of 10,000 units during the year at ₹160 per unit. The following information is furnished by the company:

- (i) Material - The manufacture of one unit of X requires one unit of each of materials A, B and C.

Raw Material	Current stock (units)	Cost per unit (₹)		
		Original cost	Current Purchase Price	Resale Value
A- Regularly being used	10,000	16	20	14
B- Old stock (Not in use)	6,000	28	24	8
C- New stock	---	---	48	---

- (ii) Direct labour

Skilled labour is paid at ₹80 per hour. It takes 0.25 hours/unit. Skilled labour has to be drawn from another production line which has a contribution of ₹ 240 per unit, with each unit requiring 2 hours of skilled labour.

Unskilled labour - 2 hours/unit @ ₹56 per hour. There is abundant Unskilled labour in the factory, but according to an agreement with the labour union, no unskilled worker can be retrenched.

- (iii) Variable overhead - ₹ 10 per unit.

- (iv) Fixed Costs –no increase.

Using relevant cost approach, you are required to find out the average variable cost per unit of X. (5 Marks)

- (b) The following table gives the unit transportation costs and the quantities demanded/supplied at different locations for a minimization problem:

<i>Demand</i> <i>Supply</i>	C_1	C_2	C_3	C_4	<i>Total Units</i>
R_1	100	120	200	110	20000
R_2	160	80	140	120	38000
R_3	180	140	60	100	16000
<i>Total Units</i>	10000	18000	22000	24000	

You are required to find out which cell gets the 3rd allocation in the initial basic feasible solution under each of the following methods and to give the cell reference, cost per unit of that cell and the quantity allocated to that cell :

- (i) North West Corner Rule
- (ii) Vogel's Approximation Method
- (iii) Least Cost Method

(Candidates may use the standard notation of $C_i R_j$ for cell reference.(e.g. $C_2 R_3$ means the cell at the intersection of Column 2 and Row 3)

(Note: The full solution is not required to be worked out). (5 Marks)

- (c) XY Ltd. makes two products X and Y, whose respective fixed costs are F_1 and F_2 . You are given that the unit contribution of Y is one.fifth less than the unit contribution of X, that the total of F_1 and F_2 is ₹ 1,50,000, that the BEP of X is 1,800 units (for BEP of X F_2 is not considered) and that 3,000 units is the indifference point between X and Y.(i.e. X and Y make equal profits at 3,000 unit volume, considering their respective fixed costs). There is no inventory build up as whatever is produced is sold.

You are required to find out the values F_1 and F_2 and units contributions of X and Y.

(5 Marks)

- (d) State whether each of the following independent activities is value-added or non-value-added:

- (i) Polishing of furniture used by a systems engineer in a software firm.
- (ii) Maintenance by a software company of receivables management software for a banking company.
- (iii) Painting of pencils manufactured by a pencil factory.
- (iv) Cleaning of customers' computer key boards by a computer repair centre.
- (v) Providing, brake adjustments in cars received for service by a car service station.

(5 Marks)

Answers

(a) Average variable cost per unit of X

Cost Element	Relevancy		Total Cost (10,000 units) ₹	Average Cost per unit ₹
Raw material A	Replacement Cost	Current Purchase price	2,00,000	20.00
Raw material B	Opportunity Cost	Opportunity Cost (6,000 units * ₹8 per unit)	48,000	
Raw material B	Incremental Cost	Current Purchase Price (4000 units * ₹24 per unit)	96,000	
		Sub total- Raw material B	1,44,000	14.40
Raw material C	Incremental Cost	Current Purchase Price (10,000 units * ₹48 per unit)	4,80,000	48.00
Skilled Labour	Opportunity Cost	Contribution Lost $10,000 \times 0.25 \times 240/2$	3,00,000	30.00
Unskilled Labour	Sunk Cost		NIL	NIL
Variable Overhead	Incremental Cost	10,000* ₹10 per unit	<u>1,00,000</u>	<u>10.00</u>
		TOTAL	<u>12,24,000</u>	<u>122.40</u>

(b)

Sl. No	Method	Cell Reference	Cost/unit	Quantity
		I	II	III
i)	North West Corner Rule	C ₂ R ₂	80	8,000
ii)	Vogel's method	C ₃ R ₂	140	6,000
		or		
		C ₁ R ₁	100	10,000
iii)	Least Cost Method	C ₁ R ₁	100	10,000

(c)

Let C_x be the Contribution per unit of Product X.

Therefore Contribution per unit of Product Y $= C_y = 4/5 C_x = 0.8 C_x$

Given $F_1 + F_2 = 1,50,000$,

$F_1 = 1,800 C_x$ (Break even volume * contribution per unit)

Therefore $F_2 = 1,50,000 - 1,800 C_x$.

$3,000 C_x - F_1 = 3,000 * 0.8 C_x - F_2$ or $3,000 C_x - F_1 = 2,400 C_x - F_2$ (Indifference point)

ie., $3,000 C_x - 1,800 C_x = 2,400 C_x - 1,50,000 + 1,800 C_x$

ie., $3,000 C_x = 1,50,000$, Therefore $C_x = ₹ 50/-$ ($1,50,000 / 3,000$)

Therefore Contribution per unit of X = ₹ 50

Fixed Cost of X $= F_1 = ₹ 90,000$ ($1,800 * 50$)

Therefore Contribution per unit of Y is ₹ $50 * 0.8 = ₹ 40$ and

Fixed cost of Y $= F_2 = ₹ 60,000$ ($1,50,000 - 90,000$)

The value of $F_1 = ₹ 90,000$, $F_2 = ₹ 60,000$ and X = ₹ 50 and ₹ 40

(d)

Sl. No	Item	
i)	Polishing furniture used by a Systems Engineer in a software firm	Non-value added
ii)	Maintenance by a software company of receivables management software for a banking company	Value-added
iii)	Painting of pencils manufactured by a pencil factory	Value-added
iv)	Customers' computer key board cleaning by a computer repair centre	Value-added
v)	Providing brake adjustments in cars for repairs by a care service station.	Value-added

Question 2

- (a) AB Ltd. makes component 'C' and billing machines. Division A makes component 'C' that is used in the final assembly of the machine in Division B.

(One unit of Component 'C' is used per machine). Component C has an outside market also. A and B operate as profit centres and each can take its own decisions. The following data is given in the existing scenario for Divisions A and B, under which Division A has enough special and external demand to use its capacity and hence is offering B rates of 800 ₹/Unit for quantity up to 750 units and 900 Rs/unit for more than 750 units, so that its outside contribution is not affected by transfers to B. A

and B can sell any quantity up to the maximum indicated under 'units sold', without affecting their future demands.

	Division A		Division B	
	External Market (normal sales)	Special sales	External Market (normal sales)	
Selling Price (₹/u)	1,000	800	4,000	
Variable manufacturing cost (₹/u)	600	600	1,500*	(* excluding component C)
Variable selling cost (₹/u)	100**	--	200**	(** Not incurred on inter division transfers)
Total variable cost (₹/unit)	700	600	1,700*	(* excluding component C)
Contribution (₹/unit)	300	200		
Units Sold	1,250	750	900	
Production capacity	2,000 units		900 units	

For the next period, A requires for its own use in its selling outlets, 50 units of billing machines produced by B. B's manager proposes as follows:

Option I - B will supply 50 machines to A on its variable manufacturing cost basis provided A supplies to B, 500 units of Component C at A's variable manufacturing cost basis.

Option II - Both A and B resort to total variable cost per unit basis applicable to normal external sale, though neither A nor B incurs any selling cost on inter division transfers. A will be given 50 machines for its use. A will have to supply B all the 900 units that B requires.

Option III - Both A and B use the external market selling price (i.e. 1,000 and 4,000 ₹/Unit for 900 units of Component 'C' and 50 machines respectively).

From a financial perspective, advise Division A's manager what he should choose. Support your advice with relevant figures.

What is the change in the rate of discount per unit given by B to A (based on unit transfer price to market price ratio) from option I to option II?

(Note: Students need not work out the total cost statements. Steps showing relevant figures for evaluation are sufficient). (10 Marks)

- (b) The standard set for a chemical mixture of a company is as under:

Material	Standard Mix(%)	Standard Price ₹/Kg
A	80	50
B	20	100

Standard yield in production is 75 %.

The actual quantity produced was 1800 kg of output from the following:

Material	Quantity (kg)	Actual Price
A	1400	60
B	600	90

Calculate the total material price, mix and yield variances, indicating whether they are favorable (F) or adverse (A or U). (6 Marks)

Answer

- (a) **Note :** The basic strategy for division A is to first divert the Special Sales and then the Normal Sales in the external market to minimize the opportunity loss. The analysis is done on this basis.

	Option 1	Option 2	Option 3
Opportunity Lost (Units)			
Special Sales	500	750	750
External Market	-	150	150
Agreed Selling Price by Division A	600	700	1,000
Agreed Selling Price by Division B (Including the Transfer price of Division A)	2,100	2,400	4,000
Contribution (Lost) / Gain ₹ per unit			
Special Sales	(200)	(100)	200
External Market	-	(200)	100
Total Contribution (Lost) / Gain (₹)			
Special Sales	(1,00,000)	(75,000)	1,50,000

External Market	-	(30,000)	15,000
Total	(1,00,000)	(1,05,000)	1,65,000
Contribution Gain per unit by buying from B (₹/u)	1,900	1,600	-
Total Contribution Gained (50 Machines) ₹	95,000	80,000	-
Net Contribution Gained (50 Machines) ₹	(5,000)	(25,000)	165,000

Decision : Option 3 is preferred.

Rate of change in discount $(1900 - 1600)/4000 = 7.5\%$

(b)

	(I) SP x SQ	(II) SP x RSQ	(III) SP x AQ	(IV) AQ x AP
A	50*1920 = 96,000	50*1600 = 80,000	50*1400 = 70,000	1400*60 = 84,000
B	100*480 = 48,000	100*400 = 40,000	100*600 = 60,000	600*90 = 54,000
TOTAL	1,44,000	1,20,000	1,30,000	1,38,000

SP- Standard Price per Kg, SQ- Standard Quantity for actual production

RSQ- Revised Standard Quantity, AQ- Actual Quantity used, AP- Actual Price per kg.

Variances : (Figures ₹)

Variances	Material Yield Variance (I-II)	Material Mix Variance (II-III)	Material Price Variance (III-IV)
A	16,000 F	10,000 F	14,000 A
B	8,000 F	20,000 A	6,000 F
TOTAL	24,000 F	10,000 A	8,000 A

Note : Standard Input = $1800 / 0.75 = 2,400$ kgs. Hence Standard quantity of A is $2,400 * 0.8 = 1920$ kgs and B = $2400 * 0.2 = 480$ kgs.

Question 3

- (a) A company is operating at 60 % of its capacity with a turnover of ₹ 43.20 lacs. If the company works at 100 % capacity, the sales-cost relation is:

Factory cost is two thirds of sales value. Prime cost is 75% of factory cost. Administration and selling expenses (75% variable) are 20% of the sales value. Factory overhead will vary according to operating capacity as given below:

Operating capacity (%)	60	80	100	120
Factory overheads (₹in lacs)	9.90	10.80	12	15

The company has planned to operate at 80 % of its capacity. Moreover, it has received an export order and its execution will involve 40 % of the capacity.

The prime cost of the order is estimated at ₹6.0 lacs and the shipping involved will be around ₹ 1.0 lac. Administration and selling expenses will be avoided on the export order. Taking the same percentage of profits as on the domestic sales, determine the minimum price to be quoted for the export order. (8 Marks)

- (b) In a transportation problem for cost minimization, there are 4 rows indicating quantities demanded and this totals up to 1,200 units. There are 4 columns giving quantities supplied. This totals up to 1,400 units. What is the condition for a solution to be degenerate? (3 Marks)
- (c) State with a brief reason whether you would recommend an activity based system of costing in each of the following independent situations:
- (i) Company K produces one product. The overhead costs mainly consist of depreciation.
 - (ii) Company L produces 5 different products using different production facilities.
 - (iii) A consultancy firm consisting of lawyers, accountants and computer engineers provides management consultancy services to clients.
 - (iv) Company S produces two different labour intensive products. The contribution per unit in both products is very high. The BEP is very low. All the work is carried on efficiently to meet the target costs. (5 Marks)

Answer

(a)

	Capacity	
	80% (Domestic sale)	40% (Export order)
	₹ in lakhs	
Sales Value	57.60	
Prime cost (50% of Sales Value ie., $2/3 \times 75\%$)	28.80	6.00
Fixed Cost (Factory Overheads, as given)	10.80	4.20
Administration and selling	8.64	
- variable ($20\% \times 75\% = 15\%$ of Sales Value)		
- fixed	3.60	
Shipping		1.00
Total Cost	51.84	11.20
Profit	5.76	

Add : Profit (Domestic Profit @80% Capacity = 10% of Sales. Hence 11.11% on Cost)	1.24
Minimum Export price	12.44

- (b) The condition for degeneracy is that the number of allocations in a solution is less than $m+n-1$.

The given problem is an unbalanced situation and hence a dummy row is to be added, since the Column quantity is greater than that of the Row quantity. The total number of Rows and Columns then = 9 i.e. (5+4). Therefore, $m+n-1 = 8$, i.e. if the number of allocations is less than 8, then degeneracy would occur.

(c)

Sl. No	Description	Recommend ABC Yes/No	Reason
i)	K produces one product. Overhead is mainly depreciation	No	- One product situation. For allocation of overhead, ABC is not required. - ABC for cost reduction not beneficial since most of the overhead is depreciation.
ii)	L produces 5 different products with different facilities.	Yes	- Multi product situation. ABC is required for allocation of overhead. - ABC is necessary for pricing. - Cost drivers are likely to be different. - Cost reduction may be possible. - Production facilities are different.
iii)	Professional services – lawyers/ accountants/ computer engineers	Yes	- Variety of services. Hence ABC is required for cost allocation. - Services are very different. - ABC is necessary for pricing. - Cost reduction possible.
iv)	S produces 2 different labour intensive products. High unit contribution and efficient operations.	No	- Different products, but labour intensive. Hence, overhead allocation based on readily traceable direct labour cost will be accurate. Hence, ABC not required for cost allocation. - Low BEP level implies low level of fixed cost as a % of sale price or as a % of total cost. - Many fixed cost activity drivers are likely

			to align with the direct labour costs. Hence not required for cost allocation.
			• Efficient operation. Hence ABC not required even for cost reduction or ABC management.

Question 4

- (a) Ezee Ltd makes two products, E and Z. All units produced are sold. There is no inventory build up. Production facilities may be used interchangeably for both the products. Sales units are the limiting factor. The following information is given:

	Price Level			Proposed increase
	E	Z	Total	Total
Contribution ₹/units	25	20		
Fixed Cost ₹			46,000	47,500
Sales units (nos)	3,000	2,000	5,000	4,000

For increase in quantities above 4,000 units for each product, there will be an increase in variable selling costs, (for the increased portion only), thereby reducing the contribution per unit to the following figures:

Units	Contribution per unit (₹)	
	E	Z
4001-5000	20	15
5001-6000	15	10
Above 6000	No Sales possible	

- (i) For the present level, find the break-even point with the present product
- (ii) What is the minimum number of incremental units to be sold to recover the additional fixed cost off ₹ 47,500 to be incurred? (Present product mix need not be maintained):
- (iii) If you are allowed to choose the best product mix for the incremental level, (while taking the present mix given in the first table above for the present level), what would be the individual product quantities and the corresponding total contributions, the total average contribution per unit and the total profits for the complete production? (8 Marks)
- (b) The following linear program is presented to you:
- Objective: Maximize $Z = 30x + 45Y$
- Subject to: (i) $2x + 3y \leq 1,440$

$$(ii) \quad 9x + 12y \geq 2,160$$

$$(iii) \quad 3x + 4y \geq 1,080$$

$$(iv) \quad x, y \geq 0$$

You are required to draw the graph taking quantities of x and y in the respective axes in steps of 60 units (scale 1 cm. = 60 units), determine the optimality and offer your comments on the solution and the constraints. (8 Marks)

Answer

(a) (i) Present Level:

Weighted average contribution per unit

$$(3,000 \times 25 + 2,000 \times 20)/(3,000+2,000) \text{ Or, } (3 \times 25 + 2 \times 20)/(2+3) = 23 \text{ ₹/unit.}$$

BEP = Present level Fixed cost/ weighted average Contribution per unit

$$= 46,000/23 = 2000 \text{ units.}$$

or (E 1200 units & Z 800 units)

(ii) Minimum units for incremental level:

$$\text{next 1,000 units of E get contribution of } 25 \times 1000 = 25,000$$

$$\text{next 1,000 units of E or Z get 20/unit as Contribution} = 20,000$$

$$\text{next 125 units of E or Z get 20/unit as Contribution} = 2,500$$

Total 2,125 units are the minimum requirement for 47,500

incremental fixed cost

Minimum units required:

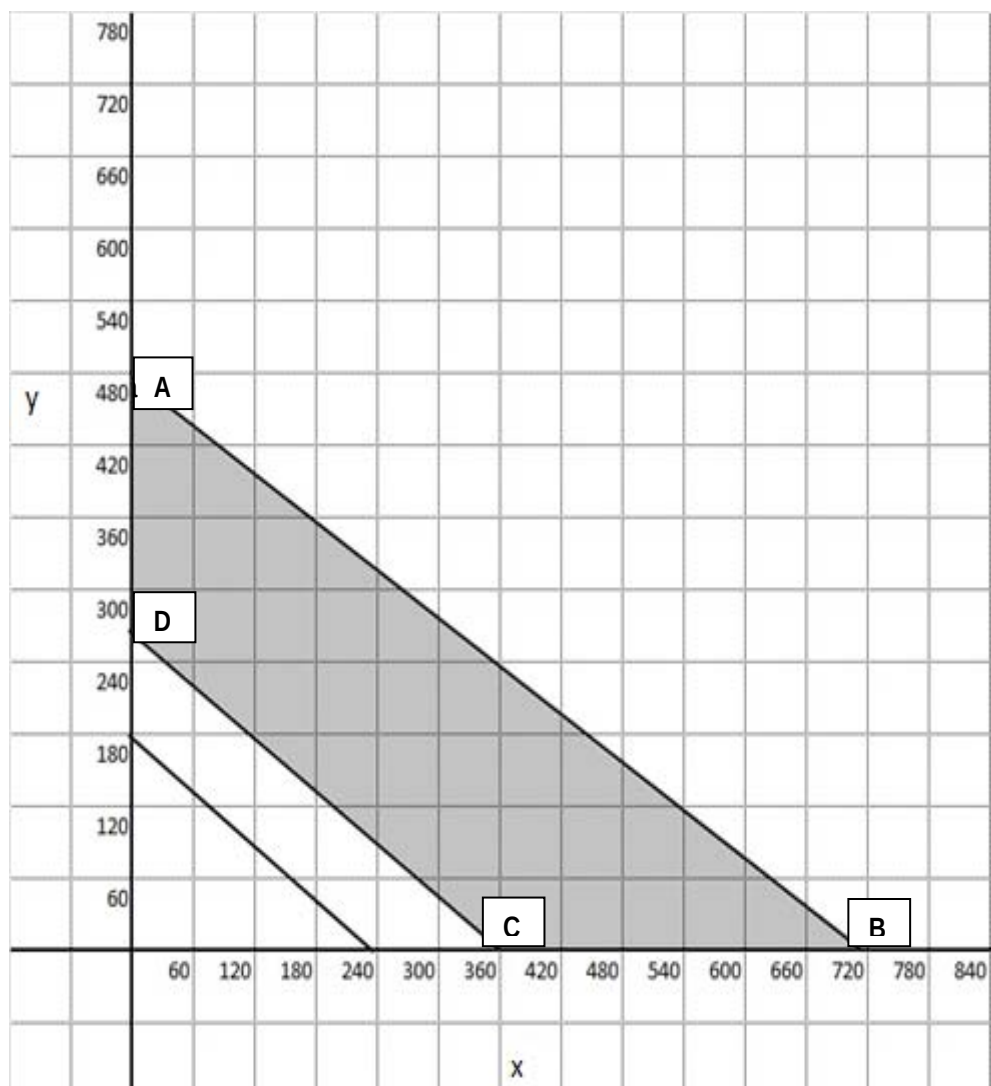
E	Z	Total
2,000	125	2,125
or		
1,000	1,125	2,125

(iii) Optimal profit – best mix:

	Product E		Product Z		Total quantity
	Units	Contribution/u	Units	Contribution/u	
Present	3,000	25	2,000	20	5,000
Next	1,000	25			1,000
Next	1,000	20	1,000	20	2,000
Next	-	-	1,000	20	1,000

Total for best mix	5,000	4,000	
Contribution value (₹)	$4,000 \times 25 + 1,000 \times 20 = 1,20,000$	$4,000 \times 20 = 80,000$	2,00,000
Average Contribution per unit (₹) = $2,00,000 / 9,000 = 22.22$			
Maximum profits (₹) = $2,00,000 - 93,500 = 1,06,500$			

(b)



Boundary points

	x	y	Max Profit	
A	0	480	21,600	*
B	720	0	21,600	*
C	360	0	10,800	
D	0	270	12,150	
* Optimum profit.				

Comment: 1 – Solution – Multiple Optimal solution exists because the objective function line $30x + 45y$ falls on the constraint line $2x+3y$ i.e., any point on the line will yield the same profit of ₹ 21,600/-.

Comment 2: - Constraint –Between Constraints (ii) $9x+12y \geq 2,160$ and (iii) $3x+4y \geq 1,080$ in the problem, constraint (iii) dominates constraint (ii).

Question 5.

(a) A machine manufacturing company needs four components A, B, C and D.

The components may be procured from outside. The cost, market price for the components and other information are given below.

Number of units required	3,000	3,500	2,000	3,000
	Figs. ₹ per unit			
	A	B	C	D
Direct Material	120	140	150	120
Direct Wages	60	80	120	80
Direct expenses at ₹40 per machine hour	80	60	80	80
Fixed Cost	40	40	30	50
Total Cost	300	320	380	330
Market Price	300	320	400	270

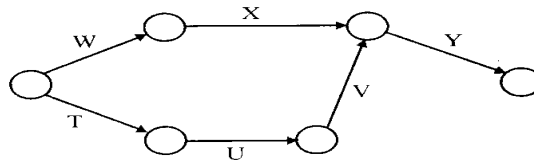
There are constraints on the machine time in manufacturing all the components. Total machine hours available is only 12,000 hours.

It is possible to use the machine time in a second shift which will attract 20 % extra wages and other fixed overheads at ₹6,000 for every 1,000 hours or part thereof.

With relevant supporting figures, advise the best course of action to maximize the profits.

(Note: Students need not work out the complete profitability statement). (8 Marks)

(b) The following network and table are presented to you:



Activity	Normal Duration (Days)	Normal Cost (₹)	Crash Duration (Days)	Crash Cost (₹)
T	8	2,250	6	2,750
U	16	1,875	11	2,750
V	14	2,250	9	3,000
W	12	3,000	9	3,750
X	15	1,000	14	2,500
Y	10	2,500	8	2,860

Perform step by step crashing and reduce the project duration by 11 days while minimizing the crashing cost. What would be the cost of the crashing exercise? (8 Marks)

Answer

(a)

	A	B	C	D
Quantity	3,000	3,500	2,000	3,000
Market price (₹)	300	320	400	270
Total Variable cost/unit (₹)	260	280	350	280
Contribution per unit (₹)	40	40	50	(10)*
*Decision: do not make D				
Machine Hours per unit	2	1.5	2	
Contribution per Machine Hour	20	26.67	25	

Ranking	III	I	II	
Hours required	6,000	5,250	4,000	15250 total hours
Allocation of Available hours	2,750**	5,250	4,000	12,000 hours
** (Balancing figure)				

Hours required in 2nd Shift 3250 hours 1625 units of A

Contribution per unit for Product A in second shift

₹ 40 – ₹12 = ₹ 28 (Direct wages will go up by ₹12)

For every 1000 hours in second shift the Contribution from A would be

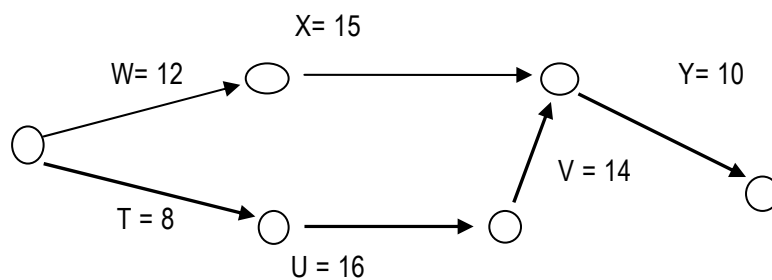
₹14,000 ie., $1,000/2 \times 28$

The increase in Fixed Cost is ₹6,000. After 3,000 hours the Contribution will be only ₹ 250/2 * 28 i.e. ₹3,500, whereas the increase in fixed cost will be ₹6,000. Hence it is not advantageous to go beyond 3,000 hours in the second shift.

Best Course of action:

- (i) Purchase D from outside: 3,000 units.
- (ii) Make B and C fully in-house in the normal shift, B:3,500 units, C:2,000 units.
- (iii) Make and buy A as follows:
 - Normal shift: 1,375 units
 - 2nd shift: 1,500 units
 - Purchase: 125 units

(b)



Paths: TUVY 8+16+14+10 = 48 days (critical path)
 WXY 12+15+10 = 37 days

	T	U	V	Y
Crash days possible	2	5	5	2

Crash cost-normal cost	500	875	750	360
Crashing cost/day	250	175	150	180
Step I crash V – 5 days			750	
Step II crash U – 5 days		875		
Step III crash Y- 1 day				180
Minimum cost of crashing exercise (₹)	750+875+180 = 1805 (for 11 days)			

Question 6

- (a) PQR Ltd is considering introducing a new product at a price of ₹ 105 per unit. 'PQR Ltd's controller has compiled the following incremental cost information based on an estimate of 1,20,000 units of sales annually for the new product:

Direct material cost	₹ 36,00,000
Direct Labour cost	₹ 24,00,000
Flexible manufacturing support	₹ 12,00,000
Sales commission	10% of sales
Capacity- related cost	₹ 20,00,000

The average inventory levels for the new product are estimated as follows:

Raw materials: 2 months' production

Work-in-progress (100% complete for

Materials and 50% complete for labour and

Flexible manufacturing support) 1 month production

Finished goods 2 months' production

Annual inventory carrying costs not included in the flexible manufacturing support listed earlier are estimated to be 12% of inventory value. In addition, the sales manager expects the introduction of new product to result in a reduction in sales of existing product from 3,00,000 to 2,40,000 units. The contribution margin for the existing product is ₹20 per unit.

Prepare a statement showing the budgeted impact on PQR's profits on the introduction of the new product. Should the new product be introduced? (8 Marks)

- (b) Explain the features of a balanced scored card. (4 Marks)

- (c) Classify the following items under the more appropriate category:

Category (CC) – Cost Control Or Category (CR) – Cost Reduction:

- (i) Costs exceeding budgets or standards are investigated.

- (ii) Preventive function
- (iii) Corrective function
- (iv) Measures to standardize for increasing productivity
- (v) Provision of proper storage facilities for materials.
- (vi) Continuous comparison of actual with the standards set.
- (vii) Challenges the standards set
- (viii) Value analysis

(4 Marks)

Answer**(a)**

Budgeted production = 120,000 per annum (10,000 units per month)		
	₹ per unit	Total ₹
Sales Value	105.00	1,26,00,000
Less: Variable Cost		
Direct material	30.00	36,00,000
Direct Labour	20.00	24,00,000
Flexible mfg. support	10.00	12,00,000
Commission 10% of sales	10.50	12,60,000
Total Variable Cost	70.50	84,60,000
Contribution	34.50	41,40,000
Fixed mfg. cost (Capacity related cost)		20,00,000
Inventory carrying cost (Refer working)		2,70,000
Profit from new product		18,70,000
Less: Loss of contribution due to lower sale of existing product 60,000 units * ₹20		12,00,000
Net incremental profit		6,70,000

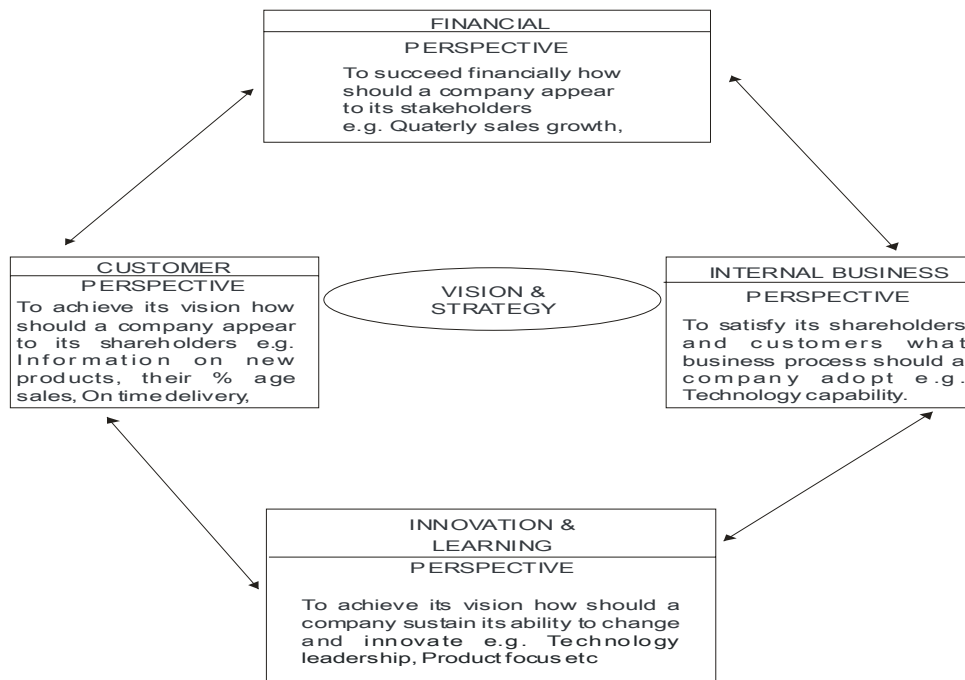
(Decision: Recommend new product)

Value of Inventory

Raw materials (36,00,000 /6)		6,00,000
Work in progress		
Materials (36,00,000/ 12)	3,00,000	

Labour (24,00,000/ 24)	1,00,000	
Flexible Manufacturing support (12,00,000 / 24)	50,000	4,50,000
Finished Goods		
(Raw materials + Labour + Flexible manufacturing support) / 6		12,00,000
TOTAL INVENTORY VALUE		22,50,000
Inventory Carrying cost - 12%		2,70,000

(b)



A Balanced score card includes information, both financial and non-financial elements under 4 perspectives with a long term goal of improved financial performance.

Perspective	Parameters
Customer	Sales % Delivery time New product information
Internal business perspective	Business process to be adopted Technological capability Internal efficiency parameters

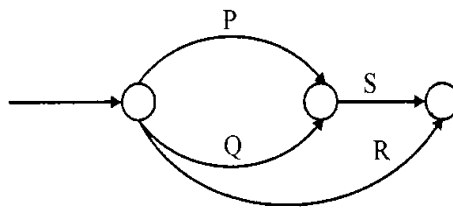
Innovation/ learning perspective	How a company should sustain its ability to change and innovate Technology leadership Product focus Kaizen approach
Financial perspective	Sales growth How the company should appear to its shareholders Operating income by segments

(c) Classification of items under cost reduction/ cost control

Sl. No.	Item	Category Cost Control (CC) Cost Reduction (CR)
(i)	Costs exceeding budgets or standards are investigated	CC
(ii)	Preventive function	CC
(iii)	Corrective function	CR
(iv)	Measures to standardize for increasing productivity	CR
(v)	Provision of proper storage facilities for materials	CC
(vi)	Continuous comparison of actual with the standards set	CC
(vii)	Challenges the standards set	CR
(viii)	Value analysis	CR

Question 7

(a) The following is a part of a network.



What are activities P and Q called? How would you rectify the situation? (4 Marks)

(b) The following matrix was obtained after performing row minimum operations on rows R_1 and R_2 in an assignment problem for minimization. Entries "xx" represent some positive numbers. (It is not meant that all "xx" numbers are equal). State two

circumstances under which an optimal solution is obtained just after the row minimum and column minimum operations.

(Candidates may use cell references as $C_i R_j$ for uniformity. e.g. $C_1 R_1$ represents the cell at the intersection of Column1 (C_1) and Row 1 (R_1) etc.

	C_1	C_2	C_3
R_1	0	xx	xx
R_2	xx	0	xx
R_3	xx	xx	xx

(4 Marks)

- (c) A refreshment centre in a railway station has two counters - (i) self-service (opted by 60 % of the customers) and (ii) attended service (opted by 40 % of the customers). Both counters can serve one person at a time. The arrival rate of customers is given by the following probability distribution:

No. of arrivals	1	3	4	0	2
Probability	0.10	0.30	0.05	0.20	0.35

Formulate the associated interval of 2 digit random numbers for generating

(i) the type of service and

(ii) the arrival rate

(4 Marks)

- (d) Define the following:

(i) maximum capacity (theoretical capacity)

(ii) practical capacity

(iii) normal capacity

(iv) principal budget factor

(The first three relate to a manufacturing plant)

(4 Marks)

- (e) Suggest suitable cost units for the following services:

(i) Hospital

(ii) Hotel

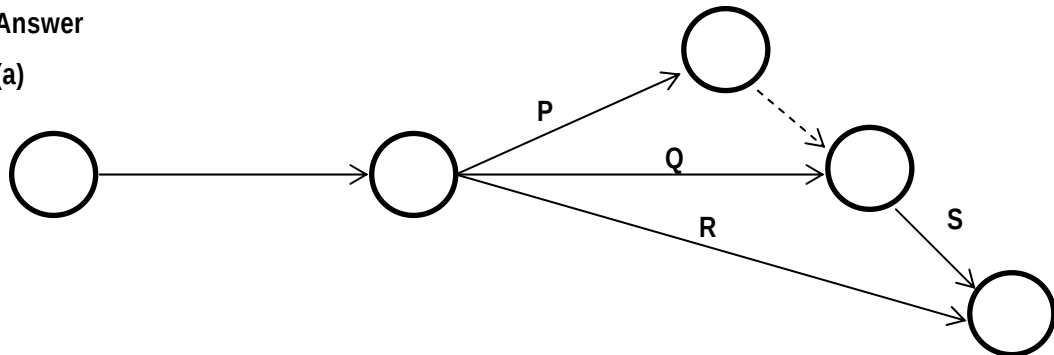
(iii) Transport

(iv) Staff canteen

(4 Marks)

Answer

(a)



Activities P and Q are called duplicate activities (or parallel activities) since they have the same head and tail events. The situation may be rectified by introducing a dummy either between P and S or between Q and S or before P or before Q (i.e. introduce the dummy before the tail event and after the duplicate activity or Introduce the dummy activity between the head event and the duplicate activity).

- (b) Situation 1 :On performing minimum operation in Row 3, if C_3R_3 is zero, the optimal solution is obtained.

0	xx	xx
xx	0	xx
xx	xx	0

Optimal solution = C_1R_1 , C_2R_2 & C_3R_3

Situation 2:On performing minimum operation in Row 3, if C_2R_3 is zero, then it necessitates the performance of minimum operation in C_3 . On account of this, if either C_3R_3 or C_3R_2 is zero then the optimal solution is obtained

0	xx	xx
xx	0	xx
xx	0	xx

And

0	xx	xx
xx	0	xx
xx	0	0

or

0	xx	Xx
xx	0	0
xx	0	Xx

Optimal = C_1R_1 , C_2R_2 & C_3R_3

OR

Optimal = C_1R_1 , C_2R_3 & C_3R_2

(i.e., C_2R_3 and C_3R_3 are zero after Row minimum and column minimum operation respectively)

(or C_2R_3 and C_3R_2 are zero after Row minimum and column minimum operation respectively).

Situation 3 :On performing minimum operation in Row 3, if C_1R_3 is zero, then it necessitates the performance of minimum operation in C_3 . On account of this, if either C_3R_3 or C_3R_1 is zero then the optimal solution is obtained.(i.e., C_1R_3 and C_3R_3 are zero after Row minimum and column minimum operation respectively).

0	xx	xx	and	0	xx	xx	or	0	xx	0	Optimal = C_1R_1 , C_2R_2 & C_3R_3 OR Optimal = C_1R_3 , C_2R_2 & C_3R_1
xx	0	xx		xx	0	0		Xx	0	Xx	
0	xx	xx		0	xx	0		0	0	Xx	

(ie., C_1R_3 and C_3R_3 are zero after Row minimum and column minimum operation respectively)

or C_1R_3 and C_3R_1 are zero after Row minimum and column minimum operation respectively).

(c)

Type of Service	Probability	Cumulative Probability	Random No. Interval
Self- Service	0.60	0.60	00 - 59
Attended Service	0.40	1.00	60 - 99

Arrival Rate:

No. of arrivals	Probability	Cumulative Probability	Random Number Interval
0	0.20	0.20	00 - 19
1	0.10	0.30	20 - 29
2	0.35	0.65	30 - 64
3	0.30	0.95	65 - 94
4	0.05	1.00	95 - 99

(d) (i) Maximum Capacity = Maximum no. of days in a period x no. of workers or

Maximum no. of hours x no. of workers

or

The maximum no. of units that can be produced by a manufacturing facility in a certain period.

(ii) Practical Capacity = Maximum capacity (minus) Sundays, holidays, normal maintenance & idle time

(iii) Normal Capacity = Average of past 3 years' normal performance excluding abnormal data.

(iv) Principal budget factor = The factor that limits the activities of the functional budgets of the organization.

- (e) (i) Hospital Patient days, or room days or patient nights
(ii) Hotel Room nights/ Room days
(iii) Transport Passenger – km or Tonne- km or quintal – km
(iv) Staff canteen No. of meals or no. of staff

PAPER – 6: INFORMATION SYSTEMS CONTROL AND AUDIT

Question No. 1 is compulsory.

Attempt any **five** questions from the remaining **six** questions.

Question 1

ABC is a leading company in the manufacturing of food items. The company is in the process of automation of its various business processes. During this phase, technical consultant of the company has highlighted the importance of information security and has suggested to introduce it right from the beginning. He has also suggested to perform the risk assessment activity and accordingly, to mitigate the assessed risk. For carrying out all these suggestions, various best practices have been followed by the company. In addition, after each activity, appropriate standards' compliances have been tested to check the quality of each process. Various policies related with business continuity planning and disaster recovery planning have been implemented to ensure three major expectations from the software, namely, resist, tolerate and recover.

Read the above carefully and answer the following:

- (a) What are the major suggestions given by the technical consultant? How the company is implementing these suggestions? (5 Marks)
- (b) Discuss risk assessment with the help of risk analysis framework in brief. (5 Marks)
- (c) Out of various types of plans used in business continuity planning, discuss recovery plan in brief. (5 Marks)
- (d) What should be the major components of a good information security policy, as per your opinion? (5 Marks)

Answer

- (a) During the automation of various processes of ABC Company, the technical consultant of the company has given the following major suggestions:

- By realizing the importance of information security, he suggested to introduce it right from the beginning.
- In addition, he also suggested to perform the risk assessment activity.
- Finally, he advised to mitigate the assessed risk.

For the implementation of all the above mentioned suggestions, the company took the following steps:

- The company followed various best practices for each process for the proper implementation of the suggestions.
- In addition, the company also tested the compliance of appropriate standards' after each activity, to check the quality of each process.

- Further, the company also implemented the policies related to business continuity planning and disaster recovery to ensure three broad expectations from the software: resist, tolerate and recover.

(b) **Risk Assessment:** A risk assessment activity can provide an effective approach, which acts as the foundation for avoiding the disasters. Risk assessment is also termed as a critical step in disaster and business continuity planning. Risk assessment is necessary for developing a well tested contingency plan. In addition, Risk assessment is the analysis of threats to resources (assets) and the determination of the amount of protection necessary to adequately safeguard the resources, so that vital systems, operations, and services can be resumed to normal status in the minimum time in case of a disaster.

Risk assessment is a useful technique to assess the risks involved in the event of unavailability of information, to prioritize applications, identify exposures and develop recovery scenarios.

A risk analysis can provide an effective approach that will serve as the foundation for avoiding the disasters. Through risk analysis, it is possible to identify, assess, and then mitigate the risk. Such an analysis entails the development of a clear summary of the current situation and a systematic plan for risk identification, characterization, and mitigation.

The framework of risk analysis is given as follows:



(c) **Recovery Plan:** The backup plan is intended to restore operations quickly so that the information system function can continue to service an organization, whereas, *recovery plans set out procedures to restore full information system capabilities*. Recovery plans should identify a recovery committee that will be responsible for working out the specification of the recovery to be undertaken.

The plan should specify the responsibilities of the committee and provide guidelines on priorities to be followed. The plan might also indicate '*which applications are to be recovered first*'. Members of a recovery committee must understand their responsibilities.

Here, there is a major issue that they will be required to undertake unfamiliar tasks. Periodically, they must review and practice for executing their responsibilities so that they are prepared for a disaster. If committee members leave the organization, new members must be appointed immediately and briefed about their responsibilities.

(d) A good Information Security Policy should clearly state the following:

- Purpose and scope of the document and the intended audience,
- The Security infrastructure,
- Security policy document maintenance and compliance requirements,
- Incident response mechanism and incident reporting,
- Security organization structure,
- Inventory and classification of assets,
- Description of technologies and computing structure,
- Physical and environmental security,
- Identity management and access control,
- IT operations management,
- IT communications,
- System development and maintenance controls,
- Business Continuity Planning (BCP),
- Legal compliances,
- Monitoring and auditing requirements, and
- Underlying technical policy.

Question 2

- (a) *What do you understand by unauthorized intrusion? What is hacking and what damage can a hacker do ?* (6 Marks)
- (b) *What are the guidelines to be followed before starting the implementation of an ERP package?* (6 Marks)
- (c) *Describe the power to make rules by Central Government in respect of Electronic Signature under Section 10 of Information Technology (Amended) Act 2008.* (4 Marks)

Answer

- (a) **Unauthorized Intrusion:** Intrusion detection is an attempt to monitor and possibly prevent the attempts to intrude into or otherwise compromise the system and network resources of an organization. The computer systems of an organization are

attached to a network, and also to the internet. The organization would allow access to that computer system from the network, by authorized people, for acceptable reasons.

For example; if there is a web server, attached to the internet, only clients, staff, and potential clients, are allowed to access the web pages stored on that web server. It does not allow unauthorized access to the system by anyone, be that staff, customers, or unknown third parties. For example, it does not want people (other than the web designers that the company has employed) to be able to change the web pages on that computer. Typically, a firewall or authentication system of some kind will be employed to prevent unauthorized access.

Hacking: Hacking is an act of penetrating computer systems to gain knowledge about the system and how it works. Technically, a hacker is someone, who is enthusiastic about computer programming and all things relating to the technical workings of a computer.

There are many ways in which a hacker can hack. Some of them are given as follows:

- NetBIOS,
- ICMP Ping,
- FTP ,
- rpc.statd, and
- HTTP.

What damage can a Hacker do?

This depends upon 'what backdoor program(s) are hiding on the PC'. Different programs can do different amounts of damage. However, most of them allow a hacker to smuggle another program onto our PC. This means that if a hacker can't do something using the backdoor program, s/he can easily put something else onto the computer.

Hackers can see everything we are doing, and can access any file on the disk. Hackers can write new files, delete files, edit files, and do practically anything to a file that could be done to a file. A hacker can install several programs on to the system without our knowledge. Such programs can also be used to steal personal information such as passwords and credit card information.

(b) There are certain general guidelines, which are to be followed before starting the implementation of an ERP package. These are given as follows:

- Understanding the corporate needs and culture of the organization and then adopting the implementation technique to match these factors;
- Doing a business process redesign exercise prior to starting the implementation;
- Establishing a good communication network across the organization;

- Providing a strong and effective leadership so that people down the line are well motivated;
- Finding an efficient and capable project manager;
- Creating a balanced team of implementation consultants, who can work together as a team;
- Selecting a good implementation methodology with minimal customization;
- Training end users; and
- Adapting the new system and making the required changes in the working environment to make an effective use of the system in future.

(c) [Section 10] Power to make rules by Central Government in respect of Electronic Signature (Modified Vide ITAA 2008):

The Central Government may, for the purposes of this Act, by rules, prescribe

- (a) the type of Electronic Signature;
- (b) the manner and format in which the Electronic Signature shall be affixed;
- (c) the manner or procedure which facilitates identification of the person affixing the Electronic Signature;
- (d) control processes and procedures to ensure adequate integrity, security and confidentiality of electronic records or payments; and
- (e) any other matter which is necessary to give legal effect to Electronic Signature.

Question 3

- (a) *What are the tangible and intangible benefits that can result from the development of a computerized system?* (6 Marks)
- (b) *What is Decision Support System? Discuss its characteristics in brief.* (6 Marks)
- (c) *What are the major activities involved in the design of a database?* (4 Marks)

Answer

- (a)** The benefits, which result from developing new or improved information systems that utilize computers can be subdivided into tangible and intangible benefits. Tangible benefits are those that can be accurately measured and are directly related to the introduction of a new system, such as decrease in data processing cost. Intangible benefits such as improved business image are harder to measure and define. Both these aforementioned benefits that can result from the development of a computerized system are summarized below:

- (i) Increase in sales or profit (improvement in product or service quality);

- (ii) Decrease in data processing costs (elimination of unnecessary procedures and documents);
- (iii) Decrease in operating costs (reduction in inventory carrying costs);
- (iv) Decrease in required investment (decrease in inventory investment required);
- (v) Increased operational ability and efficiency (improvement in production ability and efficiency);
- (vi) New or improved information availability (more timely and accurate information and new types and forms of information);
- (vii) Improved abilities in computation and analysis;
- (viii) Improved customer service (more timely service);
- (ix) Improved employee morale (elimination of burdensome and boring job tasks);
- (x) Improved management decision-making (better information and decision analysis);
- (xi) Improved competitive position (faster and better response to actions of competitors); and
- (xii) Improved business and community image (progressive image as perceived by customers, investors etc.).

(b) A **Decision Support System (DSS)** can be defined as a system providing tools to the decision making managers to address unstructured/ partially structured problems in their own personalized manner. It empowers the managers with a set of capabilities that enable them to generate the information required by them in decision making process. A DSS does not require any high technology. It is considered as more flexible and adaptable for changing decision making requirements than traditional Management reporting system.

There are three major characteristics of a Decision Support System, namely:

- (i) Semistructured or unstructured decision-making;
- (ii) Adaptable to the changing needs of decision makers; and
- (iii) Ease of learning and use.

Each of these characteristics is briefly discussed below:

- (i) *Semistructured and Unstructured Decisions*: Unstructured decisions and semistructured decisions are made when information obtained from a computer system is only a portion of the total knowledge needed to make the decision. DSS is well adapted to help with semistructured and unstructured decisions. A well-designed DSS helps in decision making process with the depth to which the available data can be tapped for useful information.

- (ii) *Ability to adapt to changing needs:* Semistructured and unstructured decisions often do not conform to a predefined set of decision-making rules. DSS provides flexibility to enable users to model their own information needs. Rather than locking the system into rigid information producing requirements, capabilities and tools are provided by DSS to enable users to meet their own output needs.
 - (iii) *Ease of Learning and Use:* DSS software tools employ user-oriented interfaces such as grids, graphics, non-procedural fourth – generation languages (4GL), natural English, and easily read documentation. These interfaces make it easier for users to conceptualize and perform the decision-making process.
- (c) The designing of a database involves four major activities, which are given as follows:
- **Conceptual Modeling:** These describe the application domain via entities/objects, attributes of these entities/objects and static and dynamic constraints on these entities/objects, their attributes, and their relationships.
 - **Data Modeling:** Conceptual Models need to be translated into data models so that they can be accessed and manipulated by both high-level and low-level programming languages.
 - **Storage Structure Design:** Decisions must be made on how to linearize and partition the data structure so that it can be stored on some device. For example-tuples (row) in a relational data model must be assigned to records, and relationships among records might be established via symbolic pointer addresses.
 - **Physical Layout Design:** Decisions must be made on how to distribute the storage structure across specific storage media and locations –for example, the cylinders, tracks, and sectors on a disk and the computers in a LAN or WAN.

Question 4

- (a) *What is IT Infrastructure Library? Discuss the configuration management under ITIL framework.* (6 Marks)
- (b) *List any six ERP vendors and describe the ERP packages offered by them.* (6 Marks)
- (c) *Discuss the parameters that would help in planning a documentation process of IS audit.* (4 Marks)

Answer

- (a) **ITIL (IT Infrastructure Library):** ITIL is a collection of books (standards); each covering a specific 'practice' within IT management. After the initial published works, the number of publications quickly grew (within ITIL v1) to over 30 books. In order to make ITIL more accessible (and affordable) to those wishing to explore it, one of the aims of the ITIL v2 project was to consolidate the works into a number of logical 'sets' that aimed to group related sets of process guidelines for different aspects of the management of Information Technology systems, applications and services together.

The eight ITIL books and their disciplines are:

The IT Service Management sets relating to:

1. Service Delivery
2. Service Support

Other operational guidance relating to:

3. ICT Infrastructure Management
4. Security Management
5. The Business Perspective
6. Application Management
7. Software Asset Management
8. Planning to Implement Service Management

Configuration Management: It is a process that tracks all of the individual Configuration Items (CI) in a system. A system may be as simple as a single server, or as complex as the entire IT department. Configuration Management includes:

- Creating a parts' list of every CI (hardware or software) in the system;
- Defining the relationship of CIs in the system;
- Tracking of the status of each CI, both its current status and its history;
- Tracking all Requests for Change to the system; and
- Verifying and ensuring that the CI parts list is complete and correct.

There are five basic activities in configuration management:

- Planning,
- Identification,
- Control,
- Status accounting, and
- Verification and Audit.

- (b) There are quite a few ERP packages available in the market these days. Out of these, most popular six ERP packages along with the vendors are listed below:

Vendor	Brief Description of ERP Package offered
Baan Corporation	Baan: Initially developed for an aircraft company, it was subsequently launched as a generalized package in 1994. It offers sound technology and coverage of broad functional scope.

Oracle	Oracle ERP Solutions: It gives Internet-enabled, network-centric computing. It also offers database, tools, implementation, applications and UNIX operating systems under one stop-shop umbrella. It is currently running on wide choice of hardware.
Marcam Corporation	Prism: Prism is a specialist process manufacturing solution for the AS/400. Its production model, which is similar to a flowchart, handles process industry problems elegantly. Although out dated, it does the job.
SAP	SAP R/3: It is a market leader with excellent philosophy of matching business processes with its modules. It covers almost all business segments.
JBA	JBA System 21: Its software license revenues are small compared to other major ERP vendors. It offers a rugged, reliable manufacturing solution.
Microsoft	Axapta (AX) and Navision (NAV): Microsoft Dynamics AX is an adaptable business management solution to streamline the business practices. Microsoft Dynamics NAV is basically designed for small and medium size companies. It is a cost effective solution that can be customized for organizations.

- (c) The following three parameters would help in planning a documentation process of IS Audit:
- (i) The importance of planning and understanding the planning process requires identifying three planning questions:
 - ◆ *Knowing Your Resources:* The three basic resources are: time, people, money. One has to check for their availability and affordability.
 - ◆ *Defining the Scope and Audience:* The same report may undergo significant changes depending on the character of the report and nature of the audience. Presentation on Balance Sheet made to bankers and to investors would be quite different in content and focus.
 - ◆ *Using a Scope Definition Report:* It is critical to know how to complete a Scope Definition Report. This report helps in developing a workable schedule for completing the project.
 - (ii) The Documentation Writer: The qualities and skills that the documentation writer would need. The requirement may often be legal in nature.
 - (iii) Rules to guide documentation writing: The four steps of writing documentation namely, writing in active voice, giving the consequences, writing from general to specific, consistency and writing online documentation.

Question 5

- (a) *What is a Virus? What policy and procedure controls can be recommended for ensuring control over virus proliferation and damage?* (6 Marks)
- (b) *How is the term 'Electronic Record' defined in IT (Amended) Act 2008? What is the provision given in the IT Act for the retention of Electronic Records?* (6 Marks)
- (c) *Discuss the constraints in operating a MIS.* (4 Marks)

Answer

- (a) **Virus:** A virus is a program (usually destructive) that attaches itself to a legitimate program to penetrate the operating system. The virus destroys application programs, data files, and operating systems in a number of ways. One common technique for the virus is to simply replicate itself over and over within the main memory, thus destroying whatever data or programs are resident. One of the most insidious aspects of a virus is its ability to spread throughout the system and to other systems before perpetrating its destructive acts.

The policy and procedural controls that can be recommended for ensuring control over virus proliferation and damage are given as follows:

- The Security Policy should address the virus threats, systems vulnerabilities and controls. A separate section on anti-virus is appropriate to address the various degrees of risks and suitable controls thereof.
- Anti-virus awareness and training on symptoms of attacks, methods of reducing damage, cleaning and quarantining should be given to all employees.
- Hardware installations and associated computing devices should be periodically verified for parameter settings.
- As a part of SDLC Controls, the development area should be free of viruses and sufficient safeguards must be in place to secure the area from viruses.
- Provision of drives to read media should be restricted to certain controlled terminals and should be write-protected.
- Network access to the Internet should be restricted preferably to stand-alone computers.
- Networks should be protected by means of firewalls that can prevent entry of known viruses.
- The servers and all terminals must have rated anti-virus software installed with sufficient number of user licenses.
- Procedures should ensure that systematic updates are applied to all anti-virus installations at frequent intervals.

- External media such as disks, CDs, tapes need to be avoided. If necessary such media should be scanned on a stand-alone machine and certified by the department.
 - Vendors and consultants should not be allowed to run their demonstrations and presentations on organizational systems.
 - All new software acquisitions should follow a controlled procedure of centralized acquisition and testing for viruses.
 - Patches to operating systems and other software and upgrades thereof should be acquired from authentic sources and scanned before installation.
 - Reporting and incident handling procedures should be in place to suitably handle virus incidents and eradicate them at the earliest.
 - An effective backup plan must be implemented and monitored to ensure that back-up media is not infected and preferably encrypted. Only new media must be used for back-up purposes.
- (b) "Electronic Record" means data, record or data generated, image or sound stored, received or sent in an electronic form or micro film or computer generated micro fiche.

[Section 7] Retention of Electronic Records:

- (1) Where any law provides that documents, records or information shall be retained for any specific period, then, that requirement shall be deemed to have been satisfied if such documents, records or information are retained in the electronic form, -
- (a) the information contained therein remains accessible so as to be usable for a subsequent reference;
 - (b) the electronic record is retained in the format in which it was originally generated, sent or received or in a format which can be demonstrated to represent accurately the information originally generated, sent or received;
 - (c) the details which will facilitate the identification of the origin, destination, date and time of dispatch or receipt of such electronic record are available in the electronic record:

However,

this clause does not apply to any information which is automatically generated solely for the purpose of enabling an electronic record to be dispatched or received.

- (2) Nothing in this section shall apply to any law that expressly provides for the retention of documents, records or information in the form of electronic records. Publication of rules, regulation, etc. in Electronic Gazette.

- (c) Major constraints, which come in the way of operating a MIS are given as follows:
- Non-availability of experts, who can diagnose the objectives of the organization and provide a desired direction for installing and operating a system. This problem may be overcome by grooming internal staff, which should be preceded by proper selection and training.
 - Experts usually face the problem of selecting the sub-system of MIS to be installed and operated upon. The criteria, which should guide the experts, depending upon the need and importance of a function for which MIS can be installed first.
 - Due to varied objectives of business concerns, the approach adopted by experts for designing and implementing MIS is a non-standardized one.
 - Non-availability of cooperation from staff is a crucial problem, which should be handled tactfully. This task should be carried out by organizing lectures, showing films and also explaining to them the utility of the system. Besides this, some persons should also be involved in the development and implementation of the system.

Question 6

- (a) *The unique nature of each LAN makes it difficult to define standard testing procedures to effectively perform a review. So, what information a Reviewer / IS Auditor should identify and understand prior to commencing a LAN review?* (6 Marks)
- (b) *As an IS Auditor, what are the steps to be followed by you while conducting IT auditing?* (6 Marks)
- (c) *What are the two types of Service Auditor's Reports under SAS 70? Describe the contents of each type of report.* (4 Marks)

Answer

- (a) The unique nature of each LAN makes it difficult to define standard testing procedures to effectively perform a review. The reviewer/IS Auditor should identify the following prior to commencing a LAN review:
- LAN topology and network design;
 - Significant LAN components (such as servers and modems);
 - Network topology (including internal LAN configuration as well as interconnections to other LANs, WANs or public networks);
 - LAN uses, including significant traffic types and main applications used over the network;
 - LAN administrator; and
 - Significant groups of LAN users.

In addition, the reviewer should gain an understanding of the following:

- Functions performed by the LAN Administrator;
- The company's division or department procedures and standards relating to network design support, naming conventions and data security; and
- LAN transmission media and techniques, including bridges, routers and gateways.

Understanding the above information should enable the reviewer to make an assessment of the significant threats to the LAN, together with the potential impact and probability of occurrence of each threat. Having assessed the risks to the LAN, the reviewer should evaluate the controls used to minimize the risks.

(b) Steps in Information Technology Audit: Different audit organizations go about IT auditing in different ways and individual auditors have their own favourite ways of working. However, it can be categorized into six major stages:

- (i) *Scoping and pre-audit survey:* Auditors determine the main area/s of focus and any areas that are explicitly out-of-scope, based normally on some form of risk-based assessment. Information sources at this stage include background reading and web browsing, previous audit reports, pre audit interview, observations and, sometimes, subjective impressions that simply deserve further investigation.
- (ii) *Planning and preparation:* During this stage, the scope is broken down into greater levels of detail, usually involving the generation of an audit work plan or risk-control-matrix.
- (iii) *Fieldwork:* It is related to gathering the evidence by interviewing staff and managers, reviewing documents, printouts and data, observing processes etc.
- (iv) *Analysis:* This step involves desperately sorting out, reviewing and trying to make sense of all that evidence gathered earlier. SWOT (Strengths, Weaknesses, Opportunities, and Threats) or PEST (Political, Economic, Social, Technological) techniques can be used for analysis.
- (v) *Reporting:* Reporting to the management is done after analysis of data gathered and analysis.
- (vi) *Closure:* Closure involves preparing notes for future audits and following up management to complete the actions they promised after previous audits.

(c) Service Auditor's Report under SAS 70: The most effective ways a service organization can communicate information about its controls is through a service Auditor's Report.

There are two types of Service Auditor's Report: Type I and Type II.

A Type I report describes the service organizations description of controls at a specific point in time (e.g. June 30, 2011). A type II report not only includes the service organization description of controls, but also includes detailed testing of the service

organization's controls over a minimum six month period (e.g. January 1, 2011 to June 30, 2011). The contents of each type of report are described in the following table:

S. No.	Report Contents	Type I Report	Type II Report
1.	Independent service auditor's report (i.e. opinion)	Included	Included
2.	Service organization's description of controls	Included	Included
3.	Information provided by the independent service auditor; includes a description of the service auditor's tests of operating effectiveness and the results of those tests.	Optional	Included
4.	Other information provided by the service organization (e.g. glossary of terms)	Optional	Optional

In a Type I report, the service auditor will express an opinion on (1) whether the service organization's description of its controls presents fairly, in all material respects, the relevant aspects of the service organizations controls that had been placed in operation as of a specific data and (2) whether the controls were suitably designed to achieve specified control objectives.

In a type II report, the service auditor will express an opinion on the same items noted above in a type I report, and (3) whether the controls that were tested were operating with sufficient effectiveness to provide reasonable, but not absolute, assurance that the control objectives were achieved during the period specified.

Question 7

Write short notes on any **four** of the following:

- (a) *Data Dictionary* (4 Marks)
- (b) *Risk Mitigation Measures* (4 Marks)
- (c) *Software Process Maturity* (4 Marks)
- (d) *Preventative and Restorative Information Protection* (4 Marks)
- (e) *Objectives of Information Technology Act 2000* (4 Marks)

Answer

- (a) **Data Dictionary:** A data dictionary is a computer file that contains descriptive information about the data items in the files of a business information system. Thus, a data dictionary is a computer file about data. Each computer record of a data dictionary contains

information about a single data item used in a business information system. This information may include:

- Codes describing the data item's length (in characters), data type (alphabetic, numeric, alphanumeric, etc.), and range (e.g., values from 1 to 99 for a department code)
- The identity of the source document(s) used to create the data item.
- The names of the computer files that store the data item.
- The names of the computer programs that modify the data item.
- The identity of the computer programs or individuals permitted to access the data item for the purpose of file maintenance, upkeep, or inquiry.
- The identity of the computer programs or individuals not permitted to access the data item.

(b) **Risk Mitigation Measures:** In risk mitigation, there is a term called, Cause analysis, which identifies events and their impact on losses. Cause models help in the implementation of risk mitigation measures. In addition to establishing causal relationship, other risk mitigation measures are:

- Self assessment;
- Calculating reserves and capital requirements;
- Creating culture supportive of risk mitigation;
- Strengthening internal controls, including internal and external audit of systems, processes and controls, including IS audit and assurance);
- Setting up operational risks limits (so business will have to reduce one or more of frequency of loss, severity of loss or size of operations);
- Setting up independent operational risk management departments;
- Establishing a disaster recovery plan and backup systems;
- Insurance; and
- Outsourcing operations with strict service level agreements so that operational risk is transferred.

Out of these afore mentioned measures, generally the following common mitigation techniques are used:

- **Insurance:** An organization may buy insurance to mitigate such risk. Under the scheme of the insurance, the loss is transferred from the insured entity to the insurance company in exchange of a premium. However while selecting such an insurance policy one has to look into the exclusion clause to assess the effective coverage of the policy.

- **Outsourcing:** The organization may transfer some of the functions to an outside agency and transfer some of the associated risks to the agency. One must make careful assessment of whether such outsourcing is transferring the risk or is merely transferring the management process.
- **Service Level Agreements:** Some of risks can be mitigated by designing the service level agreement. This may be entered into with the external suppliers as well as with the customers and users. The service agreement with the customers and users may clearly exclude or limit responsibility of the organization for any loss suffered by the customer and user consequent to the technological failure.

Here, it is noteworthy that the organization should not be so obsessed with mitigating the risk that it seeks to reduce the systematic risk - the risk of being in business. The risk mitigation tools available should not eat so much into the economics of business that the organization may find itself in a position where it is not earning adequate against the efforts and investments made.

- (c) **Software Process Maturity:** This is the extent to which a specific process is explicitly defined, managed, measured, controlled, and effective. Maturity implies a potential for growth in capability and indicates both the richness of an organization's software process and the consistency with which it is applied in projects throughout the organization.

As a software organization gains in software process maturity, it institutionalizes its software process via policies, standards, and organizational structures. Institutionalization entails building an infrastructure and a corporate culture that supports the methods, practices, and procedures of the business so that they endure after those who originally defined them have gone.

- (d) **Preventative Information Protection:** It is based on the use of security controls, which itself is a group of three types of controls such as Physical, Logical, and Administrative. These are briefly given as follows:

- Physical controls deal with Doors, Locks, Guards, Floppy Disk Access Locks, Cables locking systems to desks/walls, CCTV, Paper Shredders, Fire Suppression Systems,
- Logical controls deal with Passwords, File Permissions, Access Control Lists, Account Privileges, Power Protection Systems, and
- Administrative controls deal with Security Awareness, User Account Revocation, and Policy.

Restorative Information Protection: If an organization cannot recover or recreate critical information systems in an acceptable time period, the organization will suffer and possibly have to go out of business. Hence, the key requirement of any restorative information system protection plan is that the information systems can be recovered. The

claim of back program to backup data automatically cannot be reliable. It has so many problems. The restorative information protection program must address the following:

- Whether the recovery process has been evaluated and tested recently?
- The time taken for restoration,
- The quantum of productivity loss,
- The strict adherence of plan, and
- The time needed to input the data changes since the last backup.

(e) Objectives of Information Technology Act 2000: The objectives of Information Technology Act 2000 are given as follows:

- To grant legal recognition for transactions carried out by means of electronic data interchange and other means of electronic communication commonly referred to as “electronic commerce” in place of paper based methods of communication;
- To give legal recognition to Digital signatures for authentication of any information or matter, which requires authentication under any law;
- To facilitate electronic filing of documents with Government departments;
- To facilitate electronic storage of data;
- To facilitate and give legal sanction to electronic fund transfers between banks and financial institutions;
- To give legal recognition for keeping of books of accounts by banker's in electronic form; and
- To amend the Indian Penal Code, the Indian Evidence Act, 1872, the Banker's Book Evidence Act, 1891, and the Reserve Bank of India Act, 1934.

PAPER – 7 : DIRECT TAX LAWS

Working notes should form part of the answer.

Question No.1 is compulsory.

Attempt any **five** questions from the remaining **six** questions.

Question 1

- (a) Siddarth Ltd. has an undertaking (Unit-X) in Special Economic Zone (SEZ) and another undertaking (Unit- Y) in Free Trade Zone (FTZ) for manufacturing of computer software. It furnishes the following particulars for its 2nd year of operations ended on 31st March, 2012 :

	Unit X ₹ (In lacs)	Unit Y ₹ (In lacs)
Total Sales:	180	120
Export Sales :	120	10
(Inclusive of ₹ 10 lacs for onsite development of computer software outside India by Unit X)		
Profit earned	63	36
[After claim of bad debts under section 36(1)(vii) in Unit X]		

Plant and machinery used in the business has been depreciated at 15% on straight line method (SLM) basis and depreciation of ₹ 9 lacs was charged to profit and loss account in the proportion of sales during the previous year.

₹ 100 lacs were realized out of export sales in time and balance of ₹ 20 lacs becomes irrecoverable due to bankruptcy of one of the foreign buyers in Unit-X.

Compute the deduction under section 10AA of the Income-tax Act, 1961 and taxable income of Siddarth Ltd. for the Assessment Year 2012-13. (10 Marks)

- (b) The net wealth of a firm consisting of two partners S & K having 3 : 1 share and a capital contribution of ₹ 7,50,000 and ₹ 2,50,000 respectively is as under:

- (i) Value of assets located outside India ₹ 15 lacs.
- (ii) Value of assets located in India ₹ 40 lacs.
- (iii) Debts incurred in relation to assets in India ₹ 5 lacs

Determine the value of interest of the partners in the firm under the Wealth-tax Act, 1957. (4 Marks)

- (c) (i) What are the cases where it is deemed that net wealth chargeable to tax has escaped assessment under section 17 of the Wealth-tax Act, 1957?

The Suggested Answers for Paper 7: Direct Tax Laws are based on the provisions applicable for A.Y. 2012-13, which is the assessment year relevant for May, 2012 examination.

- (ii) Can the Assessing Officer under section 16A of Wealth-tax Act, 1957 refer valuation of assets to the Departmental Valuation Officer for the purpose of making an assessment in a case where no return of wealth has been filed by the assessee? (3 Marks)
- (d) State the circumstances in which Schedule III shall not apply for valuation of immovable property. (3 Marks)

Answer

(a) Computation of total income of Siddarth Ltd. for A.Y.2012-13

Particulars	₹	₹
Profits and gains of business or profession		
Unit X (See Note 4)	63,81,000	
Less: Deduction under section 10AA (See Working below)	<u>35,45,000</u>	
		28,36,000
Unit Y (See Note 4)		<u>36,54,000</u>
Total Income		<u>64,90,000</u>

Deduction under section 10AA in respect of Unit X (See Notes 1, 2 & 3)

$$\begin{aligned}
 &= \text{Profits of the business of the undertaking, being the Unit in SEZ} \times \frac{\text{Export turnover of the undertaking (in respect of computer software)}}{\text{Total turnover of the business of the undertaking}} \\
 &= \text{Profits of Unit X} \times \frac{\text{Export turnover of Unit X}}{\text{Total turnover of Unit X}} \\
 &= ₹ 63,81,000 \times \frac{1,00,00,000}{1,80,00,000} \\
 &= ₹ 35,45,000
 \end{aligned}$$

Notes:

- (1) Deduction under section 10AA is available in respect of units established in Special Economic Zones which begin to manufacture or produce articles or things or provide any services during the previous year relevant to A.Y.2006-07 or thereafter. Under section 10AA(1), 100% of the profits and gains derived from export of such articles or things or from services is allowable as deduction for a period of five consecutive assessment years beginning with the assessment year relevant to the previous year in which the Unit begins to manufacture or produce such articles or things or provide services, as the case may be. Therefore, in this case, the profits from Unit X, located in

a SEZ, will be eligible for deduction of 100% of the profits and gains derived from export, since P.Y.2011-12 is the second year of its operations. It is assumed that Unit X has fulfilled all the specified conditions for claim of deduction. Unit Y is, however, not eligible for deduction under section 10AA in respect of the exports made by it since it is located in a Free Trade Zone.

- (2) Export turnover, for the purpose of section 10AA, means the consideration **received** in respect of export by the unit in SEZ. Therefore, in this case, the amount of ₹ 20,00,000 which has become irrecoverable due to bankruptcy of one of the foreign buyers in Unit X will not be included in its export turnover.

Therefore, export turnover of Unit X (in SEZ) = ₹ 1,20,00,000 – ₹ 20,00,000 = ₹ 1,00,00,000.

- (3) Profits and gains from on site development of computer software outside India shall be deemed to be the profits and gains derived from export of computer software outside India. Since the same has already been included in the figure of export sales, no further adjustment is required.

- (4) **Computation of unit-wise profits of the business**

Particulars	Unit X (₹)	Unit Y (₹)	Total (₹)
Profit earned [after claim of bad debts under section 36(1)(vii) in Unit X]	63,00,000	36,00,000	99,00,000
Add: Depreciation calculated on SLM basis and charged in the proportion of sales (3:2)	5,40,000	3,60,000	9,00,000
	68,40,000	39,60,000	1,08,00,000
Less: Depreciation calculated @15% on WDV basis and charged in the proportion of sales (3:2) (See Note 5)	4,59,000	3,06,000	7,65,000
Profits of the business	63,81,000	36,54,000	1,00,35,000

- (5) Depreciation as per the Income-tax Rules, 1962 for the A.Y.2012-13 has to be calculated as follows –

Particulars	Amount in ₹
Actual cost of plant and machinery (₹ 9,00,000 / 15%)	60,00,000
Less: Depreciation @15% for P.Y.2010-11 (being the first year of operations). It is logical to assume that the assets were put to use for more than 180 days during the year.	<u>9,00,000</u>
Written down value as on 1.4.2011	<u>51,00,000</u>
Depreciation@15% on WDV for P.Y.2011-12 (₹ 51,00,000 × 15%)	7,65,000

(b) **Computation of net wealth of the firm**

Particulars	₹	₹
Value of assets located outside India		15,00,000
Value of assets located in India	40,00,000	
Less: Debts incurred in relation to such assets located in India	<u>5,00,000</u>	
		<u>35,00,000</u>
Net wealth of the firm		<u>50,00,000</u>

Value of partner's interest in the assets of the firm

Particulars	S ₹	K ₹
Net assets of the firm to the extent of capital i.e., up to ₹ 10,00,000 – to be allocated in the proportion in which capital has been contributed by the partners	7,50,000	2,50,000
Balance ₹ 40,00,000, to be distributed in profit sharing ratio (3:1)	<u>30,00,000</u>	<u>10,00,000</u>
Value of interest of partners in the net wealth of the firm	<u>37,50,000</u>	<u>12,50,000</u>

Note - As per section 4(1)(b) of the Wealth-tax Act, 1957, in computing the net wealth of an assessee, who is a partner in a firm, the value of his interest in the assets of the firm determined in the manner laid down in Schedule III shall be included.

As per Rule 16 of Schedule III, the net wealth of the firm on the valuation date shall first be determined as if it were the assessee. Thereafter, that portion of the net wealth of the firm as is equal to the amount of its capital shall be allocated amongst the partners in the proportion in which capital has been contributed by them. The remaining portion of net wealth of the firm shall be allocated amongst the partners in accordance with the agreement of partnership or, in the absence of such agreement, in the proportion in which the partners are entitled to share the profits.

- (c) (i) The provisions of section 17 are attracted if the net wealth chargeable to tax has escaped assessment, whether by reason of under-assessment or assessment at too low a rate or otherwise.

The following are the cases where it would be deemed that net wealth chargeable to tax has escaped assessment under section 17 of the Wealth-tax Act, 1957 -

- (1) where no return of net wealth has been furnished by the assessee although his net wealth or the net wealth of any other person in respect of which he is assessable on the valuation date exceeds the maximum amount not chargeable to tax i.e. ₹ 30,00,000;

- (2) where a return of net wealth has been furnished by the assessee but no assessment has been made, and the Assessing Officer notices that the assessee has understated the net wealth or claimed excessive exemption or deduction in the return.
- (ii) Reference to Valuation Officer under section 16A is made for the purposes of making an assessment under the Wealth-tax Act, 1957 where the market value of any asset is to be taken into account in such assessment.

If a person has not filed his return of wealth within the due date of filing the return, the Assessing Officer can serve a notice requiring such person to furnish the return on a specified date. If the person fails to furnish the return, then the Assessing Officer can proceed to make a best judgment assessment and estimate the net wealth of the person after giving him an opportunity of being heard.

Therefore, even in a case where return of wealth is not furnished, the Assessing Officer can make a best judgment assessment, and if the market value of any asset is to be taken into account in such assessment, he may refer the valuation of such asset to the Valuation Officer under section 16A, if having regard to the nature of the asset and other relevant circumstances, the Assessing Officer is of the opinion that it is necessary to do so.

Note – In *CWT v. Anil Tayal (HUF) (No.1) (2006) 285 ITR 243*, the Punjab & Haryana High Court held that reference under section 16A(1) could be made even where no return had been filed by the assessee.

- (d) As per section 7(1) of the Wealth-tax Act, 1957, the value of any asset, other than cash, for the purposes of this Act, shall be its value as on the valuation date determined in the manner laid down in Schedule III. Therefore, except in the case of cash, all other assets have to be valued in the manner laid down in Schedule III.

Rule 8 of Schedule III only specifies the circumstances in which Rule 3 of Schedule III shall not apply for valuation of immovable property. Even in such circumstances, the value of the property shall be determined in the manner laid down in Rule 20 of Schedule III.

Therefore, immovable property has to be valued as per Schedule III and there is no such circumstance specified in the Wealth-tax Act, 1957 where the entire Schedule III would not apply for valuation of immovable property.

Question 2

S. Ltd., engaged in the business of manufacturing, shows a net profit of ₹ 5 crores for the financial year ended 31-3-2012, after debiting/crediting the following items:

- (i) *On EPABX and mobile phones (exclusively used for the business purpose) purchased during the year, depreciation amounting to ₹ 18 lacs was claimed at higher rate of 60% treating them at par with computer.*

- (ii) ₹ 50 lacs paid to N. Ltd, towards feasibility study conducted for examining proposals for technological advancement relating to the existing business, where the project was abandoned without creating a new asset.
- (iii) ₹ 35 lacs paid for the higher studies of the director's son abroad, with a stipulation that he would be appointed as a trainee in the company under "apprentice training scheme" where there is no evidence of existence of such scheme.
- (iv) Payment of ₹ 29 lacs towards purchase of software from a non-resident, meant for subsequent resale in the Indian market (no tax deducted at source), was ultimately sold at a profit during Financial Year 2011-12.
- (v) Dividend of ₹ 10 lacs received from a foreign company in which this company holds 28% in nominal value of the equity share capital of the company. ₹ 0.25 lac expended on earning this income.
- (vi) A machine in use since past 7 financial years having WDV amounting to ₹ 1.50 lacs on 01-04-2010 was discarded on 3rd September, 2010. The depreciation on the block at 15% has been provided and charged to profit and loss account for the previous year ended 31st March, 2012. The entire block is used for the purpose of business.
- (vii) ₹ 45 lacs were paid on 3rd June, 2011 to a National Laboratory with a stipulation that the said contribution shall be used for the purpose of an approved scientific research programme only.
- (viii) Secret commission of ₹ 13 lacs was paid and debited under commission account.
- (ix) Purchased a brand new bus and donated to a school where the employees' children were studying and debited the same to the Workmen and Staff Welfare Account.

Additional Information:

- (x) A debt of ₹ 10 lacs was claimed as bad debt in the previous year 2010-11. However, the Assessing Officer allowed only a sum of ₹ 5 lacs as bad debts. In the previous year 2011-12, a sum of ₹ 4 lacs is recovered ultimately in respect of the debt.

Compute total income of S. Ltd. for the Assessment Year 2012-13 and work out the amount of tax payable on such income, indicating reasons for treatment of each item. (16 Marks)

Answer

Computation of total income of S Ltd. for the A.Y. 2012-13

Particulars	₹	₹
Profits and gains of business or profession		
Net profit as per profit and loss account		5,00,00,000
Add: Excess depreciation provided on EPABX & Mobile phones not allowable as deduction [Note (i)]	13,50,000	
Payment for higher studies of director's son abroad not allowable as deduction [Note (iii)]	35,00,000	

Expenditure on earning dividend from foreign company not deductible [Note (v)]	25,000	
Secret commission paid not allowable [Note (viii)]	<u>13,00,000</u>	<u>61,75,000</u>
		5,61,75,000
Less Dividend received from foreign company to be considered under the head "Income from other sources" [Note (v)]	10,00,000	
Payment to National Laboratory eligible for weighted deduction@ 200% under section 35(2AA) [Note (vii)]	45,00,000	
Bad debts allowable as deduction [Note (x)]	<u>1,00,000</u>	<u>56,00,000</u>
		5,05,75,000
Income from Other Sources		
Dividend from foreign company [Note (v)]		<u>10,00,000</u>
Total Income		<u>5,15,75,000</u>

Computation of tax liability of S Ltd. for the A.Y.2012-13

Particulars	₹
Tax @15% on dividend from specified foreign company ₹ 10,00,000 [Note (v)]	1,50,000
Tax @30% on the balance total income of ₹ 5,05,75,000	<u>1,51,72,500</u>
	1,53,22,500
Add: Surcharge@5% (since total income exceeds ₹ 1,00,00,000)	<u>7,66,125</u>
	1,60,88,625
Add: Education cess@2%	3,21,773
Secondary and higher education cess@1%	<u>1,60,886</u>
Total tax liability	<u>1,65,71,284</u>

Notes:

- (i) EPABX and mobile phones are not computers and therefore, are not entitled to higher depreciation@60%. It was so held by the Kerala High Court in *Federal Bank Ltd. v. ACIT (2011) 332 ITR 319*. Therefore, EPABX and mobile phones would be entitled to depreciation of ₹ 4,50,000, calculated by applying the rate of 15%, being the general rate applicable to plant and machinery, on the cost of ₹ 30,00,000 (₹ 18,00,000 × 100/60). The excess depreciation of ₹ 13,50,000 (being ₹ 18,00,000 – ₹ 4,50,000), debited to profit and loss account, should be added back.
- (ii) The issue is whether payment of ₹ 50 lakhs to N Ltd. towards feasibility study conducted for examining proposals for technological advancement relating to the existing business, where the project was abandoned without creating a new asset, is allowable as revenue expenditure.

On this issue, the Delhi High Court, in *CIT v. Priya Village Roadshows Ltd. (2011) 332 ITR 594*, observed that in such cases, whether or not a new business/asset comes into

existence would become the relevant factor. If there is no creation of a new asset, then the expenditure incurred would be of revenue nature. In this case, since the feasibility study was conducted by S Ltd. for the existing business and the study was abandoned without creating a new asset, the expenses were of revenue nature.

Since the expenditure of ₹ 50 lakhs has already been debited to profit and loss account, no further adjustment is required.

- (iii) In this case, since there is no evidence of existence of any “apprentice training scheme”, the expenditure of ₹ 35 lakhs incurred in respect of higher studies abroad for the director’s son is not allowable as deduction as there is no nexus between the education expenditure incurred abroad for the director’s son and the business of S Ltd. It was so held by the Bombay High Court in *Echjay Forgings Ltd. v. ACIT (2010) 328 ITR 286*.
- (iv) Since S Ltd. has purchased the software from a non-resident for subsequent resale in the Indian market, it had acted as a dealer and therefore the payment to the non-resident cannot be termed as royalty to attract the provisions of tax deduction at source. Therefore, section 40(a)(i) would have no application in this case and the payment made to the non-resident cannot be disallowed under section 40(a)(i) on the ground that no tax was deducted at source. It was so held by the Delhi High Court in *CIT vs. Dynamic Vertical Software India P. Ltd. (2011) 332 ITR 222*.

In this case, since the payment of ₹ 29 lakhs is already debited to profit and loss account, no further adjustment is required.

Note – The Finance Act, 2012 has amended section 9(1)(vi) retrospectively with effect from 1st June, 1976, to clarify that consideration for use or right to use of computer software is royalty and consequently, tax has to be deducted at source in respect of such payments. However, the amendments made by the Finance Act, 2012, including retrospective amendments, are not applicable for May, 2012 examination.

- (v) Under section 115BBD, dividend received by an Indian company from a foreign company in which it holds 26% or more in nominal value of the equity share capital of the company, would be subject to a concessional tax rate of 15% as against the tax rate of 30% applicable to other income of a domestic company. This rate of 15% would be applied on gross dividend, in the sense, that no expenditure would be allowable in respect of such dividend.

Therefore, dividend of ₹ 10 lakhs received by S Ltd. from a foreign company, in which it holds 28% in nominal value of equity share capital of the company, would be subject to tax@15% under section 115BBD. Such dividend would be taxable under the head “Income from other sources”. No deduction is allowable in respect of ₹ 0.25 lakhs expended on earning this income.

Since such dividend has been credited to the profit and loss account, the same has to be reduced for computing income under the head “Profits and gains of business or profession. Likewise, ₹ 0.25 lakhs, representing expenditure for earning dividend

income, which has been debited to profit and loss account, should be added back for computing business income.

- (vi) The issue under consideration is whether depreciation is allowable on the written down value of the entire block, even though the block includes some machinery which has already been discarded and hence, cannot be put to use during the relevant previous year.

The expression "used for the purposes of the business" in section 32, when used with respect to discarded machinery, would mean the use in the business, not in the relevant financial year, but in the earlier financial years. Therefore, the condition for claiming depreciation in respect of the discarded machine would be satisfied if it is used in the earlier previous years for the business. It was so held by the Delhi High Court in *CIT vs. Yamaha Motor India Pvt. Ltd. (2010) 328 ITR 297*.

Since the depreciation, in this case, has been debited to profit and loss account, no further adjustment is required.

- (vii) Under section 35(2AA), weighted deduction@200% is allowable in respect of amount paid to a National Laboratory with a specific direction that such sum shall be used for the purpose of an approved scientific research programme. Therefore, in this case, deduction of ₹ 90 lakhs (i.e., 200% of ₹ 45 lakhs) is allowable to S Ltd under section 35(2AA). Since only the actual payment of ₹ 45 lakhs has been debited to profit and loss account, the balance of ₹ 45 lakhs has to be deducted.
- (viii) As per *Explanation* to section 37(1), any expenditure incurred by an assessee for any purpose which is an offence or which is prohibited by law, shall not be deemed to have been incurred for the purpose of business and no deduction or allowance shall be made in respect of such expenditure. Therefore, payment of secret commission, if it is established as a payment for any purpose which is an offence or which is prohibited by law, cannot be allowed as deduction. It was so held in *Tarini Tarpauline Productions v. CIT (2002) 254 ITR 495 (Ori.)*. Even in cases where it cannot be so established, it would be disallowed under section 40(a)(ia) for non-deduction of tax at source under section 194H.
- (ix) The expenditure incurred for acquiring a new bus and donating it to the school is for the welfare of the children of staff/workmen of the company. Such expenditure is a part of employees' welfare expenses incurred for the purpose of securing healthy services for staff members. Therefore, such expenses were incurred wholly and exclusively for the purpose of the business. Since the bus had been donated to the school, no benefit of enduring nature was derived by S Ltd. as the right of ownership was transferred to school. Hence, it is not a capital expenditure. Since such expenditure is incurred wholly and exclusively for the purpose of business and is not capital in nature, S Ltd. is entitled to claim deduction in full under section 37(1). It was so held by the Rajasthan High Court in *CIT v. Rajasthan Spinning and Weaving Mills Ltd. (2006) 281 ITR 408*.
- (x) In a case where the debt ultimately recovered is less than the difference between the amount of debt and bad debt allowed as deduction, such deficiency will be deductible in

the previous year in which the ultimate recovery is made. Therefore, in this case, since the ultimate recovery of ₹ 4 lakhs is less than ₹ 5 lakhs (being the difference between the debt of ₹ 10 lakhs and the amount of ₹ 5 lakhs allowed as bad debts in the previous year 2010-11), the deficiency of ₹ 1 lakh will be deductible in the P.Y.2011-12, being the year in which the ultimate recovery of ₹ 4 lakhs is made. It may be noted that in a case where the net result is a deficiency, the amount recovered will not be taxable in the year of recovery. Since ₹ 4 lakhs is not credited to profit and loss account, no further adjustment is necessary.

Note - It appears that bad debts recovery of ₹ 4 lakhs is not credited to the profit and loss account since it is given under "Additional Information" in the question. The above solution has been worked out on this basis. However, if it is assumed that the bad debts recovery of ₹ 4 lakhs is credited to profit and loss account as per the correct accounting treatment, then, the same has to be reduced to compute the income chargeable under the head "Profits and gains of business or profession". In addition, the deficiency of ₹ 1 lakh will be deductible in the P.Y.2011-12, being the year in which the ultimate recovery of ₹ 4 lakhs is made. The computation of total income and tax liability, will accordingly change. The total income would be ₹ 5,11,75,000 and tax liability would be ₹ 1,64,41,504.

Note - Since the question has not specifically required calculation of minimum alternate tax nor does it contain the relevant information for such calculation, the same has not been worked out.

Question 3

- (a) Mr. W has provided the following information regarding his income and expenditure of the previous year 2011-12.

Income from business (computed)	₹ 5,00,000
Dividend income from Money Market Mutual Funds	₹ 1,25,000
Share of profit from firm	₹ 85,000
Consultancy charges to Mutual Fund agent	₹ 15,000
Interest expenditure relating to both taxable and non-taxable income	₹ 2,25,000

Value of investments in mutual fund units as on first and last day of the previous year are ₹ 5,00,000 and ₹ 3,00,000.

Value of total assets as appearing in Balance Sheet as on first day and last day of the previous year are ₹ 50,00,000 and ₹ 70,00,000.

Mr. W claims that no expenditure was incurred by him for exempt income earned.

The Assessing Officer is not satisfied with the correctness of the claim of the assessee in respect of expenditure in relation to exempt income.

You are required to compute the amount of expenditure incurred in relation to exempt income and resultant total income, assuming that Mr. W has no other income. (6 Marks)

- (b) Often controversies arise between the assessee and the department on the issue of treatment of gain arising out of transactions of sale and purchase of shares and securities.

Based on the judicial decisions, narrate the significant points of distinction in order to judge the purpose and motive of the assessee for its different treatment as income from business or income from capital gain. (5 Marks)

- (c) On an application made by Mr. Pandey, an order was passed by the Settlement Commission on 03-01-2012 under Section 245D. The said order had a mistake apparent on record. The Settlement Commission passed an amended order dated 30-04-2012 which resulted in modifying the liability of Mr. Pandey.

Mr. Pandey is of the view that order of the Settlement Commission is final and conclusive and it has no power to rectify the said mistake.

You are required to examine the following:

- (i) Correctness of claim made by Mr. Pandey
(ii) Validity of the order amended by the Settlement Commission (5 Marks)

Answer

- (a) As per section 14A, expenditure incurred in relation to any exempt income is not allowed as deduction. However, if the Assessing Officer is not satisfied with the correctness of the claim of the assessee in respect of expenditure in relation to exempt income, or the claim made by the assessee that no expenditure has been incurred in relation to exempt income for such previous year, he shall determine the amount of expenditure in relation to such income in the manner provided in Rule 8D.

In this case, since the Assessing Officer is not satisfied with the correctness of claim of Mr. W, he shall determine the amount of expenditure in relation to exempt income in the manner provided in Rule 8D.

Dividend income of ₹ 1,25,000 from mutual fund is exempt under section 10(35). ₹ 85000 representing Mr. W's share of profit from firm is exempt under section 10(2A). Therefore, both dividend and share of profit from firm represent exempt income of Mr. W. However, since the data for ascertaining average value of investment in firm has not been given in the question, the same has been ignored while computing the figures in (ii) and (iii) in the table below showing the computation of expenditure in relation to exempt income in the manner provided in Rule 8D.

	Particulars	₹
(i)	The amount of expenditure directly relating to exempt income Consultancy charges paid to Mutual Fund Agent	15,000

(ii)	Calculation of interest expenditure attributable to exempt income	
Interest expenditure incurred ×	Average value of investment in Mutual Fund Units as on the first and last day of the previous year	
	Average of total assets of the assessee as appearing in the Balance Sheet, on the first day and last day of the previous year	
	= 2,25,000 × $\frac{[(5,00,000+3,00,000)/2]}{[(50,00,000+70,00,000)/2]}$	
= 2,25,000 × $\frac{4,00,000}{60,00,000}$	15,000	
(iii)	Half per-cent of the average value of investment, income from which is exempt from tax i.e., ½% of the average value of investment in mutual funds ₹ 4,00,000 × ½%	<u>2,000</u>
Amount of expenditure in relation to exempt income		<u>32,000</u>

Computation of total income of Mr. W for the A.Y. 2012-13

Particulars	Amount (₹)
Income from business (computed)	5,00,000
Add: Amount of expenditure in relation to exempt income (See Note below)	<u>32,000</u>
Income from business / Total Income	<u>5,32,000</u>

Note - Since it has been stated in the question that Mr. W claims that no expenditure was incurred by him for exempt income earned, it is logical to assume that the entire interest expenses of ₹ 2,25,000 has been deducted to arrive at the income from business of ₹ 5,00,000. Therefore, the amount of interest expenses in relation to exempt income has been added back to compute the resultant total income.

- (b) The profit arising to an assessee from the transaction of sale and purchase of shares and securities, can be treated either as business income or capital gains.

The profit would be treated as business income if shares and securities constitute a trading asset and the assessee is a trader of shares and securities. However, the profit

would be taxable under the head “Capital Gains”, if the shares and securities are held as an investment i.e., a capital asset.

The original purpose or intention is crucial. If the original intention was to hold the shares as investment, the gains resulting from the sale of such shares will be capital gains. On the other hand, if the original intention was to carry on the activities of purchase and sale as a systematic activity and hold the shares as stock-in-trade, the gains resulting from the sale of such shares will be assessable as business income.

It is open to the assessee to maintain two portfolios, one for investments and another for dealing in shares. It was so observed by the Bombay High Court, in *Gopal Purohit vs. CIT (2011) 336 ITR 287*, where it was held that there should be uniformity in treatment and consistency in treating transactions in shares as investment or stock-in-trade, when facts and circumstances were identical. Further, the High Court also held that entries in the books of account alone are not conclusive in determining the nature of income.

In case the purchase and sale of the shares and securities is undertaken with a motive of earning profit out of the transaction, then the same would result in a trading transaction and will give rise to business income whereas if the motive of investment in the shares and securities is to earn income by way of dividend or interest, as the case may be, then the profit arising from the transaction of sale and purchase of such shares and securities will give rise to capital gain and not business income.

The magnitude of purchase and sale, the ratio between the purchase and sale of the shares and securities and holding period of the same can be considered for determining the purpose and the motive of the assessee for undertaking such transaction.

- (c) (i) Under section 245F(1), the Settlement Commission has been conferred all the powers which are vested in an income-tax authority under the Act. Under section 154, an income-tax authority has the power to amend any order passed by it in order to rectify any mistake apparent from the record. Therefore, the Settlement Commission's power to amend an order to rectify any mistake apparent from the record is embedded in section 245F(1).

Further, in order to reflect the correct intention of the legislature, sub-section (6B) has been inserted in section 245D to specifically provide that the Settlement Commission may, at any time within a period of six months from the date of the order, amend any order passed by it under section 245D(4) to rectify any mistake apparent from the record. In this case, the rectification order was passed by the Settlement Commission within six months of passing the original order.

Therefore, Mr. Pandey's view is not correct.

- (ii) In this case, the rectification has the effect of modifying the liability of Mr. Pandey. Therefore, as per the proviso to section 245D(6B), the Settlement Commission, before passing the amended order, should have –

- (1) given a notice to the applicant and the Commissioner of its intention to make such an amendment; and
- (2) allowed the applicant and the Commissioner an opportunity of being heard.

If these conditions are fulfilled, the order amended by the Settlement Commission would be a valid order, since the amended order is passed by the Settlement Commission within the permitted time limit i.e., within six months from the date of its original order.

However, if the Settlement Commission has not given notice of its intention to make such an amendment or has not allowed the applicant and the Commissioner an opportunity of being heard, then, the amended order passed by it will not be valid.

Question 4

Attempt any **four** questions out of the following questions:

- (a) *MNO Limited paid a sum of ₹ 15 Lakhs as salary to Mr. X for which no tax was deducted at source by the company. Mr. X filed his return of income and paid the tax due by way of self assessment. The Assessing Officer (AO) issued notice to Mr. X demanding interest under section 234B as no advance tax was paid by him. Your opinion is sought on the following aspects,*

- (a) *Is the action of AO valid?*
- (b) *If not, is there any other means available to AO to recover the interest? (4 Marks)*

- (b) *B. Airways Ltd. sold tickets to the travel agents in India at a minimum fixed commercial price. The agents were permitted to sell the tickets at a higher price, however, up to a maximum of published price. Commission at the rate of 9% of published price was payable to the agents of the airlines company, on which tax was deducted under section 194H by the company. The Assessing Officer raised the issue of further liability of tax deduction at source on the amount of difference between the actual sales price and the minimum fixed commercial price by treating it as "additional special commission" in the hands of the agents.*

Whether the contention raised by the Assessing Officer is tenable in law? Critically examine. (4 Marks)

- (c) *Teachwell Education is a trust approved under section 10(23C)(vi) which runs various educational institutions. During the course of assessment under section 143(3), the Assessing Officer (AO), finds that the trust has carried out its activities in contravention of the section under which it was approved for exemption. Hence, the AO wants to pass an order without giving exemption under section 10, which the assessee objects. You are required to examine the following with respect to the provisions of Income-tax Act, 1961.*

- (a) *Whether the AO can pass an order without giving exemption under section 10?*
- (b) *Can the AO get any additional time limit in completing this assessment? (4 Marks)*

- (d) *The Assessing Officer (AO) issued notices under section 133 to four banks requiring particulars relating to a customer in a specific format duly verified in a prescribed manner. One of the banks refused to part with the information on the ground that the letter did not specify about any proceeding pending against the said customer under the Income-tax Act, 1961. Discuss the correctness of action of the bank in refusing to furnish the particulars as required by the AO. (4 Marks)*
- (e) *Dhaval is in business of manufacturing customized kitchen equipments. He is also the Managing Director and held nearly 65% of the paid-up share capital of Aarav Ltd. A substantial part of the business of Dhaval is obtained through Aarav Ltd. For this purpose, Aarav Ltd. passed on the advance received from its customers to Dhaval to execute the job work entrusted to him.*

The Assessing Officer held that the advance money received by Dhaval is in the nature of loan given by Aarav Ltd. to him and accordingly is deemed dividend within the meaning of provisions of section 2(22)(e) of the Income-tax Act, 1961. The Assessing Officer, therefore made the addition by treating advance money as the deemed dividend income of Dhaval.

Examine whether the action of the Assessing Officer is tenable in law. (4 Marks)

Answer

- (a) Interest liability under section 234B is attracted only if an assessee, who is liable to pay advance tax under section 208, has failed to pay such advance tax or the tax paid by him is less than 90% of the "assessed tax".

As per section 208, an assessee shall be liable to pay advance tax in case the tax payable by him for the previous year is equal to or more than ₹ 10,000. Further, as per section 209, while computing the tax payable by the assessee for the purpose of determining his advance tax liability, the amount of income-tax which is **deductible or collectible** at source, during the said financial year under any provision of the Income-tax Act, 1961, shall be reduced.

The Uttarkhand High Court, in *DIT v. Maersk Co. Ltd. (2011) 334 ITR 79 (FB)*, has expressed a view that the use of the words "deductible" and "collectible" in section 209 indicates that the amount of "tax deductible at source" can be reduced from the total tax payable by the assessee, for assessing his liability to pay advance tax, even though such amount is not actually deducted at source by the deductor. In case the amount of tax payable by the assessee after reducing the amount of tax deductible at source is less than ₹ 10,000, he shall not be liable to pay advance tax and consequently, the liability to pay interest under section 234B, leviable in case of default in payment of advance tax, shall not arise.

- (a) In the present case, tax was liable to be deducted from the salary of ₹ 15 lakhs paid by MNO Ltd. to Mr. X, though the company did not deduct the same. In the view of the above opinion expressed by the High Court, Mr. X would not be liable to pay

advance tax in respect of salary income and therefore, interest under section 234B cannot be levied. Hence, the action of Assessing Officer is not valid. It is assumed that Mr. X is not liable to pay advance tax in respect of any other income.

- (b) There is no other provision under the Income-tax Act, 1961 which enables the Assessing Officer to recover the interest due under section 234B.

Though the Assessing Officer cannot levy the interest for default in payment of advance tax on the deductee, he can recover interest under section 201(1A) from the deductor for failure to deduct tax at source. Therefore, in this case, interest under section 201(1A) is leviable@1% per month or part of month till such tax is actually paid by way of self-assessment tax by the employee.

Such interest shall be paid before furnishing the statement in accordance with the provisions of section 200(3).

Note - The Finance Act, 2012 has amended section 209 retrospectively, with effect from 1st April, 2012, to provide that in case the payer has failed to deduct tax at source, then, the amount of tax so deductible shall not be reduced from the income-tax liability of the resident payee for determining his liability to pay advance tax. Therefore, the resident payee would be liable to pay advance tax if the tax deductible was not deducted at source, in which case the interest under section 234B for default in payment of advance tax would also be attracted.

Further, interest@1% per month or part of month would be leviable under section 201(1A) on the payer from the month in which tax was deductible till the date of furnishing of return of income by the resident payee.

This retrospective amendment by the Finance Act, 2012 is, however, not applicable for May 2012 examination.

- (b) As per the provisions of section 194H, a person is liable to deduct tax at source at the time of credit or payment, whichever is earlier, of income in the nature of commission to any resident.

In the present case, B. Airways Ltd. correctly deducted tax at source under section 194H from the commission@9% of the published price paid to the travel agents, who were allowed to sell the air tickets at any price higher than the minimum fixed commercial price subject to a maximum of published price. However, the Assessing Officer raised a contention that the airline company was required to deduct tax at source on the difference between the actual sale price and the minimum fixed commercial price by treating it as "additional special commission" in the hands of the agents.

The facts of the case are similar to the case of *CIT v. Qatar Airways (2011) 332 ITR 253*, where the Bombay High Court held that the difference between the published price and the minimum fixed commercial price of the tickets cannot be taken as "additional special commission" in the hands of the agents. This is because the published price was the maximum price and the airline company had granted permission to the agents to sell the

tickets at a price lower than the published price. Further, the airline company would have no information about the exact rate at which the tickets were ultimately sold by its agents. **In order to deduct tax at source, the exact income in the hands of the agents must necessarily be ascertainable by the airline company. However, it is not so ascertainable in this case, since the agents had been given discretion to sell the tickets at any rate between the minimum fixed commercial price and the published price.** It would be impracticable and unreasonable to expect the airline company to get a feedback from its numerous agents in respect of the price at which tickets were sold by them.

Applying the rationale of the above case to the case on hand, B. Airways Ltd. is not liable to deduct tax at source under section 194H on the difference between the actual sale price and the minimum fixed commercial price, even though the amount earned by the agent over and above minimum fixed commercial price would be taxable as income in the hands of the agent.

Therefore, the contention raised by the Assessing Officer is not tenable in law.

- (c) (a) As per the first proviso to section 143(3), in the case of an institution approved under, *inter alia*, section 10(23C)(vi), which is required to furnish the return of income under section 139(4C), the Assessing Officer shall not pass an order of assessment under section 143(3) without giving effect to the provisions of section 10, unless he is of the view that the activities of the institution are being carried on in contravention to the provisions of that section and :
- (1) he has intimated the Central Government or the prescribed authority, which had earlier approved the concerned institution, about the contravention of the relevant provisions by the institution; and
 - (2) the approval granted to such institution has been withdrawn or notification in that respect has been rescinded.

Therefore, in the aforesaid case, the Assessing Officer can pass an assessment order without giving exemption under section 10 to Teachwell Education, which is an educational institution approved under section 10(23C)(vi), only if he has intimated the contravention made by Teachwell Education to the Central Government or the prescribed authority, as the case may be, and its approval under section 10(23C)(vi) is withdrawn.

- (b) As per *Explanation 1* to section 153, in case the Assessing Officer intimates the contravention of provisions of section 10(23C)(vi) to the Central Government or the prescribed authority, the period commencing from the date of intimation of such contravention by the Assessing Officer and ending on the date on which the copy of the order of withdrawing the approval under section 10(23C)(vi) is received by the Assessing Officer, shall be excluded for computing the period of limitation for completing the assessment.

Further, in case the time limit available to the Assessing Officer for passing an assessment order, after such exclusion, is less than 60 days, such remaining period of assessment shall be deemed to have been extended to 60 days.

Therefore, the Assessing Officer will get the above mentioned additional time for completing the assessment of Teachwell Education.

- (d) As per section 133(6), power is given to an Assessing Officer to issue notice, for the purposes of the Act, requiring any person, including a banking company, to furnish information in respect of such points or matters or to furnish statement of accounts and affairs verified in the manner specified by the Assessing Officer, as may be useful for, or relevant to, any enquiry or proceeding under the Act. Therefore, the provisions of this section can be invoked even in case of any enquiry and it is not necessary that any proceeding should be pending against the customer for the same.

However, in respect of an enquiry, this power can be exercised by any income-tax authority below the rank of Director or Commissioner only after getting the prior approval of the Director or the Commissioner, as the case may be.

Therefore, the Assessing Officer can issue notice under section 133(6) asking for particulars relating to a customer in the specified format duly verified in the prescribed manner from the banking company, even if no proceeding is pending against such customer, provided he has obtained the prior approval of the Director or the Commissioner, as the case may be.

Hence, in such a case, the action of bank in refusing to provide the particulars relating to a customer as required by the Assessing Officer on the ground that no proceeding was pending against the customer, is not correct.

- (e) As per section 2(22)(e), in case a company, not being a company in which the public are substantially interested, makes payment of any sum by way of advance or loan to a shareholder holding not less than 10% of voting power/share capital of the company, then, the payment so made shall be deemed to be dividend in the hands of such shareholder to the extent to which the company possesses accumulated profits.

In the present case, Dhaval is holding 65% of the paid-up capital of Aarav Ltd. Aarav Ltd. has passed on advance received from its customers to Dhaval for execution of job work entrusted to Dhaval.

Assuming that Aarav Ltd. is not a company in which public are substantially interested, the applicability of the provisions of section 2(22)(e) in respect of such transaction has to be examined. In *CIT v. Rajkumar* (2011) 318 ITR 462 (Del.), it was held that trade advance given to the shareholder which is in the nature of money transacted to give effect to a commercial transaction, would not be deemed to be dividend in the hands of the shareholder under section 2(22)(e). The Delhi High Court ruling in *CIT v. Ambassador Travels (P) Ltd.* (2009) 318 ITR 376 also supports the above view.

In the present case, the payment is made to Dhaval by Aarav Ltd. for execution of work is in the course of commercial business transaction and therefore, it shall not be deemed as dividend in the hands of Dhaval under section 2(22)(e). Hence, the action of the Assessing Officer is not tenable in law.

Note - The above answer is based on the assumption that Aarav Ltd. is a company in which public are not substantially interested. In case it is assumed that Aarav Ltd., being a public limited company, is a company in which the public are substantially interested, then, the provisions of section 2(22)(e) shall not be applicable and the said amount paid to Dhaval shall not be treated as dividend under section 2(22)(e) in the hands of Dhaval.

Question 5

- (a) RV Ltd., an Indian company, exports grapes to DK Inc for an amount of ₹ 30 Lacs. DK Inc is located in a Notified Jurisdictional Area (NJA).

RV Ltd. charges ₹ 38 lacs and ₹ 40 lacs for sale of similar goods to CC Inc and MM Inc, respectively, which are not located in NJA and both of them are not associated enterprises of RV Ltd.

Assuming that permissible variation notified by Central Government for such class of international transactions is 6% of the transaction price, state the tax implications under section 94A in respect of the above transaction by RV Ltd. to DK Inc. (4 Marks)

- (b) "The existence of a website on Indian Soil constitutes a permanent establishment". Is this statement correct? Examine. (4 Marks)

- (c) State the powers of the Authority for Advance Ruling under the Income-tax Act, 1961.

(4 Marks)

- (d) In order to overcome a situation where the tax is deducted at a rate prescribed in the relevant Double Taxation Avoidance Agreement which is higher than the rate prescribed in the Income-tax Act, 1961, CBDT recently has clarified this issue, to avoid genuine hardship faced by the resident deductor. Explain, in brief, the contents of this CBDT circular. (4 Marks)

Answer

- (a) As per section 94A, in case an assessee enters into any transaction where one of the parties thereto is located in the Notified Jurisdictional Area (NJA) then the parties to the transaction shall be treated as associated enterprises and the transaction shall be deemed to be an international transaction. The transfer pricing provisions would, therefore, be attracted in such a case. However, the benefit of permissible variation between the transfer price and the arm's length price, as notified by the Central Government, shall not be available in such a case.

Since DK Inc. is located in a NJA, the transaction of export of grapes by the Indian company, RV Ltd., would be deemed to be an international transaction and DK Inc. and

RV Ltd. would be deemed to be associated enterprises. Therefore, the provisions of transfer pricing would be attracted in this case.

The prices of ₹ 38 lakhs and ₹ 40 lakhs charged for sale of similar goods to CC Inc. and MM Inc., respectively, being independent entities located in a non-NJA country, can be taken into consideration for determining the arm's length price (ALP) under Comparable Uncontrolled Price (CUP) Method.

Since more than one price is determined by the CUP Method, the ALP would be the arithmetical mean of such prices.

Therefore, $ALP = ₹ 39,00,000$ i.e., $[(₹ 38,00,000 + ₹ 40,00,000)/2]$

Transfer Price = ₹ 30,00,000

Since the ALP is more than the transfer price, the ALP of ₹ 39 lakhs would be considered for computing the income from the international transaction between RV Ltd. and DK Inc.

- (b) The term "permanent establishment" has not been defined in section 2 of the Income-tax Act, 1961. As per section 92F(iii), "permanent establishment" includes a fixed place of business through which the business of the enterprise is wholly or partly carried on.

The term "permanent establishment" includes (a) a place of management (b) a branch, (c) an office, (d) a factory, (e) a workshop, (f) mines, (g) warehouse, etc. In most of the DTAA's, an exhaustive definition of the term "permanent establishment" is given, wherein several more items are enumerated.

A website is a set of web documents belonging to a particular organization. It consists of data and programs in digital form, from which it is stored in a server which is accessible through internet.

A website does not normally imply "a fixed place of business", even though in the case of some entities, some business could be transacted through a website. Thus, the mere presence of a website in Indian soil, without anything more, will not amount to a permanent establishment.

If the website contains merely information about the concern, the website cannot be regarded as a permanent establishment. Where the website is being used as a virtual office for transacting orders of purchases or sales or for rendering services on a more than casual basis, then it could be regarded as a permanent establishment.

- (c) Under section 245U, the Authority of Advance Ruling will have all the powers vested in the Civil Court under the Code of Civil Procedure, 1908 as are referred to in section 131.

Accordingly, the Authority of Advance Ruling shall have the same powers as are vested in a court under the Code of Civil Procedure, 1908, when trying a suit in respect of the following matters, namely -

- (1) discovery and inspection;

- (2) enforcing the attendance of any person, including any officer of a banking company and examining him on oath;
 - (3) compelling the production of books of account and other documents; and
 - (4) issuing commissions.
- (d) The CBDT had issued *Circular No.7/2007, dated 23.10.2007* laying down the procedure for refund of tax deducted at source under section 195 to the person deducting tax at source from the payment to a non-resident. The Circular allowed refund of tax deducted at source to the person making payment to a non-resident in certain circumstances, for example, if the income does not accrue to the non-resident or if the income is accruing, no tax is due but tax has been deducted, or tax has been deducted at a higher rate specified in the Income-tax Act, 1961, whereas it is deductible at a lower rate under the relevant DTAA.

A similar situation arises in a case where tax is deducted at a rate prescribed in the relevant DTAA which is higher than the rate prescribed in the Income-tax Act, 1961. This situation is, however not included in the list of circumstances covered under the above Circular of the CBDT. Since the law requires deduction of tax at a rate prescribed in the relevant Double Taxation Avoidance Agreement (DTAA) or under the Income-tax Act, 1961, whichever is lower, there is a possibility that in such cases, excess tax is deducted relying on the provisions of relevant DTAA.

Accordingly, in order to remove the genuine hardship faced by the resident deductor, the CBDT has, vide *Circular No. 7/2011 dated 27-09-2011*, modified *Circular No.07/2007, dated 23.10.2007* to the effect that the beneficial provisions under the said Circular allowing refund of excess tax deducted at source under section 195 to the deductor shall also apply to those cases where tax has been deducted at source at a higher rate as mentioned in the relevant DTAA while a lower rate is prescribed under the domestic law.

Question 6

- (a) *What are the consequences if the amount deposited in Capital Gains Account Scheme to avail exemption from capital gains is not utilised within the stipulated time? Is there any difference in the tax treatment in the event of death of the assessee before the stipulated time?* (3 Marks)
- (b) *X carrying on a business as sole proprietor, died on 31st March, 2011. On his death, the same business was continued by his legal heirs, by forming a firm. As on 31st March 2011, a determined business loss of ₹ 5 lacs is to be carried forward under the Income-tax Act, 1961.*
- Does the firm consisting of all legal heirs of Mr. X, get a right to have this loss adjusted against its current income?* (3 Marks)
- (c) *State the cases where the benefit of indexation of cost is not available for determination of capital gains.* (7 Marks)

- (d) Mr. C borrowed on Hundi, a sum of ₹ 15,000 by way of bearer cheque on 11-09-2011 and repaid the same with interest amounting to ₹ 20,000 by account payee cheque on 12-10-2011.

The Assessing Officer (AO) wants to treat the amount borrowed as income during the previous year. Is the action of AO valid? (3 Marks)

Answer

- (a) Where the amount deposited in Capital Gains Accounts Scheme is not utilized for the specified purpose mentioned under the respective section providing for exemption (like say, section 54, 54B, 54G, etc.) within the specified period of two years or three years, as the case may be, mentioned therein, then the **unutilized amount shall be charged under section 45 as capital gain** of the previous year in which the specified period of two years or three years, as the case may be, expires.

The tax treatment will be different where before the stipulated time, the assessee expires and the amount is received by his legal heirs.

The CBDT has, in *Circular No.743 dated 6.5.1996*, clarified that in the event of death of an individual before the stipulated period, the unutilized amount would not be chargeable to tax in the hands of the legal heirs of the deceased individual, since such unutilized amount is not income but is a part of the estate devolving upon them.

- (b) Section 78(2) provides that where a person carrying on any business or profession has been succeeded in such capacity by another person, otherwise than by inheritance, then, the successor is not entitled to carry forward and set-off the loss of the predecessor against his income. This implies that generally, set-off of business losses should be claimed by the same person who suffered the loss and the only exception to this provision is when the business passes on to another person by inheritance.

The facts of case given in the question are similar to the case *CIT v. Madhukant M. Mehta (2001) 247 ITR 805*, where the Supreme Court has held that if the business is succeeded by inheritance, the legal heirs are entitled to the benefit of carry forward of the loss of the predecessor. Even if the legal heirs constitute themselves as a partnership firm, the benefit of carry forward and set off of the loss of the predecessor would be available to the firm.

In this case, the business of X was continued by his legal heirs after his death by constituting a firm. Hence, the exception contained in section 78(2) along with the decision of the Apex Court discussed above, would apply in this case. Therefore, the firm is entitled to carry forward the business loss of ₹ 5 lacs of X.

- (c) In the following cases, the benefit of indexation of cost is not available for determination of capital gains on transfer of capital assets –
1. Transfer of capital assets held for not more than 36 months (12 months in the case of listed securities, etc), since capital gains arising therefrom would be a short term capital gains.

2. Transfer of depreciable assets where computation is governed by section 50, since capital gains arising therefrom would always be short term capital gains, even if they are held for more than 36 months.
 3. Transfer of undertaking or division in a slump sale under section 50B.
 4. Transfer of bonds/debentures other than capital indexed bonds issued by the Government (*Third proviso to section 48*).
 5. Transfer of shares in or debentures of an Indian company, acquired by a non-resident in foreign currency (*First and second proviso to section 48*).
 6. Transfer of a foreign exchange asset by a non-resident Indian, who opts to be governed by the provisions of Chapter XII-A (*Section 115D*).
 7. Transfer of Global Depository Receipts purchased in foreign currency by an individual resident in India and employee of an Indian company or its subsidiary engaged in specified knowledge based industry or service (*Section 115ACA*).
 8. Transfer of units of Unit Trust of India or a Mutual Fund specified under section 10(23D) purchased in foreign currency by an overseas financial organisation referred to as Offshore Fund (*Section 115AB*).
 9. Transfer of securities by Foreign Institutional Investors (*Section 115AD*).
- (d) Section 69D provides that where any amount is borrowed on a hundi or any amount due thereon is repaid otherwise than by way of an account-payee cheque drawn on a bank, the amount so borrowed or repaid shall be deemed to be the income of the person borrowing or repaying the amount for the previous year in which the amount was so borrowed or repaid, as the case may be.

In this case, Mr. C has borrowed ₹ 15,000 on Hundi by way of bearer cheque. Therefore, it shall be deemed to be income of Mr. C for the previous year 2011-12. Since the repayment of the same along with interest was made by way of account payee cheque, the same would not be hit by the provisions of section 69D. Therefore, the action of the Assessing Officer treating the amount borrowed as income during the previous year is valid in law.

Question 7

- (a) What are the consequences of not collecting tax at source (TCS) in respect of sale of scrap by a manufacturing company? State the circumstances under which the TCS provisions are not applicable in the above case. (5 Marks)
- (b) State with reasons whether return of income is to be filed in the following cases for the Assessment Year 2012-13 :
 - (i) Mr. X, an individual, aged 80 years, has a gross total income of ₹ 6,50,000 and he is eligible for deduction of ₹ 1,60,000 under Chapter VI-A.
 - (ii) ABC, a partnership firm, has a loss of ₹ 10,000 during the previous year 2011-12.

- (iii) A registered association, eligible for exemption under section 10(23B), has income from house property of ₹ 2,10,000.
- (iv) Mr. Y, an employee of ABC (P) Ltd, draws a salary of ₹ 4,90,000 and has income from fixed deposits with bank of ₹ 10,000. (4 Marks)
- (c) Mr. X received the following gifts / amounts during the previous year 2011-12 :
- Gift of bullion worth ₹ 60,000 on his birthday from his friend.
 - Received a car from his cousin on payment of ₹ 1 lac, fair market value of which was ₹ 4 lacs.
 - Received cash gift of ₹ 18,000 each from three of his friends A, B & C on 24-09-2011.
 - Acquired an office building on 22-11-2011 from his friend Q for a consideration of ₹ 10 lacs, stamp value of which is ₹ 20 lacs.
 - In respect of land of Mr. X acquired by Railways in the year 2009, he received the following amount on 25-12-2011 as interest on enhanced compensation on the order of the court -

Relating to previous year	₹
2009-10	1,45,000
2010-11	1,75,000
2011-12	1,10,000

You are required to compute the income of Mr. X chargeable under the head "Income from other sources" for the Assessment Year 2012-13 assuming that he has no other income. (7 Marks)

Answer

- (a) As per section 206C, every person being a seller of, *inter alia*, scrap, shall, at the time of debiting of the amount payable by the buyer to the account of the buyer or at the time of receipt of such amount from the buyer, whichever is earlier, collect tax at source @ 1% of the said amount from the buyer. If the seller does not collect tax at source on sale of scrap, then, the following would be the consequences:
- He shall be deemed to be an assessee in default in respect of the tax not collected.
 - He shall be liable to pay the tax, which he ought to have collected, to the credit of the Central Government, even if he has not actually collected the tax.
 - He shall be liable to pay simple interest at the rate of 1% per month or part thereof on the amount of such tax from the date on which such tax was collectible to the date on which the tax was actually paid and such interest shall be paid before furnishing the quarterly statement for each quarter.
 - Penalty equal to the amount of tax which is not collected can be levied under section 271CA.

However, he would not be liable to collect tax at source in the following cases:

- (i) If the buyer is a resident and he furnishes to the person responsible for collecting tax, a declaration in the prescribed form to the effect that scrap is to be utilized for the purpose of manufacturing, processing or producing articles or things and not for trading purposes.
- (ii) If scrap is sold to a public sector company, the Central Government, a State Government, an embassy, a high commission, legation, commission, consulate and the trade representation of a foreign State or a club.
- (iii) If the buyer, in the retail sale of scrap, has purchased the scrap for his personal consumption.

(b)

S. No.	Is filing of return required?	Reason
(i)	Yes	As per the provisions of section 139(1), every person, whose total income without giving effect to the provisions of, <i>inter alia</i> , Chapter VI-A exceeds the maximum amount not chargeable to tax, is required to furnish the return of income for the relevant assessment year on or before the due date. The gross total income of Mr. X before deduction under section 80C is ₹ 6,50,000, which exceeds the basic exemption limit of ₹ 5,00,000 applicable to an individual aged 80 years or more. Therefore, Mr. X has to furnish his return of income for the A.Y.2012-13.
(ii)	Yes	As per section 139(1), it is mandatory for a firm to furnish its return of income or loss on or before the specified due date. Therefore, M/s ABC has to furnish its return of loss for the A.Y.2012-13 on or before the due date.
(iii)	Yes	As per section 139(4C), every institution referred to, <i>inter alia</i> , in section 10(23B), whose total income without giving effect to the provisions of section 10 exceeds the maximum amount not chargeable to tax, is required to furnish the return of income for the relevant assessment year on or before the due date. In the above case, the registered association has income from house property of ₹ 2,10,000 before exemption under section 10, which exceeds the basic exemption limit of ₹ 1,80,000. Therefore, it is under an obligation to furnish its return of income for the A.Y. 2012-13.
(iv)	Yes	As per the provisions of section 139(1), every person, whose gross total income exceeds the maximum amount not chargeable to tax, is

	required to furnish the return of income for the relevant assessment year on or before the due date. The gross total income of Mr. Y is ₹ 5,00,000 (₹ 4,90,000 + ₹ 10,000) which exceeds the basic exemption limit of ₹ 1,80,000 applicable to an individual. Therefore, Mr. Y has to furnish his return of income for the A.Y.2012-13. Note – The CBDT has issued Notification No. 9/2012 dated 17.02.2012, in exercise of its powers under section 139(1C), providing for exemption from filing return of income to an individual whose total income does not exceed ₹ 5,00,000, in case the total income consists only of salary and/or interest from savings bank account (not exceeding ₹ 10,000), subject to fulfillment of certain conditions. Since Mr. Y has income from fixed deposits with bank, he is not eligible for the above exemption and is, therefore, required to furnish his return of income for the A.Y. 2012-13. <i>This CBDT Notification was, however, not applicable for May 2012 examination, since it was issued after 31st October, 2011.</i>
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(c) Computation of “Income from other sources” of Mr. X for the A.Y.2012-13

	Particulars	₹
(i)	Since bullion is included in the definition of “property”, therefore, when bullion is received without consideration, the same is taxable under section 56(2)(vii), as the aggregate fair market value of bullion exceeds ₹ 50,000	60,000
(ii)	Since car is not included in the definition of property, therefore the difference of ₹ 3 lakh between fair market value and purchase price of car is not taxable under section 56(2)(vii)	Nil
(iii)	Cash gift received from friends is taxable under section 56(2)(vii), since its aggregate value exceeds ₹ 50,000 (₹ 18,000 × 3)	54,000
(iv)	Immovable property purchased for inadequate consideration is outside the scope of section 56(2)(vii). Therefore the difference of ₹ 10 lakh between stamp duty value and purchase price of building is not taxable under section 56(2)(vii).	Nil
(v)	Interest received during the year on enhanced compensation is taxable under section 145A in the year of receipt, irrespective of the method of accounting followed by Mr. X. The interest is taxable under section 56(2)(viii).	
	(₹ 1,45,000 + ₹ 1,75,000 + ₹ 1,10,000)	₹ 4,30,000
	Less: Deduction under section 57 @50% of ₹ 4,30,000	<u>₹ 2,15,000</u>
	Income from Other Sources	<u>3,29,000</u>

PAPER – 8 : INDIRECT TAX LAWS

Working notes should form part of the answer.

Question No.1 is compulsory.

Attempt any **five** questions from the remaining **six** questions.

Question 1

- (a) Dharma Manufacturers, engaged in the manufacture of machines (and not availing small-scale concession) sold a machine to Asha Ltd. The cum-duty sale price of the machine excluding VAT is ₹ 5,80,000. Rate of excise duty is 10%, education cess is 2% and secondary and higher education cess is 1 %.

Sale price includes the following charges:

		₹
(i)	Warranty charges	28,000
(ii)	Secondary packing	6,000
(iii)	Trade discount actually allowed	24,000
(iv)	Design and development charges of machine	20,000
(v)	Primary packing	10,000
(vi)	Cost of return fare of vehicles	4,500
(vii)	Advertisement and publicity charges borne by Asha Ltd.	16,000
(viii)	Pre-delivery inspection charges	22,000
(ix)	After sales service charges	18,000

Determine the assessable value of the machine for purpose of Central Excise duty.

Provide notes in respect of the treatment for each of the items listed at (i) to (ix) above.

(5 Marks)

- (b) Choti Ltd., which is engaged in the manufacture of excisable goods started its business in May, 2011. It availed small scale exemption in terms of Notification No. 8/2003-C.E. dated 1-3-2003 as amended for the financial year 2011-2012. The following details are provided:

(4 Marks)

	₹
15,000 kg of inputs purchased @ ₹ 992.70 per kg (inclusive of Central excise duty @ 10.3%)	1,48,90,500
Capital goods purchased on 28-6-2011 (inclusive of excise duty at 10.3%)	44,12,000
Finished goods sold (at uniform transaction value throughout the year)	2,50,00,000

The suggested answers for Indirect Tax Laws (Paper 8) are based on the provisions as amended by the Finance Act, 2011 and notifications/circulars issued up to 31.10.2012 which are relevant for May, 2012 examinations.

Calculate the amount of excise duty payable by M/s. Choti Ltd. in cash, if any, during the year 2011-12. Rate of duty on finished goods sold may be taken at 10.3% for the year and you may assume that the selling price is exclusive of central excise duty. There is neither any processing loss nor any inventory of input and output. Show your workings and notes with suitable assumptions as required. (5 Marks)

- (c) Justice & Co. (partnership) is a law firm engaged in providing legal consultancy services under section 65(105)(zzzm) of the Finance Act, 1994. Compute the service tax payable by Justice & Co. in respect of the following amounts received in the month of March, 2012.

		Receipts (₹)
(i)	Consultancy in relation to incorporation of XYZ Co. Ltd.	10,00,000
(ii)	Advance towards assistance in filing service tax return of PQR Ltd. for the half year ending March, 2012	2,00,000
(iii)	Advice to MNO & Co. in July, 2011 with regard to compliance under Point of Taxation Rules, 2011.	3,75,000
(iv)	Appearance before labour court on behalf of Mr. Worker (an individual) in the month of October, 2011.	25,000

Note: All receipts are exclusive of service tax. Justice & Co. is not eligible for small scale service provider's exemption under Notification No. 6/2005-S.T. dated 1-3-2005 in the financial year 2011-12. Show working notes with assumptions as may be required.

- (d) PQR Industries Ltd, has imported certain equipment from Japan at an FOB cost of 2,00,000 yen (Japanese). The other expenses incurred by M/s. PQR Industries Ltd. in this connection are as follows:
- (i) Freight from Japan to Indian Port 20,000 yen
 - (ii) Insurance paid to insurer in India (for the importation of the machine) ₹10,000
 - (iii) Designing charges paid to consultancy in Japan 30,000 yen
 - (iv) M/s. PQR Industries Ltd. had expended ₹ 1,00,000 in India for certain developmental activities with respect to the imported machine.
 - (v) PQR Industries Ltd., had incurred road transport cost from Mumbai port to their factory in Kamataka. ₹ 30,000
 - (vi) CBEC had notified for purposes of section 14 of the Customs Act, 1962 exchange rate of 1 yen = ₹ 0.3948. The interbank

exchange rate as announced by the authorized dealer was 1 yen = ₹ 40

(vii) M/s. PQR Industries Ltd. had effected payment based on exchange rate

1 yen = ₹ 0.4150

(viii) The commission payable to the agent in India was 5% of the

FOB cost of the equipment in Indian rupees

Arrive at the assessable value for purposes of valuation under the Customs Act, 1962 with brief notes wherever necessary for each of the adjustments at (i) to (viii) above.

- (e) Strong Constructions undertakes works contracts and maintains sufficient records to quantify the labour and other service charges. From the details given below, calculate the taxable turnover, input tax credit and net VAT payable under the State VAT Law:

(i)	Total contract price (excluding VAT)	1,80,00,00
(ii)	Materials purchased and used for the contract taxable at 12.5% VAT (inclusive of VAT)	33,75,000
(iii)	Labour charges paid for execution of the contract	40,00,000
(iv)	Other service charges paid for the execution of the contract	20,00,000
(v)	Cost of consumables used not involving transfer of property in goods	10,00,000

Strong Constructions also purchased a plant for use in the contract for ₹ 20,80,000 (inclusive of VAT). In the VAT invoice relating to the same VAT was charged at 4% separately. Assume 100% input tax credit is available on capital goods immediately. Make suitable assumptions where required and show the workings.

Answer

(a) **Computation of assessable value of the machine**

Particulars	₹	₹
Cum-duty sales price of the machine excluding VAT		5,80,000
Less: Trade discount [Note 3]	24,000	
Cost of return fare of vehicles [Note 5]	<u>4,500</u>	<u>28,500</u>
Cum-duty price for excise duty purposes		<u>5,51,000</u>
Assessable value = $\frac{5,51,500}{110.30} \times 100$		5,00,000

Notes:

1. As per the definition of the transaction value under section 4(3)(d) of the Central Excise Act, 1944, warranty charges are includible in the assessable value.
2. Amount charged from the buyer in relation to packing, irrespective of it being primary or secondary, is included in the assessable value. [Circular No. 643/34/2002 CX dated 01.07.2002]
3. As the transaction value is the price actually paid or payable, trade discount is allowable as deduction. The discount amount is reduced from the sale price on the presumption that such discount is included (added back) in the sale price of ₹ 5,80,000.
4. Design and development charges of machine are included in the assessable value as such charges are 'in connection with sale'.
5. Cost of return fare of vehicles is not included in the assessable value [Circular No. 923/13/2010 CX dated 19.05.2010].
6. Advertisement and publicity expenses borne by the buyer are included in the assessable value. [Circular No. 643/34/2002 CX dated 01.07.2002]
7. Pre-delivery inspection charges and after sales service charges are included in the assessable value. [Circular No. 936/26/2010 CX. dated 27-10-2010]

(b) Computation of the excise duty payable

Particulars	₹	₹
Finished goods sold during the year		2,50,00,000
Less : Exemption of ₹150 lakh under Notification No. 8/2003 CE dated 01-03-2003		<u>1,50,00,000</u>
Dutiable clearances [Note 1]		<u>1,00,00,000</u>
Excise duty payable @ 10.30% (₹1,00,00,000 × 10.30%)		10,30,000
Less: CENVAT credit available on inputs [Note 2] Proportion of inputs consumed in dutiable clearances $= ₹ \frac{1,00,00,000}{2,50,00,000} = 0.4$ Excise duty paid on such inputs $= \left[1,48,90,500 \times \frac{10.30}{110.30} \right] \times 0.4$	5,56,200	
Less: CENVAT credit available on capital goods [Note 3]	<u>4,12,000</u>	<u>9,68,200</u>

$=₹ \left[44,12,000 \times \frac{10.30}{110.30} \right]$		
Excise duty payable in cash		61,800

Notes:

1. Since there is neither any processing loss nor inventory of input and output, it implies that all goods manufactured have been sold and entire quantity of inputs has been used in manufacturing these goods.
2. In respect of units availing SSI exemption, no CENVAT credit is available on inputs consumed in exempt clearances of ₹150 lakh.
3. In respect of units availing SSI exemption, CENVAT credit on capital goods can be availed but utilized only after clearances of ₹150 lakh.

Further, entire credit on capital goods can be taken in the same financial year by such units.

(c) Computation of service tax payable

Particulars	₹
Consultancy in relation to incorporation of XYZ Co. Ltd. [Note 1]	10,00,000
Advance towards assistance in filing service tax return of PQR Ltd. for half year ending March, 2012 [Note 1]	2,00,000
Advice to MNO & Co. in July, 2011 with regard to compliance under Point of Taxation Rules, 2011 [Note 1]	3,75,000
Appearance before Labour Court on behalf of Mr. Worker, an individual [Note 1]	<u>Nil</u>
Value of taxable services	<u>15,75,000</u>
Service tax @10% = ₹15,75,000 × 10%	1,57,500
Education cess @ 2% = ₹1,57,500 × 2%	3,150
Secondary and higher education cess @1% = ₹1,57,500 × 1%	<u>1,575</u>
Service tax payable	<u>1,62,225</u>

Notes:

1. As per the definition of taxable legal consultancy service provided under section 65(105)(zzzzm) of the Finance Act, 1994:-
 - (a) Legal consultancy service provided to any person, by a business entity, in relation to advice, consultancy or assistance in any branch of law, in any manner is liable to service tax.

- (b) Legal consultancy service provided by any person, in relation to representational services before any court, tribunal or authority, to an individual is not liable to service tax.
2. As per rule 7 of the Point of Taxation Rules, 2011, in case of legal consultancy services, service tax is payable on receipt basis.

(d) **Computation of assessable value**

Particulars	Yen	Yen
FOB value		2,00,000.00
Add: Freight	20,000	
Designing charges paid in Japan [Note 2]	<u>30,000</u>	<u>50,000.00</u>
Total value (in yen)		<u>2,50,000.00</u>
Total value (in Indian rupees) =2,50,000 Yen × ₹ 0.3948 [Note 1] (Rate of 1 yen = ₹0.3948)		98,700.00
Add: Insurance [Note 5]	10,000.00	
Add: Agent's commission at 5% FOB value [Note 6] (5% of 2,00,000 Yen × 0.3948)	<u>3,948.00</u>	<u>13,948.00</u>
Total CIF price		1,12,648.00
Add: Landing charges @ 1% [Note 7] (1% of ₹1,12,648)		<u>1,126.48</u>
Assessable value for the purposes of customs duty (rounded off)		<u>1,13,774</u>

Notes:

- (1) Rate of exchange notified by the CBEC has been considered [Clause (a) of the explanation to section 14 of the Customs Act, 1962].
As per rule 10 of the Customs Valuation (Determination of Value of Imported Goods) Rules, 2007:
- (2) Value of design work undertaken *elsewhere than in India* is includible in the value of the imported goods. [Rule 10(1)(b)(iv)]
- (3) Value of development work undertaken *in India* is not includible in the value of the imported goods. Hence, ₹1,00,000 expended in India for developmental activities have not been considered.
- (4) Only the cost of transport of the imported goods *up to the place of importation* is includible for the purpose of valuation. Thus, transport cost from Mumbai port

(place of importation) to the factory in Karnataka has not been included in the assessable value.[Rule 10(2)(a)]

- (5) Insurance of the machine is includible in the assessable value. [Rule 10(2)(c)]
- (6) Buying commission is not includible in the value of the imported goods. Since the agent's commission does not represent buying commission, hence, it is includible. [Rule 10(1)(a)(i)]
- (7) Landing charges have been considered @ 1%. [Clause (ii) of the first proviso to rule 10(2)]
- (e) Under works contract, VAT is imposed on the sale price of the goods in which there is a transfer of property. Labour and other charges incurred for such execution are deductible.

Computation of the taxable turnover, input tax credit and net VAT payable

Particulars	₹	₹
Total contract price		1,80,00,000
Less : Deductions admissible		
Labour charges paid for executing the contract	40,00,000	
Service charges paid for execution of contract	20,00,000	
Cost of consumables not involving transfer of property in goods	<u>10,00,000</u>	<u>70,00,000</u>
Taxable turnover		<u>1,10,00,000</u>
Output VAT payable @ 12.5% [VAT rate has been assumed to be 12 5%]		13,75,000
Less : <u>Input tax credit admissible</u>		
On the material purchased	3,75,000	
$\text{₹} \left[33,75,000 \times \frac{12.5}{112.5} \right]$		
On the plant purchased $\text{₹} \left[20,80,000 \times \frac{4}{104} \right]$	<u>80,000</u>	<u>4,55,000</u>
<u>Net VAT payable</u>		<u>9,20,000</u>

Note: The above solution has been worked out by assuming output VAT rate to be 12.5% since output VAT rate has not been provided in the question.

Question 2

- (a) With reference to the amendments effected by the Finance Act, 2011, briefly explain the following:

- (i) *State the three conditions upon fulfilment of which penalty under Section 11A of the Central Excise Act, 1944 may be halved and the extended period of limitation of five years may be invoked.*
- (ii) *State the three conditions upon fulfilment of which no interest would become payable under Section 11AA of the Central Excise Act, 1944.*
- (iii) *Briefly explain the condition when accessories and goods used for providing free warranty are eligible as 'input' under rule 2 (k) of the Cenvat Credit Rules, 2004.*
(2×3=6 Marks)
- (b) *Answer the following with brief reasons and reference to the Finance Act, 1994 as amended relating to applicability of service tax.*
- (i) *Delayed payment charges collected by stock brokers.*
- (ii) *Practising chartered accountant representing a client before Income Tax Officer in assessment proceedings.*
- (iii) *Personal liability of a director or other officer of a company for offences under the Finance Act, 1994 relating to service tax.*
(2×3=6 Marks)
- (c) *Discuss briefly the provisions relating to manner of computation of limitation period of one year in three situations contemplated under Section 27(1B) of the Customs Act, 1962 for purpose of refund of duty.*
(3 Marks)

Answer

- (a) (i) Under section 11A of the Central Excise Act, 1944, extended period of limitation can be invoked and penalty be reduced to 50% on fulfillment of the following conditions:
- duty has not been levied or paid or short-levied or short-paid or erroneously refunded by the reason of fraud, collusion, any wilful mis-statement, suppression of facts, contravention of any of the provisions of this Act or of the rules made thereunder with intent to evade payment of duty.
 - the said default has been found during the course of any audit, investigation or verification.
 - details relating to the transactions are available in the specified records.
- (ii) Interest under section 11AA of the Central Excise Act, 1944 would not be payable on fulfillment of the following conditions:
- (a) Duty becomes payable consequent to issue of an order, instruction or direction by the Board under section 37B;
- (b) Full duty is paid voluntarily within 45 days from the date of issue of such order, instruction or direction; and
- (c) Right to appeal against such payment at any subsequent stage is not reserved.

- (iii) As per rule 2(k) of the CENVAT Credit Rules, 2004,
- (i) accessories would be eligible as input, if they are cleared along with the final product and their value is included in the value of the final product.
 - (ii) goods used for providing free warranty for final products would be eligible as input if warranty is provided by the manufacturer and its value is included in the price of the final product and is not charged separately from the customer.

- (b) (i) *CBEC Letter No. F.No.137/25/2011-ST dated 03.08.2011* has clarified that delayed payment charges collected by the stock brokers are not includible in taxable value as such charges are in the nature of a penal charge levied by a service provider on the service recipient for not making the payment within stipulated time.

It may be noted that service tax would not be leviable on these charges only if they are shown separately in the account statement/invoice/bill etc.

- (ii) With effect from 01.05.2011, *Notification No. 32/2011 ST dated 25.04.2011* has rescinded *Notification No. 25/2006 ST dated 13.07.2006* granting exemption to Chartered Accountants in relation to representing the client before any statutory authority in the course of proceedings initiated under any law for the time being in force, by way of issue of notice.

Therefore, a practicing Chartered Accountant representing a client before Income Tax Officer in assessment proceedings would be liable to service tax.

- (iii) Certain provisions of the Central Excise Act, 1944 are made applicable to service tax vide section 83 of the Finance Act, 1994. Section 9AA of the Central Excise Act, 1944 relating to the offences committed by companies is one such provision which has been made applicable to the service tax also.

Section 9AA provides as follows:-

In case of an offence committed by a company, every person who was in-charge of the company (in the given case, it is director) and responsible for conduct of the business at the time when offence was committed, is deemed to be guilty. However, such person will not be liable to any punishment if he proves that offence was committed without his knowledge or he had taken due care to prevent the offence. [Sub-section (1)]

If it is proved that the offence is committed with consent or connivance of, or due neglect on part of any director or other officer of the company, such person would be deemed to be guilty and can be proceeded against and punished accordingly. [Sub-section (2)]

- (c) The three situations and the manner of computation of limitation period of one year in such situations as contemplated under section 27(1B) of the Customs Act, 1962 are:

- (i) Where goods are exempt from payment of duty by a special order issued under section 25(2) of the Customs Act, 1962, the limitation of one year is computed from the date of issue of such order.
- (ii) Where the duty becomes refundable on account of any judgment, decree, order or direction of the appellate authority, Appellate Tribunal or any Court, the limitation of one year is computed from the date of such judgment, decree, order or direction.
- (iii) Where any duty is paid provisionally under section 18, the limitation of one year is computed from the date of adjustment of duty after the final assessment thereof or in case of re-assessment, from the date of such re-assessment.

Question 3

- (a) *Happy Ltd., cleared certain goods to P. Ltd., paying higher rate of excise duty in the month of March, although the rate of duty on the said goods had been reduced in the Budget of the same financial year. However, P Ltd., refused to pay the higher duty which Happy Ltd., had paid by mistake. P Ltd., raised a debit note in the month of June of the same year. Happy Ltd., applied for refund of the excess excise duty paid in August. The Department rejected the claim on the ground that the incidence of duty has been passed by Happy Ltd. to P. Ltd.*

While claiming refund Happy Ltd., relied on the debit note raised by P Ltd., in the month of June to demonstrate that its customer P Ltd, had not paid the excess duty to Happy Ltd. The Department contended that since the debit note was issued in the month of June and not March it could not be the basis for refund.

With a brief note:

- (i) *Examine, with the help of decided case law, whether the contention of the Department is correct in law.*
 - (ii) *State whether in the above case, assuming that the issue is decided in favour of Happy Ltd. by the Commissioner of Central Excise (Appeals) and the duty involved is ₹ 4,80,000, the Revenue could file an appeal before the CESTAT against such an order.* (6 Marks)
- (b) *Briefly explain with reasons whether in the following cases service tax would be applicable besides Value Added Tax (VAT) or Excise duty on the same transaction as indicated herein below with reference to decided case law:*
- (i) *SIM card supplied as part of mobile telecommunication services could be subjected to service tax and VAT.*
 - (ii) *Manufacture and sale of products where the sale price is inclusive of erection, installation and commissioning services could be subjected to excise duty and service tax on the services involved.* (6 Marks)

- (c) Write a brief note on the following with reference to decided case law and the provisions of the Customs Act, 1962.
- (i) Whether it is mandatory for the revenue officer to make available copies of seized documents to the person from whom they are seized?
 - (ii) Whether benefit of exemption notification meant for 'imported goods' could be extended in case of "smuggled goods"? (3 Marks)

Answer

- (a) (i) The facts of the given case are similar to the case of *CCE v. Techno Rubber Industries Pvt Ltd.* 2011 (272) E.L.T. 191 (Kar.) wherein the High Court has held that the Department is bound to refund the excess amount of duty received by it to the person who has paid this excess duty. In this case, the buyer had refused to pay excess duty claimed and had raised a debit note. The High Court observed that in such a situation, the only inference which could be drawn was that the assessee had not received the excess duty paid by him to the Department.

In the given case also, P Ltd. (buyer) has refused to pay the higher duty and has raised a debit note on Happy Ltd. (assessee). Thus, it can be inferred that Happy Ltd. has paid higher duty to the Department and has not received it from P Ltd. Thus, Happy Ltd. is entitled to the refund of such excess duty paid by him and the contention of the Department is not valid in law.

- (ii) No, Revenue could not have filed an appeal to CESTAT against the order passed by the Commissioner of Central Excise (Appeals) as the duty involved for refund is ₹4,80,000.

CBEC has issued the instructions vide *F.No.390/Misc./163/2010-JC dated 17.08.2011* fixing the monetary limits of duty below which an appeal cannot be filed in CESTAT, High Court and Supreme Court by the Department and these monetary limits apply to cases of refund as well. As per the said instructions, an appeal cannot be filed before the Tribunal if the duty involved in a case is ₹ 5,00,000 or below.

- (b) (i) SIM card supplied as part of mobile communications services would be subjected to service tax and not VAT in the light of the decision in case of *Idea Mobile Communications Ltd. v. CCE 2011 (23) S.T.R. 433 (SC)*.

The Apex Court has affirmed the decision of the Kerala High Court wherein it has been held that SIM card has no intrinsic value or purpose other than use in mobile phone for receiving mobile telephone service from the service provider. Thus, SIM cards are not goods sold or intended to be sold to the customer, but are supplied as part of service. The value of SIM cards forms part of the activation charges because no activation is possible without a valid functioning of SIM card. Hence,

the value of SIM card supplied by the assessee would form part of the value of taxable service on which service tax is payable by the assessee.

- (ii) Manufacture and sale of products where the sale price is inclusive of erection, installation and commissioning services would be subjected to the excise duty on the assessable value of manufactured products (excluding erection, commissioning and installation charges).

As per the decision in the case of *Commissioner of Service Tax v. Lincoln Helios (India) Ltd.* 2011 (23) S.T.R. 112 (Kar.), excise duty is levied on the aspect of manufacture and service tax is levied on the aspect of services rendered.

Hence, in case both excise duty and service tax are paid in a transaction, it would not amount to payment of tax twice.

Service tax and excise duty are not mutually exclusive. The assessee has to pay service tax on the value of services.

- (c) (i) In the case of *Manish Lalitkumar Bavishi v. Addl. DIR. General, DRI* 2011 (272) E.L.T. 42 (Bom.), it is held that it is mandatory for the Revenue officers to make available the copies of documents seized during the course of any action by an officer to the person from whose custody such documents are seized.

As per section 110(4) of the Customs Act, 1962, it is mandatory for the Customs officers to make available the copies asked for and the choice of either asking for the document or seeking extract is not available to the officers, but only to the party concerned.

- (ii) No, the benefit of the exemption notification meant for 'imported goods' could not be extended to "smuggled goods".

The Supreme Court in the case of *CCus. (Prev.), Mumbai v. M. Ambalal & Co.* 2010 (260) E.L.T. 487 has held that had smuggled goods and imported goods were to be treated as one, Customs Act, 1962 would not have provided for two different definitions for the two. Considering that curbing the ills of smuggling in the economy is one of the principal functions of the Customs Act, the purpose of exemption notifications would be defeated if the benefit meant for imported goods is given to smuggled goods.

Question 4

- (a) *Gaseous Ltd., purchased helium gas in bulk from the open market and its quality control officer had conducted various tests and issued test reports stating the results of the tests. The bulk purchase was packed and filled in cylinders of various sizes and certificates were issued along with quantities. The purchases from the open market were of generic description and after test and analysis were sold to different customers based on their specific requirements with a profit margin of 40 to 60%. The Central Excise Department*

claimed that duty had to be paid on the sale price as there was "deemed manufacture" in terms of Note 9 to Chapter 28 of the Central Excise Tariff, 1985 which reads as follows:

"In relation to products of this Chapter, labelling or relabelling of containers or repacking from bulk packs to retail packs or adoption of any other treatment to render the product marketable to the consumer shall amount to manufacture." Briefly explain with a note based on case law, if any, whether:

- (i) the process of filling the bulk gas into cylinders of smaller quantities after tests and quality processes with distinct grades would amount to 'treatment' as per the said chapter note. (2 Marks)*
- (ii) Whether it could be said that the helium gas purchased in bulk is already marketable and hence the chapter note will not be attracted in this case. (4 Marks)*
- (b) PQR & Co. was involved in the services of unloading of coal from wagon tripping system, stacking/reclaiming of coal to stacker reclaimer system and feeding of coal to boiler bunkers through conveyor system. The Department had taken a view that the charges received by PQR & Co. for such activity were taxable under the category of 'Cargo Handling Services' in terms of Section 65(105)(zr) read with Section 65(23) of the Finance Act, 1994. However PQR & Co. claimed that the services rendered by them cannot be brought under 'cargo handling services' as it is engaged only in the handling of coal from railway wagons to the required destination of the thermal power station wherein machines are used with the aid of some man power.*

Briefly explain:

- (i) with reference to relevant provisions and case law, if any, whether the stand taken by the Department is correct in law;*
- (ii) Whether in the above matter, against an adverse order passed by the Commissioner of Central Excise in adjudication proceedings against PQR & Co. and thereafter confirmed by the CESTAT, PQR & Co. could file an appeal against the order of the CESTAT before the High Court under Section 35G of the Central Excise Act, 1944. (6 Marks)*
- (c) Explain, with reference to decided case law, whether clearances from Domestic Tariff Area (DTA) to Special Economic Zone is chargeable to export duty under the SEZ Act, 2005 or the Customs Act, 1962. (3 Marks)*

Answer

- (a)** The facts of the given case are similar to the case of *Air Liquide North India Pvt. Ltd. v. CCE 2011 (271) E.L.T. 321 (S.C.)*. Hence, answers to part (i) and (ii) are based on the observations and the decision in the said case.
 - (i)** Yes, the process of filling the bulk gas into cylinders of smaller quantities after the tests and quality processes with distinct grades would amount to 'treatment' as per the said chapter note.

In the aforesaid judgment, the Apex Court observed that if the gas purchased by the assessee had not undergone any treatment and was being sold as such, customers of the assessee could have purchased the same from the assessee's suppliers. Further, the customers would not have paid a price 40% to 60% higher than the purchase price of assessee.

- (ii) No, the helium gas purchased in bulk was not already marketable and hence, chapter note will be attracted in this case.

The Supreme Court observed that the marketability of the product to “the purchaser trading in it” is distinguishable from the marketability of the product to “the purchaser purchasing the same for final consumption”. The phrase “marketable to the consumer” in the Chapter note refers to the latter case.

The helium gas purchased in bulk by the assessee was marketable to the “purchaser trading in it” and the helium sold by the assessee is marketable to “the person who purchases the product for his own consumption”. Hence, the product became marketable only after undergoing the said treatment. Thus, the chapter note is attracted thereby making the assessee liable to pay excise duty.

- (b) (i) No, the stand taken by the Department is not valid in law.

In the case of *S.B. Construction Company v. Union of India* (2006) 214 STR 545 (Raj.), it is held that service tax is levied under the cargo handling on such services which undertake the activities of packing, unpacking, loading, unloading of goods to be transported by any means of transportation namely truck, rail, ship or aircraft.

However, in the instant case, the service provided by PQR & Co. is distinct i.e., transporting coal from wagons to Thermal Power Station by conveyor belt and not by any means of transportation. Thus, the services rendered by PQR & Co. do not fall under the ambit of ‘cargo handling services’ and as such, are not liable to service tax.

- (ii) No, PQR & Co. could not have filed an appeal against the order of CESTAT before High Court under section 35G of the Central Excise Act, 1944.

In case of *CCEx. & ST v. Volvo India Ltd.* 2011 (24) S.T.R. 25 (Kar.), the High Court has held that as per section 35G of the Central Excise Act, 1944, an appeal to High Court cannot be filed to decide the question relating to the taxability of any services as this question falls squarely in the exception mentioned in section 35G viz., ‘an order relating, among other things, to the determination of any question having a relation to the rate of duty of excise or to the value of goods for purposes of assessment’. In these cases, the appeal lies to the Apex Court under section 35L of the Central Excise Act, 1944.

- (c) In the case of *Tirupati Udyog Ltd. v. UOI* 2011 (272) E.L.T. 209 (A.P.), it is held that the clearances of goods from DTA to Special Economic Zone are not chargeable to export duty either under the SEZ Act, 2005 or under the Customs Act, 1962 on the basis of the following observations:-

- The charging section needs to be construed strictly. If a person is not expressly brought within the scope of the charging section, he cannot be taxed at all.
- SEZ Act does not contain any provision for levy and collection of export duty on goods supplied by a DTA unit to a Unit in a Special Economic Zone for its authorised operations. Since there is no charging provision in the SEZ Act providing for the levy of customs duty on such goods, export duty cannot be levied on the DTA supplier.
- Reading section 12(1) of the Customs Act, 1962 along with sections 2(18), 2(23) and 2(27) makes it apparent that customs duty can be levied only on goods imported into or exported beyond the territorial waters of India.

Since both the SEZ unit and the DTA unit are located within the territorial waters of India, supplies from DTA to SEZ would not attract section 12(1) [charging section for customs duty].

Question 5

- (a) (i) Explain briefly whether “assembly” would tantamount to ‘manufacture’ under the Central Excise Act, 1944.
- (ii) Briefly explain the situations where transaction value under Section 4 of the Central Excise Act, 1944 does not apply. (3×2=6 Marks)
- (b) (i) Major Ltd., imports business support services from Wilfred Ltd., of USA on 18-8-2011. The relevant invoice for \$ 1,50,000 is raised by Wilfred Ltd., on 20-9-2011. Assuming that Major Ltd. makes the above mentioned payment on the dates as indicated in the following table, determine the point of taxation under the Point of Taxation Rules, 2011 in each case giving reasons for your answer:
- | | | |
|---------|------------|-----------|
| CASE I | 10-12-2011 | |
| CASE II | 15-04-2012 | (4 Marks) |
- (ii) Write a brief note on Tax Payer's Identification Number (TIN) for purpose of VAT. (2 Marks)
- (c) What is the purpose of the interpretation rules regarding Customs Tariff? Do they form part of the Tariff Schedule? Briefly explain Akin rule of interpretation. (3 Marks)

Answer

- (a) (i) Assembly is a process of putting together a number of items or their parts to make a product. All cases of assembly may not amount to manufacture as an already manufactured item may also be assembled to put it in a readily usable form.
- However, assembly of various parts and components may tantamount to manufacture if a new product which is movable and marketable emerges out of such assembly. Therefore, if an “immovable property” emerges after such assembly, it will not be considered as manufacture.

The Apex Court in the case of *Narne Tulaman Manufacturers Pvt. Ltd. V CCE 1988 (38) E.L.T. 566 (S.C)* held that if the assembly results in new commercial commodity with a distinct name, character and use, then it would amount to manufacture.

- (ii) As per section 4 of the Central Excise Act, 1944, following four conditions are to be fulfilled individually and cumulatively for valuing excisable goods on the basis of transaction value:

- (1) There should be sale of goods.
- (2) The goods sold should be for delivery at the time and place of removal.
- (3) The assessee and the buyer of the goods should not be related persons.
- (4) The price should be sole consideration for the sale.

The transaction value will not apply if any of the above requirements is not fulfilled.

- (b) (i) As per rule 7 of the Point of Taxation Rules 2011, the point of taxation for persons who are required to pay tax as recipients in respect of notified services is the date on which payment is made. However, in case the payment is not made within a period of six months from the date of invoice, the provisions of rule 7 do not apply and the point of taxation is determined under rule 3, 4, 5, 6 or 8 as applicable.

Since, the given case relates to import of services where service tax is to be paid by the service receiver, the point of taxation in each of the two cases will be determined as under:

CASE I The point of taxation is date of payment i.e., 10.12.2011 since Major Ltd. makes the payment within six months from the date of invoice.

CASE II As Major Ltd. does not make the payment within six months from the date of invoice, provisions of rule 7 will not apply and point of taxation will be determined on the basis of rule 3, i.e, issuance of invoice or date of making the payment, whichever is earlier.

However, since invoice has NOT been issued within 14 days from the date of completion of provision of service, earlier of the following two dates will be the point of taxation:

- (i) Date of completion of provision of service; or
- (ii) Date of payment.

Since, date of completion of provision of service [18.08.2011] precedes the date of payment [15.04.2012], it will be the point of taxation.

- (ii) Tax Payer's Identification Number (TIN) is the registration number of the dealer. It consists of 11 digit numerals throughout the country. First two characters represent the State Code and the next nine characters are different in different States.

TIN facilitates computer applications such as detecting stop filers and delinquent accounts. It also helps in cross-checking the information on tax payer compliance.

(c) The purpose of Interpretation Rules of Customs Tariff is:

- (i) to give clear direction as to how the nomenclature in the Schedule is to be interpreted and
- (ii) to give statutory force to the Interpretation Rules and the general explanatory notes.

The Interpretation Rules are integral part of the schedule.

Rule 4 of the Rules of Interpretation is called as Akin Rule. This rule lays down that goods which cannot be classified in accordance with rules 1, 2 and 3 of the Rules of Interpretation would be classified under the heading appropriate to the goods to which they are most akin.

Question 6

(a) Briefly explain the procedure to be followed by the Authority for Advance Rulings on receipt of application for Advance Ruling under the Central Excise Act, 1944. (6 Marks)

OR

(i) Briefly specify under what circumstances it may be beneficial to pay duty and claim rebate under rule 18 of the Central Excise Rules, 2002. (3 Marks)

(ii) Can the Department file an appeal in respect of the same assessee if in respect of some years no appeal was filed in matters involving identical dispute. Write a brief note with reference to the Central Excise Act, 1944. (3 Marks)

(b) Dwarka Ltd. is engaged in providing taxable services under the Finance Act, 1994.

(i) For the half year ending on 30-9-2011, it furnished the return on 24-12-2011. On the basis of information provided answer the following:

(i) Specify the due date and form for filing the return (1 Mark)

(ii) Compute the amount of late fee payable by Dwarka Ltd., under the Finance Act, 1994 and rules made there under. (2 Marks)

(ii) Explain the system of cross-checking under VAT Laws. (3 Marks)

(c) Write a brief note on self assessment in customs under the Customs Act, 1962. (3 Marks)

Answer

(a) As per section 23D of the Central Excise Act, 1944, following procedure is to be followed by the Authority for Advance Rulings on receipt of application for advance ruling:-

1. On receipt of application for advance ruling, the Authority has to forward a copy to the relevant Commissioner.

2. The Authority may accept or reject the application. The Authority will pass an order of admission or rejection of the application and give a copy of such order to the applicant and the Commissioner.
3. Application can be rejected in the following cases only after giving an opportunity of being heard to the applicant:-
 - (i) where the question raised in the application is already pending before any Central Excise Officer, the Appellate Tribunal or any Court; or
 - (ii) where the question raised is the same as in a matter already decided by any Appellate Tribunal or any Court.
4. The Authority can further examine any material placed before it after admission of the application.
5. The Authority has to pronounce the final order within 90 days of receipt of application.
6. Duly signed copies of the final order are to be given to the applicant as well as the Commissioner of Central Excise.

OR

- (i) Under the following situations, it is beneficial to pay duty and claim rebate under rule 18 of Central Excise Rules, 2002:
 - (i) If the assessee has unutilized balance of CENVAT credit in respect of capital goods because credit in respect of capital goods is never refundable.
 - (ii) SSI unit may pay excise duty and claim rebate, as getting refund of CENVAT credit of inputs is not easy and it cannot claim refund of duty paid on capital goods.
 - (iii) When duty paid goods are proposed to be exported.
- (ii) It has been held by the Supreme Court in the case of *C.K Gangadharan v. CIT, Cochin, 2008 (228) ELT 497* that merely because Revenue has not preferred an appeal in some cases, it would not prevent the Revenue to prefer an appeal in another case if it is in the public interest or there is just cause for doing so or for a pronouncement by the higher Court when divergent views are expressed by the different High Courts.

However, the Supreme Court has given a conflicting decision in the case of *CIT v. J.K. Charitable Trust 2008 (232) ELT 769 (SC 3 members bench)* wherein it has held that if in respect of some years, in respect of same assessee, no appeal was filed involving an identical dispute, revenue can be precluded from filing an appeal if the fact situation in subsequent years remains the same.

Further, it may be noted that section 35R inserted vide the Finance Act, 2011 provides *inter alia* that where in pursuance of any instruction issued by CBEC with regard to fixing monetary limits for filing appeal etc., Central Excise Officer has not filed any appeal against any decision passed under the provisions of the Act, then it shall not preclude

such officer from filing appeal in any other case involving the same or similar issues or questions of law.

- (b) (i) (i) As per rule 7 of the Service Tax Rules, 1994, due date for filing the service tax return for the half year ending on 30.09.2011 is 25.10.2011. The return has to be filed in Form ST-3.
- (ii) Dwarka Ltd. furnished its return on 24.12.2011. Therefore, the delay in submission of return is 60 days (6 days of October + 30 days of November + 24 days of December).

As per rule 7C of the Service Tax Rules, 1994, if the return is filed beyond 30 days from the due date, ₹1,000 plus ₹100 for every day from the 31st day till the date of furnishing the said return, subject to a maximum of ₹20,000, is payable as late fee.

Therefore, late fees payable by Dwarka Ltd. is ₹1,000 + (₹100 × 30 days) = ₹4,000

Note: It may be noted that the due date of filing the return for the half year ending on 30.09.2011 had been extended to 20th January, 2012 vide *Order No. 1/2012 dated 09.01.2012*.

- (ii) A comprehensive cross-checking system is a pre-requisite for an efficient VAT system as VAT system requires the assessee to self-assess the VAT liability and only a few returns are scrutinized on a selective basis. A threshold limit for purchases/sales may be specified exceeding which the dealers may be asked to submit the list of purchases/sales or the dealer-wise list from whom or to whom the goods have been purchased/sold.

A cross-checking computerized system is being worked out which would facilitate the comparison between the tax returns and set-off documents of VAT system of the States and those of Central Excise and Income-tax. Cross checking reduces tax evasion which leads to significant growth of tax revenue. It protects the honest dealers and penalizes the fictitious or dishonest ones and creates a level playing field.

- (c) (i) Self-assessment of duty has been introduced in the Customs Act, 1962 vide the Finance Act, 2011 by recasting section 17 of the Customs Act, 1962.
- (ii) The importer or the exporter has to self-assess the duty leviable on goods imported or exported.
- (iii) The proper officer may verify the self-assessment of such goods by examining/testing the goods, if necessary. He may also ask the importer or the exporter to furnish any document or information for ascertaining the duty.
- (iv) After verification, if it is found that the self-assessment has not been done correctly, the proper officer may re-assess the duty leviable on such goods.

- (v) If the order of the reassessment is contrary to the self-assessment, the proper officer should pass a speaking order on the re-assessment within 15 days from the date of reassessment.
- (vi) Where re-assessment has not been done or a speaking order has not been passed on re-assessment, the proper officer may audit the assessment of duty of the imported/export goods at his office or at the premises of the importer/exporter.

Question 7

- (a) (i) *Briefly explain the provisions in respect of waiver of physical warehousing in case of exigency in respect of export goods under the Central Excise Act, 1944.*
- (ii) *Under Excise Audit 2000, the selection of the unit is based on "risk factors". Explain in brief the expression 'risk factors' giving any two examples. (3 × 2 = 6 Marks)*
- (b) (i) *KPL Ltd. did not pay its service tax dues of ₹ 30 lakhs for the period ending 30-9-2011. Can the Department create first charge on the property of KPL Ltd.? If the answer is in the affirmative, whether there are any limitations in respect of creation of such first charge? Briefly explain with reference to the Finance Act, 1994.*
- (ii) *Who are not eligible for composition scheme under the VAT regime. Write a brief note. (3 × 2 = 6 Marks)*
- (c) *What are the ways that would constitute circumvention of antidumping duty imposed on an article that may warrant action by the Central Government based on inquiry as it may consider necessary for purpose of Section 9A(1A) of the Customs Tariff Act, 1975. (3 Marks)*

Answer

- (a) (i) The officer-in-charge of the warehouse may permit waiver from physical warehousing on the written request of the exporter provided all the formalities relating to record-keeping are completed with suitable record in the Warehousing Register: 'warehousing waived'. Such cases should be reported to the Superintendent-in-charge of the warehouse at the earliest.

The permission is given in the following exceptional cases if the entire consignment is entered for export in the original packing:

- (i) where delay occurred due to delayed supply from the factory or longer transit period; or
- (ii) requirement of immediate export; or
- (iii) any other genuine reasons.
- (ii) **Risk factors** under Excise Audit, 2000 means that the assessee who have a **bad track record** are taken up for audit on priority basis over those who enjoy a clean track record.

For example:

- (i) assessee having past duty evasion cases

- (ii) late payment of duty/late filing of returns
- (iii) major audit objections
- (iv) no cash payment of duty (all CENVAT adjustment)
- (v) past duty dues, etc.

Note : Any two examples may be given.

- (b) (i)** Section 88 of the Finance Act, 1994 creates first charge on the property of the defaulter for recovery of service tax dues. Thus, the Department can create first charge on the property of KPL Ltd. for recovery of service tax dues of ` 30 lakhs.

Yes, there are limitations in respect of creation of such first charge. The first charge can be created subject to the provisions of following specified Acts:-

- (1) Companies Act, 1956 (Section 529A)
- (2) Recovery of Debts due to Banks and the Financial Institutions Act, 1993; and
- (3) Securitization and Reconstruction of Financial Assets and the Enforcement of Security Interest Act, 2002.

- (ii)** The following persons are not eligible for the composition scheme under the VAT regime-

- (i) a manufacturer or a dealer who sells goods in the course of inter-State trade or commerce; or
- (ii) a dealer who sells goods in the course of import into or export out of territory of India; or
- (iii) a dealer transferring goods outside the State otherwise than by way of sale or for execution of works contract; or
- (iv) a dealer whose turnover exceeds ₹ 50 lakh in the last financial year.

Note: Any three points may be mentioned.

- (c)** As per section 9A(1A) of the Customs Tariff Act, 1975, following are the ways that would constitute circumvention of antidumping duty imposed on an article that may warrant action by the Central Government:

- (i) altering the description or name or composition of the article subject to such anti-dumping duty,
- (ii) import of such article in an unassembled or disassembled form,
- (iii) changing the country of its origin or export, or
- (iv) any other manner, whereby the anti-dumping duty so imposed is rendered ineffective.

Note: Any three points may be mentioned.

EXAMINERS' COMMENTS ON THE PERFORMANCE OF CANDIDATES

PAPER – 5 : ADVANCED MANAGEMENT ACCOUNTING

General Comments

The performance of the candidates in both theory and practical questions has not been satisfactory. It is important for students to understand thoroughly various concepts relating to subject 'Advance Management Accounting'. Conceptual clarity will help students to approach examination with higher confidence. Students are advised to read extremely various materials relating to the subject and to practice more and more problems in examination conditions.

Specific Comments

Question 1.(a) This question was from 'Relevant Costing' and required to calculate average variable cost per unit. This question was well attempted by the candidates. However, some candidates were unable to calculate opportunity cost of 'skilled labour'. Concepts regarding the use of historical cost vs replacement cost, sunk cost, average unit cost, opportunity cost and relevant cost were tested in this question.

(b) This question related to 'Transportation Problem' requires to find out cost per unit, cell reference and quantity under different methods in third allocation. Candidates' performance was good. However, some of the candidates were not able to solve it correctly and did not answer in appropriate manner to find out 'cost minimization'.

(c) This question was from CVP analysis and required to find out fixed cost and unit contribution of two different products. Most of the candidates were not able to form and solve equation due to lack of clarity of the concept regarding CVP analysis and understanding the application of the information given in the question.

(d) In this question independent activities were given to find out value added activities and non value added activities. Performance of candidates was very good. However, few candidates wasted time in unnecessary elaboration of 'concept of value added'. Candidates have applied theoretical concepts well in the said question.

Question 2.(a) This was a problem related to 'Transfer Pricing'. Best option was required to be selected from the financial perspective of a division. Many candidates wasted their time in making unnecessary assumptions and elaboration. Candidates were not clear about the concept and applications of opportunity cost and incremental costs. Both were mixed up. Moreover, for each option, a different approach was used by candidates. Though many candidates were able to present the steps of opportunity costs, they made the fundamental mistake of not taking the component cost of 'C' into the final product. The error was similar among many candidates. Overall, performance of the candidates was poor in this question.

(b) This was a problem from Standard Costing required to calculate Material price, mix and yield variances. Performance by the candidates was satisfactory in this question. Most of the candidates calculated all the variances correctly except few who have made mistakes in the yield variance and mix variance.

Question 3.(a) This question required determination of minimum price to be quoted for export order. Some candidates were not able to differentiate between fixed and variable costs. Performance of the candidates was average.

(b) This Transportation problem was required to mention the conditions of degeneracy under the circumstances given in the question. Some candidates had superficially read the condition for degeneracy. There were confusion among the candidates whether the 'm' or 'n' included the dummy, and whether the allocations were $> m+n-1$ or vice versa. Hence many adopted the ' $\neq$ ' symbol. Inadequate depth in the concept led to poor performance. Performance of the candidates was average.

(c) In this question candidates had to identify the situations where Activity Based Costing can be recommended. Good performance showed by the candidates. However, many candidates gave irrelevant reasons and could not recognize the cost reduction part of Activity Based Costing management in part (iv) of the question.

Question 4.(a) This question required finding out break- even point, minimum number of incremental units to be sold out to recover the addition fixed cost and best product mix. Performance of the candidates was not satisfactory. Very few candidates could solve the whole part of the problem. Lack of understanding in average contribution in a two-product situation and product preference was observed.

(b) This question was from Linear Programming and asked to determine optimal solution and comments on it. Though the performance of the candidates was good but some of the candidates could not comment on the solution or on the constraints.

Question 5.(a) This question was on Decision making and required best course of action to maximize the profit under the given constraints. Overall performance of the candidates was good. However, some candidates could not present the requirements of the question properly and some wasted time calculating the various unrequited combinations of products and the corresponding profits.

(b) This question from 'Networking Analysis' required to find out crashing cost. Some candidates made mistakes in the order of crashing and simply restricted themselves on not to crash activity Y, common to both the paths. Some candidates wasted time in unnecessary explanations and calculations. Good performance of the candidates was observed in this question.

Question 6.(a) This question was from Budget and Budgetary Control, required to prepare a statement to show the budgeted impact on the profit. Average performance of candidates was observed in this question in this part. Many candidates made mistakes in valuation of raw material, WIP and finished goods of inventory.

(b) This was a theory question on Balanced Score card. Satisfactory performance of the candidates was observed in this question.

(c) This question required to classify items given in the question into Cost control and Cost reduction category. This question was well attempted by the candidates.

Question 7.(a) This question was from Network analysis required to identify the activities and rectification of defect identified. This question was well attempted by the candidates. Though some candidates were not able to name the defect.

(b) This was an Assignment problem required to state two circumstances for optimal solution. Performance was satisfactory in this question. Many candidates could not write more than one situation and many did repeat of same situation in different style.

(c) This was a problem from Simulation for formulation of interval of 2 digit random numbers. Performance of the candidates was not satisfactory. Most of the candidates solved the problem in the same order as was given in the question rather than arranging arrivals in ascending order.

(d) In this question candidates were asked to write definitions of Maximum capacity, Practical capacity Normal capacity and Principle budget factor. Performance of the candidates was average. Many candidates could not write the correct definition of the above concepts.

(e) In this question candidates had to suggest suitable cost unit of few services. This question was well answered by the candidates.

PAPER – 6: INFORMATION SYSTEMS CONTROL AND AUDIT

Question 1. It was a simple case study based question comprising four sub parts.

(a) For the first part, most of the candidates were able to write the suggestions given by the technical consultant. In second part, the ways for implementing these suggestions by ABC Company were also covered fairly well by most of the candidates. Performance was very good for this question.

(b) Most of the candidates could not draw the diagram relating to the Risk Analysis Framework. Hence, the performance was below average for this part.

(c) Many candidates discussed the recovery plan well but some of them discussed Business Continuity Plan (BCP) instead of discussing recovery plan. Overall performance was average for this question.

(d) Only a few candidates wrote the correct answer by mentioning the major components of a good information security policy. Hence, performance was poor for this part.

Question 2.(a) Most of the candidates have been clear about the 'unauthorized intrusion', 'hacking' and 'damages that a hacker can do'. Accordingly, they discussed well all these points. Hence, good performance was observed for this part.

(b) Many candidates explained the guidelines to be followed before starting the implementation of an ERP package but on the other hand, some of them discussed the methodology of ERP implementation or the reasons for the selection of an ERP. Overall performance was average for this question.

(c) In many cases, a generalized discussion on the Electronic Signature was given by the candidates; they did not write it with reference to Section 10 of Information Technology (Amended) Act, 2008. Overall performance was average for this question.

Question 3.(a) Tangible and intangible benefits from the development of a computerized system were written well by most of the candidates. Accordingly, very good performance was observed for this part.

(b) Some of the candidates wrote the appropriate answer by discussing DSS and its characteristics. However, some of them wrote DSS components instead of DSS characteristics. Therefore, overall performance was average.

(c) The concept related to the designing of a database was not clear to most of the candidates. Accordingly, they wrote poor quality answers. Hence, overall performance was below average for this part.

Question 4.(a) Most of the candidates could not explain IT Infrastructure Library and Configuration Framework. Hence, performance was poor for this part.

(b) Many candidates did not attempt the question in the desired way by writing any six ERP vendors and the packages offered by them. However, some of them did well. Therefore, overall performance was average for this part.

(c) For this part, some of the candidates wrote a generalized answer instead of writing the specific parameters that help in planning a documentation process of IS audit. Hence, overall performance was average for this part.

Question 5.(a) In this question, most of the candidates wrote the correct answer by defining a virus and related policy and procedural controls that can be recommended for ensuring control over virus proliferation and damage. Overall performance was good for this part.

(b) Many candidates did not write the answer with reference to Information Technology (Amended) Act, 2008 rather they wrote the answer based on the general understanding. Hence, overall performance was average.

(c) The question based on the constraints in operating a MIS was well attempted by many candidates. However, a few candidates did not write the specific answer and wrote other related points to MIS. Hence, overall performance was average.

Question 6.(a) Most of the candidates were unable to describe the information, which should be identified and understood by a Reviewer/IS Auditor prior to commencing a LAN review, instead some of the candidates wrote a general description about the topic. As a result of this, overall performance was below average for this question.

(b) Many of the candidates discussed well about the steps to be followed by an IS Auditor while conducting IS auditing but some of them could not write the same. Overall performance was average.

(c) Many candidates wrote the correct answer by discussing two types of Service Auditor's Reports under SAS 70. On the other hand, a few candidates were unable to write the main features of these reports and distinction between these two. But overall performance was good for this part.

Question 7. This question was based on the short notes.

(a) Many candidates could not describe Data Dictionary well; accordingly, average performance was observed for this part.

(b) Most of the candidates wrote the risk mitigation measures correctly; hence, overall performance was good for this part.

(c) The concept of Software Process Maturity was explained well by a few candidates while some of them did not understand the term correctly. Accordingly, average performance was observed for this part.

(d) First part based on the Preventive Information Protection was well written by the candidates but the second part based on Restorative Information Protection was not discussed correctly by many candidates. Hence, overall performance was average for this part.

(e) Most of the candidates clearly mentioned the objectives of Information Technology Act 2000; hence, performance was good for this part.

PAPER – 7 : DIRECT TAX LAWS

General Comments

Many candidates were not aware of the recent amendments, and this was reflected in their answers to certain questions, namely, Q.2, Q.5(a), Q.5(d), etc. As regards case law based questions, though many candidates were able to mention the name of the parties involved, they were not able to explain the relevant provisions and the principle to be applied to arrive at the correct conclusion.

Specific Comments

Question 1. (a) Most of the candidates were not aware of the provisions of section 10AA of the Income-tax Act, 1961, and hence, could not solve the problem correctly. Even the depreciation was not computed correctly in many cases.

(b) Few candidates have wrongly excluded the value of assets located outside India while computing net wealth.

(c) (i) Most of the candidates were not aware of the provisions of section 17 specifying certain cases where net wealth chargeable to tax is deemed to have escaped assessment.

(ii) Many candidates have wrongly stated that reference to the Valuation Officer cannot be made by the Assessing Officer in cases where no return of wealth has been filed by the assessee. Some other candidates have answered in the affirmative without substantiating their answer.

Question 2. Some candidates were not aware of the treatment of recovery of bad debts, where a portion had been allowed as a deduction in the past. Further, though the problem required the candidates to adduce reason for treatment of each item, many of them did not append any note for items which did not affect the computation of total income.

Question 3.(a) Most of the candidates were not aware of the provisions of Rule 8D and hence, were not able to determine the amount of expenditure in relation to exempt income.

(b) Many candidates were not aware of the principles enunciated in judicial decisions for the treatment of gains arising from sale of shares and securities and the circumstances in which the resultant income would be regarded as business income or capital gains.

(c) This is a question relating to validity of order of rectification passed by the Settlement Commission. Many candidates were not aware that an amendment which has the effect of modifying the liability of the applicant cannot be made unless the Settlement Commission has given notice to the applicant and the Commissioner of its intention to do so and has allowed them an opportunity of being heard.

Question 4.(c) The question is based on the provisions of section 143(3) and the period of limitation under section 153. Most of the candidates were not aware of these provisions and hence, could not answer the question correctly.

(d) Though many candidates were able to conclude correctly that the action of the bank in refusing to furnish the particulars as required by the Assessing Officer is not correct, the underlying reasons for arriving at such conclusion were not properly put forth by a vast majority of them.

Question 5.(a) This is a question based on the newly inserted section 94A. Few candidates were not aware that the benefit of permissible variation between the transfer price and the arm's length price, as notified by the Central Government, would not be available in the case of transaction with a party located in a Notified Jurisdictional Area.

(b) Most of the candidates could not write the answer in a satisfactory manner. They have only defined "permanent establishment", but have not substantiated as to why a website can or cannot be treated as a permanent establishment.

(c) This is a question based on the provisions of section 245U, which majority of the candidates were not aware of. Many of the answers were general and irrelevant.

(d) Many of the answers were vague, indicating that the candidates were not aware of the relevant circulars containing the procedure for obtaining refund of TDS by the deductor in respect of payments made to non-residents in certain circumstances.

Question 6.(a) The tax treatment of consequences for failure to utilize the amounts deposited in the Capital Gains Account Scheme, especially the treatment in the hands of the legal heirs in the event of death of the assessee, was not known to several candidates. They have wrongly answered that the unutilized amount in the capital gains deposit scheme would be taxable in the hands of the legal heirs.

(b) Many candidates have omitted to mention that carry forward is permissible only in the case of succession by inheritance and not otherwise.

(c) Only a few candidates could correctly state the cases where the benefit of indexation is not available for determination of capital gains. Most of the candidates were able to mention only two to three cases.

(d) Only a few candidates were aware that the provisions of section 69D have to be applied to answer this question. Most of the candidates have wrongly applied the provisions of sections 269SS and 269T to answer this question.

Question 7.(a) Most of the candidates were neither aware of the consequences of not collecting tax at source in respect of sale of scrap by a manufacturing company nor of the circumstances under which the provisions for collection of tax at source were not applicable in such a case. Hence, they were not able to answer this question correctly.

(b) The question related to the necessity of filing return of income in the four circumstances given therein. Most of the candidates were not aware that a firm has to file a return of income compulsorily, even if it has incurred a loss.

(c) Some candidates wrongly included the difference between the fair market value and the purchase price of car as taxable under section 56(2)(vii), without considering that "car" is not included in the definition of "property" therein. Further, some candidates were not aware that the provisions of section 56(2)(vii) are not attracted in respect of immovable property received for inadequate consideration.

PAPER – 8 : INDIRECT TAX LAWS

Specific Comments

Question 1.(b) Majority of the candidates calculated excise duty on entire sales value of ₹ 250 lakhs instead of allowing exemption of ₹ 150 lakhs under *Notification No. 8/2003 CE dated 01-03-2003*, even though the question clearly stated that the unit was availing SSI exemption under *Notification No. 8/2003*. Also, 100% of CENVAT credit on capital goods was not availed by many candidates. Further, few of the candidates failed to work out CENVAT credit on inputs on proportionate basis.

Question 5.(a)(i) Very few candidates were able to mention correctly as to when assembly amounts to manufacture, which is the basis of levy of Central Excise duty.

(a)(ii) In a number of cases, the candidates could not explain the required situations where transaction value under section 4 of the Central Excise Act, 1944 does not apply. Instead, they wrongly mentioned valuation rules under Central Excise, which was not the requirement of the question.

Question 6.(c) Majority of the candidates were not aware of the concept of self assessment in customs under the Customs Act, 1962. They merely mentioned that it was assessment by assessee without bringing out the exact provisions under the Customs Act, 1962.

Question 7.(b) Many candidates have not mentioned the limitations in respect of creation of first charge with reference to the Finance Act, 1994. They have merely answered in the affirmative without explaining the essential part of the answer.