

## PRIME ACADEMY

### 31ST SESSION PROGRESS TEST – ADVANCED MANAGEMENT ACCOUNTING

No. of Pages: 2

Total Marks: 75

Time Allowed: 2Hrs

1. Your management is not satisfied with the meager profit that it is making. You have been asked as a cost accountant to prepare a note stating areas you should look into with the idea of improving profits. Your answer should be in the form of a memorandum. 15 Marks
2. A company running an orchard, with a an adequate supply of labour, presents the following data and requests your advice about the area to be allotted for the cultivation of various types of fruits, plates growing Apples, Lemons, Oranges and Peaches.

	Apples	Lemons	Oranges	Peaches
Selling price per box (Rs.)	15	15	30	45
Season's yield in boxes per acre	500	150	100	200
	Rs.	Rs.	Rs.	Rs.
Cost: Material per acre	270	105	90	150
Labour :				
Growing per acre	300	225	150	195
Picking and packing per box	1.5	1.5	3	4.5
Transport per box	3	3	1.5	4.5

The fixed costs in each season would be:

Cultivation and Growing (Rs.)	56,000
Picking (Rs.)	42,000
Transport (Rs.)	14,424
Administration (Rs.)	1,00,000
Land Revenue (Rs.)	30,000

The following limitations are also placed before you:

- (a) The area available is 450 acres, but out of this, 300 acres are suitable for growing only Oranges and Lemons. The balance 150 acres is suitable for growing any of the four fruits, viz., Apples, Lemons, Oranges and Peaches.
- (b) As the produce may be hypothecated to banks, area allotted for any fruit should be demarcated in complete acres and not in fractions of an acre.
- (c) The marketing strategy of the company requires the compulsory production of all the four types of fruits in a season and the minimum quantity of any one type to be 18,000 boxes.

Calculate the total profit that would accrue if your advice is accepted. Also compute the overall break even point. 25 Marks

3. Five salesmen are to be assigned to five territories. Based on the past performance, the following table shows the annual sales (in rupees lakhs) that can be generated by each salesman in each territory. Find the optimal assignment.

Salesman	Territory				
	T1	T2	T3	T4	T5
S1	26	14	10	12	9
S2	31	27	30	14	16
S3	15	18	16	25	30
S4	17	12	21	30	25
S5	20	19	25	16	10

15 Marks

4. A company currently operating at 80% capacity has the following profitability particulars:

Particulars	Rs.	Rs.
Sales		1,280,000
Costs:		
Direct materials	400,000	
Direct labour	160,000	
Variable overheads	80,000	
Fixed overheads	520,000	1,160,000
Profit		<u>120,000</u>

An export order has been received that would utilize half the capacity of the factory. The order has either to be taken in full and executed at 10% below the normal domestic prices, or rejected totally. The alternatives available to the management are given below:

- Reject the order and continue with the domestic sales only, as at present.
- Accept order, split capacity equally between overseas and domestic sales and turn away excess domestic demand
- Increase capacity so as to accept the export order and maintain the present domestic sales by
- Buying an equipment that will increase capacity by 10% and fixed cost by Rs.40,000 and
- Work overtime at one and half time the normal rate to meet balance of required capacity.

Prepare comparative statements of profitability and suggest the best alternative. 20 Marks

**PRIME ACADEMY**  
**31ST SESSION PROGRESS TEST – ADVANCED MANAGEMENT ACCOUNTING**  
**SUGGESTED ANSWERS**

- 1) From: Cost Accountant to: General Manager In pursuance to your instructions to ascertain the reasons for meager profits and the areas which have to be looked into for improving profitability. I submit hereunder my observations and suggestions.

**Observations:** Profit is basically the difference between the selling price of the products and their costs. Thus, lower sales or higher costs any of them or both of them can be the cause of lower profits. Lower sales may be due to lower selling price or lower volume of sales. Lower selling price may have to be kept on account of market to competition or inadequate demand for the goods. Lower volume of sales may be due to tough market competition, insufficient sales promotion activities, shortfall in output, customer dissatisfaction due to inferior quality of goods, non-fulfilment of delivery promises, etc. Cost of production may be higher because of underutilization of resources, inadequate control measures leading to more waste of material, labour, etc, lack of coordination, motivation or incentive among employees, inflationary market conditions resulting in rise in the cost of materials, labour and overheads.

**Suggestions:** The figure of profit, as indicated above, is not affected by only one factor. In order to improve the figure of profit, it is therefore necessary that correct reason or reasons should be found out. The overall profit percentage will not be of much help. It will be necessary to ascertain the profitability of each product, process, department or profit centre. Profit/volume ratio will be greatly helpful in this respect. In order to ascertain whether low profit is due to underutilization of fixed assets, it will be proper to find out the return on capital employed and compare it with the figure for the previous years and also with the rate of return earned by similar other companies. The system of budgetary control and standard costing may also be introduced in the organization to have a more effective control over costs and profits.

- 2) Statement showing Contribution per acre

	Apples	Lemons	Oranges	Peaches
Selling price per box (Rs.)	15	15	30	45
Season's yield in boxes per acre	500	150	100	200
Sale value per acre: (Rs.) {A}	7500	2250	3000	9000
Material cost per acre (Rs.)	270	105	90	150
Labour -Growing per acre	300	225	150	195
Picking packing and transport per acre	2250	675	450	1800
Variable cost per acre (Rs.) {B}	2820	1005	690	2145
Contribution per acre (A - B)	4,680	1,245	2,310	6,855
Preference according to contribution per acre	II	IV	III	I
Minimum Quantity	18000/500	18000/150	18000/150	18000/150
	36	120	180	90
				24

Lemons and Orange require 300 acres even to produce. Moreover, 300 acres of land suitable only for these two products, hence 300 acres would be used to produce only these products. The balance of 24 acres is available for production of any of the fruits. Since peaches give the highest contribution per acre and hence they should be preferred for allocation of 24 acres. The total acreage for peaches would therefore be 90+24 = 114 acres.

### Statement of profit

	Apples	Lemons	Oranges	Peaches	Total
Area (Acres)	36	120	180	114	450
Sales (Rs)	270000	270000	540000	1026000	2106000
Contribution per acre (Rs.)	4,680	1,245	2,310	6,855	
Total contribution (Rs.)	168,480	149,400	415,800	781,470	1,515,150
Less: Fixed costs (Rs)					<u>2,42,424</u>
Net profit (Rs)					<u>12,72,726</u>

Overall BEP:  $(242424/1515150) \times 2106000 = 3,36,960$

- 3) **Step 1:** Since the matrix represents the sales which can be generated by each salesman in each territory, the objective function of the assignment problem is, therefore, to maximize the total sales generated. But the algorithm for assignment problem is for minimization of the objective function. We, therefore, convert the given problem to minimization problem by taking, i.e., by subtracting all the elements of the given matrix from the maximum element 30 to obtain the following matrix:

**Table 1:**

Salesman	Territory				
	T1	T2	T3	T4	T5
S1	5	17	21	19	22
S2	0	4	1	17	15
S3	16	13	15	6	1
S4	14	19	10	1	6
S5	11	12	6	15	21

**Step 2:** Row subtraction

Salesman	Territory				
	T1	T2	T3	T4	T5
S1	0	12	16	14	17
S2	0	4	1	17	15
S3	15	12	14	5	0
S4	13	18	9	0	5
S5	5	6	0	9	15

**Step 3:** Column subtraction

Salesman	Territory				
	T1	T2	T3	T4	T5
S1	0	8	16	14	17
S2	0	0	1	17	15
S3	15	8	14	5	0
S4	13	14	9	0	5
S5	5	2	0	9	15

#### Step 4: Optimal Assignment

Salesman	Territory				
	T1	T2	T3	T4	T5
S1	0	8	16	14	17
S2	0	0	1	17	15
S3	15	8	14	5	0
S4	13	14	9	0	5
S5	5	2	0	9	15

The optimal assignment is :

S1 – T1, S2 – T2, S3 – T5, S4 – T4, S5 – T3 and the maximum sales generated are:

$$26+27+30+30+25 = 138.$$

4)

Particulars	Alt 1	Alt 2	Alt 3
Domestic	80%	50%	80%
Export	Nil	50%	50%
Nature of Export			Balance capacity 20%
			Additional Capacity 10%
			Overtime 20%
Profitability Statement	(Figures in 000's)		
Domestic Sales	1,280	800	1,280
Export	Nil	720(800-10%)	720
Total Sales	1280	1520	2000
Variable Cost			
Materials	400	500	650
Labour	160	200	260
VOH	80	100	130
Total VC	640	800	1040
Contribution	640	720	960
Fixed Cost			
Existing	520	520	520
Additional Capacity	Nil	Nil	40
Overtime Premium	Nil	Nil	20 (20/80*160*0.5)
Net Profit	120	200	380
Decision	Alt 3 is better		

# PRIME ACADEMY

## 31ST SESSION PROGRESS TEST – INFORMATION SYSTEMS CONTROL & AUDIT

No. of Pages: 1

Total Marks: 75

Time Allowed: 2Hrs

### PART – A

25 Marks

1. The first step in SDLC is \_\_\_\_\_ (1 Mark)
2. The deliverable of the design phase of SDLC is \_\_\_\_\_ (1 Mark)
3. The process of planning new systems or systems to replace/support existing systems is called as \_\_\_\_\_ and is done by \_\_\_\_\_ (2 Marks)
4. The three broad steps in preliminary investigation are \_\_\_\_\_, \_\_\_\_\_ and \_\_\_\_\_ (3 Marks)
5. As far as obtaining new application software is concerned, the organization has a choice to either \_\_\_\_\_, \_\_\_\_\_ or \_\_\_\_\_ (3 Marks)
6. Shifting user needs is called as \_\_\_\_\_ and is attributed to lack of \_\_\_\_\_ (2 Marks)
7. A usable system or system component built quickly at a lesser cost and with intention of being modified or replaced with a full scale or fully operational system is called as \_\_\_\_\_ (1 Mark)
8. \_\_\_\_\_ is a methodology which enables organization to develop strategically important systems quickly while reducing costs and maintaining quality (1 Mark)
9. Two ways of collecting information for the purpose of preliminary investigation are \_\_\_\_\_ and \_\_\_\_\_ (2 Marks)
10. Proper training of personnel and Firewalls are examples of \_\_\_\_\_ controls (1 Mark)
11. Two broad impact of any control are \_\_\_\_\_ and \_\_\_\_\_ (2 Marks)
12. \_\_\_\_\_ are controls which can replace a similar control while \_\_\_\_\_ are controls which reduce the risk of the original or primary controls not being there (2 Marks)
13. The three objectives of audit trails as a control are \_\_\_\_\_, \_\_\_\_\_ and \_\_\_\_\_ (3 Marks)
14. \_\_\_\_\_ is carried out to ascertain whether benefits anticipated in the feasibility stage or requirement analysis stage have actually been achieved. (1 Mark)

**PART - B**

**(50 Marks)**

- 1) (a) There are many reasons why organizations fail to achieve systems development objective"- Explain (10 Marks)  
(b) Explain direct change over, parallel conversion and gradual conversion strategies (10 Marks)
  
- 2) (a) "The move towards more automated financial statements has had an impact in the way auditors carry out their work"- Explain (10 Marks)  
(b) What are audit trails? Explain the objectives of audit trail (10 Marks)
  
- 3) (a) Write short notes on denial service attacks and trap doors (5 Marks)  
(b) Write short notes on End-user development approach and data dictionary (5 Marks)

**PRIME ACADEMY**  
**31ST SESSION PROGRESS TEST – INFORMATION SYSTEMS CONTROL & AUDIT**  
**SUGGESTED ANSWERS**

**PART A**

Q .No.	Answer
1	Preliminary Investigation/Feasibility Study
2	Systems Manual
3	Systems Design, Systems Designer
4	Request clarification, feasibility study and approval of request
5	Buy, develop it in-house or lease
6	Scope creep, software base lining
7	Prototype
8	Rapid Application development
9	Review of Internal Documents, Interviewing of users
10	Preventive Control
11	It involves an element of cost, it slows down organisational processes
12	Alternate Controls, Compensatory Controls
13	Help detect unauthorised access, facilitate reconstruction of events, fix accountability
14	Post-implementation review

## PART - B

- 1) (a) Some reasons which can be attributed for failure of systems development objective are:
1. **Lack of senior management effort and involvement**
    - Developers and users watch as to which projects are getting senior manager attention. They would shift focus from projects they feel is not getting the required attention of top management.
    - Also it is the top management which commits resources to the projects and controls its progress.
  2. **Shifting user needs (called as scope creep- due to lack of software base lining)**
    - User requirements for information systems keep changing. More changes imply more requests for systems development and more development projects.
    - Also if changes occur during development effort, there would be no baseline and developers find it very difficult to provide for every change request.  
**Ex:** Say a accounts software is in the process of development. A user request comes asking for additional report generation not stated in earlier requirement specification. When this development is being done another user may come with further requests and so on, there is no end to it.
  3. **Development of unstructured or strategic systems.**
    - The requirements, specification and objectives of strategic systems are difficult to define and hence it would be difficult to determine if development effort is successful or not.(**Ex:** Expert Systems)
  4. **New technologies**
    - When management tries to leverage new technology to its competitive advantage, it may face a problem that personnel are not familiar with the technology.  
**Ex:** An organisation may want to achieve good results by implementing an ERP package, but may face a problem if users' do not know how to use the package.
  5. **Lack of standard project management and systems development methodologies.**
    - Lack of formal project management methodologies makes it difficult to stick to time schedules/budget schedules.
  6. **Over-worked or under-trained development efforts.**
    - Systems development team is over-worked due to constant requests
    - Most of the company's do not invest in employee training and hence the employees are not up-date on current technologies.
  7. **Resistance to change**
    - Any development effort is countered by resistance to change.
    - If employees perceive that as a result of business process re-engineering their power position will be affected or that there may be "down-sizing/retrenchment" they will work against the development effort.  
**Example:** When computerisation was introduced in banks, in the early stages it faced lot of resistance from employee unions who felt it would adversely affect their job security.
  8. **Lack of user participation**
    - If users are not involved in the development efforts, they may not feel responsible for the success of the projects. Also there may be resistance to change.
    - Hence user involvement is critical to the success of the project.

9. Inadequate testing and user training.

- If new systems are not tested properly, they may not meet the business objectives. Also it may give rise to control risks.
- End user training on the new system is critical since any system is as effective as the user who uses it.

(b)

<i>Conversion method</i>	<i>Meaning</i>	<i>Advantages</i>	<i>Disadvantages</i>
1. Direct change over method (also called Plunge method)	On a specified date old system is dropped and new system is put to use  Can be adopted only if extensive testing done beforehand	Users straight away use the new system-adaptation easy.	1. Risky 2. Long delays if errors occur since this the only system available to do the processing 3. Users resent/resist since unfamiliar system 4. Cannot compare results with the old system(since old system has been discarded)
2. Parallel conversion	Running the old system and the new system in parallel at the same time  Results of the new system compared with that of the old	1. Since data available from both old and new systems, any errors in new system can be corrected.	1. Cost of running both systems (old and new) is very high. 2. Employees work load increases during conversion. 3. Unless new system is replacing old manual
<i>Conversion method</i>	<i>Meaning</i>	<i>Advantages</i>	<i>Disadvantages</i>
	system and if reliable over a period of time, old system is stopped and new system put to use.	2. Users feel secure as they are not faced with abrupt change	system, output comparison difficult. 4. If new system is an improvement over existing system, outputs would differ and hence difficult to compare. 5. Users familiar with old system and will continue to use only that.
3. Gradual conversion	Attempts to combine the good features of parallel and direct changeover method. Volume of transaction gradually increased → new system is phased in.	Users can use the new system gradually and there is a possibility of detecting and correcting errors without much system downtime.	1. Time consuming as it may take a long time to put the new system in use. 2. Not the best method for small, simple systems.

- 2) (a) As organisations move towards computerisation of their business processes (Information Systems), the internal control mechanisms and audit processes also undergo a change. While the control objectives (purpose to be achieved by implementing a control) in an computerised environment may remain same as in manual environment, the manner in which controls are implement may be different.

For example internal controls as known in manual environment (i.e non computerised environment) like physical verification of documents or two people authorising high value payments by signing the vouchers etc. may not work in a computerised environment. These may be replaced by online authorisation process etc.

The impact of IS on audit process can be classified into:

1. Change in audit trail and audit evidence (i.e moving towards digital evidence)
2. Change in internal control environment
3. High probability for unconventional errors and frauds (i.e cyber crimes)
4. Change in audit procedures

### 1. Change in audit trail and audit evidence.

While in manual environment audit trails were easily visible and traceable, in computerised environment the audit trails are fragmented and difficult to trace. For example a payment voucher manually generated provides sufficient audit trail. If the same payment is made through say electronic clearing system or net banking, audit trails are not very visible and difficult for the auditor to trace. This is called as digital evidence. Issues relating to digital evidence are:

#### a. Data Retention Policy

Depending on the data retention policy of an organisation, past transactions may or may not be readily available for verification on the system. They may have to be retrieved on demand. Also the data stored on the system may require specific software to interpret the data and may be as easy as auditing from a printed document.

#### b. Direct data entry or lack of physical input documents

Many transaction processing systems work under the direct entry mode wherein data is input into the system directly without any supporting documents- for example ATM transactions which affects account balances but has no input documents.

#### c. Lack of visible audit trail or short retention period of audit trails:

Some organisations retain audit trails only for a short period of time- thus auditors may have to modify his audit approach suitably to look for compensating controls

#### d. Reduction in printed outputs

As printed outputs are declining, audits may have to be carried out directly on data on the system through a separate access mechanism.

#### e. Automated or system generated transactions

Certain transactions are system generated- for example if safety stock and re-order limits are set in an ERP, on reaching a particular stocking quantity, the ERP system may generate an automated purchase order and even email it to the supplier/vendor. Such transactions have no human intervention for authorisation and hence no judgement thereby increasing the chances of errors.

#### f. Legal Issues:

In contracts and payments which are concluded online, territorial jurisdiction issues arise as regards place of origination, taxation, dispute resolution etc. For example for an online purchase of goods, the buyer may be located in one state, the web site may be located in a server in another state or country, the goods may be shipped from a different location and payment may be credited online with a Bank in another country. In such a transaction, fixing the jurisdiction for say a dispute is quite difficult.

Similarly admissibility of digital evidence-i.e whether it is good evidence or not- in a court of law is a challenge and is in very nascent stages.

### 2. Change in internal control environment

Some of the basic internal controls in an organisation pertain to :

- Integrity and competency of personnel
- Segregation of duties in order to ensure that a single person cannot put through a transaction end to end.
- Maker-checker or authorisation procedures

- Control over documents
- Access restrictions over assets and records (ex: cash as an asset can be accessed only by authorised personnel)
- Overall control and supervision by the management

While the need for the above mentioned controls are there even in a computerised environment, the methodology of implementing the controls may be different. For example:

**a. Segregation of duties**

In manual environment the auditor was concerned with say whether the maintenance of cash function was segregated from the physical verification of cash function. Similar control in computerised environment would be segregation within IT Department- say systems administration function should be segregated from computer operator function.

In computerised environment proper segregation of duties is essential since a risk arises if one employee or group of employees are aware of the complete data flow and process logic.

**b. Centralisation of data and application programs**

Predominantly most organisations choose to centralise their data and programs in a single server or servers in one location. For example all the program and customer data of a Bank is located in one location called as the Data Centre. This is in contrast to a manual environment where data was stored in distributed locations (say at various branches). While centralisation helps in operational efficiency, the impact of a threat is far greater since there is concentration at one place. For example if the data centre fails or is hacked, entire operations would come to a stand still.

**c. Access Controls**

While in manual environment access control was predominantly physical access control (like door locks, security guard etc.) in computerised environment the access controls are predominantly logical access controls (like passwords, PIN etc.).

**3. High probability for unconventional errors and frauds (i.e cyber crimes)**

**a. Triggered transactions or system generated transactions:**

As discussed in earlier paragraphs, system generated transactions are difficult to trace and audit and it requires knowledge about the program functioning.

**b. Systematic errors**

Computers are programmed to do transactions in a consistent manner- i.e same inputs with the same application software would generate same outputs every time. Thus correct input and correct processing would always lead to correct output. While correct input with wrong processing would always lead to wrong output. For example one error in payroll software can lead to all net salary values for the month being calculated erroneously. Thus the impact is wide spread and needs to be corrected at the source rather than at the transaction level.

**4. Change in audit procedures**

Since most of the audit evidence required to form an opinion is system based, manual audit procedures may not prove to be effective in a computerised environment. For example use of audit tools like ACL, IDEA may be required to query data and obtain sufficient evidence from a computerised environment.

**(b) Meaning**

It refers to recording or logging of activities at the operating system, network, application software, user and database levels. For example application logs contain details of who initiated a transaction, who authorised it, date and time etc.

**Objective**

The objective of audit trail control are three fold:

S.No.	Objective	Example
a.	Help detect unauthorised access	An unauthorised user trying a user-id password wrong three

	or attempted access to the system	times would be logged by the system
b.	Facilitate reconstruction of events in case of system failure	Database logs contain before image and after image of data values which help reconstruct the database tables in case of a failure.
c.	Fixing of accountability	transactions can be traced to individual users based on the user-id details appearing in the logs. The person carrying out the transaction cannot later deny it since his user-id is captured in the log.

**Explanation for the objectives:**

**a. Detecting unauthorised action**

This detection can be either real time detection or after the fact detection. Real time detections are alerts configured to trigger even when unauthorised access is being attempted. These are very effective but require a lot of processing resources and monitoring mechanisms. The other alternate is to store the logs and review it as and when required.

**b. Facilitate reconstruction of events**

Logs keep track of events leading to system failures, security violations and application processing errors (ex: errors in calculation of interest and charges). These logs help analyse the error condition and prevent future occurrence. Similarly logs help reconstruct account balances if the files are corrupted.

**c. Fixing accountability**

Using logs user activity can be monitored and this acts as a deterrent against unauthorised access or policy violations by users.

3) (a)

Denial of Service attack (DOS)	Disruption and complete denial of service to legitimate users, networks, systems or other resources. The intent of any such attack is malicious in nature and the requisite tools are readily available. Ex: Remote unauthorised shut-down of sensitive systems and hence causing a denial of service.
Trap Doors	Exits out of an authorised operating system that allow insertion of specific logic, to permit a review of data during processing. They may be exploited to insert unauthorised program logic. They circumvent the normal operating system access controls to allow programmers to maintain the system. They should be eliminated during the final editing of the codes

(b) Write short notes on End-user development approach and data dictionary (5 Marks)

End user development approach

With increased availability of low-cost technology like micro computers and rapid application development tools (RAD, Object Oriented Programming), it is end users who are responsible for systems development and not the EDP department.

The systems development methodology followed by end user may differ from the formal procedures as in traditional approach.

**Risks in end-user development**

- a) **Decline in standards & controls** since in end-user development paper walk-through unlikely to be carried out and standards and policies are unlikely to be enforced with the same seriousness as done when an analyst is involved.
- b) **Requirement specification may not be comprehensive** as users may not have the competency as that of an analyst to capture the accurate requirement specification.
- c) **Reduction in quality assurance and stability of the system** due to lack of adequate requirement specification.

**d) Increase in unrelated & incompatible systems** (called as lack of standardisation)

Each department would choose their own software and hardware leading to incompatibility- i.e. system of one department would not be able to communicate with that of other. Hence management would not be able to implement corporate wide data base.

**Difficult to access a common database** as different systems run varied applications.

Data Dictionary

- It contains **data about data** (called as "meta data")
- Contains descriptive information about data items in the files of the information system.  
**Ex:** Date field is a data field. Data dictionary contains information like date field accepts data only in "dd/mm/yyyy" format. It is describing the characteristic of the data field.

**Some information contained in the data dictionary**

- Codes describing data length , data type (numeric, alphabetic etc.)
- Information about the source document used to create the data item.
- Names of the computer files storing data items.

As new data fields are added to the record structure —————> data dictionary is updated.

**Example:** If roll number field is added to a screen, the data dictionary is updated to state that this field will contain a maximum of 8 characters, the first two places will be alphabets, and the next 6 will be reserved for numbers. Like **AB2455**.

As a data field is deleted ———> corresponding entries are deleted in the data dictionary.

If new computer programs are created to access the existing data items in the files —> data dictionary is updated about the data items these programs access.

**Use of data dictionary**

- As a document to aid programmers and analyst
- As a security tool to restrict access to certain data fields for specified employees/ programs.  
**Ex:** Employees who are in department other than payroll department- would be denied access to data fields containing payroll data.
- Accountants and auditors use it to trace audit trail i.e. for input source identification, the process and the output reports.
- It can also be used by accountants to plan the flow of transaction data through the system when participating in the design of a new system.  
Can be used for investigating or documenting internal control procedures since it contains details about edit tests, methods of file security etc.

**PRIME ACADEMY**  
**31ST SESSION PROGRESS TEST – DIRECT TAX LAWS**

No. of Pages: 2

Total Marks: 75  
 Time Allowed: 2Hrs

1. X Ltd., a company incorporated in US, sells laser printer cartridge to its 100% Indian subsidiary A Ltd. @ \$50 per cartridge. X Ltd. also sells its laser printer cartridge to another company Y Ltd. In India @ \$80 per cartridge. Total income of A Ltd. for the assessment year 2009-10 is Rs. 12, 00, 000 after making payment for 100 cartridges @ \$50(1\$=Rs.49). A Ltd. has deducted tax at source while making payments to X Ltd. in this case, sale to unrelated party is at \$80 per cartridge. Compute the arm's length price and taxable income of X Ltd. and A Ltd. The rate of one dollar may be assumed to be equivalent to Rs.49 in all transactions for the sake of simplicity. Determine Arm's length Price (6 Marks)

2. Determine the arm's length price in the following circumstances under pre and post amendment circumstances

S . No	Nature of the transaction	Arm's Length Price	Transfer Price
1	Income	Rs.500000	Rs 600000
2	Expenditure	Rs 450000	Rs 465000
3	Income	Rs 350000	Rs 330000
4	Expenditure	Rs 100000	Rs 115000

(8 Marks)

3. Write short notes on:

1. Associated Enterprises
2. Income deemed to accrue or arise in India
3. Deduction u/s 35AD

(3 x 4 = 12 Marks)

4. R. Ltd., credited to its profit and loss account drawn for the financial year ending 31-3-2009, the following amounts:

- (a) Unclaimed wages for the year 2003 - 2005 Rs.450000
- (b) Deposits received from its customers (during the financial year 2001-02 Rs.75000 and 2002-03 Rs.235000 for supply of spare parts remaining unclaimed) Rs.310000
- (c) Amounts claimed and recovered from the agents of its customers, the excess freight paid by the customers of the assessee-company remaining unclaimed by the customers during the last 4-5 years Rs.325000
- (d) Amounts collected by way of sales tax from its customers in the financial year 2000-01 and deposited with the State government refunded the amount to the assessee-company when the relevant provision relating to levy of sales tax was struck down by the High Court

The assessee company contends that it is not liable to pay any tax in respect of any of the aforesaid credits made to its profits and loss account during the financial year 2009-10 for the following diverse reasons:

- i. There has been no cessation of assessee company's liability to its workers and/or customers merely by its unilateral act of crediting the amounts to its profit and loss account.
- ii. The way in which the entries are made by an assessee in his books of account is not determinative of the question, whether it has earned any assessable profit or suffered any assessable loss.
- iii. Amounts received by it from the customers and /or recovered by it from the agent of the customers were never claimed by and/or allowed to it as a business deduction in any of the earlier years.
- iv. The liability of the assessee-company in respect of the aforesaid sums became barred by limitation long before 1-4-2009
- v. Are you in agreement with company's contentions? Give your observations with reasons on each of the items credited to profit & loss account (12 Marks)

5. Complete the following table:

Situation	Type of Income (Income accruing in India, outside India etc)	Taxable for which category of assessee (Resident, non resident etc)
Mr. Michael Schumacher received a sum of USD 500,000 from Ferrari India for endorsing their brand in India. Payment for the endorsement was made in Germany.		
Mr. Sanjay Nayar is working for CITIBANK India. During the year, he was posted to Singapore on deputation for a period of 6 months. Salary for the period was remitted in India while he was receiving allowance for his stay abroad.		
Mr. Gary Kirsten, citizen of South Africa, works for the Indian cricket team. He receives salary for his work with the Indian cricket team and travels across the globe with the team		
Mr. Mallaya has a huge resort in Goa which has been let out to UniLever Plc UK on a monthly rent of Rs 10 lacs. The sum is being credited in equivalent pounds every month in his Swiss bank account		

(8 Marks)

6. Write short notes:

1. Application and Accumulation of Trust Income
2. Treatment of Donations in Kind and Business Income received by a Trust
3. Taxation of Anonymous Donations
4. Charitable Purpose

(4 X 3 = 12 Marks)

7. An employee working for a company in US was posted to India on deputation to work for the subsidiary of the foreign parent company. During the previous year he was fully residing in India and performing his services. He was paid salary in India by the Indian subsidiary and was also paid a fixed monthly sum by the foreign parent. Income tax authority claims that the sum paid by the foreign employer is also subject to tax in India. However the assessee claims that the payment is outside the jurisdiction of Indian Authorities and hence not taxable. Discuss

(6 Marks)

8. A Partnership firm, consisting of three partners A, B and C was engaged in the business of Civil Construction and received the following amounts by way of contract receipts:

	Rs.
Contract work for supply of labour	30, 00,000
Value of materials supplied by Government	<u>8, 00,000</u>
Total value of contract	38, 00,000

Each partner of the firm was entitled to draw Rs. 2, 500 by way of salary as authorized by the terms of the partnership deed. Interest of Rs. 1, 00,000 was also paid to partner C on the capital of Rs. 5, 00,000 contributed by him. The profit as per books of accounts before deduction of salary to partners and interest to partner C amounted to Rs. 2, 50,000. Compute the total income of the firm, applying the provisions of Sec. 44AD

(6 Marks)

9. Lufthansa airlines incorporated as a company in Australia operates its flights to India and vice versa during the year 2008-09 (April 2008 to March 2009) and collects charges of Rs.30crores for carriage of passengers and cargo out of which Rs.20crores were received in US dollars for the passenger fare booked from Sydney to Mumbai. The total expenses for the year on operation of such flights were Rs.18crores. Compute the income chargeable to tax of the foreign airlines.

(5 Marks)

**PRIME ACADEMY**  
**31ST SESSION PROGRESS TEST – DIRECT TAX LAWS**  
**SUGGESTED ANSWERS**

1. - In this case, the sale price to Indian Subsidiary – A Ltd is \$ 50 while sale to an unrelated party happens at \$ 80.
- In the absence of information pertaining to the variation in the nature of the transactions between the subsidiary and that of the un relate entity- it is assumed that both happen on similar terms of payment.
- In this case, arm's length price shall be the price at which the transaction is being executed with an unrelated concern ie \$ 80 per cartridge.
- However no adjustment shall be made since such adjustment would only lead to increase in expenditure and decrease in taxable income.

2.

Situation	Particulars	Arm's Length Price	Transfer Price	Pre Amendment	Post Amendment	
1	Income	Rs 500000	Rs 600000	6000000	6000000	
2	Expenditure	Rs 450000	Rs 465000	465000	465000	(Note 1)
3	Income	Rs 350000	Rs 330000	332500	350000	(Note 2)
4	Expenditure	Rs 100000	Rs 115000	95000	100000	(Note 3)
Note 1	Particulars	Pre Amendment (Range based on ALP)	Post Amendment (Range Based on Transfer Price)			
	Arm's Length Price	450000	450000			
	Transfer Price	465000	465000			
	Range : Minimum (-5%)	427500	441750			
	Range : Maximum(+5%)	472500	488250			
	Arm's Length Price	465000	465000			
Note 2	Particulars	Pre Amendment (Range based on ALP)	Post Amendment (Range Based on Transfer Price)			
	Arm's Length Price	350000	350000			
	Transfer Price	330000	330000			
	Range : Minimum (-5%)	332500	313500			
	Range : Maximum(+5%)	367500	346500			
	Arm's Length Price	332500	350000			
	Transfer Pricing Adjustment	2500	20000			
Note 3	Particulars	Pre Amendment (Range based on ALP)	Post Amendment (Range Based on Transfer Price)			
	Arm's Length Price	100000	100000			
	Transfer Price	115000	115000			
	Range : Minimum (-5%)	95000	109250			
	Range : Maximum(+5%)	105000	120750			
	Arm's Length Price	95000	100000			
	Transfer Pricing Adjustment	10000	-15000			

3. 1. **Associated Enterprises - Sec 92A:** According to Sec 92A(1), the term associated enterprise with respect to another enterprise means:
- An enterprise which participates *directly or indirectly* or through one or more intermediaries in:
    - a) Management of the other enterprise or
    - b) Control of the other enterprise or
    - c) Capital of the other enterprise.
  
  - An enterprise in respect of which one or more persons participate *directly or indirectly* or through one or more intermediaries in management, control or capital, are the same persons who participate, *directly or indirectly* or through one or more intermediaries in management, control or capital of the other enterprise.

**Situations where two or more enterprises shall be associated enterprises- Sec 92A(2).**

Sec 92A(1) gives a broad indicator as to when two or more enterprises can be associated enterprises however the section does not clearly explain the situations when control, management or capital is said to be established. This section provides a list of 13 situations during which the relationship is said to have been established:

- **Enterprise Ownership (1):** Any enterprise having *direct or indirect ownership* in shares having *not less than 26%* in voting power. (since the term voting power is used, preference share holders are not covered)
  
- **Mutual Holding (2):** Any person, having *direct or indirect ownership* in shares having *not less than 26%* in voting power, in two or more enterprises – such enterprises shall be deemed to be associated enterprises.
  
- **Substantial Lender (3):** Where the loan advanced by an enterprise constitutes *not less than 51%* of the *book value of the assets* of the borrower, the lender and borrower shall be deemed to associated enterprises.
  
- **Guarantor for Borrowings (4):** Where one enterprise guarantees *not less than 10%* of the *total borrowings* of the enterprise, both the enterprises shall be deemed to be associated enterprises.
  
- **Appointment of Board (5):** Two enterprises shall be considered as associated enterprise if one enterprise has the following powers with respect to the other enterprise:
  - a) Appoint *more than half of the Board of Directors* or members of the governing board or
  - b) *One or more executive directors* or executive members of the governing board
  
- **Appointment of Board in two or more entities (6):** Where a person has the following powers with respect to two or more enterprises, such enterprises shall be considered as associated enterprises:
  - a) *Appoint more than half of the Board of Directors* or members of the governing board or
  - b) *One or more executive directors* or executive members of the governing board
  
- **Dependency on Intangibles(7):** Where:
  - a) One enterprise is engaged in manufacturing or processing of goods or articles or any other business
  - b) The business of such enterprise is wholly dependant on the use of intangible asset/s like patents, copyrights etc
  - c) Such intangible asset is owned by another enterprise or the other enterprise has exclusive right to use or exploit the intangible asset.
  
- **Supply Dependency (8):** Two enterprises shall be considered as associated enterprises where one enterprise is engaged in manufacturing or processing of goods /articles and *atleast 90%* of *the raw materials or consumables*:
  - a) Are supplied by the other enterprise or
  - b) Are supplied by persons specified by the other enterprise

**AND**

  - c) Prices and other conditions of supply are specified by the other enterprise

- **Sale Dependency (9):** Two enterprises shall be considered as associated enterprises where one enterprise is engaged in manufacturing or processing of goods /articles and such goods/ articles:
  - a) Are sold to the other enterprise or
  - b) Are sold to persons specified by the other enterprise
  - AND**
  - c) Prices and other conditions of sale are specified by the other enterprise
- **Individual – Control (10):** Where one enterprise is controlled by an individual any other enterprise controlled by the individual or his relatives shall be considered as an associated enterprise.

“Control” means that an *individual, either himself or along with his relatives* has the power to *make major decisions* regarding the management of both the enterprises.

“Relative u/s 2(41)” means spouse, brother, sister or any lineal ascendant or descendant of that individual.

- **HUF- Control (11):** Two enterprises shall be considered as associated enterprise where one enterprise is controlled by a HUF and the other enterprise is controlled by:
  - a) A Member of such HUF or
  - b) A relative of a member of such HUF or
  - c) Jointly by a member and his relative
- **Minority holding in a Firm, AOP or BOI (12):** Where an enterprise holds **not less than 10%** interest in a firm, AoP or Bol, such enterprise shall be considered as an associated enterprise.
- **Mutual Relationship (13):** Where there exists a mutual relationship, as may be prescribed, between two enterprises, such enterprises shall be considered as associated enterprises. So far no such relationship has been prescribed.

**Note:**

- For the purpose of clause 1 and 2, terms used are “directly or indirectly”. However for the purpose of all other clauses, only direct relationships considered.

2. Income deemed to accrue or arise in India:

Nature of Income	Condition
Business Income	When there is business connection in India (Please refer to the definition of the term Business Connection- discussed below)
Property income	Property or asset source is in India
Income from transfer of a capital asset	When the capital asset is in India
Income from Salaries	Where services are rendered in India
	Indian citizen, working for the Government of India and rendering services outside India
Dividend Income	Dividend payable/paid by an Indian Company
Interest, Royalty and Fees for Technical Services	If the income is received from: <ul style="list-style-type: none"> <li>- Government of India</li> <li>- A resident assessee except where such payment is for business outside India</li> <li>- A non resident assessee where the payment pertains to business in India</li> </ul>

3. Deduction in respect of Specified Businesses – 35AD:

- **Eligible Assessee:**
  - o Any assessee engaged in a "Specified Business" is eligible for deduction under this section.
  - o Specified business means any one or more of the following namely:
    - Setting up and operating a cold chain facility;
    - Setting up and operating a warehousing facility for storage of agricultural produce;
    - Laying and operating a cross-country natural gas or crude or petroleum oil pipeline network for distribution, including storage facilities being an integral part of such network
  
- **Year of Commencement of Business:** The provisions of this section shall apply to the specified business if it commences its operations,—
  - a. On or after the 1st day of April, 2007, where the specified business is in the nature of laying and operating a cross-country natural gas pipeline network for distribution, including storage facilities being an integral part of such network; and
  - b. On or after the 1st day of April, 2009, in all other cases not falling under clause (a).

The assessee carrying on the business of the nature referred to in clause (a) above shall be allowed, a deduction in the previous year 2010-11, of an amount in respect of expenditure of capital nature incurred during any earlier previous year, if—

- o The business referred to in clause (a) of sub-section (5) has commenced its operation at any time during the period beginning on or after the 1st day of April, 2007 and ending on the 31st day of March, 2009; and
  - o No deduction for such amount has been allowed or is allowable to the assessee in any earlier previous year
- 
- **Year of Deduction:**
    - o **In case of Expenses after to commencement of operations:** In the previous year in which such expenditure is incurred.
    - o **In case of Expenses prior to commencement of operations:** Expenditure incurred, wholly and exclusively, for the purposes of any specified business, shall be allowed as deduction during the previous year in which he commences operations of his specified business, if:
      - The expenditure is incurred prior to the commencement of its operations; and
      - The amount is capitalised in the books of account of the assessee on the date of commencement of its operations.

***Any expenditure of capital nature shall not include any expenditure incurred on the acquisition of any land or goodwill or financial instrument***

- **Deduction:**
  - o 100% of capital expenditure incurred wholly and exclusively for the specified business
  
- **Additional Conditions:** The specified business must fulfill the following conditions:
  - o It is not set up by splitting up, or the reconstruction, of a business already in existence
  - o It is not set up by the transfer to the specified business of machinery or plant previously used for any purpose. However upto 20% of the total value of plant and machinery can comprise of used machinery and this shall not be construed as a violation of this provision.
  - o Any machinery or plant which was used outside India by any person other than the assessee shall not be regarded as machinery or plant previously used for any purpose, if—
    - i. Such machinery or plant was not, at any time prior to the date of the installation by the assessee, used in India;
    - ii. Such machinery or plant is imported into India from any country outside India; and
    - iii. No deduction on account of depreciation in respect of such machinery or plant has been allowed or is allowable under the provisions of this Act in computing the total income of any person for any period prior to the date of the installation of the machinery or plant by the assessee;

- In the case of assessee engaged in laying and operating a cross-country natural gas or crude or petroleum oil pipeline network for distribution, including storage facilities being an integral part of such network:
  - It is owned by an Indian company or a consortium of Indian companies or by an authority or a board or a corporation established or constituted under any Central or State Act
  - It has been approved by the Petroleum and Natural Gas Regulatory Board and notified by the Central Government in the Official Gazette in this behalf
  - It has made not less than one-third of its total pipeline capacity available for use on common carrier basis by any person other than the assessee or an *associated person*.
  - It fulfills any other condition as may be prescribed
- **Miscellaneous Provisions:**
  - The assessee shall not be allowed any deduction in respect of the specified business under the provisions of Chapter VIA under the heading "C.— *Deductions in respect of certain incomes (Sec 80IA, IB etc)*
  - No deduction in respect of the expenditure referred to in this section shall be allowed to the assessee under any other section in any previous year or under this section in any other previous year.
- **Definitions:**
  - (a) an "associated person", in relation to the assessee, means a person,—
    - i. who participates, directly or indirectly, or through one or more intermediaries in the management or control or capital of the assessee;
    - ii. who holds, directly or indirectly, shares carrying not less than twenty-six per cent of the voting power in the capital of the assessee;
    - iii. who appoints more than half of the Board of directors or members of the governing board, or one or more executive directors or executive members of the governing board of the assessee; or
    - iv. who guarantees not less than ten per cent of the total borrowings of the assessee;
  - (b) "cold chain facility" means a chain of facilities for storage or transportation of agricultural and forest produce, meat and meat products, poultry, marine and dairy products, products of horticulture, floriculture and apiculture and processed food items under scientifically controlled conditions including refrigeration and other facilities necessary for the preservation of such produce;

4. No, we do not agree with the company's contentions in respect of above points and our observation in this regard is as under :

- (a) According to section 41(1), where any allowance or deduction has been made in the assessment of any year in respect of loss, expenditure or trading liability and, subsequently, during any previous year, any amount is received by the assessee, whether in cash or in any other manner whatsoever, in respect of such loss or expenditure or some benefits in respect of trading liability by way of remission or cessation thereof, the amount obtained by him or by virtue of benefit accruing to him is chargeable to tax as business income.

Further by Explanation to section 41(1), it has been provided that the expression "loss or expenditure or some benefit in respect of any such trading liability by way or remission or cessation thereof", shall be defined to include the remission or cessation of any liability by any unilateral act of the assessee by way of writing off such liability in his accounts.

In, the present problem, unclaimed wages for the years 2003 to 2005 have been credited to the profit and loss account, amounts to unilateral remission of the liability and, accordingly, Rs.450000 shall be taxable as business income under section 41(1).

- (b) This problem is based on the case decided by Bombay High Court in CIT v Batilboi & Co (Pvt) Ltd. (1984) 149 ITR 604 where it was held that surplus arising from advance deposits received from intending purchasers against supplies to be made and transferred to profit and loss accounts would be assessable as income. Hence, Rs.310000 credited to profits and loss remaining unclaimed shall be taxable as income.
- (c) This problem is based on a case decided by Supreme Court in CIT v T.V Sundaram Iyengar and sons Ltd. (1996) 222 ITR 344 where it was held that if an amount is received in the course of a trading transaction, even though it is not taxable in the year of receipt as being of revenue character, the amount changes character when the amount becomes the assessee's own money because of limitation or by any other statutory or contractual right. When such a thing happens common sense demands that the amount should be treated as income of the assessee. Hence Rs.325000 shall be taxable.
- (d) This problem is based on a decision of the Supreme Court in CIT v Thirumalaiswamy Naidu & sons (1998) 230 ITR 534 in which the court held that where a deduction has been availed of in respect of sales tax liability or payment and later the same was refunded back to the assessee, the refund will have the character of revenue receipt and the same would be eligible to tax by virtue of the express provisions of section 41(1). No doubt, if the assessee returns any portion of the amount of such refund to its customers, the assessee will be entitled to claim deduction as and when such return/refund is made to the customers.  
Hence it shall be taxable.

5.

Situation	Type of Income	Residential Status
Mr. Michael Schumacher received a sum of USD 500,000 from Ferrari India for endorsing their brand in India. Payment for the endorsement was made in Germany.	Income deemed to accrue and arise in India but received outside India	Non resident
Mr. Sanjay Nayar is working for CITIBANK India. During the year, he was posted to Singapore on deputation for a period of 6 months. Salary for the period was remitted in India while he was receiving allowance for his stay abroad.	Income earned outside India but received in India	Resident and Ordinary resident
Mr. Gary Kirsten, citizen of South Africa, works for the Indian cricket team. He receives salary for his work with the Indian cricket team and travels across the globe with the team	Income deemed to accrue and arise in India and received in India	Resident and not ordinary resident Or Non resident
Mr. Mallaya has a huge resort in Goa which has been let out to UniLever Plc UK on a monthly rent of Rs 10 lacs. The sum is being credited in equivalent pounds every month in his Swiss bank account	Income deemed to accrue and arise in India but received outside India	Resident and ordinary resident

6. **Application of Trust Income:** For the purposes of exemption u/s 11 and 12, income should be applied during the previous year for charitable or religious purposes. The term applied shall include:

- Income actually applied during the previous year for charitable or religious purposes or
- Income deemed to have been applied during the previous year for charitable or religious purposes

## **Income deemed to have been applied during the previous year for charitable or religious purposes – Clause 2 of Explanation to Sec 11(1)**

Where the income applied for charitable or religious purposes falls short of 85% of the income derived during the previous year either:

- a. For the reason that whole or part of the income has not been received during the previous year or
- b. For any other reason,

the trust has been given an option to spend such income for charitable or religious purposes in the following manner:

- In case of (a) above: during the previous year in which such income is received or in the immediately succeeding previous year. For example if income of the previous year 08-09 is received on 05-06.10, the amount can be applied during the previous year 10-11 or in the succeeding previous year 11-12.
- In case of (b) above: during the immediately succeeding previous year. For example if income is received on 30.03.09, the amount can be applied during the previous year 09-10.

To avail the facility of the above extended period of application of income, the trust has to exercise an option in writing before the time limit for furnishing return of income u/s 139(1).

### **Consequences where income is not applied within the extended period allowed – Sec 11(1B):**

- In case of (a) above : It shall be treated as income of the previous year immediately succeeding the year of receipt ie previous year 2011-12 in our example above.

In case of (b) above : It shall be treated as income of the previous year immediately succeeding the year in which income has been derived ie 09-10 in our example above.

### **Accumulation in excess of 15% of the Income earned – Sec 11(2):**

- An assessee is allowed to accumulate up to 15% of the income earned during the previous year
- Accumulation in excess of 15% is possible subject to the following conditions:
  - Assessee shall give a notice in writing in the prescribed Form to the Assessing officer specifying the purpose and period of accumulation
  - The period of accumulation shall not exceed 5 years
  - The amount accumulated is deposited in the form or mode specified u/s 11(5)
  - The accumulation of income must be for the objects of the trust.

### **Treatment of Donations in Kind – Circular No 580 dated 14-09-1990:**

- Donation received in kind by a trust or institution shall be considered as its income u/s 2(24)
- Where these are used for the purpose of the trust or institution, it shall be considered as application of income
- Where such donations could not be used as above, they should be converted into specified modes u/s 11(5) before the expiry of one year from the end of the year in which these were acquired.

### **Taxation of Anonymous Donations – Sec 115BBC (w.e.f assessment year 07-08): Anonymous donations received by any:**

- Trust or institution referred u/s 11
- University or educational institution u/s 10(23C)(iiiad) and (vi)
- Hospital u/s 10(23C)(iii ae) and (via)
- Fund or institution u/s 10(23C)(iv)
- Fund or institution u/s 10(23C)(v)

Shall be taxed at a flat rate of 30%. However the following anonymous donations are not covered u/s 115BBC:

- Donations received by any trust or institution created *wholly for religious purposes*
- Donations received by any trust or institution created for *both religious and charitable purposes* other than anonymous donations made with a specific direction that such donation is for any university or other educational institution or any hospital or medical institution run by such trust or institution.

Anonymous Donations mean any voluntary contribution where the person receiving such contribution does not maintain a record consisting of the identity of the person making such contribution indicating the name, address and such other particulars as may be prescribed.

### Charitable Purpose

According to Sec 2(15), the term charitable or religious purpose includes:

- Relief to poor
- Education
- Medical relief
- Any other object of general public utility

Amendment by Finance Act 2008: In order to limit the scope of the definition u/s 2(15), it is provided that the term any other object of general public utility shall not be a charitable purpose if it involves carrying on of:

- An activity in the nature of trade, commerce or business or
- An activity of rendering of any service in relation to any trade, commerce or business

for a fees or cess or any other consideration, irrespective of the nature of use or application of the income from such activity, or the retention of such income by the concerned entity.

7. Where an employee is working in India and is also receiving salary from his home country abroad from a group concern, the Indian employer is duty bound to consider home salary for the purpose of TDS u/s 192 in India- *Supreme Court in Eli Lilly and Co. (India) P. Ltd. (2009) 312 ITR 225*  
Therefore in the present case, the claim of the assessee is not tenable.

8.

		Rs
	Gross Receipts for the purpose of Sec 44AD	3000000
	8% of gross receipts	240000
	Taxable Income u/s 44AD before interest and salary	240000
Less:	Interest to Partners (Partner C @ 12% on Rs 5 lacs)	60000
	Book Profit	180000
Less:	Remuneration to partners u/s 40b (90% of Book Profits or 2500*3*12 whichever is less)	90000
	Taxable profit	90000
Note:	Value of materials supplied by the Government shall not be included in Turnover	

9. As per sec 44BBA, in case of Airlines the income is presumed to be 5% of the following:
- i. The amount paid or payable (whether in or out of India) to the assessee or any person on his behalf on account of the carriage of passengers, livestock, mail or goods from any place in India, and
  - ii. The amount received or deemed to be received in India by or on behalf of the assessee on account of the carriage of passengers, livestock, mail or goods from any place outside India.

Hence the taxable income will be determined as under:

	Passenger fare booked from Mumbai to Sydney whether paid in India or not Rs.	Passenger fare booked from Sydney to Mumbai if received in India Rs.
Fare	10, 00, 000	20, 00, 000
Taxable income	50, 000	1, 00, 000

**Note:** if the passenger fare booked from Sydney to Mumbai is not received in India, then such fare shall not be included for calculating presumptive income.

**PRIME ACADEMY**  
**31ST SESSION PROGRESS TEST – INDIRECT TAXES**

No. of Pages: 1

Total Marks: 75  
Time Allowed: 2Hrs  
10 x 2.5 = 25 Marks

**PART A**

- (1) At the time of manufacture of product X attracts 14% BED. At the time of removal the rate of duty is 8%. Which is the duty attracts for the product X
  - (a) 14%
  - (b) 8%
  - (c) 11% (Average)
  - (d) Zero (Because the rate has changed)
  
- (2) Purchase of CKD components from supplier and installation of the same in client's premises amounts to manufacture- Explain.
  
- (3) Discuss the duty liability on  
Processing of cashewnuts, peanuts, pista and almonds and packing and clearance under brand name.
  
- (4) Repair and Maintenance Charges: Assessee are entitled to deductions for repair & maintenance and rental charges for PMX machine from the assessable value.
  
- (5) A manufacturer purchased inputs from supplier 'ABC Co.'. The invoice was for Rs.11,000, comprising of price of goods as Rs.10,000 and Rs.1,000 as excise duty, which is available as Cenvat credit to the manufacturer. Pass journal entry for the purchase of goods.
  
- (6) Goods covered by Central Excise Tariff but fully exempt from duty are -----(excisable/not excisable)
  
- (7) Determination of annual production capacity for Duty based on production capacity.
  
- (8) Compulsory after sales service and service in warranty period whether to be included as a part of the "Transaction Value" under section 4 of central Excise Act.
  
- (9) Treatment of Equalised freight.
  
- (10) State true or false:-  
In case of CIF contract , the assessee will be entitled to deduction of outward insurance and freight while calculating assessable value.

## PART – B

- 1) (a) How will you deal with the following items in the course of arriving at assessable value:
- (i) Packing charges
  - (ii) Taxes & duties
  - (iii) Moulds & dies supplied by customer
  - (iv) Interest on delayed payments
- (4 x 1=4 Marks)
- (b) "There are different methods of Valuation for different goods" – examine the correctness of the statement with reasons. (4 Marks)
- c) "Money value of any additional consideration flowing directly or indirectly from the buyer to the assessee should be included in the assessable value" – Explain (2 Marks)
- 2) Info Dynamics Private Limited imported Hard disks Loaded with computer software. The price paid for six such hard disks was approximately Rs.68 lacs while the value of the hard disk simplicitor would be roughly Rs.60000/-. Customs duty on hard disk is leviable under chapter heading 84.71 at higher rate and on computer software under chapter heading 85.24 at lower rate. The Assessing Officer has asked to pay duty at higher rate, saying the goods imported as "hard disks". As a consultant, advise about the appropriate classification of the imported goods and the rate of duty applicable on it. (Higher/Lower). (10 Marks)
- 3) 1500 Pieces of product A were manufactured during the Financial year. Its List price (i.e retail price) is Rs.250 per piece, exclusive of taxes. The manufacturer offers 20% discount to wholesalers on the list price. During the year, 840 pieces were sold in wholesale, 510 pieces were sold in retail, and 35 pieces were distributed as free samples. Balance quantity of 115 pieces was in stock at the end of the year. The rate of duty payable is 8% plus education cess and secondary and Higher education cesses as may be applicable. What is the total duty paid during the Financial Year? Assume that the manufacturer is not eligible for SSI concession. (10 Marks)
- 4) (a) The selling price of a product, inclusive of excise duty and sales tax is Rs.300 per piece. Sales tax rate is 4%. Tariff rate of excise is 8% .Education cesses as applicable. What is Assessable Value, and, what is the duty payable per piece?
- (b) The selling price of a product, inclusive of basic excise excise duty @8% and education cess is Rs.1500. What is the Assessable value and duty payable per piece? (10 Marks)
- 5) ABC Limited wanted a stainless steel tank for their manufacturing process. Since the tank was huge size, they decided to fabricate the same in their own factory to save problems of transportation. The contract of fabrication was given to XYZ Limited who are experts in specialized steel tank designing, manufacturing and welding. The tank was fabricated at site designed by XYZ Limited. Stainless steel sheets required for manufacture of tank were supplied by ABC Limited. The Tank was affixed to ground with bolts but could be removed without dismantling. No excise duty was paid on the tank.
- Excise department wants to issue show cause notice demanding duty. Whether duty is payable? If duty is found to be payable, whether demand notice should be issued to ABC Limited or XYZ Limited? (10 Marks)

**PRIME ACADEMY**  
**31ST SESSION PROGRESS TEST – INDIRECT TAXES**  
**SUGGESTED ANSWERS**

**PART A**

- 1) B
- 2) The Purchase of CKD components from supplier and installation of same in the client's place does not amount to manufacture And thus no levy was attracted. CCE Vs Blow plast Limited 2009 236 ELT (631) Del.
- 3) Processing of cashew nuts, peanuts, almonds, pista and packing and clearance under brand name are activities amounting to manufacture and liable to excise duty. SKB Dry fruits Marketing company Private limited 2008 (224) ELT 339(SC).
- 4) Assesseees are entitled to deductions for repair & maintenance and rental charges for PMX machine from the assessable value. Dhillion Cool Drinks & Bevarages 2009 238 ELT A26 SC.
- 5) 

Purchase A/c	Dr	Rs.10000	
Cenvat Credit Receivable A/c (input goods)	Dr	Rs. 1000	
To Sundry Creditors A/c		Rs. 11000	

(Being input Goods purchased from ABC Co).
- 6) Excisable
- 7) The Annual capacity fixed will be deemed to be annual production of such goods from the Factory. If factory is not working for part of the year, annual production will be calculated on proportionate basis. If factors determining capacity are changed during the year, annual capacity will be re-determined.[ Section 3A (2) (ii)].
- 8) The Heads "servicing" and "warranty" have been specifically included in definition of payments includible in "transaction value".\

Department, in its circular No 354/81/2000-TRU dated 30-6-2000 has clarified that warranty charges will be includible whether they are optional or compulsory.- reiterated in chapter 3 Part III Para 2.5(i) of CBE& C's CE Manual,2001.

- 9) Sometimes, manufacturers fix uniform all India price of the goods. The actual cost of transport will actually vary from place to place. In such case, though the Invoice shows the uniform price, deduction will be available on the basis of average freight i.e. equalised freight (Till 28.2.2003, deduction on account of equalized freight was not permissible).

The deduction is allowable only if there is "sale" at Factory gate i.e. factory is "place of removal" even if seller has agreed to bear freight charges.

The provision of equalized freight applies only when there is sale from factory. If sale is from depot, freight from factory to depot is not allowable as deduction.

ICWAI has issued Cost Accounting standard CAS 5 for determination of Average (equalized) cost of Transportation on 21.07.2005.

- 10) It is possible that contract is ex-destination or FOR destination and price quoted by assessee is inclusive of transport charges upto destination. This does not necessarily mean that there is 'no sale' at the Factory gate. Even in such cases, 'factory' can be place of removal if factory in goods passes to buyer at factory gate.

In Such case 'place of delivery' will be destination but 'place of removal' will be factory gate as 'sale' takes place at factory gate and transporter acts as agent of buyer.

## PART - B

### 1) (a)

#### (i) Packing charges

Packing charges shall form part of the assessable value as it is a charge in connection with production and sale of the goods, recovered from the buyer irrespective of the nature of packing i.e. primary or secondary. In the case of reusable containers (glass bottles, crates etc.), normally the cost is amortized and included in the cost of the product itself. Therefore, the same is not required to be included in the value of the product unless it is found that the cost of reusable container has not been amortised and included in the value of the product.

#### (ii) Taxes & duties

The definition of transaction value mentions that whatever amount is actually paid or actually payable to the Government or the relevant statutory authority by way of excise, sales tax and other taxes, such amount shall be excluded from the transaction value. If any excise duty or other tax is paid at a concessional rate for a particular transaction, the amount of excise duty or tax actually paid at the concessional rate shall only be allowed to be deducted from price.

#### (iii) Moulds & dies supplied by customer

Rule 6 of the Valuation rules provide that where goods given by the buyer free of cost or at concessional price, the value of such goods or the concession so received may be added or apportioned and should be included in the value of finished goods. If moulds & dies are supplied by buyer, price charged for goods is not the 'sole consideration'. In such cases, proportionate cost of such moulds & dies should be added to 'transaction value' to arrive at 'assessable Value'. Cost of moulds and dies supplied by buyer should be amortised over the life span of moulds and dies.

#### (iv) Interest on delayed payments

Where the manufacturer recovers **interest** from buyer, if he does not make payment as per agreed terms, the interest on such delayed payments will not be includible since the payment is by reason of late payment and not by reason of sale. However, the interest should be clearly distinguished from the price, the financing arrangement should be made in writing.

(b) Value of the excisable goods has to be necessarily determined when the rate of duty is on ad-valorem basis. Accordingly, under the Central Excise Act, 1944 the following values are relevant for assessment of duty. Transaction value is the most commonly adopted method.

- Transaction value under Section 4.
- Value determined on basis of maximum Retail Sale Price as per Section 4A, if applicable to a given commodity.
- Tariff value under Section 3, if applicable

The essential conditions for application of a Transaction value are:

- (a) The goods are sold by an assessee for delivery at the time of place of removal. The term "place of removal" has been defined basically to mean a factory or a warehouse, and will include a depot, premises of a consignment agent or any other place or premises from where the excisable goods are to be sold after their clearances from the factory
- (b) The assessee and the buyer of the goods are not related; and
- (c) The price is the sole consideration for the sale.

For certain items the Government may fix a tariff value as per provisions of Section 3(2) of the Central Excise Act, 1944. In such cases the assessment of duty shall be on the basis of the tariff value. Tariff Value has been fixed for Pan Masala in retail packages of certain quantities.

Value is based on maximum retail sale price in terms of Section 4A of the Central Excise Act, 1944 in respect of notified commodities. The notification issued in this regard indicates the extent of abatement to be allowed for arriving at the assessable value for determination of amount of duty. Eg. Drugs, chocolates, biscuits etc

(c) In cases where price is not the sole consideration for the sale, but the other requirements of clause (a) of sub-section (1) of section 4 of the Central Excise Act are satisfied, the value shall be determined in accordance with the provisions of Rule 6 of the valuation rules. This provides for adding to the transaction value the money value of any additional consideration flowing directly or indirectly from the buyer to the assessee. Such additional consideration would include the money value of goods and services provided free or at reduced cost by or on behalf of the buyer to the assessee. The 'goods and services' whose value is to be added to the value includes materials including packing materials, components, moulds, tools, dies, drawings, engineering, development, art work, plans and sketches etc.

However, where an assessee receives any advance payment from the buyer against delivery of any excisable goods, no notional interest on such advances will be added to value unless it is evidenced that the advance has influenced the fixation of sale price by way of charging a lesser price from or offering a special discount to the buyer who has made the advance deposit. An Explanation has been added in the rule from 1.3.2003 only to remove any doubts with respect to its scope.

- 2) It has been clarified that (even after amendment of chapter note 6 to chapter 85 w.e.f(1.1.2002) software /records/ tapes etc supplied along with equipment/apparatus for which it is imported will be classifiable as software. However, software/record/tapes etc supplied along with product for which it is not intended (eg along with book), classification will be as per rule 3 (b) ie on basis of item which gives essential character.- CBEC&C circular No.51/2002 –cus dated 12-8-2002. Note that software imports are exempt from customs duty.

In Sprint RPG India v CC 2000 AIR SCW 290=116 ELT 6 (SC) , computer software loaded on hard disk drive was imported. Value of Hard disk was Rs.65000 while cost of computer software was Rs. 67 lacs. It was held that the Computer software gives its essential character. The Hard disk is only a container. Hence, the goods will be classified as "Software".

In Technova Imaging systems V CCE 2003(151) ELT 404 (CEGAT), it was held that value of software supplied with machine is not included in the value of machine. The software should be classified in 85.24.

Book with CD and Software with Manual:

Sometimes, a floppy is attached to a book. Such diskette is supplementary or accessory to the book , which either explains the content of the book or supplies some freeware or some tutorials. On the other hand, a manual is supplied along with the software. The manual gives instructions as to how to use the software. In the former case, the "essential character" of the goods is "book", while in the later case, the "essential character " is "software". Hence, the goods will be classified according to "essential character" as per Rule 3(b)- CBE&C circular no 528/106/93-CUS(TU) dt 24.08.1993.

- 3) The total selling price is as follows-

Qty	Price Rs	Total Rs
510	250	1,27,500
840	200	1,68,000
35	200	7,000
	Total	3,02,500

Duty payable is 8% of Rs.24,200, plus education cess @3% i.e. Rs.726.

Note

- a) Since 115 pieces were in stock at year end, no duty will be payable. Duty will be payable only when goods are cleared from factory.
- b) In case of samples, as per rule 4 of valuation rules, value nearest at the time of removal, subject to reasonable adjustments is required to be taken. However since prices are varying, value nearest to the time of removal will not be ascertainable and will not be acceptable for valuation as prices are changing. In such case, recourse will be taken to Rule 11 of Valuation rules, ie the Best judgment Assessment. We can take recourse to rules 7 and 9 where principle of Normal transaction value is accepted when prices are varying. As per Rule 2 (B) of Valuation rules, 'normal Transaction Value' means the transaction value at which the greatest aggregate quantity of goods is sold. Since greatest quantity of 840 pieces are sold at Rs.200, that will be the 'normal Transaction Value' which will be taken for valuation for free samples.

- 4) a) Assume that Assessable Value (AV) is equal to "Z".
- |   |                 |
|---|-----------------|
| Duty @8.24%                                   | = 0.0824 Z      |
| Sub Total                                     | = 1.0824 Z      |
| Add: Sales Tax @ 4%                           | = 0.0433 Z      |
| Total Price (inclusive of Duty and Sales tax) | = 1.1257 Z      |
| Now, 1.1257 Z                                 | = Rs.300        |
| Hence, "Z"                                    | = Rs.300/1.1257 |
| Z   | = Rs.266.50     |
- b) Assume that Assessable Value (AV) is equal to "Z".
- |               |                  |
|---------------|------------------|
| Duty @8.24%   | = 0.0824 Z       |
| Sub Total     | = 1.0824 Z       |
| Now, 1.0824 Z | = Rs.1500        |
| Hence, Z      | = Rs.1500/1.0824 |
| Z             | = Rs.1385.80     |

- 5) Raw Material supplier will not be manufacturer even when fabrication is carried out in the premises of raw material supplier, if relationship between the fabricator (of tanks) and raw material supplier is on principal to principal basis and raw material supplier has no control over the manufacturing process or job worker –Mohan Breweries V CCE 1999(111) ELT 72(CEGAT) . The raw material supplier is not manufacturer even if he has provided space within factory to independent contractor and inspection of final product is carried out before taking delivery. Fort Gloster Industries V CCE 2001 (134) ELT (CEGAT)

Sub contractor is manufacturer if relation is on principal to principal basis, even when job work is done at site- Dempo Engg Services V CCE 2000(117) ELT 328(CEGAT) . Voltas Limited V CCE 2002 (139) ELT 223 (CEGAT). Voltas Limited V CCE 2002(144) ELT 108(CEGAT)