CA INTERMEDIATE

VIVITSU

PAPER 1

Advanced Accounting Reviewer

Chapter-wise compilation
RTP, MTP and PYP questions

KEY HIGHLIGHTS

- Easy to Hard Difficulty Level
- Importance levels marked as A, B or C
- Reference to all questions
- Quick recap of important concepts
- Exam Insights
- Last Day Revision Questions Marked

APPLICABLE FOR MAY'25, SEPT'25 AND JAN'26

ADVANCED ACCOUNTING

REVIEWER

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STRIVING TOWARDS KNOWLEDGE

Wavelength Educom Private Limited

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VIVITSU

STRIVING TOWARDS KNOWLEDGE

This book belongs to future,

CA Finalist ________________________________

"You become what you believe."

-Oprah Winfrey

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YOU MUST BE WONDERING

How to Read this book?

Step 1
Prioritize more time for 'A' chapters in the ABC analysis

Step 2
Identify key concepts in each chapter.

Step 3
Solve questions in order, from easy to difficult.

Step 4
Focus on solving LDR questions during the final revision

01 02 03 04

Step 1: Prioritize your chapters

Chapters in the index are categorized as A, B, or C based on their importance. Focus more on 'A' chapters, as they carry the most weight, and give adequate attention to 'B' chapters. While all chapters must be covered, this approach helps manage time efficiently for better results.

Step 2: Identify key concept

Identify the key concepts for each chapter using the list provided at the start of the chapter. Ensure you understand them thoroughly. If you struggle with a question, revisit the concepts, review them, and strengthen your understanding before moving forward.

Step 3: Start easy

Start with Question 1, as they progress from easy to difficult, helping you build confidence throughout the chapter. Pay close attention to the “EXAM INSIGHTS” to avoid common mistakes. Questions are segregated topic wise where possible.

LDR

Step 4: Last Day Revision (LDR)

Focus on solving LDR questions during the final revision. In the 1.5 days before the exam, prioritize these questions as they cover the most critical concepts from each chapter. You'll find a quick summary of LDR question numbers listed right before each chapter for easy reference.

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ABC Analysis

A Very Important, Read on priority

B Moderately Important

C Less critical but still essential

Ensure you thoroughly read all chapters without skipping any. The ABC analysis is designed to help you prioritize based on past trends, but it should not replace comprehensive preparation.

A

CHAPTER 5.2: AS–10 PROPERTY, PLANT AND EQUIPMENT

CONCEPTS OF THIS CHAPTER

- Definition of PPE
- Recognition Criteria for PPE
    - Initial Costs
    - Subsequent Costs
- Measurement at Recognition
    - Elements of Cost
    - Measurement of Cost
- Measurement after Recognition
    - Cost Model
    - Revaluation Model
- Depreciation
    - Depreciable Amount & Useful Life
    - Depreciation Method
- Retirement of PPE
- Derecognition of PPE
- Disclosure Requirements

LDR Questions
Q 20

QUICK REVIEW OF IMPORTANT CONCEPTS

The principal issues in Accounting for PPE are

• Recognition of PPE	• Determination of their carrying amounts
• Depreciation charge	• Impairment losses to be recognised in relation to them.

AS 10 (Revised) Not applicable to

- Biological Assets* (other than Bearer Plants) related to agricultural activity
- Wasting Assets including Mineral rights, Expenditure on the exploration for and extraction of minerals, oil, natural gas and similar non regenerative resources

PPE (Tangible Items)

Condition 1: Held for	• Use in Production or Supply of Goods or Services • For Rental to others • For Administrative purposes
Condition 2: Expected to be	• Used for more than 12 months

Other definitions

ical Asset	• Living Animal	• AS 10 (Revised) does not apply if definition of PPE not met
	• Plant	• AS 10 (Revised) applies to Bearer Plants

Bearer Plant: Is a plant that (satisfies all 3 conditions

• Is used in the production or supply	Of Agricultural produce
• Is expected to bear produce	For more than a period of 12 months

• Has a remote likelihood of being sold as Agricultural produce	Except for incidental scrap sales

Following are not "Bearer Plants"

• Plants cultivated to be harvested as Agricultural produce	Trees grown for use as lumber
• Plants cultivated to Produce Agricultural produce and Harvest and sell the plant as Agricultural produce	Trees which are cultivated both for their fruit and their lumber
• Annual Crops	Maize and wheat

Recognition Criteria for PPE

The cost of an item of PPE **should be recognised as an asset** if, and only if:

• It is probable that future economic benefits associated with the item will flow to the enterprise, and	• The cost of the item can be measured reliably

Notes:

- It may be appropriate to aggregate individually insignificant items, such as moulds, tools and dies and to apply the criteria to the aggregate value.
- An enterprise may decide to expense an item which could otherwise have been included as PPE, because the amount of the expenditure is not material.

Treatment of Spare Parts, Stand by Equipment and Servicing Equipment

• Case I If they meet the definition of PPE as per AS 10 (Revised):	Recognised as PPE as per AS 10 (Revised)
• Case II If they do not meet the definition of PPE as per AS 10 (Revised):	items are classified as Inventory as per AS 2 (Revised)

Treatment of Subsequent Costs

Cost of day-to-day servicing

- Costs of day-to-day servicing are primarily the costs of labour and consumables, and may include the cost of small parts. -e purpose of such expenditures is often described as for the 'Repairs and Maintenance' of the item of PPE
- An enterprise does not recognise in the carrying amount of an item of PPE the costs of the day-to-day servicing of the item. Rather, these costs are recognised in the Statement of Profit and Loss as incurred

Replacement of Parts of PPE

- Parts of some items of PPE may require replacement at regular intervals
- An enterprise recognises in the carrying amount of an item of PPE the cost of replacing part of such an item when that cost is incurred if the recognition criteria are met.

Notes: The carrying amount of those parts that are replaced is derecognised in accordance with the de-recognition provisions of this Standard.

Regular Major Inspections - Accounting Treatment

- When each major inspection is performed, its cost is recognised in the carrying amount of the item of PPE as a replacement, if the recognition criteria are satisfied
- Any remaining carrying amount of the cost of the previous inspection (as distinct from physical parts) is derecognised.

Cost of an Item of PPE

Includes	• Purchase Price
	• Any Directly Attributable Costs
	• Decommissioning, Restoration and similar Liabilities
Excludes	• Costs of opening a new facility or business (Such as, Inauguration costs) • Costs of introducing a new product or service (including costs of advertising and promotional activities) • Costs of conducting business in a new location or with a new class of customer (including costs of staff training) • Administration and other general overhead costs

The following costs are not included in the carrying amount of an item of PPE:

- Costs incurred while an item capable of operating in the manner intended by management has yet to be brought into use or is operated at less than full capacity
- Initial operating losses, such as those incurred while demand for the output of an item builds up. And
- Costs of relocating or reorganising part or all of the operations of an enterprise

Measurement of Cost

Cost of an item of PPE	If payment is deferred beyond normal credit terms	Total payment minus Cash price equivalent	is recognised as an interest expense over the period of credit
			unless such interest is capitalised in accordance with AS 16
	PPE acquired in Exchange for a Non-Monetary Asset or Assets or combination of Monetary and Non-monetary Assets	Cost of such an item of PPE is measured at fair value unless	Exchange transaction lacks Commercial substance; Or
			Fair value of neither the asset(s) received nor the asset(s) given up is reliably measurable.

Measurement after Recognition	Cost model	PPE carried at	Cost Less Any Accumulated Depreciation and Any Accumulated Impairment losses
	Revaluation Model	PPE carried at a revalued amount	Whose fair value can be measured reliably.

Frequency of Revaluations (Sufficient Regularity)	Items of PPE experience significant and volatile changes in Fair value	Annual revaluation
	Items of PPE with only insignificant changes in Fair value	Revalue the item only every 3 or 5 years

Revaluation - Increase or Decrease

Revaluation	Increase	Credited directly to owners' interests under the heading of Revaluation surplus	
		Exception: When it is subsequently Increased (Initially Decreased)	Recognised in the Statement of profit and loss to the extent that it reverses a revaluation decrease of the same asset previously recognised in the Statement of profit and loss.
	Decrease	Charged to the Statement of profit and loss	
		Exception: When it is subsequently Decreased (Initially Increased)	Decrease should be debited directly to owners' interests under the heading of Revaluation surplus to the extent of any credit balance existing in the Revaluation surplus in respect of that asset.

Methods of Depreciation	Straight-line Method	Results in a constant charge over the useful life if the residual value of the asset does not change.
	Diminishing Balance Method	Results in a decreasing charge over the useful life
	Units of Production Method	Results in a charge based on the expected use or output.

De-Recognition

Derecognition of Carrying amount PPE:	• On disposal	– By sale; – By entering into a finance lease, or; – By donation,
	• When no future economic benefits are expected from its use or disposal	
	• Accounting Treatment	– Gain or loss arising from de-recognition of an item of PPE should be included in the Statement of Profit and Loss when the item is derecognised unless AS 19 on Leases, requires otherwise on a sale and leaseback (AS 19 on Leases, applies to disposal by a sale and leaseback.) – Gain or loss arising from de-recognition of an item of PPE

= Net disposal proceeds (if any) - Carrying Amount of the item

Disclosures	• General	• Additional	• Disclosures related to Revalued Assets

General Disclosures:

- The measurement bases (i.e., cost model or revaluation model) used for determining the gross carrying amount;
- The depreciation methods used;
- The useful lives or the depreciation rates used.

Additional Disclosures

- The existence and amounts of restrictions on title, and property, plant and equipment pledged as security for liabilities;
- The amount of expenditure recognised in the carrying amount of an item of property, plant and equipment in the course of its construction;
- The amount of assets retired from active use and held for disposal;
- The amount of contractual commitments for the acquisition of property, plant and equipment;
- If amount of contractual commitments is not disclosed separately on the face of the statement of profit and loss, the amount of compensation from third parties for items of property, plant and equipment that were impaired, lost or given up that is included in the statement of profit and loss.

Disclosures related to Revalued Assets:

- The effective date of the revaluation;
- Whether an independent valuer was involved;
- The methods and significant assumptions applied in estimating fair values of the items;
- The extent to which fair values of the items were determined directly by reference to observable prices in an active market or recent market transactions on arm's length terms or were estimated using other valuation techniques; and
- The revaluation surplus, indicating the change for the period and any restrictions on the distribution of the balance to shareholders

Question & Answers

Question 1

A Ltd. has incurred the following costs. Determine if the following costs can be added to the invoiced purchase price and included in the initial recognition of the cost of the item of property, plant and equipment:

1. **Import duties paid**
2. **Shipping costs and cost of road transport for taking the machinery to the factory**
3. **Insurance for the shipping**
4. **Inauguration costs for the factory**
5. **Professional fees charged by consulting engineer for the installation process**
6. **Costs of advertising and promotional activities**
7. **Administration and other general overhead costs**
8. **Cost of site preparation. *(RTP May '22)***

Answer 1

Included in Cost: Point no. 1,2,3,5,8

Excluded from Cost: Point no. 4,6,7

Question 2

A company changed its method of depreciation from SLM to WDV. How should the change be recognised? *(SM)*

Answer 2

As per AS 10, Property, Plant and Equipment, the depreciation method applied to an asset should be reviewed at least at each financial year-end and, if there has been a significant change in the expected pattern of consumption of the future economic benefits embodied in the asset, the method should be changed to reflect the changed pattern. Such a change should be accounted for as a change in an accounting estimate in accordance with AS 5.

Accordingly, the change in method of depreciation should be accounting for as a change in accounting estimate, prospectively.

Question 3

A company has debited the Building Account with the Cost of the Land on which the building stands and has provided depreciation on such total cost. Comment on the accounting treatment. *(SM)*

Answer 3

As per AS 10, Property, Plant and Equipment, each part of an item of property, plant and equipment with a cost that is significant in relation to the total cost of the item should be depreciated separately. Further, Land and buildings are separable assets and are accounted for separately, even when they are acquired together. With some exceptions, such as quarries and sites used for landfill, land has an unlimited useful life and therefore is not depreciated. Buildings have a limited useful life and therefore are depreciable assets.

In the given case, land should not be depreciated unless it has a limited useful life. Accordingly, it is incorrect to debit the cost of land to the Building Account and provide depreciation on the aggregate cost.

Question 4

An entity is setting up a manufacturing plant. Construction of the plant is completed in August and the plant is ready for commercial production in November. However, the entity commences production in March. When should be company start charging depreciation. *(SM)*

Answer 4

As per AS 10, Property, Plant and Equipment, depreciation of an asset begins when it is available for use, i.e., when it is in the location and condition necessary for it to be capable of operating in the manner intended by management.

In the given case, since the plant is ready for commercial production in November, depreciation shall commence from November. The date of commencement of commercial production is irrelevant for charging depreciation.

Question 5

Which factors should be considered by a company while determining useful life? *(SM)*

Answer 5

All the following factors are considered in determining the useful life of an asset:

(a) expected usage of the asset. Usage is assessed by reference to the expected capacity or physical output of the asset.

(b) expected physical wear and tear, which depends on operational factors such as the number of shifts for which the asset is to be used and the repair and maintenance programme, and the care and maintenance of the asset while idle.

(c) technical or commercial obsolescence arising from changes or improvements in production, or from a change in the market demand for the product or service output of the asset. Expected future reductions in the selling price of an item that was produced using an asset could indicate the expectation of technical or commercial obsolescence of the asset, which, in turn, might reflect a reduction of the future economic benefits embodied in the asset.

(d) legal or similar limits on the use of the asset, such as the expiry dates of related leases.

Question 6

Mohan Ltd. has an existing freehold factory property, which it intends to knock down and redevelop. During the redevelopment period, the company will move its production facilities to another (temporary) site.
The following incremental costs will be incurred:
Setup costs of Rs. 5,00,000 to install machinery in the new location.
Rent of Rs. 15,00,000
Removal costs of Rs. 3,00,000 to transport the machinery from the old location to the temporary location.
Mohan Ltd. wants to seek your guidance as whether these costs can be capitalized into the cost of the new building. You are required to advise in line with AS 10 "Property, Plant and Equipment".
(MTP 5 Marks May 20, April 21, March 18, Oct '18 & Apr'22 & Oct '22) **(SM)**

Answer 6

Constructing or acquiring a new asset may result in incremental costs that would have been avoided if the asset had not been constructed or acquired. These costs are not be included in the cost of the asset if they are not directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management.
The costs to be incurred by the company are in the nature of costs of reducing or reorganizing the operations of the accompany. These costs do not meet that requirement of AS 10 "Property, Plant and Equipment" and cannot, therefore, be capitalized.

Question 7

(i) **Entity A carried plant and machinery in its books at ₹ 2,00,000 which were destroyed in a fire. These machines were insured 'New for old' and were replaced by the insurance company with new machines of fair value ₹ 20,00,000. The old destroyed machines were acquired by the insurance company and the company did not receive any cash compensation. State, how Entity A should account for the same? *(MTP 2.5 Marks Oct 20, Mar 22)***

(ii) **Omega Ltd, a supermarket chain, is renovating one of its major stores. The store will have more available space for store promotion outlets after the renovation and will include a restaurant. Management is preparing the budgets for the year after the store reopens, which include the cost of remodeling and the expectation of a 15% increase in sales resulting from the store renovations, which will attract new customers. Decide whether Omega Ltd. can capitalize the remodeling cost or not as per provisions of AS 10 "Property plant & Equipment". *(MTP 2.5 Marks Oct 20, Oct'19, Mar 22)***

Answer 7

(i) Entity A should account for a loss in the Statement of Profit and Loss on de-recognition of the carrying value of plant and machinery in accordance with AS 10 on Property, Plant and Equipment. Entity A should separately recognize a receivable and a gain in the income statement resulting from the insurance proceeds once receipt is virtually certain. The receivable should be measured at the fair value of assets provided by the insurer.

(ii) The expenditure in remodeling the store will create future economic benefits (in the form of 15% of increase in sales). Moreover, the cost of remodeling can be measured reliably, therefore, it should be capitalized in line with AS 10.

Question 8

ABC Ltd. has entered into a binding agreement with XYZ Ltd. to buy a custom-made machine amounting to Rs. 4,00,000. As on 31st March, 2020 before delivery of the machine, ABC Ltd. had to change its method of production. The new method will not require the machine ordered and so it shall be scrapped after delivery. The expected scrap value is 'NIL'. Show the treatment of machine in the books of ABC Ltd. *(MTP 5 Marks Oct 20, Oct 18, Mar 22, Aug 18, Oct'19)*

Answer 8

A liability is recognized when outflow of economic resources in settlement of a present obligation can be anticipated and the value of outflow can be reliably measured. In the given case, ABC Ltd. should recognize a liability of ₹ 4,00,000 payable to XYZ Ltd. When flow of economic benefit to the enterprise beyond the current accounting period is considered improbable, the expenditure incurred is recognized as an expense rather than as an asset. In the present case, flow of future economic benefit from the machine to the enterprise is improbable. The entire amount of purchase price of the machine should be recognized as an expense. Hence ABC Ltd. should charge the amount of ₹ 4,00,000 (being loss due to change in production method) to Profit and loss statement and record the corresponding liability (amount payable to XYZ Ltd.) for the same amount in the books for the year ended 31st March, 2020.

Question 9

With reference to AS-10 Revised, classify the items under the following heads:

HEADS

(i) Purchase Price of Property, plant and Equipment (PPE)

(ii) Directly attributable cost of PPE or

(iii) Cost not included in determining the carrying amount of an item of PPE.

ITEMS

(1) Import duties and non-refundable purchase taxes.

(2) Initial delivery and handling costs.

(3) Initial operating losses, such as those incurred while demand for the output of an item builds up.

(4) Costs incurred while an item capable of operating in the manner intended by management has yet to be brought into use or is operated at less than full capacity.

(5) Trade discounts and rebates.

(6) Costs of relocating or reorganizing part or all of the operations of an enterprise.

(7) Installation and assembly costs.

(8) Administration and other general overhead costs. *(SM)*

Answer 9

Heads

(i) Purchase price of PPE

(ii) Directly attributable cost of PPE

(iii) Cost not included in determining the carrying amount of an item of PPE

	Items	Classified under Head
1	Import duties and non-refundable purchase taxes	(i)
2	Initial delivery and handling costs	(ii)
3	Initial operating losses, such as those incurred while demand for the output of an item builds up	(iii)
4	Costs incurred while an item capable of operating in the manner intended by management has yet to be brought into use or is operated at less than full capacity.	(iii)
5	Trade discounts and rebates (deducted for computing purchase price)	(i)
6	Costs of relocating or reorganizing part or all of the operations of an enterprise.	(iii)
7	Installation and assembly costs	(ii)
8	Administration and other general overhead costs	(iii)

Question 10

Neon Enterprise operates a major chain of restaurants located in different cities. The company has acquired a new restaurant located at Chandigarh. The new-restaurant requires significant renovation expenditure. Management expects that the renovations will last for 3 months during which the restaurant will be closed.

Management has prepared the following budget for this period – Salaries of the staff engaged in preparation of restaurant before its opening Rs. 7,50,000 Construction and remodelling cost of restaurant Rs. 30,00,000. Explain the treatment of these expenditures as per the provisions of AS 10 "Property, Plant and Equipment". *(MTP 5 Marks March '21, Sep '22 & Oct '23) (PYP Nov'18, 5 Marks)*

Answer 10

As per provisions of AS 10, any cost directly attributable to bring the assets to the location and conditions necessary for it to be capable of operating in the manner indicated by the management are called directly attributable costs and would be included in the costs of an item of PPE.

Management of Neon Enterprise should capitalize the costs of construction and remodeling the restaurant, because they are necessary to bring the restaurant to the condition necessary for it to be capable of operating in the manner intended by management. The restaurant cannot be opened without incurring the construction and remodeling expenditure amounting Rs. 30,00,000 and thus the expenditure should be considered part of the asset.

However, the cost of salaries of staff engaged in preparation of restaurant Rs. 7,50,000 before its opening are in the nature of operating expenditure that would be incurred if the restaurant was open and these costs are not necessary to bring the restaurant to the conditions necessary for it to be capable of operating in the manner intended by management. Hence, Rs. 7,50,000 should be expensed.

Question 11

An entity gave the following Note in its Financial Statements:

'The company chooses not to charge depreciation on Property, Plant and Equipment on account of:

a. **Annual Maintenance Contracts being expensed thereby ensuring timely repairs of Plant and Machinery.**
b. **Depreciation being a non-cash expense has no impact on cash flows. Accordingly, it is not necessary to depreciate an asset when repairs and maintenance charges are expensed in the Statement of Profit and Loss.**
c. **The values of certain assets like Property increase with passage of time, and hence charging depreciation does not make sense.**
d. **At the end of the useful life, the asset is ultimately sold, and since the asset is at cost due to no depreciation, exact profit or loss on sale of the asset is stated.'**

You are required to state the appropriateness of the above accounting policy in line with the relevant Accounting Standards. *(SM)*

Answer 11

Depreciation refers to writing off the value of the asset over its useful life. Such write-off is necessitated on account of normal wear-and-tear, usage, or obsolescence. Since items of Property, Plant and Equipment are generally used in generating revenue, the pro-rated write-off in value of such item should be recorded in the books against the income earned by such an asset.

Providing depreciation is mandatory, in spite of the fact that repairs are expensed in the Statement of Profit and Loss, or the value of the Property is appreciating. Depreciation is a systematic allocation of cost of the asset against the income generated from the continued use of the asset. Further, the Companies Act, 2013 mandates depreciation to be charged in order to determine the correct profits. Thus, not charging depreciation would result in non-compliance with the Companies Act provisions as well.

The argument laid down by the company and the reasons for the same being invalid are discussed below.

(a) Annual Maintenance Contracts being expensed thereby ensuring timely repairs of Plant and Machinery:

The fact that the company enters into Annual Maintenance Contracts for timely repairs can be regarded as a running cost. Such expense is incurred in order to ensure that the machine continues to run as intended. Thus, it implies that because the machine is being utilized, it will need regular repairs. In other words, continuous use is resulting in normal wear-and-tear which is the reason why depreciation should be charged by the company. By stating that the company incurs Annual Maintenance Expenses, the company is recording only the 'maintenance expenses', but not the wear-and-tear requiring the maintenance in the first place. Hence, this argument put forth by the company is not valid.

(b) Depreciation being a non-cash expense has no impact on cash flows. Accordingly, it is not necessary to depreciate an asset when repairs and maintenance charges are expensed in the Statement of Profit and

Loss.

When viewed from the prism of depreciation alone, it appears that the fact that depreciation is a non-cash item is correct. However, it must be noted that at the time of procurement of the asset, the company would have paid cash. Depreciation is after all writing off this amount over the life of the asset. Hence the argument that depreciation is a non-cash item is not valid. Depreciation is writing off the cost of the asset (which was already paid for) over the useful life of the asset, and hence is mandatory.

(c) The values of certain assets like Property increase with passage of time, and hence charging depreciation does not make sense.

Certain assets like immovable property do increase in value with the passage of time. However, such assets are 'used for the purposes of business' and are not 'held for sale' or held as investment property. Accordingly, since the asset is being used for carrying on business, providing depreciation will give a true and fair view of the results of the company, and hence the argument that the value of the property appreciates is not valid.

If the company wants to show the fair market value of the PPE, then it has the option to apply Revaluation model. However, depreciation is mandatory to be charged in Revaluation model also.

(d) At the end of the useful life, the asset is ultimately sold, and since the asset is at cost due to no depreciation, exact profit or loss on sale of the asset is stated.

The value of any asset, after usage, will reduce. Accordingly, the argument that the 'exact profit or loss on sale of the asset' will be obtained is incorrect. Due to usage of the asset, the value of the asset would be lower than the cost. Charging depreciation would seek to bring the book value approximating to such reduced value. Thereafter, on sale of the asset, the true profit or loss would be available. Accordingly, this argument is also invalid.

It may be pertinent to note that Accounting Standard 1, Disclosure of Accounting Policies states that Disclosure of accounting policies or of changes therein cannot remedy a wrong or inappropriate treatment of the item in the accounts. In other words, the company cannot be absolved of the fact that it has not complied with the relevant accounting standards merely by giving a disclosure of incorrect policies or practices being followed.

Thus, the company's stand of disclosing the incorrect policy as a remedy is not correct. The company is suggested to charge depreciation on a systematic basis over the useful life of the asset thereby complying with the Accounting Standards.

Question 12

You are required to give the correct accounting treatment for the following in line with provisions of AS 10:

(a) Trozen Ltd. operates a major chain of supermarkets all over India. It acquires a new store in Pune which requires significant renovation expenditure. It is expected that the renovations will be done in 2 months during which the store will be closed. The budget for this period, including expenditure related to construction and remodeling costs (Rs. 18 lakhs), salaries of staff (Rs. 2 lakhs) who will be preparing the store before its opening and related utilities costs (Rs. 1.5 lakhs), is prepared. The cost of salaries of the staff and utilities are operating expenditures that would be incurred even after the opening of the supermarket. What will the treatment of all these expenditures in the books of accounts?

(b) ABC Ltd is setting up a new refinery outside the city limits. In order to facilitate the construction of the refinery and its operations, ABC Ltd. is required to incur expenditure on the construction/development of railway siding, road and bridge. Though ABC Ltd. incurs the expenditure on the construction/development, it will not have ownership rights on these items and they are also available for use to other entities and public at large. Can ABC Ltd. capitalize expenditure incurred on these items as property, plant and equipment (PPE)? *(RTP May '21)*

Answer 12

(a) Trozen Ltd. should capitalize the costs of construction and remodeling the supermarket, because they are necessary to bring the store to the condition necessary for it to be capable of operating in the manner intended. The supermarket cannot be opened without incurring the remodeling expenditure. Therefore, this construction and remodeling expenditure of Rs. 18 lakhs should be considered as part of the cost of the asset. However, the cost of salaries of the staff Rs. 2 lakh and utilities cost Rs. 1.5 lakh are operating expenditures that would be incurred even after the opening of the supermarket. Therefore, these costs are not necessary to bring the store to the condition necessary for it to be capable of operating in the manner intended by the management and should be expensed.

(b) AS 10 states that the cost of an item of property, plant and equipment shall be recognized as an asset if, and only if:

(a) it is probable that future economic benefits associated with the item will flow to the entity; and

(b) the cost of the item can be measured reliably.

Further, the standard provides that the standard does not prescribe the unit of measure for recognition, i.e., what constitutes an item of property, plant and equipment. Thus, judgement is required in applying the recognition criteria to an entity's specific circumstances. The cost of an item of property, plant and equipment comprise any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management.

In the given case, railway siding, road and bridge are required to facilitate the construction of the refinery and for its operations. Expenditure on these items is required to be incurred in order to get future economic benefits from the project as a whole which can be considered as the unit of measure for the purpose of capitalization of the said expenditure even though the company cannot restrict the access of others for using the assets individually. It is apparent that the aforesaid expenditure is directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management.

In view of this, even though ABC Ltd. may not be able to recognize expenditure incurred on these assets as an individual item of property, plant and equipment in many cases (where it cannot restrict others from using the asset), expenditure incurred may be capitalized as a part of overall cost of the project. From this, it can be concluded that, in the given case the expenditure incurred on these assets, i.e., railway siding, road and bridge, should be considered as the cost of constructing the refinery and accordingly, expenditure incurred on these items should be allocated and capitalized as part of the items of property, plant and equipment of the refinery.

Question 13

Arka Ltd. purchased machinery for ₹ 3,000 lakhs. Depreciation was charged at 10% on SLM basis for a useful life of 10 years. At the end of Year 4, the machinery was revalued to ₹ 2,700 lakhs and the same was adopted. What will be the carrying amount of the asset at the end of Year 5 and Year 6? Assume no change in the useful life. *(SM)*

Answer 13

Particulars	**₹ in lakhs**
Original Cost of the Asset	3,000.00
Less: Depreciation for 4 years (₹ 3,000 lakhs x 10% x 4 years)	(1,200.00)
Book Value at the end of Year 4	1,800.00
Add: Revaluation Surplus (balancing figure)	900.00
Revalued Amount as given (= revised depreciable value)	2,700.00
Less: Depreciation for Year 5 (₹ 2,700 lakhs ÷ 6 years)	450.00
Carrying Amount at the end of Year 5	2,250.00
Less: Depreciation for Year 6 (₹ 2,700 lakhs ÷ 6 years)	450.00
Carrying Amount at the end of Year 6	1,800.00

Question 14

Preet Ltd. intends to set up a steel plant, for which it has acquired a dilapidated factor having an area of 5,000 acres at a cost of ₹ 60,000 per acre. Preet Ltd. has incurred ₹ 1.10 crores on demolishing the old Factory Building thereon. A sum of ₹ 63,00,000 (including 5% GST thereon) was realized from the sale of material salvaged from the site. Preet Ltd. incurred Stamp Duty and Registration Charges of 7% of land value, paid legal and consultancy charges ₹ 8,00,000 for land acquisition and incurred ₹ 1,25,000 on title guarantee insurance. Compute the value of the land acquired. *(SM)*

Answer 14

Particulars	**₹**

Purchase Price: 5,000 acres x ₹ 60,000 per acre	3,000.00
Stamp Duty and Registration Charges at 7%	210.00
Legal and Consultancy Fees	8.00
Title Guarantee Insurance	1.25
Demolition Expenses (Net of Salvage Income) [₹ 110 lakhs (–)₹ 60 lakhs (₹ 63 lakhs x 100/105)]	50.00
Cost of Land	3,269.25

Question 15

RS Ltd. has acquired a heavy plant at a cost of ₹ 2,00,00,000. The estimated useful life is 10 years. At the end of the 2nd year, one of the major components i.e., the Boiler has become obsolete (which was acquired at price of ₹ 50,00,000) and requires replacement, as further maintenance is uneconomical. The remainder of the plant is perfect and is expected to last for next 8 years. The cost of a new boiler is ₹ 60,00,000. Can the cost of the new boiler be recognised as an asset, and, if so, what should be the carrying value of the plant at the end of second year? *(RTP Nov'22)*

Answer 15

Recognition of Asset: The new boiler will produce economic benefits to RS Ltd., and the cost is measurable. Hence, the item should be recognized as an asset. The cost old boiler should be de-recognized and the new boiler will be added.

Statement showing cost of new boiler and machine after year 2

Original cost of plant	₹ 2,00,00,000
Less: Accumulated depreciation [(2,00,00,000 /10) x 2]	**₹ 40,00,000**
Carrying value of the plant after two years	₹ 1,60,00,000
Less: Current Cost of Old Boiler to be derecognized	
Less: WDV of Boiler (replaced) after 2 years (50,00,000/10 x 8)	**₹ 40,00,000**
	₹ 1,20,00,000
Add: Cost of new Boiler to be recognized	**₹ 60,00,000**
Revised carrying amount of Plant	₹ 1,80,00,000

Question 16

A property costing ₹ 10,00,000 is bought on 1.4.2020. Its estimated total physical life is 50 years. However, the company considers it likely that it will sell the property after 25 years. The estimated residual value in 25 years' time, based on current year prices, is:
Case (a) ₹ 10,00,000
Case (b) ₹ 9,00,000
You are required to compute the amount of depreciation charged for the year ended 31.3.2021.
(RTP Nov 21, SM)

Answer 16

Case (a)

The company considers that the residual value, based on prices prevailing at the balance sheet date, will equal the cost. There is, therefore, no depreciable amount and depreciation is zero.

Case (b)

The company considers that the residual value, based on prices prevailing at the balance sheet date, will be ₹ 9,00,000 and the depreciable amount is, therefore, ₹ 1,00,000.

Annual depreciation (on a straight-line basis) will be ₹ 4,000 [{10,00,000 – 9,00,000} ÷ 25].

Question 17

Skanda Ltd. acquired a machinery for ₹ 2,50,00,000 five years ago. Depreciation was charged at 10% p.a. on SLM basis, useful life being 10 years. At the beginning of Year 3, the machinery was revalued to ₹ 3,00,00,000 with the surplus on revaluation being credited to Revaluation Reserve. Depreciation was provided on the revalued amount over the balance useful life of 8 years. The machinery was sold in the current year for ₹ 1,12,50,000. Give the accounting treatment for the above in the Company's accounts. What will be the treatment if the machinery fetched only ₹ 42,50,000 now? *(SM)*

Answer 17

Particulars	₹
Original Cost of the Asset	2,50,00,000
Less: Depreciation for 2 years (₹ 2,50,00,000 x 10% x 2 years)	50,00,000
Book Value at the beginning of Year 3	2,00,00,000
Add: Revaluation Surplus (balancing figure)	1,00,00,000
Revalued Amount as given (= revised depreciable value)	3,00,00,000
Less: Depreciation for Years 3-5 (₹ 3,00,00,000 ÷ 8 yrs x 3 yrs)	1,12,50,000
Carrying Amount at the end of Year 5	1,87,50,000

The treatment of Gain / Loss on Disposal / Revaluation is as below:

Particulars	Disposal Proceeds = ₹ 1,12,50,000	Disposal Proceeds = ₹ 42,50,000
Book Value Less Disposal Proceeds = Loss recognized in Profit or Loss	₹ 1,87,50,000 – ₹ 1,12,50,000 = ₹ 75,00,000 (Loss)	₹ 1,87,50,000 – ₹ 42,50,000 = ₹ 1,45,00,000 (Loss)
Revaluation Surplus directly transferred to Retained Earnings	₹ 1,00,00,000	₹ 1,00,00,000

Question 18

Bharat Infrastructure Ltd. acquired a heavy machinery at a cost of ₹ 1,000 lakhs, the breakdown of its components is not provided. The estimated useful life of the machinery is 10 years. At the end of Year 6, the turbine, which is a major component of the machinery, needed replacement, as further usage and maintenance was uneconomical. The remainder of the machine is in good condition and is expected to last for the remaining 4 years. The cost of the new turbine is ₹ 450 lakhs. Give the accounting treatment for the new turbine, assuming SLM Depreciation and a discount rate of 8%. *(SM)*

Answer 11

As per AS 10, Property, Plant and Equipment, the derecognition of the carrying amount of components of an item of Property, Plant and Equipment occurs regardless of whether the cost of the previous part / inspection was identified in the transaction in which the item was acquired or constructed. If it is not practicable for an enterprise to determine the carrying amount of the replaced part/ inspection, it may use the cost of the replacement or the estimated cost of a future similar inspection as an indication of what the cost of the replaced part/ existing inspection component was when the item was acquired or constructed.

In the given case, the new turbine will produce economic benefits to Bharat Infrastructure Ltd. and the cost is measurable. Since the recognition criteria is fulfilled, the same should be recognised as a separate item of Property, Plant and Equipment. However, since the initial breakup of the components is not available, the cost of the replacement of ₹ 450 lakhs can be used as an indication based on the guidance given above, discounted at 8% for the 6-year period lapsed.

Thus, estimate of cost 6 years back = ₹ 450 lakhs ÷ 1.08^6 = ₹ 283.58 lakhs

Current carrying amount of turbine (to be de-recognised) = Estimated cost ₹ 283.58 lakhs (–) SLM depreciation at 10% (useful life 10 years) for 6 years ₹ 170.15 lakhs= ₹ 113.43 lakhs.

Hence revised carrying amount of the machinery will be as under:

Particulars	**₹ in lakhs**
Historical Cost [₹ 1,000 lakhs (–) SLM Depreciation at 10% (10 year life) for 6 years]	400.00

Add: Cost of new turbine	450.00
Less: Derecognition of current carrying amount of old turbine	(113.43)
New Carrying Amount of Machinery	736.57

Question 19

(i) A Limited has contracted with a supplier to purchase machinery which is to be installed at its new plant in four months' time. Special foundations were required for the machinery which were to be prepared within this supply lead time. The cost of the site preparation and laying foundations were ₹ 2,10,000. These activities were supervised by an Architect during the entire period, who is employed for this purpose at a salary of ₹ 35,000 per month. The machinery was purchased for ₹ 1,27,50,000 and a sum of ₹ 2,12,500 was incurred towards transportation charges to bring the machinery to the plant site. An Engineer was appointed at a fee of ₹ 37,500 to supervise the installation of the machinery at the plant site. You are required to ascertain the amount at which the machinery should be capitalized in the books of A Limited. *(PYP 2.5 Marks Jul'21)*

(ii) B Limited, which operates a major chain of retail stores, has acquired a new store location. The new location requires substantial renovation expenditure. Management expects that the renovation will last for 4 months during which the store will be closed. Management has prepared the budget for this period including expenditure related to construction and re-modelling costs, salary of staff who shall be preparing the store before its opening and related utilities cost. How would such expenditure be treated in the books of B Limited? *(PYP 2.5 Marks, July,21, SM)*

Answer 19

(i) Statement Showing the Computation of the amount at which the Machinery should be capitalized in the books of A Limited

Particulars		Amount (₹)
Purchase cost of machinery	Given	1,27,50,000
Add: Site Preparation Cost	Given	2,10,000
Architect's Salary	Specific / Attributable overheads for 4 months (₹ 35,000 x 4)	1,40,000
Initial Delivery Cost	Transportation	2,12,500
Professional Fees for Installation	Engineer's Fees	37,500
Total Cost of Machinery to be capitalized		1,33,50,000

(ii) Management should capitalize the costs of construction and remodeling the store, because they are necessary to bring the store to the condition necessary for it to be capable of operating in the manner intended by management. The store cannot be opened without incurring the remodeling expenditure, and thus the expenditure should be considered part of the asset. However, if the cost of salaries, utilities and storage of goods are in the nature of operating expenditure that would be incurred if the store was open, then these costs are not necessary to bring the store to the condition necessary for it to be capable of operating in the manner intended by management and should be expensed.

Question 20

LDR

ABC Ltd. is installing a new plant at its production facility. It has incurred these costs:

Cost of the plant (cost per supplier's invoice plus taxes)	**Rs. 25,00,000**
Initial delivery and handling costs	**Rs. 2,00,000**
Cost of site preparation	**Rs. 6,00,000**
Consultants used for advice on the acquisition of the plant	**Rs. 7,00,000**
Interest charges paid to supplier of plant for deferred credit	**Rs. 2,00,000**
Estimated dismantling costs to be incurred after 7 years	**Rs. 3,00,000**
Operating losses before commercial production	**Rs. 4,00,000**

Please advise ABC Ltd. on the costs that can be capitalised in accordance with AS 10 (Revised). *(MTP Aug. '18, 5 Marks) (Same concept lesser adjustments MTP 5 Marks Nov'21, MTP 5 Marks Mar'23, SM, RTP May'19, Nov'18 & Nov '23)*

Answer 20

According to AS 10 (Revised), the following costs can be capitalized:

Cost of the plant	Rs. 25,00,000
Initial delivery and handling costs	Rs. 2,00,000
Cost of site preparation	Rs. 6,00,000
Consultants' fees	Rs. 7,00,000
Estimated dismantling costs to be incurred after 7 years	**Rs. 3,00,000**
	Rs. 43,00,000

Note: Interest charges paid on "Deferred credit terms" to the supplier of the plant (not a qualifying asset) of Rs.2,00,000 and operating losses before commercial production amounting to Rs.4,00,000 are not regarded as directly attributable costs and thus cannot be capitalized. They should be written off to the Statement of Profit and Loss in the period they are incurred.

Question 21

Akshar Ltd. installed a new Plant (not a qualifying asset), at its production facility, and incurred the following costs:

- **Cost of the Plant (as per supplier's invoice): ₹ 30,00,000**
- **Initial delivery and handling costs: ₹ 1,00,000**
- **Cost of site preparation: ₹ 2,00,000**
- **Consultant fee for advice on acquisition of Plant: ₹ 50,000**
- **Interest charges paid to supplier against deferred credit: ₹ 1,00,000**
- **Estimate of Dismantling and Site Restoration costs: ₹ 50,000 after 10 years (Present Value is ₹ 30,000)**
- **Operating losses before commercial production: ₹ 40,000**

The company identified motors installed in the Plant as a separate component and a cost of ₹ 5,00,000 (Purchase Price) and other costs were allocated to them proportionately. The company estimates the useful life of the Plant and those of the Motors as 10 years and 6 years respectively and SLM method of Depreciation is used.

At the end of Year 4, the company replaces the Motors installed in the Plant at a cost of ₹ 6,00,000 and estimated the useful life of new motors to be 5 years. Also, the company revalued its entire class of Fixed Assets at the end of Year 4. The revalued amount of Plant as a whole is ₹ 25,00,000. At the end of Year 8, the company decides to retire the Plant from active use and also disposed the Plant as a whole for ₹ 6,00,000. There is no change in the Dismantling and Site Restoration liability during the period of use. You are required to explain how the above transaction would be accounted in accordance with AS 10. ***(SM)***

Answer 21

1. **Cost at Initial Recognition:**

Particulars	₹
Cost of the Plant (as per Invoice)	30,00,000
Initial Delivery and Handling Costs	1,00,000
Cost of Site Preparation	2,00,000
Consultants' Fees	50,000
Estimated Dismantling and Site Restoration Costs	30,000
Total Cost of Plant including Motors	33,80,000
Less: Cost of Motors identified as a separate component (1/6)*	5,63,333
Cost of the Plant (excluding Motors – balance 5/6)	**28,16,667**

* Purchase price of Motors = ₹ 5,00,000 out of ₹ 30,00,000 i.e., 1/6 of value of Plant

Note:

Since the asset is not a qualifying asset, payment of interest to the supplier is not capitalized. Further, operating losses of ₹40,000 incurred before commercial production is not a directly attributable cost, and hence excluded from cost of asset. These costs are expensed to the P/L as and when they are incurred.

2. Recognition of Motors Replacement

Particulars	₹
Cost of Motors determined above	5,63,333
Less: Depreciation for 4 years (as per SLM)	3,75,555
5,63,333 ÷ 6 years x 4 years	
Carrying Amount of Motors at the end of Year 4	**1,87,778**

Accounting:

The company should derecognize the existing Carrying Amount of Motors replaced of ₹ 1,87,778. Further, the acquisition cost of new motors of ₹ 6,00,000 would be capitalized as a separate component. This amount will be depreciated over the next 5 years at ₹ 6,00,000 ÷ 5 years = ₹ 1,20,000 p.a.

3. Revaluation

Particulars	₹
Cost of the Plant at initial recognition [from (1) above]	28,16,667
Less: SLM Depreciation for 4 years: ₹ 28,16,667 ÷ 10 years x 4 years	11,26,667
Carrying Amount of Plant at the end of Year 4	16,90,000
Revalued Amount of Plant (Excluding Motors, since the same is treated as a separate component: ₹ 25,00,000 – ₹ 6,00,000)	19,00,000
Therefore, Gain on Revaluation credited to Revaluation Reserve	2,10,000
Revised Depreciation Charge p.a.: 19,00,000 ÷ 6 years	3,16,667

4. Derecognition

Particulars	Motors	Plant (excluding Motors)
Cost / Revalued Amount at end of Year 4	6,00,000	19,00,000
Less: Depreciation for Years 5-8	1,20,000 x 4 = 4,80,000	3,16,667 x 4 =12,66,668
Carrying Amount before Disposal / De- recognition	1,20,000	6,33,332
Less: Disposal Proceeds ₹ 6,00,000 allocated in ratio of carrying amount	95,575	5,04,425
Loss to be written off to P/L	24,425	1,28,907

Notes:

(a) The Revaluation Surplus of ₹ 2,10,000 would be transferred directly to Retained Earnings.

(b) The allocation of disposal proceeds of ₹ 6,00,000 for the plant as whole is apportioned based on carrying amount of motors and plant (excluding motors)

Alternatively, it may be apportioned as 1/6 towards motors and 5/6 plant (excluding motors) based on the reasoning that the initially, motors amounted to 1/6 of the entire plant. This approach may not be preferable because there has been a revaluation of the plant (excluding motors) and a disposal and subsequent acquisition of the Motor, which is not in the initial proportion of 5/6 and 1/6 respectively.

Question 22

Star Limited purchased machinery for ₹ 6,80,000 (inclusive of GST of ₹ 40,000). Input credit is available for entire amount of GST paid. The company incurred the following other expense for installation.

	₹
Cost of preparation of site for installation	**21,200**
Total Labour charges	**56,000**

(200 out of the total of 500 men hours worked, were spent on installation of the machinery)

Spare parts and tools consumed in installation	**5,000**

Total salary of supervisor	**26,000**
(Time spent for installation was 25% of the total time worked) **Total technical expense**	**34,000**
(1/10 relates to the plant installation) **Test run and experimental production expenses**	**18,000**
Consultancy charges to architect for plant set up	**11,000**
Depreciation on assets used for installation	**12,000**

The machine was ready for use on 15.01.2021 but was used from 01.02.2021. Due to this delay further expenses of ₹ 8,900 were incurred. Calculate the value at which the plant should be capitalized in the books of Star Limited. ***(RTP May 23, SM)***

Answer 22

Calculation of Cost of Plant

Particulars		**₹**
Purchase Price	Given	6,80,000
Add: Site Preparation Cost	Given	21,200
Labor charges	(56,000×200/500) Given	22,400
Spare parts		5,000
Supervisor's Salary	25% of ₹ 26,000	6,500
Technical costs	1/10 of ₹ 34,000	3,400
Test run and experimental production charges	Given	18,000
Architect Fees for set up	Given	11,000
Depreciation on assets used for installation	Given	12,000
Total Cost of Asset		7,79,500
Less: GST credit receivable		(40,000)
Value to be capitalized		7,39,500

Note: Further Expenses of ₹ 8,900 from 15.1.2021 to 1.2.2021 to be charged to profit and loss A/c as plant was ready for production on 15.1.2021.

Question 23

A Ltd. had following assets. Calculate depreciation for the year ended 31st March, 2020 for each asset as per AS 10 (Revised):

(i) Machinery purchased for ₹ 10 lakhs on 1st April, 2015 and residual value after useful life of 5 years, based on 2015 prices is ₹ 10 lakhs.

(ii) Land for ₹ 50 lakhs.

(iii) A Machinery is constructed for ₹ 5,00,000 for its own use (useful life is 10 years). Construction is completed on 1st April, 2019, but the company does not begin using the machine until 31st March, 2020.

(iv) Machinery purchased on 1st April.2017 for ₹ 50,000 with useful life of 5 years and residual value is NIL. On 1st April, 2019, management decided to use this asset for further 2 years only. ***(PYP 5 Marks Nov 20) (MTP 5 Marks Sep '23)***

Answer 23

Computation of amount of depreciation as per AS 10

		₹
(i)	Machinery purchased on 1/4/15 for ₹ 10 lakhs (having residual value of ₹ 10 lakhs) Reason: The company considers that the residual value, based on prices prevailing at the balance sheet date, will equal the cost. Therefore, there is no depreciable amount and depreciation is correctly zero.	Nil
(ii)	Land (50 lakhs) (considered freehold) Reason: Land has an unlimited useful life and therefore, it is not depreciated.	Nil
(iii)	Machinery constructed for own use (₹ 5,00,000/10) Reason: The entity should begin charging depreciation from the date the machine is ready for use i.e. 1st April,2019. The fact that the machine was not used for a period after it was ready to be used is not relevant in considering when to begin charging depreciation.	50,000
(iv)	Machinery having revised useful life Reason: The entity has charged depreciation using the straight-line method at ₹ 10,000 per annum i.e. (50,000/5 years). On 1st April,2019 the asset's net book value is [50,000 – (10,000 x 2)] i.e. ₹ 30,000. The remaining useful life is 2 years as per revised estimate. The company should amend the annual provision for depreciation to charge the unamortized cost over the revised remaining life of 2 years. Consequently, it should charge depreciation for the next 2 years at ₹ 15,000 per annum i.e. (30,000 / 2 years).	15,000

Question 24

XYZ Limited provided you the following information for the year ended 31 st March, 2022.

(i) The carrying amount of a property at the end of the year amounted to ₹ 2,16,000 (cost/value ₹ 2,50,000 and accumulated depreciation ₹ 34,000). On this date the property was revalued and was deemed to have a fair value of ₹ 1,90,000. The balance in the revaluation surplus relating to a previous revaluation gain for this property was ₹ 20,000.
You are required to calculate the revaluation loss as per AS 10 (Revised) and give its treatment in the books of accounts.

(ii) An asset that originally cost ₹ 76,000 and had accumulated depreciation of ₹ 62,000 was disposed of during the year for ₹ 4,000 cash.
You are required to explain how the disposal should be accounted for in the financial statements as per AS 10 (Revised). *(PYP 5 Marks May '22)*

Answer 24

(i) As per AS 10, a decrease in the carrying amount of an asset arising on revaluation should be charged to the statement of profit and loss. However, the decrease should be debited directly to owners' interests under the heading of revaluation surplus to the extent of any credit balance existing in the revaluation surplus in respect of that asset.

Calculation of revaluation loss and its accounting treatment

		₹
Carrying value of the asset as on 31st March, 2022	a	2,16,000
Revalued amount of the asset	b	**(1,90,000)**
Total revaluation loss on asset	c=a-b	26,000
Adjustment of previous revaluation reserve	d	**(20,000)**
Net revaluation loss to be charged to the Profit and loss account	e=c-d	6,000

(ii) AS 10 states that the carrying amount of an item of property, plant and equipment is derecognized on disposal of the asset. It further states that the gain or loss arising from the derecognition of an item of property, plant and equipment should be included in the statement of profit and loss when the item is derecognized. Gains should also not be classified as revenue.

Calculation of loss on disposal of the asset and its accounting treatment

		₹

Original cost of the asset	a	76,000
Accumulated depreciation till date	b	62,000
Carrying value of the asset as on 31st March, 2022	c=a-b	14,000
Cash received on disposal of the asset	d	4,000
Loss on disposal of asset charged to the Profit and loss account	e=c-d	10,000

Question 25

In the books of Top maker Limited, carrying amount of Plant and Machinery as on 1stApril, 2022 is ₹ 56,30,000. On scrutiny, it was found that a purchase of Machinery worth ₹ 21,12,000 was included in the purchase of goods on 1stJune, 2022. On 30thJune, 2022 the company disposed a Machine having book value of ₹ 9,60,000 (as on 1stApril, 2022) for ₹ 8,25,000 in part exchange of a new machine costing ₹ 15,65,000.
The company charges depreciation @ 10% p.a. on written down value method on Plant and Machinery.
You are required to compute:
(i) Depreciation to be charged to Profit & Loss Account;
(ii) Book value of Plant & Machinery as on 31stMarch, 2023; and
(iii) Profit/Loss on exchange of Plant & Machinery. ***(PYP 5 Marks May '23)***

Answer 25
(i) Depreciation to be charged in the Profit & Loss Account

Particulars	**Amount in ₹**
Depreciation on old Machinery	1,40,750
[10% on ₹ 56,30,000 for 3 months (01.04.2022 to 30.06.2022)] Add: Depreciation on Machinery acquired on 01.06.2022	1,76,000
(₹21,12,000 X 10% X10/12) Add: Depreciation on Machinery after adjustment of Exchange [10% of ₹ 56,30,000 – 9,60,000 + 15,65,000) for 9 months]	4,67,625
Total Depreciation to be charged in Profit & Loss A/c	**7,84,375**

(ii) Book value of Plant & Machinery as on 31.3.2023

Particulars		**Amount in ₹**
Balance as per books on 01.04.2022		56,30,000
Add: Included in purchases on 01.06.2022	21,12,000	
Add: Purchases on 30.06.2022	15,65,000	36,77,000 93,07,000
Less: Book value of Machine sold on 30.06.2022		(9,60,000) 83,47,000
Less: Depreciation on Machinery in use ₹ (7,84,375 -24,000)		(7,60,375)
Book Value as on 31.03.2023		75,86,625

Note: The computation of depreciation and book value of Plant & Machinery can be presented in the following alternative manner:

Particulars	**Book Value or Cost or Acquisition**	**Period**	**Depreciation**	**Book Value as on 31.03.2023**
Opening Value	46,70,000 (56,30,000 – 9,60,000)	01.04.2022 to 31.03.2023	4,67,000 (46,70,000 x 10%)	42,03,000
Sold	9,60,000	01.04.2022 to 30.06.2022	24,000 (9,60,000 x 10% x 3/12)	-

Purchases	21,12,000	01.06.2022 to 31.03.2023	1,76,000 (21,12,000 x 10% x 10/12)	19,36,000
New Machinery	15,65,000	01.07.2022 to 31.03.2023	1,17,375	14,47,625
			(15,65,000 x 10% x 9/12)	
Total			7,84,375	75,86,625

(iii) Profit/Loss on Exchange of Machinery

Particulars	**Amount in**
Balance as per books on 01.04.2022	9,60,000
Less: Depreciation for 3 months (₹ 9,60,000 x 10 /100 x 3 / 12)	**(24,000)**
W.D.V. as on 30.06.2022	9,36,000
Less: Exchange value	(8,25,000)
Loss on Exchange of Machinery	1,11,000

Question 26

MS Ltd. has acquired a heavy machinery at a cost of ₹ 1,00,00,000 (with no breakdown of the component parts). The estimated useful life is 10 years. At the end of the sixth year, one of the major components, the turbine requires replacement, as further maintenance is uneconomical. The remainder of the machine is perfect and is expected to last for the next four years. The cost of a new turbine is ₹ 45,00,000. The discount rate assumed is 5%.

Can the cost of the new turbine be recognised as an asset, and, if so, what treatment should be used? *(RTP Jan'25)*

Answer 26

The new turbine will produce economic benefits to MS Ltd., and the cost is measurable. Hence, the item should be recognised as an asset. The original invoice for the machine did not specify the cost of the turbine; however, the cost of the replacement ₹ 45,00,000 can be used as an indication (usually by discounting) of the likely cost, six years previously.

Statement showing cost of new turbine and machine after 6th year

			₹
Cost of machines recognized on purchase			1,00,00,000
Less: Depreciation charged for 6 years	[(1,00,00,000/ 10) x 6]		(60,00,000)
			40,00,000
Less: Current cost of turbine to be derecognized:			
Cost of Turbine before 6 years	[45,00,000 x {1 / $(1.05)^6$}]	33,57,900	
Less: Depreciation for 6 years	[(33,57,900 / 10) x 6]	(20,14,740)	(13,43,160)
Add: Cost of new turbine to be recognised			45,00,000
Revised carrying amount of machine			71,56,840

Multiple Choice Questions (MCQ)

1. As per AS 10 (Revised) 'Property, plant and equipment', which of the following costs is not included in the carrying amount of an item of PPE

(a) Costs of site preparation

(b) Costs of relocating

(c) Installation and assembly costs.

(d) initial delivery and handling costs

Ans: (b)

2. As per AS 10 (Revised) 'Property, Plant and Equipment', an enterprise holding investment properties should value Investment property.

(a) as per fair value

(b) under discounted cash flow model.

(c) under cost model

(d) under cash flow model

Ans: (c)

3. A plot of land with carrying amount of ₹ 1,00,000 was revalued to ₹ 1,50,000 at the end of Year 2. Subsequently, due to drop in market values, the land was determined to have a fair value of ₹ 1,30,000 at the end of Year 4. Assuming that the entity adopts Revaluation Model, what would be the accounting treatment of Revaluation?

(a) Initial upward valuation of ₹ 50,000 credited to Revaluation Reserve. Subsequent downward revaluation of ₹ 20,000 debited to P/L.

(b) Initial upward valuation of ₹ 50,000 credited to P/L. Subsequent downward revaluation of ₹ 20,000 debited to P/L.

(c) Initial upward valuation of ₹ 50,000 credited to Revaluation Reserve. Subsequent downward revaluation of ₹ 20,000 debited to Revaluation Reserve.

(d) Initial upward valuation of ₹ 50,000 debited to P/L. Subsequent downward revaluation of ₹ 20,000 credited to P/L.

Ans: (c)

4. A plot of land with carrying amount of ₹ 1,00,000 was revalued to ₹ 90,000 at the end of Year 2. Subsequently, due to increase in market values, the land was determined to have a fair value of ₹ 1,05,000 at the end of Year 4. Assuming that the entity adopts Revaluation Model, what would be the accounting treatment of Revaluation?

(a) Initial downward valuation of ₹ 10,000 debited to Revaluation Reserve. Subsequent upward revaluation of ₹ 15,000 credited to P/L.

(b) Initial downward valuation of ₹ 10,000 debited to P/L. Subsequent upward revaluation of ₹ 15,000 credited to P/L.

(c) Initial downward valuation of ₹ 10,000 debited to P/L. Subsequent upward revaluation of ₹ 10,000 credited to P/L and ₹ 5,000 credited to Revaluation Reserve.

(d) Initial downward valuation of ₹ 10,000 credited to P/L. Subsequent upward revaluation of ₹ 10,000 debited to P/L and ₹ 5,000 debited to Revaluation Reserve.

Ans: (c)

5. On sale of an asset which was revalued upwards, what would be the treatment of Revaluation Reserve?

(a) The Revaluation Reserve is credited to P/L since the profit on sale of such asset is now realized.

(b) The Revaluation Reserve is credited to Retained Earnings as a movement in reserves without impacting the P/L.

(c) No change in Revaluation Reserve since profit on sale of such asset is already impacting the P/L.

(d) The Revaluation Reserve is reduced from the asset value to compute profit or loss.

Ans: (b)

6. A machinery was purchased having an invoice price ₹ 1,18,000 (including GST ₹ 18,000) on 1 April 20X1.

The GST amount is available as input tax credit. The rate of depreciation is 10% on SLM basis. The depreciation for 20X2 -X3 would be

(a) ₹ 10,000.

(b) ₹ 11,800.

(c) ₹ 9,000.

(d) ₹ 10500

Ans: (a)

7. Accounting Standard 10, Property, Plant and Equipment is applicable to: *(MTP 2 Marks Nov'24)*

(a) Biological Assets (other than Bearer Plants) related to agricultural activity

(b) Wasting Assets including Mineral rights, Expenditure on the exploration for and extraction of minerals, oil, natural gas and similar non regenerative resources

(c) Inventories

(d) Bearer Plant (except produce on Bearer Plants)

Ans: (d)

B

CHAPTER 9.1: AS 12 "ACCOUNTING FOR GOVERNMENT GRANTS"

CONCEPTS OF THIS CHAPTER	
· Accounting treatment of government grants · Capital vs. income approach · Recognition of government grants · Non-monetary government grants	LDR Questions Q 17 Q 19

QUICK REVIEW OF IMPORTANT CONCEPTS

Two approaches

'Capital approach'	Grant is treated as part of shareholders' funds	Grants which have the characteristics similar to those of promoters' contribution should be treated as part of shareholders' funds
'Income approach'	Grant is taken to income over one or more periods	Income approach may be more appropriate in the case of other grants

Presentation of Grants

Related to Specific Fixed Assets

Method I :	**Method II:**
• The grant is shown as a deduction from the Gross value of the asset concerned in arriving at its book value.	• Grants related to depreciable assets are treated as deferred income which is recognised in the profit and loss statement on a systematic and rational basis over the useful life of the asset
• The grant is thus recognised in the profit and loss statement over the useful life of a depreciable asset • by way of a reduced depreciation charge.	• Grants related to non-depreciable assets are credited to capital reserve as there is usually no charge to income in respect of such assets.
• Where the grant equals the whole, or virtually the whole, of the cost of the asset, the asset is shown in the balance sheet at a nominal value.	• If a grant related to a non-depreciable asset requires the fulfilment of certain obligations, the grant is credited to income over the same period over which the cost of meeting such obligations is charged to income

- is recorded by increasing the book value of the asset or by reducing the deferred income balance, as appropriate, by the amount refundable
- In the first alternative, i.e., where the book value of the asset is increased, depreciation on the revised book value is provided prospectively over the residual useful life of the asset.

Related to Revenue

- Grants related to revenue are sometimes presented as a credit in the profit and loss statement, either separately or under a general heading such as 'Other Income'. Alternatively, they are deducted in reporting the related expense.

• is applied first against any unamortised deferred credit remaining in respect of the grant	• To the extent that the amount refundable exceeds any such deferred credit, or where no deferred credit exists,	• the amount is charged immediately to profit and loss statement

In nature of Promoters' Contribution

- Where the government grants are of the nature of promoters' contribution, i.e., they are given with reference to the total investment in an undertaking or by way of contribution towards its total capital outlay (for example, central investment subsidy scheme) and no repayment is ordinarily expected in respect thereof, the grants are treated as capital reserve which can be neither distributed as dividend nor considered as deferred income.
- In the nature of promoters' contribution
- Refundable, in part or in full, to the government on non-fulfilment of some specified conditions, the relevant amount recoverable by the government is
- Reduced from the capital reserve.

Disclosure

- The accounting policy adopted for government grants, including the methods of presentation in the financial statements
- The nature and extent of government grants recognised in the financial statements, including grants of non-monetary assets given at a concessional rate or free of cost.

Question & Answers

Question 1

AS 12 deals with recognition and measurement of government grants. Please elaborate the parameters which are required to be met before an entity can recognise government grants in its books? (SM)

Answer 1

A government grant is recognised when there is reasonable assurance that:

- the enterprise will comply with the conditions attaching to it; and
- the grant will be received.

Receipt of a grant is not of itself conclusive evidence that the conditions attaching to the grant have been or will be fulfilled.

Question 2

Supriya Ltd. received a grant of Rs. 2,500 lakhs during the accounting year 20X1-20X2 from government for welfare activities to be carried on by the company for its employees. The grant prescribed conditions for its utilization. However, during the year 20X2-20X3, it was found that the conditions of grants were not complied with and the grant had to be refunded to the government in full. Elucidate the current accounting treatment, with reference to the provisions of AS-12 *(SM)*

Answer 2

As per AS 12 'Accounting for Government Grants', Government grants sometimes become refundable because certain conditions are not fulfilled. A government grant that becomes refundable is treated as an extraordinary item as per AS 5.

The amount refundable in respect of a government grant related to revenue is applied first against any unamortized deferred credit remaining in respect of the grant. To the extent that the amount refundable exceeds any such deferred credit, or where no deferred credit exists, the amount is charged immediately to profit and loss statement.

In the present case, the amount of refund of government grant should be first adjusted against the unamortised deferred income in the books and the excess if any will be debited to profit & loss account of the company as an extraordinary item in the year 20X2-20X3.

Question 3

S Ltd. has received a grant of 18 crores from the Government for setting up a factory in a backward area. Out of this grant, the company distributed 12 crores as dividend. Also, S Ltd. received land free of cost from the State Government, but it has not recorded it at all in the books as no money has been spent. In the light of AS-12 examine, whether the treatment of both the grants is correct. *(RTP Nov'23)*

Answer 3

As per AS 12, when government grant is received for a specific purpose, it should be utilized for the same.
Thus, the grant received for setting up a factory is not available for distribution of dividend.
As per AS-12, if an asset is acquired free of cost it is to be recorded at a nominal value.
Thus, even if the company has not spent money for the acquisition of land, land should be recorded in the books of accounts at a nominal value.
The treatment of both the elements of the grant is incorrect as per AS 12.

Question 4

Energy Ltd. has acquired a generator on 1.4.2023 for ₹ 100 lakh. On 2.4.2023, it applied to Indian Renewal Energy Development Authority (IREDA) for a subsidy. The subsidy was granted in June, 2024 after the accounts for 2023-2024 were finalized. The company has not accounted for the subsidy for the year ended 31.3.2024. State

(i) Is this a prior period item?

(ii) How should the subsidy be accounted in the accounting year 2024-2025? *(RTP Sep'24)*

Answer 4

(i) Whether a subsidy applied is to be classified as prior period item as per AS 5, depends upon whether the company has committed an error in 2023-2024 by not recognizing the subsidy?
The answer is in para 13 of AS 12 "Accounting for Government Grants" which permits recognition of grant only when there is reasonable assurance that -
(i) the enterprise will comply with the conditions attached to them and
(ii) the subsidy will be received.
Mere making of an application does not provide the reasonable assurance that the subsidy will be received. Letter of sanction from IREDA is required to provide this assurance. Since, the subsidy was granted in June, 2024 after approval of accounts, non-recognition of grant in 2023-2024 will not be considered as an error. Hence, this is not a prior period item. Therefore, the company was right in not recognizing the grant.
Further, AS 4 requires adjustment of events occurring after the balance sheet date only upto the date of approval of accounts by the Board of Directors. In view of this, the company is correct in not adjusting the same in the accounts in the year 2023-2024.

(ii) The subsidy should be deducted from the cost of the generator. The revised unamortised amount of generator should be written off over the remaining useful life.
Alternatively, the same may be treated as 'deferred income' and allocated over the remaining useful life in the proportion in which depreciation is charged.

Question 5

Viva Ltd. received a specific grant of ₹ 30 lakhs for acquiring the plant of ₹ 150 lakhs during 2018-19 having useful life of 10 years. The grant received was credited to deferred income in the balance sheet and was not deducted from the cost of plant. During 2021-22, due to non-compliance of conditions laid down for the grant, the company had to refund the whole grant to the Government. Balance in the deferred income on that date was ₹ 21 lakhs and written down value of plant was ₹ 105 lakhs. What should be the treatment of the refund of the grant and the effect on cost of the fixed asset and the amount of depreciation to be charged during the year 2021-22 in profit and loss account? *(MTP 5 Marks, Sep'22, May'20 & Mar'21, RTP May'19)*

Answer 5

As per AS-12, 'Accounting for Government Grants', "the amount refundable in respect of a grant related to specific fixed asset should be recorded by reducing the deferred income balance. To the extent the amount refundable exceeds any such deferred credit, the amount should be charged to profit and loss statement. In this case the grant refunded is ₹ 30 lakhs and balance in deferred income is ₹ 21 lakhs, ₹ 9 lakhs shall be charged to the profit and loss account for the year 2021-22. There will be no effect on the cost of the fixed asset and depreciation charged will be on the same basis as charged in the earlier years.

Question 6

D Ltd. acquired a machine on 01-04-2017 for ₹ 20,00,000. The useful life is 5 years. The company had applied on 01-04-2017, for a subsidy to the tune of 80% of the cost. The sanction letter for subsidy was received in November 2020. The Company's Fixed Assets Account for the financial year 2020-21 shows a credit balance as under:

Particulars	**₹**
Machine (Original Cost)	**20,00,000**
Less: Accumulated Depreciation (from 2017-18- to 2019-20 on Straight Line Method)	**12,00,000**
	8,00,000
Less: Grant received	**(16,00,000)**
Balance	**(8,00,000)**

You are required to explain how should the company deal with this asset in its accounts for 2020-21? *(MTP 5 Marks Mar'23) (RTP Nov'21, May'18)*

Answer 6

From the above account, it is inferred that the Company has deducted grant from the book value of asset for accounting of Government Grants. Accordingly, out of the ₹ 16,00,000 that has been received, ₹ 8,00,000 (being the balance in Machinery A/c) should be credited to the machinery A/c. The balance ₹ 8,00,000 may be credited to P&L A/c, since already the cost of the asset to the tune of ₹ 12,00,000 had been debited to P&L A/c in the earlier years by way of depreciation charge, and ₹ 8,00,000 transferred to P&L A/c now would be partial recovery of that cost.

There is no need to provide depreciation for 2020-21 or 2021-22 as the depreciable amount is now Nil.

Question 7

A fixed asset is purchased for ₹ 30 lakhs. Government grant received towards it is ₹ 12 lakhs. Residual Value is ₹ 6 lakhs and useful life is 4 years. The company charges depreciation based on Straight-Line method. Asset is shown in the balance sheet net of grant. After 1 year, grant becomes refundable to the extent of ₹ 7.5 lakhs due to non-compliance with certain conditions. You are required to give necessary journal entries for second year. *(RTP May'22)*

Answer 7

Journal Entries

Year	**Particulars**		**₹ in lakhs (Dr.)**	**₹ in lakhs (Cr.)**
2nd	Fixed Asset Account	Dr.	7.5	
	To Bank Account			7.5
	(Being government grant on asset partly refunded which increased the cost of fixed asset)			
	Depreciation Account (W.N.)	Dr.	5.5	
	To Fixed Asset Account			5.5
	(Being depreciation charged on SLM on revised value of fixed asset prospectively)			

	Profit & Loss Account	Dr.	5.5	
	To Depreciation Account (Being depreciation transferred to Profit and Loss Account at the end of year 2)			5.5

Working Note:

Depreciation for Year 2

	₹ in lakhs
Cost of the Asset	30
Less: Government grant received	(12)
Less: Depreciation for the first year [18-6 / 4]	18
	3
	15
Add: Government grant refundable	7.5
Depreciation for the second year [22.5-6 / 3]	22.5

Question 8

Caseworker Limited received a specific grant of ₹ 6 crore for acquiring the plant of ₹ 30 crore on 1.4.2016 having useful life of 10 years. At the beginning of the financial year 2021-2022, due to non-compliance of conditions laid down for the grant of ₹ 6 crore, the company had to refund the grant to the Government. What should be the treatment of the refund if grant was deducted from the cost of the plant during financial year 2016-2017? Assume depreciation is charged on fixed assets as per Straight Line Method. *(MTP 5 Marks Apr'23 & Nov'21)*

Answer 8

As per AS 12, the amount refundable in respect of grant related to specific fixed assets should be recorded by increasing the book value of the asset or by reducing the capital reserve or the deferred income balance, as appropriate, by the amount refundable. Where the book value of the asset is increased, depreciation on the revised book value should be provided prospectively over the residual useful life of the asset.

Where grant was deducted from the cost of the asset, initial value of the plant after deduction of grant amount of Rs. 6 crore would have been = Rs. 30 crore — Rs. 6 crore = Rs. 24 crore.

Carrying value of the plant after 5 years on 1.4.2021 = [(Rs. 24 crore / 10 years) x 5 years] = Rs. 12 crore. Annual depreciation charge would be Rs. 2.4 crore.

On refund of grant to the Government, the book value of the plant shall be increased by Rs. 6 crore i.e. Rs. 12 crore + Rs. 6 crore = Rs. 18 crore. The increased cost of Rs. 18 crore of the plant should be amortised prospectively over remaining 5 years of useful residual life. Depreciation charge in the year 2021-2022 would be Rs. 18 crore 15 years = Rs. 3.6 crore instead of earlier Rs. 2.4 crore.

Question 9

Darshan Ltd. purchased a Machinery on 1st April, 2016 for ₹ 130 lakhs (Useful life is 4 years). Government grant received is ₹ 40 lakhs for the purchase of above Machinery.

Salvage value at the end of useful life is estimated at ₹ 60 lakhs.

Darshan Ltd. decides to treat the grant as deferred income.

Your are required to calculate the amount of depreciation and grant to be recognized in profit & loss account for the year ending 31st March, 2017,31st March, 2018, 31st March, 2019 & 31st March, 2020.

Darshan Ltd. follows straight line method for charging depreciation.

(MTP 5 Marks Oct'21, PYP 5 Marks Jan'21)

Answer 9

As per 12 "Accounting for government grants", grants related to depreciable assets, if treated as deferred income are recognized in the profit and loss statement on a systematic and rational basis over the useful life of the asset. Amount of depreciation and grant to be recognized in the profit and loss account each year

Depreciation per year:

	₹ in lakhs
Cost of the Asset	130
Less: Salvage value	(60)
	70
ciation per year (70lakhs / 4)	17.50

₹ 17.50 Lakhs depreciation will be recognized for the year ending 31st March, 2017, 31st March, 2018, 31st March, 2019 and 31st March, 2020.
Amount of grant recognized in Profit and Loss account each year:
40 lakhs /4 years = ₹ 10 Lakhs for the year ending 31st March, 2017, 31st March, 2018, 31st March, 2019 and 31st March, 2020.

Question 10

Samrat Limited has set up its business in a designated backward area which entitles the company for subsidy of 25% of the total investment from Government of India. The company has invested Rs.80 crores in the eligible investments. The company is eligible for the subsidy and has received Rs.20 crores from the government in February 2019. The company wants to recognize the said subsidy as its income to improve the bottom line of the company.
Do you approve the action of the company in accordance with the Accounting Standard?
(RTP Nov'19, Nov'22)

Answer 10
As per AS 12 "Accounting for Government Grants", where the government grants are in the nature of promoters' contribution, i.e., they are given with reference to the total investment in an undertaking or by way of contribution towards its total capital outlay (for example, Central Investment Subsidy Scheme) and no repayment is ordinarily expected in respect thereof, the grants are treated as capital reserve which can be neither distributed as dividend nor considered as deferred income. The subsidy received by Samrat Ltd. for setting up its business in a designated backward area will be treated as grant by the government in the nature of promoter's contribution as the grant is given with reference to the total investment in an undertaking i.e. subsidy is 25% of the eligible investment and also no repayment is apparently expected in respect thereof. US $ 8,547 = 5,00,000/58.50 Since the subsidy received is neither in relation to specific fixed assets nor in relation to revenue. Thus, the company cannot recognize the said subsidy as income in its financial statements in the given case. It should be recognized as capital reserve which can be neither distributed as dividend nor considered as deferred income.

Question 11

Alps Limited has received the following Grants from the Government during the year ended 31st March, 2021:
(i) ₹ 120 Lacs received as Subsidy from the Central Government for setting up an Industrial undertaking in Medak, a notified backward area.
(ii) ₹ 15 Lacs Grant received from the Central Government on installation of Effluent Treatment Plant.
(iii) ₹ 25 Lacs received from State Government for providing Medical facilities to its workmen during the pandemic.
Advise Alps Limited on the treatment of the above Grants in its books of Account in accordance with AS-12 "Government Grants". *(PYP Jul'21, 5 Marks)*

Answer 11
(i) As per AS 12 'Accounting for Government Grants', where the government grants are in the nature of promoters' contribution i.e., they are given with reference to the total investment in an undertaking or by way of contribution towards its total capital outly and no repayment is ordinarily expected in respect thereof, the grants are treated as capital reserve which can be neither distributed as dividend nor considered as deferred income. In the given case, the subsidy received from the Central Government for setting up an industrial undertaking in Medak is neither in relation to specific fixed asset nor in relation in revenue. Thus, the amount of ₹ 120 Lacs should be credited to capital reserve.

(Note: Subsidy for setting up an industrial undertaking is considered to be in the nature of promoter's contribution)

(ii) As per AS 12 'Accounting for Government Grants', two methods of presentation in financial statements of grants related to specific fixed assets are regarded as acceptable alternatives –

(a) The grant is shown as a deduction from the gross value of the asset concerned in arriving at its book value. The grant is thus recognised in the profit and loss statement over the useful life of a depreciable asset by way of a reduced depreciation charge. Where the grant equals the whole, or virtually the whole, of the cost of the asset, the asset is shown in the balance sheet at a nominal value.

(b) Grants related to depreciable asset are treated as deferred income which is recognised in the profit and loss statement on a systematic and rational basis over the useful life of the asset.

(iii) In the given case, ₹ 15 Lacs was received as grant from the Central Government for installation of Effluent Treatment Plant. Since the grant was received for a fixed asset, either of the above methods can be adopted.

(iv) ₹ 25 lacs received from State Government for providing medical facilities to its workmen during the pandemic is a grant received in nature of revenue grant. Such grants are generally presented as a credit in the profit and loss statement, either separately or under a general heading such as "Other Income". Alternatively, ₹ 25 lacs may be deducted in reporting the related expense i.e., employee benefit expense.

EXAM INSIGHTS: Majority of the examinees failed to explain the treatment of the grant in the given situations as per the provisions of AS 12.

Question 12

Ram Ltd. purchased machinery for Rs. 80 lakhs (useful life 4 years and residual value Rs. 8 lakhs). Government grant received was Rs. 32 lakhs. The grant had to be refunded at the beginning of third year. Show the Journal Entry to be passed at the time of refund of grant and the value of the fixed assets in the third year and the amount of depreciation for remaining two years, if the grant had been credited to Deferred Grant A/c. *(MTP 5 Marks Apr'21, Apr'19, Apr'22 & Oct'23, MTP 7 Marks Aug'24)*

Answer 12

As per AS 12 'Accounting for Government Grants,' income from Deferred Grant Account is allocated to Profit and Loss account usually over the periods and in the proportions in which depreciation on related assets is charged. Accordingly, in the first two years (Rs. 32 lakhs /4 years) = Rs. 8 lakhs x 2 years= Rs. 16 lakhs will be credited to Profit and Loss Account and Rs. 16 lakhs will be the balance of Deferred Grant Account after two years. Therefore, on refund of grant, following entry will be passed:

		Rs.	Rs.
Deferred Grant A/c	Dr.	16 lakhs	
Profit & Loss A/c	Dr.	16 lakhs	
To Bank A/c			32 lakhs
(Being Government grant refunded)			

1. **Value of Fixed Assets after two years but before refund of grant**
   Fixed assets initially recorded in the books = Rs. 80 lakhs
   Depreciation for each year = (Rs. 80 lakhs – Rs.8 lakhs)/4 years = Rs. 18 lakhs per year
   Book value of fixed assets after two years = Rs. 80 lakhs – (Rs. 18 lakhs x 2 years) = Rs. 44 lakhs
2. **Value of Fixed Assets after refund of grant**
   On refund of grant the balance of deferred grant account will become nil. The fixed assets will continue to be shown in the books at Rs. 44 lakhs.
3. **Amount of depreciation for remaining two years**
   Depreciation will continue to be charged at Rs. 18 lakhs per annum for the remaining two years.

Question 13

On 01.04.2018, XYZ Ltd. received Government grant of ₹ 100 Lakhs for an acquisition of new machinery costing ₹ 500 lakhs. The grant was received and credited to the cost of the assets. The life span of the machinery is 5 years. The machinery is depreciated at 20% on WDV method. The company had to refund the entire grant in

2nd April, 2021 due to non-fulfilment of certain conditions which was imposed by the government at the time of approval of grant. How do you deal with the refund of grant to the Government in the books of XYZ Ltd. as per AS 12? *(MTP 5 Marks, Mar'22, MTP 5 Marks Oct'20) (PYP 5 Marks May'18 & Nov'20)*

Answer 13

According to AS 12 on Accounting for Government Grants, the amount refundable in respect of a grant related to a specific fixed asset (if the grant had been credited to the cost of fixed asset at the time of receipt of grant) should be recorded by increasing the book value of the asset, by the amount refundable. Where the book value is increased, depreciation on the revised book value should be provided prospectively over the residual useful life of the asset.

		(₹ in lakhs)
1st April, 2018	Acquisition cost of machinery (₹ 500 – ₹ 100)	400.00
31st March, 2019	Less: Depreciation @ 20%	(80)
1st April, 2019	Book value	320.00
31st March, 2020	Less: Depreciation @ 20%	(64)
1st April, 2020	Book value	256.00
31st March, 2021	Less: Depreciation @ 20%	(51.20)
1st April, 2021	Book value	204.80
2nd April, 2021	Add: Refund of grant	100.00
	Revised book value	304.80

Depreciation @ 20% on the revised book value amounting ₹ 304.80 lakhs is to be provided prospectively over the residual useful life of the asset.

Question 14

Ram Ltd. purchased machinery for Rs. 80 lakhs (useful life 4 years and residual value Rs. 8 lakhs). Government grant received was Rs. 32 lakhs. The grant had to be refunded at the beginning of third year. Show the Journal Entry to be passed at the time of refund of grant and the value of the fixed assets in the third year and the amount of depreciation for remaining two years, if the grant had been credited to Deferred Grant A/c. *(MTP 5 Marks Apr'21, Apr'19, Apr'22 & Oct'23, MTP 7 Marks Aug'24)*

Answer 14

As per AS 12 'Accounting for Government Grants,' income from Deferred Grant Account is allocated to Profit and Loss account usually over the periods and in the proportions in which depreciation on related assets is charged. Accordingly, in the first two years (Rs. 32 lakhs /4 years) = Rs. 8 lakhs x 2 years= Rs. 16 lakhs will be credited to Profit and Loss Account and Rs. 16 lakhs will be the balance of Deferred Grant Account after two years. Therefore, on refund of grant, following entry will be passed:

		Rs.	Rs.
Deferred Grant A/c	Dr.	16 lakhs	
Profit & Loss A/c	Dr.	16 lakhs	
To Bank A/c			32 lakhs
(Being Government grant refunded)			

1. **Value of Fixed Assets after two years but before refund of grant**
   Fixed assets initially recorded in the books = Rs. 80 lakhs
   Depreciation for each year = (Rs. 80 lakhs – Rs.8 lakhs)/4 years = Rs. 18 lakhs per year
   Book value of fixed assets after two years = Rs. 80 lakhs – (Rs. 18 lakhs x 2 years) = Rs. 44 lakhs
2. **Value of Fixed Assets after refund of grant**
   On refund of grant the balance of deferred grant account will become nil. The fixed assets will continue to be shown in the books at Rs. 44 lakhs.
3. **Amount of depreciation for remaining two years**
   Depreciation will continue to be charged at Rs. 18 lakhs per annum for the remaining two years.

Question 15

On 01.04.2018, XYZ Ltd. received Government grant of ₹ 100 Lakhs for an acquisition of new machinery costing ₹ 500 lakhs. The grant was received and credited to the cost of the assets. The life span of the machinery is 5 years. The machinery is depreciated at 20% on WDV method. The company had to refund the entire grant in 2nd April, 2021 due to non-fulfilment of certain conditions which was imposed by the government at the time of approval of grant. How do you deal with the refund of grant to the Government in the books of XYZ Ltd. as per AS 12? *(MTP 5 Marks, Mar'22, MTP 5 Marks Oct'20) (PYP 5 Marks May'18 & Nov'20)*

Answer 15

According to AS 12 on Accounting for Government Grants, the amount refundable in respect of a grant related to a specific fixed asset (if the grant had been credited to the cost of fixed asset at the time of receipt of grant) should be recorded by increasing the book value of the asset, by the amount refundable. Where the book value is increased, depreciation on the revised book value should be provided prospectively over the residual useful life of the asset.

		(₹ in lakhs)
1st April, 2018	Acquisition cost of machinery (₹ 500 – ₹ 100)	400.00
31st March, 2019	Less: Depreciation @ 20%	(80)
1st April, 2019	Book value	320.00
31st March, 2020	Less: Depreciation @ 20%	(64)
1st April, 2020	Book value	256.00
31st March, 2021	Less: Depreciation @ 20%	(51.20)
1st April, 2021	Book value	204.80
2nd April, 2021	Add: Refund of grant	100.00
	Revised book value	304.80

Depreciation @ 20% on the revised book value amounting ₹ 304.80 lakhs is to be provided prospectively over the residual useful life of the asset.

Question 16

Answer the following Questions:

Suraj Limited provides you the following information:

(i) It received a Government Grant @40% towards the acquisition of Machinery worth ₹ 25 Crores.

(ii) It received a Capital Subsidy of ₹ 150 Lakhs from Government for setting up a Plant costing ₹ 300 Lakhs in a notified backward region.

(iii) It received ₹ 50 Lakhs from Government for setting up a project for supply of arsenic free water in a notified area.

(iv) It received ₹ 5 Lakhs from the Local Authority for providing Corona Vaccine free of charge to its employees and their families.

(v) It also received a performance award of ₹ 500 Lakhs from Government with a condition of major renovation in the Power Plant within 3 years. Suraj Limited incurred 90% of amount towards Capital expenditure and balance for Revenue Expenditure.

State how you will treat the above in the books of Suraj Limited. *(PYP 5 Marks, May'22)*

Answer 16

(i) As per AS 12 "Accounting for Govt. Grants", two methods of presentation in financial statements of grants related to specific fixed assets are regarded as acceptable alternatives. Under the first alternative, the grant of ₹ 10 crores (40% of 25 crores) is shown as a deduction from the gross value of the asset concerned in arriving at its book value. The grant is thus recognized the profit and loss statement over the useful life of a depreciable asset by way of a reduced depreciation charge. Under second alternative method, grant amounting ₹ 10 crores is treated as deferred income which is recognized in the profit and loss statement on a systematic and rational basis over the useful life of the asset.

(ii) In the given case, the grant amounting ₹ 150 lakhs received from the Central Government for setting up a plant in notified backward area may be considered as in the nature of promoters' contribution. Thus, amount of ₹ 150 lakhs should be credited to capital reserve and the plant will be shown at ₹ 300 lakhs.

(iii) ₹ 50 lakhs received from Govt. for setting up a project for supply of arsenic free water in notified area should be credited to capital reserve. Alternatively, if it is assumed that the project consists of capital asset only, then the amount of ₹ 50 lakhs received from Govt. for setting up a project for supply of arsenic free water should either be deducted from cost of asset of the project concerned in the balance sheet or treated as deferred income which is recognized in the profit and loss statement on a systematic and rational basis over the useful life of the asset.

(iv) ₹ 5 lakhs received from the local authority for providing corona vaccine to the employees is a grant received in nature of revenue grant. Such grants are generally presented as a credit in the profit and loss account, either separately or under a general heading 'Other Income'. Alternatively, ₹ 5 lakhs may be deducted in reporting the related expense i.e. employee benefit expenses.

(v) ₹ 500 Lakhs will be reduced from the renovation cost of power plant or will be treated as deferred income irrespective of the expenditure done by the entity out of it as it was specifically received for the purpose major renovation of power plant. However, it may be, later on, decided by the Govt. whether the grant will have to be refunded or not due to non-compliance of conditions attached to the grant.

EXAM INSIGHTS: Majority of the examinees were not able to explain the correct treatment of grant in line with the provisions of AS 12 "Accounting for Government Grant".

Question 17 LDR

(i) Hygiene Ltd. had received a grant of Rs. 50 lakh in 2012 from a State Government towards installation of pollution control machinery on fulfilment of certain conditions. The company, however, failed to comply with the said conditions and consequently was required to refund the said amount in 2020. The company debited the said amount to its machinery account in 2020 on payment of the same. It also reworked the depreciation for the said machinery from the date of its purchase and passed necessary adjusting entries in the year 2020 to incorporate the retrospective impact of the same. State whether the treatment done by the company is correct or not. (RTP May'21, May'23, New SM)

(ii) ABC Ltd. received two acres of land received for set up of plant. It also received Rs.2 lakhs received for purchase of machinery of Rs. 10 lakhs. Useful life of machinery is 5 years. Depreciation on this machinery is to be charged on straight-line basis. How should ABC Ltd. recognize these government grants in its books of accounts? *(RTP May'21)*

Answer 17

(i) As per the facts of the case, Hygiene Ltd. had received a grant of Rs.50 lakh in 2012 from a State Government towards installation of pollution control machinery on fulfilment of certain conditions. However, the amount of grant has to be refunded since it failed to comply with the prescribed conditions. In such circumstances, AS 12, "Accounting for Government Grants", requires that the amount refundable in respect of a government grant related to a specific fixed asset is recorded by increasing the book value of the asset or by reducing the capital reserve or the deferred income balance, as appropriate, by the amount refundable. The Standard further makes it clear that in the first alternative, i.e., where the book value of the asset is increased, depreciation on the revised book value should be provided prospectively over the residual useful life of the asset. Accordingly, the accounting treatment given by Hygiene Ltd. of increasing the value of the plant and machinery is quite proper. However, the accounting treatment in respect of depreciation given by the company of adjustment of depreciation with retrospective effect is improper and constitutes violation of AS 12.

(ii) ABC Ltd. should recognize the grants in the following manner:

- As per AS 12, government grants may take the form of non-monetary assets, such as land or other resources, given at concessional rates. In these circumstances, it is usual to account for such assets at their acquisition cost. Non-monetary assets given free of cost are recorded at a nominal value. Accordingly, land should be recognized at nominal value in the balance sheet.
- The standard provides option to treat the grant either as a deduction from the gross value of the asset or to treat it as deferred income as per provisions of the standard. Under first method, the grant is shown as a deduction from the gross value of the asset concerned in arriving at its book value. The grant is thus recognised in the profit and loss statement over the useful life of a depreciable asset by way of a reduced depreciation charge. Accordingly, the grant of Rs. 2 lakhs is deducted from the cost of the machinery.

Machinery will be recognised in the books at Rs. 10 lakhs – Rs. 2 lakhs = Rs. 8 lakhs and depreciation will be charged on it as follows:
Rs. 8 lakhs/ 5 years = Rs. 1.60 lakhs per year.
Under the second method, grants related to depreciable assets are treated as deferred income which is recognised in the profit and loss statement on a systematic and rational basis over the useful life of the asset. Such allocation to income is usually made over the periods and in the proportions in which depreciation on related assets is charged. Rs. 2 lakhs should be recognised as deferred income and will be transferred to profit and loss over the useful life of the asset. In this case, Rs. 40,000 [Rs. 2 lakhs / 5 years] should be credited to profit and loss each year over the period of 5 years.

Question 18

How would you treat the following in the accounts in accordance with AS 12 'Government Grants'?
(i) Rs.35 Lakhs received from the Local Authority for providing Medical facilities to the employees.
(ii) Rs.100 Lakhs received as Subsidy from the Central Government for setting up a unit in a notified backward area.
(iii) Rs.10 Lakhs Grant received from the Central Government on installation of anti- pollution equipment.
(RTP Nov'20, RTP May'20, MTP Oct'22, 5 Marks, Old & New SM)

Answer 18

(i) Rs.35 lakhs received from the local authority for providing medical facilities to the employees is a grant received in the nature of revenue grant. Such grants are generally presented as a credit in the profit and loss statement, either separately or under a general heading such as 'Other Income'. Alternatively, Rs.35 lakhs may be deducted in reporting the related expense i.e. employee benefit expenses.
(ii) As per AS 12 'Accounting for Government Grants', where the government grants are in the nature of promoters' contribution, i.e. they are given with reference to the total investment in an undertaking or by way of contribution towards its total capital outlay and no repayment is ordinarily expected in respect thereof, the grants are treated as capital reserve which can be neither distributed as dividend nor considered as deferred income. In the given case, the subsidy received from the Central Government for setting up a unit in notified backward area is neither in relation to specific fixed asset nor in relation to revenue. Thus, amount of Rs.100 lakhs should be credited to capital reserve.
(iii) Rs.10 lakhs grant received for installation anti-pollution equipment is a grant related to specific fixed asset. Two methods of presentation in financial statements of grants related to specific fixed assets are regarded as acceptable alternatives. Under first method, the grant is shown as a deduction from the gross value of the asset concerned in arriving at its book value. The grant is thus recognized in the profit and loss statement over the useful life of a depreciable asset by way of a reduced depreciation charge. Under the second method, grants related to depreciable assets are treated as deferred income which is recognised in the profit and loss statement on a systematic and rational basis over the useful life of the asset.
Thus, Rs.10 lakhs may either be deducted from the cost of equipment or treated as deferred income to be recognized on a systematic basis in profit & Loss A/c over the useful life of equipment.

Question 19

LDR

On 1st April, 2016, Mac Ltd. received a Government Grant of ₹ 60 lakhs for acquisition of machinery costing ₹ 300 lakhs. The grant was credited to the cost of the asset. The estimated useful life of the machinery is 10 years. The machinery is depreciated @ 10% on WDV basis. The company had to refund the grant in June 2019 due to non- compliance of certain conditions. How the refund of the grant is dealt with in the books of Mac Ltd. assuming that the company did not charge any depreciation for the year 2019-20. Pass necessary Journal Entries for the year 2019-20.
(PYP 5 Marks Nov'20) (Same concept different figures MTP 5 Marks, Mar'22, MTP 5 Marks Oct'20, PYP 5 Marks May'18)

Answer 19

		(₹ in lakhs)
1st April, 2016	Acquisition cost of machinery Less: Government Grant	300.00

		60.00
		240.00
31st March, 2017	Less: Depreciation @ 10%	(24.00)
1st April, 2017	Book value	216.00
31st March, 2018	Less: Depreciation @ 10%	(21.60)
1st April, 2018	Book value	194.40
31st March, 2019	Less: Depreciation @ 10%	(19.44)
1st April, 2019	Book value Less: Depreciation @10% for 2 months	174.96 (2.916)
1st June, 2019	Book value	172.044
June 2019	Add: Refund of grant*	60.00
	Revised book value	232.044

Depreciation @10% on the revised book value amounting to ₹ 232.044 lakhs is to be provided prospectively over the residual useful life of the machinery.

*considered refund of grant at beginning of June month and depreciation for two months already charged. Alternative answer considering otherwise also possible.

Journal Entries

Machinery Account	Dr.	60	
To Bank Account (Being government grant on asset partly refunded which increased the cost of fixed asset)			60
Depreciation Account	Dr.	19.337	
To Machinery Account (Being depreciation charged on revised value of fixed asset prospectively for 10 months)			19.337
Profit & Loss Account	Dr.	22.253	
To Depreciation Account (Being depreciation transferred to Profit and Loss Account amounting to ₹ (2.916 + 19.337= 22.253)			22.253

Question 20

A Ltd. purchased a Machinery for ₹ 75 Lakhs. Government Grant received towards this Machinery is ₹ 10, Lakhs. Residual Value of Machinery at the end of useful life of 6 Years is ₹ 5 Lakhs.

Asset is shown in Balance Sheet at net of grant.

At the beginning of the 3rd year, an amount becomes refundable to the extent of ₹ 8 Lakhs due to non-compliance of certain conditions of grant.

You are required to give necessary Journal entries for the 1st year and the 3rd year in the books of A Ltd *(PYP 5 Marks Nov'23) (Same Concept Different Figure SM)*

Answer 20

Journal Entries in the Books of A Ltd.

Year	Particulars		₹ in lakhs (Dr.)	₹ in lakhs (Cr.)
1	Machinery Account	Dr.	75	
	To Bank Account			75
	(Being machinery purchased)			
	Bank Account	Dr.	10	
	To Machinery Account			10
	(Being grant received from the government reduced from the cost of machinery)			
	Depreciation Account (W.N.1)	Dr.	10	
	To Machinery Account			10

	(Being depreciation charged on Straight Line method (SLM))			
	Profit & Loss Account	Dr.	10	
	To Depreciation Account			10
	(Being depreciation transferred to Profit and Loss Account at the end of year 1)			
3	Machinery Account	Dr.	8	
	To Bank Account			8
	(Being government grant on machinery partly refunded which increased the cost of fixed asset)			
	Depreciation Account (W.N.2)	Dr.	12	
	To Machinery Account			12
	(Being depreciation charged on SLM on revised value of fixed asset prospectively)			
	Profit & Loss Account	Dr.	12	
	To Depreciation Account			12
	(Being depreciation transferred to Profit and Loss Account at the end of year 3)			

Working Notes:

1. **Depreciation for Year 1**

	₹ in lakhs
Cost of the Machinery	75
Less: Government grant received	(10)
	65
Depreciation $\left[\frac{65-5}{6}\right]$	10

2. **Depreciation for Year 3**

	₹ in lakhs
Cost of the Machinery	75
Less: Government grant received	(10)
	65
Less: Depreciation for the first two years	20
	45
Add: Government grant refundable	8
	53
Depreciation for the third year $\left[\frac{53-5}{4}\right]$	12

EXAM INSIGHTS: Few examinees could not calculate the depreciation to be charged to Profit & Loss Account for 1 and 3 years, resulting in incorrect journal entries.

Question 21

On 1st April 2021, Eleanor Limited purchased a manufacturing Plant for ₹ 60 lakhs, which has an estimated useful life of ₹ 10 years with a salvage value of ₹ 10 lakhs. On purchase of the Plant, a grant of ₹ 20 lakhs was received from the government.

You are required to calculate the amount of depreciation as per AS-12 for the financial year 2022-23 in the following cases:

(i) If the grant amount is deducted from the value of Plant.

(ii) If the grant is treated as deferred income.

(iii) If the grant amount is deducted from the value of Plant, but at the end of the year 2022-2023 grant is refunded to the extent of ₹ 4 lakhs, due to non-compliance of certain conditions.

(iv) If the grant is treated as the promoter's contribution.

(Assume depreciation on the basis of Straight-Line Method.) ***(PYP 5 Marks May'23)***

Answer 22

Calculation of depreciation as per AS 12 for the financial year 2022-23:

(i) If the grant amount is deducted from the value of Plant, then the amount of deprecation will be ₹ 3,00,000 p.a. (₹ 60,00,000 - ₹ 10,00,000 - ₹ 20,00,000) / 10 year.

(ii) If the grant is treated as deferred income, then amount of depreciation will be ₹ 5,00,000 p.a. (₹ 60,00,000 - ₹ 10,00,000) / 10 year.

(iii) If the grant amount is deducted from the value of plant, but at the end of the year 2022-23 grant is refunded to the extent of ₹ 4 lakh then the amount of depreciation will be ₹ 3,00,000 p.a.

(₹ 60,00,000 - ₹ 10,00,000 - ₹ 20,00,000) /10 year for year 202122 and for the year 2022-23 Depreciation will be ₹ 3,00,000 calculated as follows, (₹60,00,000 - ₹ 10,00,000 - ₹ 20,00,000– ₹ 3,00,000) / 10 years.

Note: It is assumed that the depreciation for the year has been charged on the book value on the plant before making adjustment for grant. Alternatively, if it is considered otherwise then the depreciation will be charged after making adjustment for grant. In that case depreciation for the year 2022-23 will be as ₹ 3,44,444 calculated as follows, (₹ 60,00,000 - ₹10,00,000 - ₹ 20,00,000 + 4,00,000– ₹ 3,00,000 / 9 years

(iv) If the grant is treated as promoter's contribution, then the amount of depreciation will be ₹ 5,00,000 p.a. (₹ 60,00,000 -10,00,000) /10 year.

NOTE: The answer can be presented in the following alternative manner:

		(i)	**(ii)**	**(iii)**	**(iv)**
Date	**Particulars**	**Grant Value deducted from Plant**	**Grant treated as Deferred Income**	**Grant Refunded**	**Grant is treated as Promoter's Contribution**
01.04.2021	Cost of Plant Less: Salvage	60,00,000 10,00,000	60,00,000 10,00,000	60,00,000 10,00,000	60,00,000 10,00,000
		50,00,000	**50,00,000**	**50,00,000**	**50,00,000**
01.04.2021	Less: Grant	20,00,000	-	20,00,000	-
		30,00,000	50,00,000	30,00,000	50,00,000
	Useful Life (years)	10	10	10	10
31.03.2022	Depreciation FY 2021-22	3,00,000	5,00,000	3,00,000	5,00,000
1.4.2022	Cost of Plant Less: Salvage			60,00,000 10,00,000	
				50,00,000	
	Less: Grant			20,00,000	
	Less:			30,00,000	
	Depreciation FY 2022-23			3,00,000	
				27,00,000	
	Book value at the time of refund of grant i.e. at the end of period			4,00,000	
	Add: Grant Refundable at end of 22-23 Book value available for remining 8 years.			31,00,000	

Note:

It is assumed that the depreciation for the year has been charged on the book value on the plant before making adjustment for grant. Alternatively, if it is considered otherwise then the depreciation will be charged after making adjustment for grant. In that case depreciation for the year 2022-23 will be as:

Cost of Plant	60,00,000
Less: Salvage	10,00,000

	50,00,000
Less: Grant	20,00,000
	30,00,000
Add: Grant Refundable	4,00,000
	34,00,000
Less: Depreciation For 2021-22	3,00,000
	31,00,000
Useful Life (years)	9
Depreciation For 2022-23	3,44,444

EXAM INSIGHTS: Some of the examinees failed to calculate the amount of depreciation as per AS 12 "Accounting for Govt. Grants" for the financial year 2022-23 in the different cases.

Multiple Choice Questions (MCQ)

1. To encourage industrial promotion, IDCI offers subsidy worth Rs. 50 lakhs to all new industries set up in the specified industrial areas. This grant is in the nature of promoter's contribution. How such subsidy should be accounted in the books?

(a) Credit it to capital reserve
(b) Credit it as 'other income' in the profit and loss account in the year of commencement of commercial operations
(c) Both (a) and (b) are permitted
(d) Credit it to general reserve

Ans: (a)

2. Government grants that are receivable as compensation for expenses or losses incurred in a previous accounting period or for the purpose of giving immediate financial support to the enterprise with no further related costs, should be

(a) recognised and disclosed in the Statement of Profit and Loss of the period in which they are receivable as an ordinary item.
(b) recognised and disclosed in the Statement of Profit and Loss of the period in which the losses or expenses were incurred.
(c) recognised and disclosed in the Statement of Profit and Loss of the period in which they are receivable, as an extraordinary item if appropriate as per AS 5.
(d) Disclosed in the Statement of Profit and Loss of the period in which they are receivable, as an extraordinary item.

Ans: (c)

3. Which of the following is an acceptable method of accounting presentation for a government grant relating to an asset?

(a) Credit the grant immediately to Income Statement
(b) Show the grant as part of Capital Reserve
(c) Reduce the grant from the cost of the asset or show it separately as a deferred income on the Liability side of the Balance Sheet.
(d) Show the grant as part of General Reserve

Ans: (c)

4. X Ltd. has received a grant of ₹ 20 crore for purchase of a qualified machine costing ₹ 80 crore. X Ltd has a policy to recognize the grant as a deduction from the cost of the asset. The expected remaining useful life of the machine is 10 years. Assume that there is no salvage value and the depreciation method is straight-line. The amount of annual depreciation to be charged as an expense in Profit and Loss Statement will be:

(a) ₹ 10 crore
(b) ₹ 6 crore

(c) ₹ 2 crore

(d) ₹ 8 crore

Ans: (b)

5. X Ltd has received a grant of ₹ 20 crore for purchase of a qualified machine costing ₹ 80 crore. X Ltd. has a policy to recognise the grant as deferred income. The expected remaining useful life of the machine is 10 years. Assume that there is no salvage value and the depreciation method is straight-line. The amount of other income to be to be recognized in the Profit and Loss Statement will be:

(a) ₹ 10 crore

(b) ₹ 6 crore

(c) ₹ 2 crore

(d) ₹ 8 crore

Ans: (c)

CA INTERMEDIATE

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PAPER 2

Corporate & Other Laws Reviewer

Chapter-wise compilation RTP, MTP and PYP questions

KEY HIGHLIGHTS

- Easy to Hard Difficulty Level
- Importance levels marked as A, B or C
- Reference to all questions
- Quick recap of important concepts
- Exam Insights
- Last Day Revision Questions Marked

APPLICABLE FOR MAY'25, SEPT'25 AND JAN'26

Corporate & Other Laws

REVIEWER

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STRIVING TOWARDS KNOWLEDGE

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STRIVING TOWARDS KNOWLEDGE

This book belongs to future,

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"You become what you believe."

-Oprah Winfrey

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YOU MUST BE WONDERING

How to Read this book?

Step 1
Prioritize more time for 'A' chapters in the ABC analysis

Step 2
Identify key concepts in each chapter.

Step 3
Solve questions in order, from easy to difficult.

Step 4
Focus on solving LDR questions during the final revision

01 — 02 — 03 — 04

Step 1: Prioritize your chapters

Chapters in the index are categorized as A, B, or C based on their importance. Focus more on 'A' chapters, as they carry the most weight, and give adequate attention to 'B' chapters. While all chapters must be covered, this approach helps manage time efficiently for better results.

Step 2: Identify key concept

Identify the key concepts for each chapter using the list provided at the start of the chapter. Ensure you understand them thoroughly. If you struggle with a question, revisit the concepts, review them, and strengthen your understanding before moving forward.

Step 3: Start easy

Start with Question 1, as they progress from easy to difficult, helping you build confidence throughout the chapter. Pay close attention to the “EXAM INSIGHTS” to avoid common mistakes. Questions are segregated topic wise where possible.

Step 4: Last Day Revision (LDR)

Focus on solving LDR questions during the final revision. In the 1.5 days before the exam, prioritize these questions as they cover the most critical concepts from each chapter. You'll find a quick summary of LDR question numbers listed right before each chapter for easy reference.

Table of Contents

ABC Analysis

A Very Important, Read on priority

B Moderately Important

C Less critical but still essential

Ensure you thoroughly read all chapters without skipping any. The ABC analysis is designed to help you prioritize based on past trends, but it should not replace comprehensive preparation.

A

CHAPTER 8: DECLARATION AND PAYMENT OF DIVIDEND TRANSFER TO RESERVES

CONCEPTS OF THIS CHAPTER

- Sec 123(1) proviso 2- Declaration of Dividend when there is Immediacy or Absence of Profits
- Prohibition on Declaration of Dividend
- Sec 123(3)- Interim Dividend
- Sec 124- Unpaid Dividend Account
- Sec 127- Punishment for failure to distribute Dividend
- Sec 125- Investor Education & Protection Fund

LDR Questions
Q 5
Q10
Q12
Q18

QUICK REVIEW OF IMPORTANT CONCEPTS

Provisions regarding Declaration of Dividend

Dividend can be declared out of following sources

Current year profits	after depreciation	Out of both the above sources
Out of the profits of the company for any previous financial year/s	Arrived at after providing for depreciation in accordance with Schedule II and remaining undistributed	
Money provided by the Central Government/ State Government for the payment of dividend by the Co.	in pursuance of a guarantee given by that particular Government	

Depositing amount of Dividend

The amount of dividend shall be deposited in a scheduled bank in a separate account within 5 days from the date of declaration of such dividend

Declaration of Dividend in Case of Inadequate/No Profits

1. Declaring dividend out of past year profits

Where, owing to inadequacy or absence of profits in any financial year

- Company may propose to declare dividend
- out of the accumulated profits earned by it in previous years and transferred by the company to the free reserves
- Such declaration of dividend shall be made in accordance with Rule 3 of the Companies (Declaration and Payment of Dividend) Rules, 2014

2. Amounts not treated as free reserves

- Amounts representing unrealised gains

- Notional gains
- Revaluation of assets, whether shown as reserve or otherwise
- Any change in carrying amount of an asset or of a liability recognized in equity, including surplus in P&L Account on measurement of the asset or the liability at fair value

3. Rules to be followed while declaring dividend in case of inadequacy/ absence of profits

Rate of Dividend ≤ (RD1 +RD2 + RD3)/ 3. Where, RD1, RD2, RD3 are rates at which dividend was declared by it in the 3 years immediately preceding that year

However, this condition will not apply if a company has not declared any dividend in each of the 3 preceding financial years

Total amount that can be drawn from accumulated profits

- not exceed 1/10th of its paid up share capital + free reserves
- As per latest audited financial statement

Drawn amount must be first utilized to set off losses incurred in FY in which dividend is declared

Balance of reserves after such withdrawal

- not fall below 15% of its paid up share capital
- As per latest audited financial statement

These rules are not applicable to a Government Company in which the entire paid up share capital is held by the Central Government, or by any State Government or Governments or by the Central Government and one or more State Governments

Prohibition on Declaration of Dividend

In case of any defaulting company	• A company fails to comply with • provisions of section 73 and 74 of the Companies Act
In case of section 8 companies	• company with licence under section 8 • Its profits are applied only in promoting the objects for which it is formed.

Unpaid Dividend Account (UPA)

- Declared Dividend
- **30 Days** Dividend Not Paid/ Claimed
- **7 Days** Deposit the unpaid/ unclaimed dividend amount in Scheduled Bank (Called Unpaid Dividend Account)
- **If not done** Pay Interest @ 12% p.a. (from the date of default)
- **90 Days** Prepare Statement (Name, Last known address, Unpaid dividend amount)
  - **Website of Company**
  - **Website approved by Government for thispurpose**
- **After the expiry of 7 Years** Transfer to IEPF (Unpaid/Unclaimed dividend + interest)
- Any person claiming for the amount transferred in UPA may apply to Co. for the payment of money claimed

Investor Education and Protection Fund (IEPF)

1. Amounts to be credited to the Fund

- Amount given by the Central Government
  - by way of grants after due appropriation made by Parliament
- Donations given by the Central Government, State Governments, companies or any other institution
  - for the purposes of the Fund
- Amount lying in the Unpaid Dividend Account
- Amount in the General Revenue Account of the Central Government
  - that had been transferred to that account under section 205A(5) of the Companies Act, 1956 and remaining unpaid or unclaimed on the commencement of the Companies Act, 2013
- Amount in IEPF
  - as per section 205C of the Companies Act, 1956
- Interest or other income
  - received out of investments made from the Fund

- Amount received through disgorgement or disposal of Securities
  - seized from a person who has been convicted for personation for acquisition of securities
- Application Money
  - for allotment of any securities and due for refund (only if such amount has remained unclaimed and unpaid for a period of 7 years from the date it became due for payment)
- Matured Deposits
- Matured Debentures
- Interest
  - accrued on the amounts mentioned as Application money, Matured deposits and matured debentures and interest thereon
- Amount received from Sale Proceeds
  - of fractional shares arising out of issuance of bonus shares, merger and amalgamation for 7 or more years
- Redemption amount of preference shares
  - remaining unpaid or unclaimed for 7 or more years
- Other amounts

  (a) amounts payable as mentioned in clause (a) to (n) of section 125 (2)

  (b) shares in whose case dividends have not been claimed or paid for 7 consecutive years or more

  (c) all the resultant benefits arising out of shares held by the Authority under clause (b) above

  (d) all grants, fees and charges received by the Authority

  (e) all sums received by the Authority from such other sources as may be decided upon by the Central Government

  (f) all income earned by the Authority in any year

  (fa) all shares held by the Authority in accordance with proviso of sub-section section 90(9)

  (g) all amounts payable as mentioned in section 10B(3) of the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970, section 10B of the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980, section 38A(3) of the State Bank of India Act, 1955 and section 40A of the State Bank of India (Subsidiary Bank) Act, 1959

  (h) all other sums of money collected by the Authority as envisaged in the Act

2. **Utilization of the Fund**

- refund of unclaimed dividends, matured deposits, matured debentures, application money due for refund and interest thereon
- promotion of investors' education, awareness and protection
- distribution of any disgorged amount among eligible and identifiable applicants for shares or debentures by, shareholders, debenture-holders or depositors who have suffered losses due to wrong actions by any person, in accordance with the orders made by the Court which had ordered disgorgement
- reimbursement of legal expenses incurred in pursuing class action suits under sections 37 and 245 by members, debenture-holders or depositors as may be sanctioned by the Tribunal
- any other purpose incidental thereto

Punishment for failure to Distribute Dividends

1. **Punishment and liability**

Declared Dividend	Dividend not paid/Warrant not Posted (within 30 days from the date of declaration)	**1.** Every Director (If knowingly a party to default)	• Imprisonment ≤ 2 years
			• Fine ₹ 1,000 per day (during which default continues)
		2. Company	• Simple Interest @18% per annum

2. **Exceptions under which no offence shall be deemed to have been committed**

Exemption from punishment on failure to pay dividend

- Not be paid by reason of operation of any law
- Shareholder gave directions regarding payment but same cannot be complied with and communicated to him

- Dispute regarding right to receive it
- Any other reason- the failure to pay/ post dividend/ warrant within the prescribed time, was not due to any default on the part of the company
- It has been lawfully adjusted against any sum due from shareholder to Co.

Question & Answers

Case based

Question 1

G Medical Instruments Limited is a manufacturing company & has proposed a dividend @ 10% for the year 2023-24 out of the profits of current year. The company has earned a profit of ₹ 910 crores during 2023-2024. The company does not intend to transfer any amount to the general reserves out of the profits. Is G Medical Instruments Limited allowed to do so, as per the provisions of the Companies Act, 2013? *(MTP 3 Marks Oct'22 SM)*

Answer 1

According to section 123 of the Companies Act, 2013, a company may, before the declaration of any dividend in any financial year, transfer such percentage of its profits for that financial year as it may consider appropriate to the reserves of the company. Such transfer is not mandatory and the percentage to be transferred to reserves is at the discretion of the company.

As per the given facts, G Medical Instruments Limited has earned a profit of ₹ 910 crores for the financial year 2023-2024. It has proposed a dividend @ 10%. However, it does not intend to transfer any amount to the reserves of the company out of the profits of current year.

As per the provisions stated above, the amount to be transferred to reserves out of profits for any financial year is at the discretion of the company acting through its Board of Directors. Therefore, at its discretion, if G Medical Instruments Limited decides not to transfer any profit to reserves before the declaration of dividend at 10%, it is legally allowed to do so.

Question 2

(i) YZ Ltd is a manufacturing company & has proposed a dividend @ 10% for the year 2017-18 out of the current year profits. The company has earned a profit of Rs. 910 crores during 2017-18. YZ Ltd. does not intend to transfer any amount to the general reserves of the company out of current year profit. Is YZ Ltd. allowed to do so? Comment *(MTP Oct'20, April '19 , 3 Marks, PYP Nov '18 , 3 Marks)*

Answer 2

(i) Transfer to reserves (Section 123 of the Companies Act, 2013): A company may, before the declaration of any dividend in any financial year, transfer such percentage of its profits for that financial year as it may consider appropriate to the reserves of the company. Therefore, the company may transfer such percentage of profit to reserves before declaration of dividend as it may consider necessary. Such transfer is not mandatory and the percentage to be transferred to reserves is at the discretion of the company.

As per the given facts, YZ Limited has earned a profit of Rs. 910 crores for the financial year 2017-18. It has proposed a dividend @ 10%. However, it does not intend to transfer any amount to the reserves of the company out of current year profit.

As per the provisions stated above, the amount to be transferred to reserves out of profits for a financial year is at the discretion of the YZ Ltd. acting vide its Board of Directors.

Sec 123(1) proviso 2- Declaration of Dividend when there is Immediacy or Absence of Profits

Case based

Question 3

Alex limited is facing loss in business during the financial year 2023-2024. In the immediate preceding three financial years, the company had declared dividend at the rate of 7%, 11% and 12% respectively. The Board of Directors has decided to declare 12% interim dividend for the current financial year at least to be in par with the immediate preceding year. Is the act of the Board of Directors valid? *(SM)*

Answer 3

As per Section 123(3) of the Companies Act, 2013, the Board of Directors of a company may declare interim dividend during any financial year out of the surplus in the profit and loss account and out of profits of the financial year in which such interim dividend is sought to be declared.

Provided that in case the company has incurred loss during the current financial year up to the end of the quarter immediately preceding the date of declaration of interim dividend, such interim dividend shall not be declared at a rate higher than the average dividends declared by the company during the immediately preceding three financial years.

According to the given facts, Alex Ltd. is facing loss in business during the financial year 2023-2024. In the immediate preceding three financial years, the company declared dividend at the rate of 7%, 11% and 12% respectively. Accordingly, the rate of dividend declared shall not exceed 10%, the average of the rates (7+11+12=30/3) at which dividend was declared by it during the immediately preceding three financial years.

Therefore, the act of the Board of Directors as to declaration of interim dividend at the rate of 12% during the F.Y 2023-2024 is not valid.

Question 4

Vishal Limited has paid dividend consistently every year at the rate of 10% on its equity share capital in the last 5 years (2015-2016 to 2019-2020). The company has incurred loss in the current financial year (FY 2020-2021). It still wants to declare dividend for the FY 2020-2021. Whether the company can do so? Explain. (*RTP May '22) (Similar to May'20 but different figures)*

Answer 4

As per second proviso to Section 123(1) of the Companies Act, 2013 read with Rule 3 of the Companies (Declaration and Payment of Dividend) Rules, 2014, where in any year there is absence of profit or there are no adequate profits for declaring dividend, the company may declare dividend out of the profits of any previous year transferred by it to the free reserves, only in accordance with the procedure laid down.

However, such declaration shall be subject to the following conditions:

(a) The rate of dividend declared shall not exceed the average of the rates at which dividend was declared by the company in the three years immediately preceding that year. Provided that this sub-rule shall not apply to a company, which has not declared any dividend in each of the three preceding financial year.

(b) The total amount to be drawn from such accumulated profits shall not exceed 10% of the sum of its paid-up share capital and free reserves as appearing in the latest audited financial statement.

(c) The amount so drawn shall first be utilized to set off the losses incurred in the financial year in which dividend is declared and only thereafter, any dividend in respect of equity shares shall be declared.

(d) The balance of reserves after such withdrawal shall not fall below 15% of its paid -up share capital as appearing in the latest audited financial statement.

Hence, if the company wants to pay dividend in the current financial year, it can do so if all the above conditions have been fulfilled.

Question 5

LDR

A company has accumulated Free Reserves of ₹75 lakhs during last five years. It has not declared any dividend during these years. Now, the company proposes to appropriate a part of this amount for making payment of dividend for current year in which it has earned a profit of ₹ 12 lakhs. The Board proposes a payment of dividend of ₹30 lakhs i.e. 30% on the paid up capital. Examine, as per the provisions of the Companies Act, 2013, whether, the proposal of the company is valid? *(PYP 6 Marks Nov '22)*

Answer 5

In the question given, the company is intending to declare dividend out of current year profits and past year's profits. As per provisions of Section 123 of the Companies Act, 2013, where in any year, there are no adequate profits for declaring dividend, the company may declare dividend out of the profits of any previous year transferred by it to the free reserves only in accordance with the procedure laid down in Rule 3 of the Companies (Declaration and Payment of Dividend) Rules, 2014.

Conditions of Rule 3:

Condition 1: The rate of dividend declared shall not exceed the average of the rates at which dividend was declared by the company in the immediately preceding three years.

Condition 2: The total amount to be drawn from such accumulated profits shall not exceed 10% of its paid-up share capital and free reserves as appearing in the latest audited financial statement.

Condition 3: The balance of reserves after such withdrawal shall not fall below 15% of its paid up share capital as appearing in the latest audited financial statement.

Calculations For Each Condition

Condition 1: This condition shall not apply if the company has not declared any dividend in each of the three preceding financial year.

Thus, condition 1 shall not be applicable on the company in question as it has not declared dividend in last 5 years.

Condition 2: As per the facts, the Board proposes a payment of dividend of ₹ 30 lakhs i.e., 30% on the paid up capital.

So, the Paid up Share Capital of the company = ₹ 100 Lakh

Paid-up Capital + Free Reserves = 100+ 75 = ₹ 175 Lakh

10% thereof = ₹ 17.5 Lakh

Hence the dividend to be declared is to be restricted to ₹ 17.5 Lakh.

Condition 3:

Here, Free Reserves = ₹ 75 Lakh

Proposed withdrawal for declaration of dividend ₹ 17.5 Lakh

Balance of Reserves = ₹75 Lakh- 17.5 Lakh = ₹ 57.5 Lakh

This (balance of reserve) is more than 15% of paid-up capital (i.e 15% of ₹ 100 Lakh) i.e. ₹ 15 Lakh.

Thus, the company can declare a dividend of ₹ 17.5 lakh i.e. at a rate of 17.5% on its paid-up capital of ₹ 100 lakh.

Hence, the proposal of company for payment of dividend of ₹ 30 lakh i.e. 30% on the paid up capital in the current year in which it has earned a profit of ₹ 12 lakh, is invalid.

Question 6

Long Boots Ltd. a listed company is engaged in the manufacturing of shoes and related accessories. The Business is set on a recovery mode by the induction of the new Production Manager, Mr. A. The Board of Directors of the company has recommended the declaration of a dividend of ₹ 50 lakh after a gap of eight years during which profits were inadequate to distribute the same.

The dividend thus proposed is to be met partially out of the current year profit of ₹ 16 lakh. Accumulated profits during the past eight years were₹ 170 lakh which is 25% of the total share capital of the company. Referring to the provisions of the Companies Act, 2013 decide, whether the conditions with regard to declaration of dividend in case of inadequate profit are met? You are requested to support your answer with requisite calculations. ***(5 Marks) (PYP 5 Marks May'24)***

Answer : 6

According to second proviso to section 123, where in any year there are no adequate profits for declaring dividend, the company may declare dividend out of the accumulated profits earned by it in previous years and transferred by it to the free reserves only in accordance with the procedure laid down in Rule 3 of the Companies (Declaration and Payment of Dividend) Rules, 2014.

Free Reserves means such reserves which, as per the latest audited balance sheet of a company, are available for distribution as dividend.

Under Rule 3 such declaration shall be subject to the following conditions:

CONDITION I

The rate of dividend declared shall not exceed the average of the rates at which dividend was declared by the company in the immediately preceding three years.
However, this condition shall not apply if the company has not declared any dividend in each of the three preceding financial year.

CONDITION II

The total amount to be drawn from such accumulated profits shall not exceed 10% of its paid-up share capital and free reserves as appearing in the latest audited financial statement.

CONDITION III

The amount so drawn shall first be utilised to set off the losses incurred in the financial year in which dividend is declared and only thereafter, any dividend in respect of equity shares shall be declared.

CONDITION IV

The balance of reserves after such withdrawal shall not fall below 15% of its paid- up share capital as appearing in the latest audited financial statement.

In the given question, since Long Boots Ltd. current year profits of₹ 16 lakh are insufficient to meet the dividend requirement of ₹ 50 lakh, hence the company has to fulfil the conditions as prescribed under Rule 3 (mentioned above).

Particulars	**Amount (in ₹)**
Amount of dividend declared (A)	50 lakh
Current year profits (B)	16 lakh
Amount to be withdrawn accumulated profits [(A)- (B)]	34 lakh
Accumulated profits during the past 8 years	170 lakh
Total share capital of the company [170/25%]	680 lakh

Fulfilment of Conditions mentioned in Rule 3

Conditions	**Calculation**		**Met/ Not Met**
I	This condition is not applicable the company has not declared any dividend in each of the three preceding financial year.		-
II	Paid-up share capital and free reserves	680+ 170	Met
		= 850 lakh (C)	
	10% of (C)	85 lakh	
	Amount to be withdrawn accumulated profits i.e. 34 lakhs is less than (C)		
III	The company has since made profit in the financial year in which dividend is declared.		Met
IV	Free Reserves (D)	170 lakh	Met
	Amount drawn for payment of dividend (E)	34 lakh	
	Balance of reserves after such withdrawal (F) =(D)- (E)	136 lakh	
	15% of its paid up share capital (G)	102 lakh	
	(F) more than (G)		

In the given question, since all the conditions are met, hence Long Boots Ltd. has validly declared dividend.

Prohibition on Declaration of Dividend

Theory

Question 7

Referring to the provisions of the Companies Act, 2013, examine the validity of the following:

The Board of Directors of ABC Tractors Limited proposes to declare dividend at the rate of 20% to the equity shareholders, despite the fact that the company has defaulted in repayment of public deposits accepted before the commencement of this Act. (SM)

Answer 7

Section 123(6) of the Companies Act, 2013, specifically provides that a company which fails to comply with the provisions of section 73 (Prohibition of acceptance of deposits from public) and section 74 (Repayment of deposits, etc., accepted before the commencement of this Act) shall not, so long as such failure continues, declare any dividend on its equity shares.

In the given instance, the Board of Directors of ABC Tractors Limited proposes to declare dividend at the rate of 20% to the equity shareholders, in spite of the fact that the company has defaulted in repayment of public deposits accepted before the commencement of the Companies Act, 2013. Hence, according to the above provision, declaration of dividend by the ABC Tractors Limited is not valid.

Case based

Question 8

Alpha Herbals, a Section 8 company is planning to declare dividend in the Annual General Meeting for the Financial Year ended 31-03-2024. Mr. Chopra is holding 800 equity shares as on date. State whether the act of the company is according to the provisions of the Companies Act, 2013. ***(MTP 3 Marks Oct 20, RTP May '21, PYP May'18,2 Marks, SM)***

Answer 8

According to Section 8(1) of the Companies Act, 2013, the companies licenced under Section 8 of the Act (Formation of companies with Charitable Objects, etc.) are prohibited from paying any dividend to their members. Their profits are intended to be applied only in promoting the objects for which they are formed.

Hence, in the instant case, the proposed act of Alpha Herbals, a company licenced under Section 8 of the Companies Act, 2013, which is planning to declare dividend, is not according to the provisions of the Companies Act, 2013.

Sec 123(3)- Interim Dividend

Case based

Question 9

TAT Ltd. incurred loss in business upto current quarter of financial year 2017-18. The company has declared dividend at the rate of 12%, 15% and 18% respectively in the immediate preceding three years. Inspite of the loss, the Board of Directors of the company have decided to declare interim dividend @ 15% for the current financial year. Examine the decision of TAT Ltd. stating the provisions of declaration of interim dividend under the Companies Act, 2013. ***(MTP May'20, March'19, Aug'18 6 Marks, PYP May '18 & May '19 , 4 Marks)(Similar to MTP Apr'21 & Apr'22 5 Marks but different figures)***

Answer 9

Interim Dividend: According to section 123(3) of the Companies Act, 2013, the Board of Directors of a company may declare interim dividend during any financial year or at any time during the period from closure of financial year till holding of the annual general meeting out of the surplus in the profit and loss account or out of profits of the financial year for which such interim dividend is sought to be declared or out of profits generated in the financial year till the quarter preceding the date of declaration of the interim dividend.

However, in case the company has incurred loss during the current financial year up to the end of the quarter immediately preceding the date of declaration of interim dividend, such interim dividend shall not be declared at a rate higher than the average dividends declared by the company during the immediately preceding three financial years.

In the instant case, Interim dividend by TAT Ltd. shall not be declared at a rate higher than the average dividends declared by the company during the immediately preceding three financial years [i.e. (12+15+18)/3 = 45/3 =15%]. Therefore, decision of Board of Directors to declare 15% of the interim dividend for the current financial year is tenable.

Question 10 LDR

ESPN Heavy Engineering Ltd. is a listed entity engaged in the business of providing engineering solutions to clients across the country. The company followed consistent growth over the years. Rate of Declaration of dividend in immediately preceding three financial years were 15%, 20%, and 25%.

Unfortunately, due to obsolescence of a special part of machinery, company incurred losses in current financial year.

Even though, during the financial year 2021-22, the company declared interim dividend of 10% on the equity shares.

The Board of Directors of the company approved the financial result for the financial year 2021-22 in its meeting held on 5th August, 2022, and recommended a final dividend of @15% in this board meeting.

The general meeting of the shareholders was convened on 31st August, 2022. The shareholders of the company demanded that since interim dividend @10% was declared by the company, so the final dividend should not be less than 20%. It was also submitted that Rate of Declaration of dividend in immediately preceding three years were 15%, 20% and 25%, but the Company Secretary emphasised that final dividend cannot be increased.

(i) Whether company can declare interim dividend, if company incurred losses during the current financial year? What should be correct rate interim dividend?

(ii) Do you think decision of Company Secretary is correct? What should be correct rate of final dividend? Justify your answer with reference to provisions of the Companies Act, 2013. ***(PYP 6 Marks, May '23 ,MTP 5 Marks July'24)***

Answer 10

Interim dividend: As per section 123(3) of the Companies Act, 2013, the Board of Directors of a company may declare interim dividend during any financial year out of the surplus in the profit and loss account and out of profits of the financial year in which such interim dividend is sought to be declared.

Provided that in case the company has incurred loss during the current financial year up to the end of the quarter immediately preceding the date of declaration of interim dividend, such interim dividend shall not be declared at a rate higher than the average dividends declared by the company during the immediately preceding three financial years.

Final dividend: The company in general meeting may declare dividends, but no dividend shall exceed the amount recommended by the Board. [Clause 80 of Table F in Schedule I]

Accordingly, following shall be the answers:

(i) **Interim dividend:** According to the given facts, ESPN Heavy Engineering Ltd. incurred losses in current financial year 2021-2022. In the immediately preceding three financial years, the company declared dividend at the rate of 15%, 20% and 25% respectively. Accordingly, the rate of dividend declared shall not exceed 20%, the average of the rates (15+20+25=60/3) at which dividend was declared by it during the immediately preceding three financial years.

Yes, as per law company can declare interim dividend, even if company incurred losses during current financial year. Dividend to be declared shall be given at the rate not exceeding 20%.

(ii) **Final dividend:** Board of Directors of the Company recommended a final dividend @15% for financial year 2021-2022 in the meeting held on 5th August 2022. It was approved in the general meeting. However, shareholders demanded that since Interim dividend was at the rate of 10%, so final dividend should not be less than 20%. The general meeting cannot declare the dividend at a rate higher than the rate of dividend recommended by the Board.

Yes, the decision of Company Secretary that final dividend cannot be increased beyond the rate of 15% as recommended in the Board Meeting, is correct.

Exam insights: Performance of the examinees was above average. Majority of the examinees have provided the correct provision and answer regarding the rate of declaration of interim dividend but failed to give correct conclusion as regards to the proposal of the shareholders for increasing the rate of final dividend recommended by the Board in accordance with the provisions of the Companies Act, 2013.

Sec 124- Unpaid Dividend Account

Question 11

Mr. R, holder of 1000 equity shares of ` 10 each of Vimal Ltd. approached the company in the last week of September, 2022 with a claim for the payment of dividend of ` 2000 declared @ 20% by the Company at its Annual General Meeting held on 31.08.2014 with respect to the financial year 2013-14. The Company refused to accept the request of R and informed him that his shares on which dividend has not been claimed till date, have also been transferred to the Investor Education and Protection Fund.

Examine, in the light of the provisions of the Companies Act, 2013, the validity of the decision of the Company and suggest the remedy, if available, to him for obtaining the unclaimed amount of dividend and re-transfer of corresponding shares in his name. *(MTP 6 Marks April '23 & Sep '23, PYP 5 Marks Jan 21)*

Answer 11

According to section 124 of the Companies Act, 2013:

(1) **Unpaid or Unclaimed Dividend to be transferred to the Unpaid Dividend Account** - Where a dividend has been declared by a company but has not been paid or claimed within thirty (30) days from the date of declaration, the company shall, within seven (7) days from the expiry of the said period of 30 days, transfer the total amount of unpaid or unclaimed dividend to a special account called the Unpaid Dividend Account (UDA). The UDA shall be opened by the company in any scheduled bank.

(2) **Transfer of Unclaimed Amount to Investor Education and Protection Fund (IEPF)** - Any money transferred to the Unpaid Dividend Account which remains unpaid or unclaimed for a period of seven (7) years from the date of such transfer shall be transferred by the company along with interest accrued thereon to the Investor Education and Protection Fund.

(3) **Transfer of Shares to IEPF**- All shares in respect of which dividend has not been paid or claimed for 7 consecutive years or more shall be transferred by the company in the name of Investor Education and Protection Fund along with a statement containing the prescribed details.

(4) **Right of Owner of 'transferred shares' to Reclaim** - Any claimant of shares so transferred to IEPF shall be entitled to reclaim the 'transferred shares' from Investor Education and Protection Fund in accordance with the prescribed procedure and on submission of prescribed documents.

As per the provisions of sub-section (3) of section 125 of the Companies Act, 2013, read with rule 7 of Investor Education and Protection Fund Authority (Accounting, Audit, Transfer and Refund) Rules, 2016, any person, whose unclaimed dividends have been transferred to the Fund, may apply for refund, to the Authority, by submitting an online application.

In the given question, Mr. R did not claim the payment of dividend on his shares for a period of more than 7 years (i.e. expiry of 30 days from 31.08.2014 to last week of September 2022). As a result, his unclaimed dividend (` 2,000) along with such shares (1,000 equity shares) must have been transferred to Investor Education and Protection Fund Account. Therefore, the company is justified in refusing to accept the request of Mr. R for the payment of dividend of ` 2,000 (declared in Annual General Meeting on 31.8.2014).

In terms of the above stated provisions, Mr. R should be advised as under:

(i) If Mr. R wants to reclaim the transferred shares, he should apply to IEPF authorities along with the necessary documents in accordance with the prescribed procedure.

(ii) He is also entitled to get refund of the dividend amount, which was transferred to the above fund; in accordance with the prescribed rules.

Question 12 LDR

The Board of Directors of Future Fashions Limited at its meeting recommended a dividend on its paid-up equity share capital which was later on approved by the shareholders at the Annual General Meeting. Thereafter, the directors at another meeting of the Board passed a board resolution for diverting the total dividend to be paid to the shareholders for purchase of certain short-term investments in the name of the company. As a result, dividend was paid to shareholders after 45 days. Examining the provisions of the Companies Act, 2013, state whether the act of directors is in violation of the provisions of the Act and if so, state the consequences that shall follow for the above violative act. (*MTP 6 Marks Nov 21, RTP Nov'21, & SM, PYP 2 Marks Dec '21)*

Answer 12

According to section 124 of the Companies Act, 2013, where a dividend has been declared by a company but has not been paid or claimed within 30 days from the date of the declaration, the company shall, within 7 days from the date of expiry of the said period of 30 days, transfer the total amount of dividend which remains unpaid or unclaimed to a special account to be opened by the company in any scheduled bank to be called the Unpaid Dividend Account.

Further, according to section 127 of the Companies Act, 2013, where a dividend has been declared by a company but has not been paid or the warrant in respect thereof has not been posted within 30 days from the date of declaration to any entitled shareholder, every director of the company shall, if he is knowingly a party to the default, be liable for punishment.

In the present case, the Board of Directors of Future Fashions Limited at its meeting recommended a dividend on its paid-up equity share capital which was later on approved by the shareholders at the Annual General Meeting. Thereafter, the directors at another meeting of the Board decided by passing a board resolution for diverting the total dividend to be paid to the shareholders for purchase of certain short-term investments in the name of the company. As a result, dividend was paid to shareholders after 45 days.

(i) Since, declared dividend has not been paid within 30 days from the date ofthe declaration to any shareholder entitled to the payment of dividend, the company shall, within 7 days from the date of expiry of the said period of 30 days, transfer the total amount of dividend which remains unpaid or unclaimed to a special account to be opened by the company in any scheduled bank to be called the Unpaid Dividend Account.

(ii) The Board of Directors of Future Fashions Limited has violated section 127 of the Companies Act, 2013 as it failed to pay dividend to shareholders within 30 days due to its decision to divert the total dividend to be paid to shareholders for purchase of certain short-term investments in the name of the company.

Consequences: The following are the consequences for violation of the above provisions:

(a) Every director of the company shall, if he is knowingly a party to the default, be punishable with maximum imprisonment of two years and shall also be liable for a minimum fine rupee one thousand for everyday during which such default continues.

(b) The company shall also be liable to pay simple interest at the rate of 18% p.a. during the period for which such default continues.

Sec 127- Punishment for failure to distribute Dividend

Question 13

A Ltd. declares a dividend for its shareholders in its AGM held on 27th September, 2024. Referring to provisions of the General Clauses Act, 1897 and Companies Act, 2013, advice, the dates during which A Ltd. is required to pay the dividend? *(MTP 4 Marks Aug'24) (MTP 4 Marks Apr'24)*

Answer 13

As per section 9 of the General Clauses Act, 1897, for computation of time, the section states that in any legislation or regulation, it shall be sufficient, for the purpose of excluding the first in a series of days or any other period of time to use the word "from" and for the purpose of including the last in a series of days or any other period of time, to use the word "to".

In the given instance, A Ltd. declares dividend for its shareholder in its Annual General Meeting held on 27th September 2024. Under the provisions of section 127 of the Companies Act, 2013, a company is required to pay declared dividend within 30 days from the date of declaration, i.e. from 28th September 2024 to 27th October 2024. In this series of 30 days, 27th September 2024 will be excluded and last 30th day, i.e. 27th October 2024 will be included. Accordingly, A Ltd. will be required to pay dividend within 28th September 2024 and 27th October 2024 (both days inclusive).

Question 14

Smart Limited declared dividend at its Annual General Meeting held on 31-07-2023. The dividend warrants to Mr. A, a shareholder was posted on 22nd August, 2023. Due to postal delay Mr. A received the warrant on 5th September, 2023 and encashed it subsequently. Can Mr. A initiate action against the company for failure to distribute the dividend within 30 days of declaration under the provisions of the Companies Act, 2013? *(MTP 2 Marks Mar'24) (PYP 3 Marks Jul'21) (MTP Oct '23)*

Answer 14

Section 127 of the Companies Act, 2013, requires that the declared dividend must be paid to the entitled shareholders within the prescribed time limit of 30 days from the date of declaration of dividend. In case dividend is paid by issuing dividend warrants, such warrants must be posted at the registered addresses within the prescribed time. Once posted, it is immaterial whether the same are received within 30 days by the shareholders or not.

In the given question, the dividend was declared on 31.07.2023 and the dividend warrant was posted within 30 days from date of declaration of dividend (posted on 22nd August, 2023). It is immaterial if Mr. A has received it on 5th September 2023 (i.e., after 30 days from 31.07.2023). Hence, Mr. A cannot initiate action against the company for failure to distribute the dividend within 30 days of declaration.

<u>Exam insights:</u> Majority of the examinees have answered correctly and explained the requisite provisions w.r.t payment of dividend under the Companies Act, 2013.

Question 15

Star Computers Limited declared and paid dividend in time to all its equity holders for the financial year 2023-24, except in the following two cases:

(i) Mrs. Sheela Bhatt, holding 250 shares had mandated the company to directly deposit the dividend amount in her bank account. The company, accordingly remitted the dividend but the bank returned the payment on the ground that there was difference in surname of the payee in the bank records. The company, however, did not inform Mrs. Sheela Bhatt about this discrepancy.

(ii) Dividend amount of Rs. 50,000 was not paid to the successor of Late Mr. Mohan, in view of the court order restraining the payment due to family dispute about succession.

You are required to analyse these cases with reference to provisions of the Companies Act, 2013 regarding failure to distribute dividends. *(SM)*

Answer 15

(i) Section 127 of the Companies Act, 2013 provides for punishment for failureto distribute dividend on time. One of such situations is where a shareholder has given directions to the company regarding the payment of the dividend and those directions could not be complied with but the non- compliance was not communicated to him.

In the given situation, the company has failed to communicate to the shareholderMrs. Sheela Bhatt about non-compliance of her direction regarding payment ofdividend. Hence, the penal provisions under section 127 will be applicable.

(ii) Section 127, inter-alia, provides that no offence shall be deemed to have been committed where the dividend could not be paid by reason of operation of law.

In the present case, the dividend could not be paid because it was not allowed to be paid by the court until the matter was resolved about succession. Hence, there will not be any liability on the company and its

directors, etc.

Question 16

Karan was holding 5000 equity shares of Rs. 100 each of M/s. Future Ltd. A final call of Rs. 10 per share was not paid by Karan. M/s. Future Ltd. declared dividend of 10%. Examine with reference to relevant provisions of the Companies Act, 2013, the amount of dividend Karan should receive.*(MTP Mar'21, April '19 , 3 Marks, SM, RTP May '21, PYP, 3 Marks Nov '18*)

Answer 16

As per the proviso to section 127 of the Companies Act, 2013, no offence will be said to have been committed by a director for adjusting the calls in arrears remaining unpaid or any other sum due from a member from the dividend as is declared by a company.

Thus, as per the given facts, M/s Future Ltd. can adjust the sum of Rs. 50,000 unpaid call money against the declared dividend of 10%, i.e. 5,00,000 x 10/100 = 50,000. Hence, Karan's unpaid call money (Rs. 50,000) can be adjusted fully from the entitled dividend amount of Rs. 50,000/-.

Question 17

Vishal Limited declared and paid 10% dividend to all its shareholders except Mr. Ricky, holding 500 equity shares, who instructed the company to deposit the dividend amount directly in his bank account. The company accordingly remitted the dividend, but the bank returned the payment on the ground that the account number as given by Mr. Ricky doesn't tally with the records of the bank. The company, however, did not inform Mr. Ricky about this discrepancy. ·Comment on this issue with reference to the provisions of the Companies Act, 2013 regarding failure to distribute dividend. *(MTP 3 Marks March 21, MTP 3 Marks Oct'22, SM, PYP May '19 2 Marks)*

Answer 17

Section 127 of the Companies Act, 2013 provides for punishment for failure to distribute dividend on time. One of such situations is where a shareholder has given directions to the company regarding the payment of the dividend and those directions cannot be complied with and the same has not been communicated to the shareholder.

In the instant case, Vishal Ltd. has failed to communicate to the shareholder Mr. Ricky about non-compliance of his direction regarding payment of dividend. Hence, the penal provisions under section 127 will be attracted.

Question 18

LDR

The Director of Lion Limited proposed dividend at 12% on equity shares for the financial year 2019-20. The same was approved in the annual general meeting of the company held on 20th September, 2020. Mr. A, holding equity shares of face value of ` 10 lakhs has not paid an amount of ` 1 lakh towards call money on shares. Can the same be adjusted against the dividend amount payable to him?
(MTP 3 Marks Oct 21, RTP May 18) (Same concept different figures PYP 2 Marks May '22)

Answer 18

The given problem is based on the proviso provided in the section 127 (d) of the Companies Act, 2013. As per the law where the dividend is declared by a company and there remains calls in arrears and any other sum due from a member, in such case no offence shall be deemed to have been committed where the dividend has been lawfully adjusted by the company against any sum due to it from the shareholder.

As per the facts given in the question, Mr. A is holding equity shares of face value of ` 10 Lakhs and has not paid an amount of ` 1 lakh towards call money on shares. Referring to the above provision, Mr. A is eligible to get ` 1.20 lakh towards dividend, out of which an amount of ` 1 lakh can be adjusted towards call money due on his

shares. ` 20,000 can be paid to him in cash or by cheque or in any electronic mode.
According to the above mentioned provision, company can adjust sum of ` 1 lakh due towards call money on shares against the dividend amount payable to Mr. A.

Question 19

The Annual General Meeting of ABC Bakers Limited held on 30 th May, 2024, declared a dividend at the rate of 30% payable on its paid-up equity share capital as recommended by Board of Directors. However, the Company was unable to post the dividend warrant to Mr. Ranjan, an equity shareholder, up to 25th July, 2024. Mr. Ranjan filed a suit against the Company for the payment of dividend along with interest at the rate of 20 percent per annum for the period of default. Decide in the light of provisions of the Companies Act, 2013, whether Mr. Ranjan would succeed? Also, state the directors' liability in this regard under the Act. ***(MTP 6 Marks Sep'22, MTP 5 Marks Mar'23, MTP 5 Marks Oct'19, SM)***

Answer 19
Section 127 of the Companies Act, 2013 lays down the penalty for non-payment of dividend within the prescribed time period of 30 days. According to this section where a dividend has been declared by a company but has not been paid or the warrant in respect thereof has not been posted within 30 days from the date of declaration of dividend to any shareholder entitled to the payment of dividend:

(1) every director of the company shall, if he is knowingly a party to the default, be punishable with imprisonment maximum up to two years and with minimum fine of rupees one thousand for every day during which such default continues; and
(2) the company shall be liable to pay simple interest at the rate of 18% per annum during the period for which such default continues.
In the given question, the company was unable to post dividend warrant within 30 days from the date of declaration of dividend. Thus, the directors will be liable as per the above provisions and the company is liable to pay simple interest. However, Mr. Ranjan will not succeed if he claims interest at 20% per annum interest as the limit prescribed under section 127 is 18% per annum.

Question 20

The dividend amounts received or receivable on equity shares held by Mr. Vaibhav for the financial year 2021-22 was as follows:

Name of the Company	Dividend Declaration Date	Dividend Amount (`)	Remarks
Suvaas Limited	25.08.2022	800	Dividend was paid on 23.10.2022.
Bhandol Nidhi Limited	04.09.2022	100	Dividend was not paid within the stipulated time period.

Also, Mr. Vaibhav holds 100 cumulative preference shares of face value ` 1,00,000, in aggregate, of Jipanti Limited on which dividend payable is at the rate of 8% p.a. However, during financial year 2021-22, Jipanti Limited did not earn any profits.
In the context of aforesaid case-scenario, please answer to the following question(s):-

(a) What could be the punishment to the company(ies) aforesaid in the table, with respect to delayed payment of dividend amount(s)?
(b) Whether Jipanti Ltd. is required to pay dividend on cumulative preference shares for financial year 2021-22? ***(RTP Nov '23)***

Answer 20
According to Section 127 of the Companies Act, 2013
In case a company fails to pay declared dividends or fails to post dividend warrants within 30 days of declaration, then the company shall be liable to pay simple interest at the rate of 18% p.a. during the period for which such

default continues.

Further, in terms of Notification No. GSR 465 (E), dated 05-06-2015, section 127 dealing with punishment shall apply to the Nidhis, subject to the following modification:

In case the dividend payable to a member is ` 100 or less, it shall be sufficient compliance of the provisions of section 127, if the declaration of the dividend is announced in the local language in one local newspaper of wide circulation and announcement of the said declaration is also displayed on the notice board of the Nidhi company for at least 3 months.

(i) In case of Suvaas Limited

Dividend was declared on 25.08.2022 but was paid on 23.10.2022 to Mr. Vaibhav, its share-holder.

The dividend declared should have been paid or dividend warrants should have been posted, to each of its share-holder, within 30 days of dividend declaration i.e. by 24.09.2022.

Accordingly, the interest payable by Suvaas Limited would be calculated as follows:

Dividend Amount (`)	Dividend Declaration Date	Interest @ 18% to be calculated from 25.09.2022 to 23.10.2022	Interest (`)
800	25.08.2022	800×18%×29/365	11

(ii) In case of Bhandol Nidhi Limited

Here, Bhandol Nidhi Limited is a Nidhi company and the dividend payable to Mr. Vaibhav was ` 100.

So, in such a case, it would have been sufficient compliance of the provisions of section 127, if the dividend declared was announced by the company in local language in one local newspaper of wide circulation and announcement of the said declaration was also displayed on the notice board of the company for at least 3 months i.e. till 04.12.2022 (3 months from 04.09.2022).

Accordingly, if the aforesaid compliances have been made by Bhandol Nidhi Limited then no punishment could be imposed upon it, otherwise, it would be liable for punishment.

(b) A cumulative preference share is one in respect of which dividend gets accumulated and any arrears of such dividend arising due to insufficiency of profits during the current year is payable from the profits earned in the later years.

Until and unless dividend on cumulative preference shares is paid in full, including arrears, if any, no dividend is payable on equity shares.

Here, it is given that during financial year 2021-22, Jipanti Limited did not earn any profits and accordingly, in such case the company may accumulate such dividend for financial year 2021-22 to be carried forward to following financial year(s) and such arrears of dividend would be payable from the following financial year(s) profits.

Sec 123(3)- Interim Dividend

Question 21

XYZ Limited is a company having a paid up equity share capital of ₹ 75 crore. Though it was performing well in the recent years it suffered losses in the first and second quarter of the financial year 2023-2024. In order to sustain its image, the Board of Directors declared an interim dividend at the rate of 30 percent on the paid-up equity share capital on 4/10/2023. The following are the additional information extracted from the books of account for the past 5 Financial Years:

Financial year ending 31st March	Rate of Dividend declared
2019	20%
2020	15%
2021	15%
2022	15%
2023	30%

Examining the provisions of the Companies Act, 2013, decide the validity of the Board's declaration of 30% interim dividend. ***(PYP 5 Marks Sep'24)***

Answer 22

As per section 123(3) of the Companies Act, 2013, the Board of Directorsof a company may declare interim dividend during any financial year out of the surplus in the profit and loss account and out of profits of the financial year in which such interim dividend is sought to be declared.

Provided that in case the company has incurred loss during the current financial year up to the end of the quarter immediately preceding the date of declaration of interim dividend, such interim dividend shall not be declared at a rate higher than the average dividends declared by the company during the immediately preceding three financial years.

According to the given facts, XYZ Ltd. is facing losses in business duringthe first and second quarter of financial year 2023-2024. In the immediately preceding three financial years, the company declared dividend at the rate of 15%, 15% and 30% respectively. Accordingly, the rate of dividend declared shall not exceed 20%, the average of the rates (15+15+30=60/3) at which dividend was declared by it during theimmediately preceding three financial years.

Therefore, the act of the Board of Directors as to declaration of interim dividend at the rate of 30% during the F.Y. 2023-2024 is not valid.

Sec 127- Punishment for failure to distribute Dividend

Question 23

Anoj Limited declared a final dividend to its shareholders at the Annual General Meeting on 1st August, 2024. As per the decision, the dividend payment was to be made within the stipulated 30-day period. However, due to internal financial constraints, the company failed to pay the declared dividend and did not dispatch the dividend warrants to the shareholders within the required timeframe. The default continued until 15th October, 2024, leading to shareholder complaints.

In light of this scenario, what specific punishments and liabilities couldthe company and the directors face due to this failure to pay the declared dividend within the 30-day period? Give your answer as per the provisions of the Companies Act, 2013. (MTP 5 Marks Nov'24)

Answer 23

According to section 127 of the Companies Act, 2013, in case a company fails to pay declared dividends or fails to post dividend warrants within 30 days of declaration, following punishments are applicable:

(i) Every director of the company shall be punishable with imprisonment of up to two years, if he is knowingly a party to the default. And, he shall also be liable to pay minimum fine of ₹ 1,000 for every day during which such default continues.

(ii) The company shall be liable to pay simple interest at the rate of18% p.a. during the period for which such default continues.

Transfer to Reserves

MULTIPLE CHOICE QUESTIONS MCQ

1. **Amount to be transferred to reserves out of profits before any declaration of dividend is ___________ *(MTP 1 Mark Oct 21, Apr'22, SM)***

   (a) 5%

   (b) 7.5%

   (c) 10%

   (d) at the discretion of the company.

   Ans : (d)

Payment of Dividend

2. Dividend once declared, should be paid within   days from the date of declaration . (MTP 1 Mark Oct '23)

(a) 14

(b) 21

(c) 30

(d) 60

Ans: (C)

Sec 123(3)- Interim Dividend

3. When the dividend is declared at the Annual General Meeting of the company, it is known as …. (MTP 1 Mark Nov 21, Sep'22, SM)

(a) Final Dividend

(b) Interim Dividend

(c) Dividend on preference shares

(d) Scrip Divided

Ans: (a)

4. The Board of Directors of Vidyut Limited are contemplating to declare interim dividend in the last week of July, 2024 but the company has incurred loss during the current financial year up to the end of June, 2024. However, it is noted that during the previous five financial years i.e., 2019-20, 2020-21, 2021-22, 2022-23, 2023-24, the company had declared dividend at the rate of 8%, 9%, 12%, 11% and 10% respectively. Advise the Board as to the maximum rate at which they can declare interim dividend despite incurring loss during the current financial year. *(SM, MTP 2 Marks Oct 21)*

(a) Maximum at the rate of 10%.

(b) Maximum at the rate of 11%.

(c) Maximum at the rate of 10.5%.

(d) Maximum at the rate of 11.5%.

Ans: (b)

Sec 125- Investor Education & Protection Fund

5. The amount accumulated in the Investor Education and Protection Fund shall not be used for: *(SM, RTP May'23)*

(a) refunds in respect of unclaimed dividends, matured deposits, matured debentures, application money due for refund and interest thereon.

(b) reimbursement of legal expenses incurred in pursuing class action suits under section 37 and 245.

(c) grants or donation to the Central Government for the purpose of investor's education and training.

(d) distribution of any disgorged amount among eligible and identifiable applicants who have suffered losses.

Ans: (c)

Prohibition on Declaration of Dividend

6. In case a company fails to pay declared dividends or fails to post dividend warrants within 30 days of declaration, company shall be liable to pay simple interest at the rate of ………during the period for which such default continues.

(a) 6% p.a.

(b) 12% p.a.

(c) 15% p.a.

(d) 18% p.a.

Ans: (d)

7. Mr. Guru bought 40,000 shares of Real Consultancy Services (RCS) of face value 10 each out of his savings. On such shares, the final call of Rs. 2 is due but unpaid by Mr. Guru. In the meantime, RCS declared dividend at a rate of 15%. Regarding un-paid call money by Mr. Guru, in light of dividend due to him from RCS, state which of following the statements is correct? *(MTP 2 Marks Nov 21)*

(a) Dividend cannot be adjusted against the unpaid call money

(b) The dividend of Rs. 48,000 can be adjusted against unpaid call money

(c) The dividend of Rs. 48,000 can be adjusted against unpaid call money, only if consent is given by Mr. Guru.

(d) The dividend of Rs. 64,000 can be adjusted against unpaid call money, even if consent is not given by Mr. Guru.

Ans: (b)

B

CHAPTER 11: COMPANIES INCORPORATED OUTSIDE INDIA

CONCEPTS OF THIS CHAPTER

• Sec 2(42)- Foreign Company	• Sec 387- Dating of Prospectus & Particulars to be contained therein
• Sec 379- Application o the Act to Foreign Companies	• Sec 389- Registration of Prospectus
• Sec 380- Documents to be delivered to Registrar by Foreign Companies	• Sec 392- Punishment for Contravention
• Sec 381- Accounts of Foreign Company	• Sec 393- Co's failure to comply with provisions to not affect validity of contracts
• Sec 382- Display of Name etc of Foreign Company	

LDR Questions
Q 4
Q9
Q14
Q17
Q19

QUICK REVIEW OF IMPORTANT CONCEPTS

Foreign Company

Any company or body corporate incorporated outside India

- has a place of business in India whether by itself or through an agent, physically or through electronic mode
- conducts any business activity in India in any other manner

electronic mode carrying out electronically based, whether main server is installed in India or not, including, but not limited to

- business to business and business to consumer transactions, data interchange and other digital supply transactions.
- offering to accept deposits or inviting deposits or accepting deposits or subscriptions in securities, in India or from citizens of India;
- financial settlements, web based marketing, advisory and transactional services, database services and products, supply chain management;
- online services such as telemarketing, telecommuting, telemedicine, education and information research; and
- all related data communication services

whether conducted by:

• e-mail	• mobile devices	• social media
• cloud computing	• document management	• voice or data transmission or otherwise

Documents, etc., to be delivered to Registrar by Foreign Companies

Every foreign company within 30 days of establishment of place of business in India, deliver to the Registrar for registration

- certified copy of the charter, statutes or memorandum and articles (in English language)
- full address of the registered office
- list of the directors and secretary of the company

- name and address or the names and addresses of one or more persons resident in India authorised to accept on behalf of the company any notices or other documents required to be served on the company
- full address of principal place of business in India
- particulars of opening and closing of a place of business in India on earlier occasion/s
- declaration that none of the directors of the company or the authorised representative in India has ever been convicted or debarred from formation of companies and management in India or abroad

Other Points

- Any document which any foreign company is required to deliver to the Registrar shall be delivered to the Registrar having jurisdiction over New Delhi
- If any foreign company ceases to have a place of business in India, it shall forthwith give notice of the fact to the Registrar, and from the date on which such notice is so given, the obligation of the company to deliver any document to the Registrar shall cease, provided it has no other place of business in India
- Any alteration in the documents is to be delivered to the Registrar within 30 days of such alteration (a return containing the particulars of the alteration)

Display of name, etc., of foreign company

1. **NAME of foreign company and the country in which it is incorporated**
    - Conspicuously exhibit on outside of every office or place where it carries on business in India in letters easily legible in English characters
    - And one of the languages in general use in the locality in which the office or place is situate

2. **Name of Co. in Business Letters, bill-heads and letter paper, and in all notices, and other official publications**
    - Name of the company and of the country in which the company is incorporated
    - It is to be stated in legible English characters

3. **When liability of the members of the company is limited**
    - cause notice of that fact: - stated in point 1. and 2.

Service on foreign company

- Any process, notice, or other document required to be served on a foreign company
- Be sufficiently served
- if addressed to any person whose name and address have been delivered to the Registrar under section 380, and
- left at, or sent by post to, the address which has been so delivered to the Registrar or by electronic mode

Registration of prospectus

1. **Signing and delivery of prospectus**
    - No person shall issue, circulate or distribute in India any prospectus offering for subscription in securities of a company incorporated or to be incorporated outside India, whether the company has or has not established, or when formed will or will not establish, a place of business in India, unless before the issue, circulation or distribution of the prospectus in India;
    - copy of prospectus certified by the chairperson of the company and 2 other directors of the company as having been approved by resolution of the managing body has been delivered for registration to the Registrar; and
    - states on the face of it that a copy has been so delivered, and
    - there is endorsed on or attached to the copy, any consent to the issue of the prospectus required by section 388 and such documents as may be prescribed.

2. **Documents to be annexed to the prospectus**
    - any consent to the issue of the prospectus required from any person as an expert;
    - copy of contracts for appointment of managing director or manager and in case of a contract not reduced into writing, a memorandum giving full particulars thereof;

- a copy of any other material contracts, not entered in the ordinary course of business, but entered within preceding two years;
- a copy of underwriting agreement; and
- a copy of power of attorney, if prospectus is signed through duly authorized agent of directors

Punishment in case of failure to comply with provisions of this Chapter

Defaulting foreign company	In case of continuing default Additional fine	Every defaulting officer of the foreign company
₹ 1 Lakh to ₹ 3 Lakh	₹ 50,000 per day after the first during which the contravention continues	₹ 25,000 to ₹ 5 Lakh

Company's failure to comply with provisions of this Chapter not to affect validity of contracts, etc.

Not affecting the validity of

- any contract, dealing or transaction entered into by the company
- its liability to be sued in respect thereof

The Co. shall not be entitled to

- bring any suit,
- claim any set-off,
- make any counter- claim
- institute any legal proceeding in respect of any such contract, dealing or transaction
- until the company has complied with the provisions of the Companies Act, 2013, applicable to it

Question & Answers

Sec 2(42)- Foreign Company

Case based

Question 1

In the light of the provisions of the Companies Act, 2013, examine whether the following Companies can be considered as a 'Foreign Company':

(i) Red Stone Limited is a Company registered in Singapore. The Board of Directors meets and executes business decisions at their Board Meeting held in India.

(ii) Xen Limited Liability Company registered in Dubai has installed its main server in Dubai for maintaining office automation software by Cloud Computing for its client in India. *(SM)*

Answer 1

According to section 2(42) of the Companies Act, 2013, "Foreign company" means any company or body corporate incorporated outside India which-

(a) has a place of business in India whether by itself or through an agent, physically or through electronic mode; and

(b) conducts any business activity in India in any other manner.

According to the Companies (Registration of Foreign Companies) Rules, 2014, "electronic mode" means carrying out electronically based, whether main server is installed in India or not, including, but not limited to-

(a) business to business and business to consumer transactions, data interchange and other digital supply transactions;

(b) offering to accept deposits or inviting deposits or accepting deposits or subscriptions in securities, in India or from citizens of India;

(c) financial settlements, web-based marketing, advisory and transactional services, database services and products, supply chain management;

(d) online services such as telemarketing, telecommuting, telemedicine, education and information research;

and

(e) all related data communication services,

Whether conducted by e-mail, mobile devices, social media, cloud computing, document management, voice or data transmission or otherwise.

(f) In the given situation, Red Stone Limited is registered in Singapore. However, it does not have a place of business in India whether by itself or through an agent, physically or through electronic mode; and does not conduct any business activity in India in any other manner. Mere holding of board meetings and executing business decisions in India cannot be termed as conducting business activity in India. Hence, M/s Red Stone Limited is not a foreign company as per the Companies Act, 2013.

(g) In the given situation, Xen Limited Liability Company is registered in Dubai and has installed its main server in Dubai for maintaining office automation software by Cloud Computing for its client in India. Thus, it can be said that M/s Xen Limited Liability Company has a place of business in India through electronic mode and is conducting business activity in India. Hence, Xen Limited Liability Company is a foreign company as per the Companies Act, 2013.

Question 2

(i) In the light of the provisions of the Companies Act, 2013, discuss the status of Gram Pte, which is a company registered in Singapore, that is conducting online business through telemarketing in India without a physical place of business. It is also informed that for the telemarketing business in India, its main server located outside India.

(j) (ii) In continuance of (i) above, Prism Ltd. (registered in India), a wholly owned subsidiary company of Gram Pte decided to follow different financial year for consolidation of its accounts outside India. State the procedure to be followed in this regard. *(RTP Sep'24)*

Answer 2

(i) According to section 2(42) of the Companies Act, 2013, "foreign company" means any company or body corporate incorporated outside India which –

(a) has a place of business in India whether by itself or through an agent, physically or through electronic mode; and

(b) conducts any business activity in India in any other manner.

According to Rule 2(1)(c)(iv) of the Companies (Registration of Foreign Companies) Rules, 2014, "electronic mode" means carrying out electronically based, whether main server is installed in India or not, including, but not limited to, online services such as telemarketing, telecommuting, telemedicine, education and information research.

In view of the above provisions of the Companies Act, 2013 and the facts of the question, it can be said that being involved in online business of telemarketing services in India having its main server outside India, Gram Pte will be treated as foreign company.

(ii) Where a company or body corporate, which is a holding company or a subsidiary or associate company of a company incorporated outside India and is required to follow a different financial year for consolidation of its accounts outside India, the Central Government may, on an application made by that company or body corporate in such form and manner as may be prescribed, allow any period as its financial year, whether or not that period is a year.

Here, Prism Ltd. is advised to follow the above procedure accordingly.

Question 3

As per provisions of the Companies Act, 2013, what is the status of XYZ Ltd., a Company incorporated in London, U.K., which has a share transfer office at Mumbai? *(MTP 2 Marks Mar 19, Oct'19, May'20, MTP 4 Marks Apr'21, RTP May'18)*

Answer 3

(i) In terms of the definition of a foreign company under section 2 (42) of the Companies Act, 2013 a "foreign company" means any company or body corporate incorporated outside India which:

(a) Has a place of business in India whether by itself or through an agent, physically or through electronic mode; and

(b) Conducts any business activity in India in any other manner

According to section 386 of the Companies Act, 2013, for the purposes of Chapter XXII of the Companies Act, 2013 (Companies incorporated outside India), "Place of business" includes a share transfer or registration office.

From the above definition, the status of XYZ Ltd. will be that of a foreign company as it is incorporated outside India, has a place of business in India and it may be presumed that it carries on a business activity in India.

Question 4 LDR

I. Search & Find Pte. Ltd., incorporated in Singapore. The Company sells its goods through electronic mode on the e-commerce platforms in India, however, it does not have any branch or office in India. Is the Company required to submit the documents as required under Section 380 of the Companies Act, 2013. *(3 Marks April '23)*

II. Arica is a Company Limited incorporated in Singapore desires to establish a branch office at Mumbai. You being a practicing Chartered Accountant have been appointed by the company as a liaison officer for compliance of legal formalities on behalf of the company. Examining the provisions of the Companies Act, 2013, answer the following:

(1) Whether branch office will be considered as a company incorporated outside India.

(2) If yes, state the documents you are required to furnish on behalf of the company, on the establishment of a branch office at Mumbai.*(MTP 5 Marks April '23, SM)*

Answer 4

(i) Yes, as per 2(42) of the Companies Act, 2013, any company or body corporate incorporated outside India which-

(a) has a place of business in India whether by itself or through an agent, physically or through electronic mode; and

(b) conducts any business activity in India in any other manner shall be considered as a foreign company.

Accordingly, as Search & Find Pte. Ltd., is conducting its business through electronic mode, it is considered a foreign company as per Companies Act, 2013 and is required to submit the documents mentioned under Section 380 of the Companies Act, 2013.

(ii) (1) According to section 2(42) of the Companies Act, 2013, "Foreign company" means any company or body corporate incorporated outside India which-

(a) has a place of business in India whether by itself or through an agent, physically or through electronic mode; and

(b) conducts any business activity in India in any other manner.

Further, branch offices are generally considered as reflection of the Parent Company' office. Thus, branch offices of a company incorporated outside India are considered as a place of business for conducting business activity in India and will be required to follow provisions of this chapter and such other provisions as may be specified elsewhere under Companies Act, 2013.

(2) Under section 380(1) of the Companies Act, 2013 every foreign company shall, within 30 days of the establishment of place of business in India, deliver to the Registrar for registration the following documents:

(a) a certified copy of the charter, statutes or memorandum and articles, of the company or other instrument constituting or defining the constitution of the company.

(b) the full address of the registered or principal office of the company;

(c) a list of the directors and secretary of the company containing their respective details as per the rules.

(d) the name/s and address/s of one or more persons resident in India authorised to accept on behalf of the company service of process and any notices or other documents required to be served on the company;

(e) the full address of the office of the company in India which is deemed to be its principal place of business in India;

(f) particulars of opening and closing of a place of business in India on earlier occasion or occasions;

(g) declaration that none of the directors of the company / the authorised representative in India has ever been convicted or debarred from formation of companies and management in India or abroad; and

(h) any other information as may be prescribed.

According to the Companies (Registration of Foreign Companies) Rules, 2014, any document which any foreign company is required to deliver to the Registrar shall be delivered to the Registrar having jurisdiction over New Delhi.

Question 5

Analyze under the provisions of the Companies Act, 2013, whether the following Companies can be considered as a Foreign Company:

(i) A Company incorporated outside India and registered in Moscow, Russia has installed its main server in Moscow for maintaining office automation software by cloud computing for its client in India.

(ii) A Company which is incorporated outside India employs agents in India but has no place of business in India.

(iii) A Company incorporated outside India and registered in Australia has authorized Mr. X in India to source customers and subsequently to enter into contracts with them on behalf of the Company.

(iv) A Company incorporated outside India and is registered in Mauritius. All the business models, financial strategy, important decisions are carried and taken out at the Board Meetings held only in India. ***(PYP 4 Marks Jan '21)***

Answer 5

(i) As per the facts, a company is registered in Moscow, Russia and has installed its main server in Moscow for maintaining office automation software by Cloud Computing for its client in India. Thus, it can be said that this company has a place of business in India through electronic mode and is conducting business activity in India. Hence, the above company is a foreign company by taking into account the provisions of Section 2(42) of the Companies Act, 2013 read with the Companies (Registration of Foreign Companies) Rules, 2014.

(ii) In this case, a company is incorporated outside India and employs agents in India but does not have a place of business in India. As per section 2(42) of the Companies Act, 2013, foreign company means any company or body corporate incorporated outside India which has a place of business in India whether by itself or through an agent, physically or through electronic mode. Since, the company though employed agent in India but have no place of business in India, so it cannot be termed as foreign company.

(iii) In the given situation, a company is registered in Australia. It has authorised Mr. X in India to source customers and enter into contract on behalf of the company. Thus, it can be said that this company has both place of business in India through an agent, physically or through electronic mode; and is conducting business activity in India. Hence, this company is a foreign company as per the Companies Act, 2013.

(iv) In the given situation, a company is registered in Mauritius. However, it does not have a place of business in India whether by itself or through an agent, physically or through electronic mode; and does not conduct any business activity in India in any other manner. Mere holding of board meetings and executing business models, financial strategies and important decisions in India cannot be termed as conducting business activity in India. Hence, the above company is not a foreign company as per the Companies Act, 2013.

Sec 379- Application o the Act to Foreign Companies

Case based

Question 6

Elegant Educations Ltd. is a UK based company, engaged in the business of providing on- line education. It has introduced some certificate courses having duration of 4 to 6 months and any person can enrol in the courses. The education is provided through on-line classes, webinars and study materials are supplied through e-mails to the registered candidates. The company is not having any place of business in India. It is mentioned that all the candidates who have enrolled in the course are the Indian Citizens residing in India.

(i) Based on the above facts of procuring 100% business from India, whether the company will be treated as

foreign company or an Indian company.

(ii) What will be your answer if in the above question, more that 55% of that foreign company's paid-up share capital is held by Indian Companies or Indian Citizens. *(MTP 3 Marks Oct 22)*

Answer 6

(i) In terms of Section 2(42) "Foreign Company" means any company or body corporate incorporated outside India which—

(a) has a place of business in India whether by itself or through an agent, physically or through electronic mode; and

(b) conducts any business activity in India in any other manner.

Further Rule 2(1)(c)(iv) of the Companies (Registration of Foreign Companies) Rules, 2014 provides that for the purposes of clause (42) of section 2 of the Act, "electronic mode" means carrying out electronically based, whether main server is installed in India or not, including, but not limited to online services such as telemarketing, telecommuting, telemedicine, education and information research.

Thus, from the above provisions the company is treated as foreign company irrespective of the fact that its 100% business comes from India.

(ii) Section 379(2) provides that where not less than 50% of the paid-up share capital, whether equity or preference or partly equity and partly preference, of a foreign company is held by-

a. one or more citizens of India; or
b. one or more companies; or
c. bodies corporate incorporated in India;
d. one or more citizens of India and one or more companies or bodies corporate incorporated in India,

whether singly or in the aggregate, such company shall comply with the provisions of Chapter XXII and such other provisions of this Act as may be prescribed with regard to the business carried on by it in India as if it were a company incorporated in India. Thus, in the given case, if more that 50% of the paid-up share capital is held by Indian Companies / Citizen it shall be treated as a company incorporate in India and such company shall abide by the provisions of Section 380 to 386 (both inclusive) and Section 392 and 393 shall be applicable.

Question 7

Tokushima Motors Ltd. was incorporated in Japan. Its share capital is held by the following persons-Citizens of India – 10% Indian Companies– 40%

The company has opened its representative office in Mumbai on 15 th January, 2021, in order to receive orders from the Indian Market and make available the delivery of Japanese luxury cars to the Indian purchasers.

The company was not aware of the Indian Company Law, hence could not file the required documents to the Registrar. The company could file all the required documents only on 28th February, 2021.

Based on the above facts, answer the following questions:

(i) Whether the provisions of Chapter XXII of the Companies Act, 2013 are applicable on Tokushia Motors Ltd?

(ii) What documents are required to be filed by Tokushia Motors Ltd to the Registrar of Companies?

(iii) By what time all the requisite documents shall be filed? *(RTP Nov 21)*

Answer 7

(i) Section 379(2) of the Companies Act, 2013, provides that where not less than fifty per cent of the paid-up share capital, whether equity or preference or partly equity and partly preference, of a foreign company is held by one or more citizens of India or by one or more companies or bodies corporate incorporated in India, or by one or more citizens of India and one or more companies or bodies corporate incorporated in India, whether singly or in the aggregate, such company shall comply with the provisions of this Chapter and such other provisions of this Act as may be prescribed with regard to the business carried on by it in India as if it were a company incorporated in India.

In the given case, although the company was incorporated in Japan, however its share capital of not less than 50% is held by the Indian citizens and Indian companies, hence in terms of section 379(2) all the provisions pertaining to Chapter XXII of the Companies Act, 2013, shall be applicable on it.

(ii) In terms of section 380(1) every foreign company shall, within thirty days of the establishment of its place of business in India, deliver to the Registrar for registration—

(a) a certified copy of the charter, statutes or memorandum and articles, of the company or other instrument constituting or defining the constitution of the company and, if the instrument is not in the English language, a certified translation thereof in the English language;

(b) the full address of the registered or principal office of the company;

(c) a list of the directors and secretary of the company containing such particulars as may be prescribed;

(d) the name and address or the names and addresses of one or more persons resident in India authorised to accept on behalf of the company service of process and any notices or other documents required to be served on the company;

(e) the full address of the office of the company in India which is deemed to be its principal place of business in India;

(f) particulars of opening and closing of a place of business in India on earlier occasion or occasions;

(g) declaration that none of the directors of the company or the authorised representative in India has ever been convicted or debarred from formation of companies and management in India or abroad; and

(h) any other information as may be prescribed.

Further its sub-section (3) provides that where any alteration is made or occurs in the documents delivered to the Registrar under this section, the foreign company shall, within thirty days of such alteration, deliver to the Registrar for registration, a return containing the particulars of the alteration in the prescribed form.

(iii) In the given, case the company had established its representative office in India on 15.01.2021, it was required to file the documents latest by 14.02.2021 with the Registrar.

Question 8

Zell Power LLC (ZPL), is foreign company as per definition provided in the Companies Act 2013, carrying business in India also. It is strictly observing the provisions stated for foreign companies in Companies Act 2013, while Registrar (ROC, Delhi) is of opinion that ZPL apart from observing the provision prescribed for foreign companies (section 380 to 386 along section 392 and 393) ZPL also need to observe other provisions of the Companies Act, 2013 with regard to the business carried on by it in India as if it were a company incorporated in India.

ZPL is not agreed to opinion of Registrar and continue to observe only those provisions which are applicable to foreign companies. ZPL also furnish the following details to ROC. ZPL capital includes;

Ordinary Share (6 Million @ Face Value £ 5 with £ 2 Paid-up) – £12 Million Preference Stock (1.2 Million @ £10 fully Paid-Up) - £ 12 Million

Debt Fund - £ 21.25 Million

Out of which;

Mr. Trishi who is an Indian citizen and Residing in India being part of promoter group own 2,932,780 ordinary shares of ZPL

Mr. Nirav who is an Indian citizen but residing in UAE own 109,205 preference stock of ZPL

Modern Engineering Limited that an Indian Company own 67,220 ordinary shares and 142,320 preference stocks of ZPL Raj Investment Limited, which is an Indian Company holds 393,475 preference stocks of ZPL

You are required to evaluate the facts, and determine whose opinion hold legal validity in the light of the relevant provisions of the Companies Act, 2013. *(RTP May 23)*

Answer 8

Section 379 of the Companies Act 2013 deals with application of Act to foreign companies.

Sub-section 2 to section 379 provides where not less than fifty percent of the paid-up share capital (whether equity or preference or partly equity and partly preference) of a foreign company is held by

(i) one or more citizens of India or

(ii) one or more companies or bodies corporate incorporated in India, or

(iii) one or more citizens of India and one or more companies or bodies corporate incorporated in India,

Whether singly or in the aggregate, such company shall comply with the provisions of this Chapter and such other provisions of this Act as may be prescribed with regard to the business carried on by it in India as if it were a company incorporated in India.

Total of ordinary shares held by Indian citizen or corporation in aggregate are 3 million (i.e. 2932780 and 67220) whose paid-up value is ₤6 million

Total of preference stock held by Indian citizen or corporation in aggregate are 0.645 million (i.e. 109,205, 142,320, and 393,475) whose paid-up value is ₤6.45 million

Since out of paid-up capital of ₤24 (i.e. ₤12 million ordinary share capital + ₤12 million preference share capital) of ZPL, ₤12.45 million held by citizens of India along with companies incorporated in India, in aggregate hence ZPL shall comply with the provisions of this Chapter and such other provisions of this Act as may be prescribed with regard to the business carried on by it in India as if it were a company incorporated in India.

Opinion of Registrar is legally valid and shall prevail.

Question 9 LDR

RFC Limited has been incorporated in Singapore and has a business place in Mumbai. The company has issued 5,00,000 shares of USD 100 each, consisting of 4,00,000 equity shares and 1,00,000 preference shares. The issued share capital is fully paid up except 5,000 preference shares where USD 50 per share is unpaid.

RJW, an Indian citizen is holding 26,000 preference shares which include 1100 partly paid- up shares and Ronte Limited incorporated in New-Delhi (India) is holding 2,23,500 equity shares in RFC Limited.

The Registrar of Companies issued notice under Section 379 of the Companies Act, 2013 addressed to the person whose name and address has been delivered to the Registrar by RFC Limited for compliance under the Companies Act, 2013 for foreign companies.

The above notice was Delivered at the address which was given by RFC Limited to the Registrar of Companies.

Answer the following, referring to the provisions of the Companies Act, 2013:

(i) Whether RFC Limited is a foreign company?

(ii) Whether service of notice by the Registrar of companies valid? *(PYP 4 Marks May '22)*

Answer 9

(i) Whether RFC Limited is a Foreign Company ? Definition of a Foreign Company

As per Section 2(42) of the Companies Act, 2013, "Foreign Company" means any company or body corporate incorporated outside India which has a place of business in India whether by itself or through an agent, physically or through electronic mode; and conducts any business activity in India.

Provision of Section 379(2): Requirement of holding of paid up share capital of Foreign Company:

Further, in the light of the inputs given in the problem, where not less than 50% of the paid-up share capital, whether equity or preference or partly equity and partly preference, of a foreign company incorporated outside India is held by one or more citizens of India and one or more companies or bodies corporate incorporated in India, whether singly or in the aggregate, such foreign company shall also comply with the provisions of Chapter XXII and such other provisions of this Act as may be prescribed with regard to the business carried on by it in India as if it were a company incorporated in India. [Section 379(2)]

In the given case, RFC Limited, incorporated in Singapore has a business place in Mumbai. The Company has issued 5,00,000 shares of USD 100 each i.e. of USD 5,00,00,000 comprising of USD 4,00,00,000 equity share capital (i.e. 4 lac* USD 100) and USD 1,00,00,000 preference share capital (i.e,1 lac * USD 100).

As the issued capital was fully paid up except 5,000 preferences shares (i..e, 5000* 50= USD 2,50,000), so, total paid up share capital of the RFC limited is:

Equity Share Capital	USD 4,00,00,000
Preference Share Capital (Full Paid)	USD 95,00,000
Preference Share Capital (Partly Paid)	USD 2,50,000
Total Paid up Share Capital	USD 4,97,50,000

As per facts, shareholding by RJW, an Indian citizen is USD 25,45,000 preference share capital (i.e. 26,000 shares *USD 100- 1100 shares * USD 50) and Ronte Limited incorporated in New-Delhi (India) is holding USD 2,23,50,000 equity share capital (i.e., 2,23,500 *USD 100) in RFC Limited. Aggregate shareholding is USD 2,48,95,000.

As per requirement of Section 379(2), RJW, an Indian citizen and Ronte Limited incorporated (an Indian Company) were holding more than 50% of the shareholding (i.e. 50%* USD 4,97,50,000 = 2,48,75,000) in RFC Limited.

Therefore, RFC Ltd. is not only a foreign company as per Section 2(42) but shall also be complying with the provisions of Chapter XXII and other provisions of this Act with regard to the business carried on by it in India, as if it were a company incorporated in India as per Section 397(2) .

(ii) Whether service of notice by the RoC is valid?

Yes, the service of notice by the Registrar of Companies is valid in the light of Section 383 of the Companies Act, 2013. According to the provision any process, notice, or other document required to be served on a foreign company, shall be deemed to be sufficiently served, if addressed to any person whose name and address have been delivered to the Registrar and left at, or sent by post to, the address which has been so delivered to the Registrar or by electronic mode.

Sec 380- Documents to be delivered to Registrar by Foreign Companies

Question 10

Jackson & Jackson LLC, incorporated in Germany, is proposing to establish a business in Mumbai, India. Its official documents are in German language. Whether Jackson & Jackson LLC can file the required documents with Registrar in the same language. *(SM)*

Answer 10

Every foreign company shall, within 30 days of the establishment of its place of business in India, deliver the documents to the Registrar as per Section 380 of the Companies Act, 2013. Further, if the original instruments/ documents are not in the English language, a certified translation in the English language is required for the same and submitted to Registrar.

Question 11

Fine Publishers, registered in Tokyo, began operating in India during the financial year 2016. The company has duly submitted all necessary documents to the registrar within the specified due date. On 1st March, 2024, Fine Publishers has shifted its principal office in Tokyo. Is Fine Publishers required to undertake any steps due to change in address of principal office. Give your answer in reference to the provisions of the Companies Act, 2013. *(RTP May '24, New SM)*

Answer 11

Section 380 (3) of the Companies Act, 2013, provides that where any alteration is made or occurs in the documents delivered to the Registrar under section 380, the foreign company shall, within 30 days of such alteration, deliver to the Registrar for registration, a return containing the particulars of the alteration in the prescribed form. The Companies (Registration of Foreign Companies) Rules, 2014, has prescribed that the return containing the particulars of the alteration shall be filed along with prescribed fees. Accordingly, Fine Publishers is required to submit to the Registrar the full address of the new registered or principal office of the company by March 30, 2024.

Question 12

CNC Limited is a foreign company having its places of business in Mumbai and Ahmedabad in India. It has amended its Memorandum of Association on 1 st June, 2022 and closed branch office situated at Mumbai. Referring to the provisions of the Companies Act, 2013 advise the company on the following matters:

(i) Compliance procedure as regards to amendment of Memorandum of Association.

(ii) Compliance procedure as regards to closure of Mumbai office and discontinuing submission of documents to the Registrar of Companies afterwards. *(PYP 4 Marks Nov 22)*

Answer 12

According to section 380 of the Companies Act, 2013 read with Rule 8 of the Companies (Registration of Foreign Companies) Rules, 2014, following shall be the compliances duly required to be fulfilled by the CNC Limited, a foreign company, for closure of one of its branch of Mumbai office.

(i) W.r.t. Compliance procedure as regards to amendment of Memorandum of Association

According to Section 380 (3) of the Act which provides that where any alteration is made or occurs in the documents delivered to the Registrar under section 380, the foreign company shall, within 30 days of such alteration, deliver to the Registrar for registration, a return containing the particulars of the alteration in the prescribed form. The Companies (Registration of Foreign Companies) Rules, 2014, has prescribed that the return containing the particulars of the alteration shall be filed in form *FC-2* along with prescribed fees.

As in the instance, the CNC Limited has amended its Memorandum of Association on 1st of June 2022 and closed its branch office of Mumbai. This altered document is required to be delivered to Registrar by CNC Limited within 30 days i.e. latest by 1st of July 2022.

(ii) W.E.T.T. compliance procedure as regards to closure of Mumbai office and discontinuing submission of documents to the registrar of companies afterwards

If any foreign company ceases to have a place of business in India, it shall forthwith give notice of the fact to the Registrar, and from the date on which such notice is so given, the obligation of the company to deliver any document to the Registrar shall cease, provided it has no other place of business in India.

Here, in the given case, CNC Limited has still Ahmedabad as a place of business in India. So, will continue the submission of document to the Registrar even after the closure of Mumbai office.

Exam insights: Majority of the examinees have attempted this question in a generalized manner without referring the provisions of section 380 of the Companies Act, 2013 for filing of documents by foreign companies read with Rule 8 of the Companies (Registration of Foreign Companies) Rules, 2014 for compliance procedure as regards to amendment of memorandum of association and closure of office and discontinuance of submission of documents to the Registrar of Companies afterwards.

Question 13

ABC Ltd., a foreign company having its Indian principal place of business at Kolkata, West Bengal is required to deliver various documents to Registrar of Companies under the provisions of the Companies Act, 2013. You are required to state, where the said company should deliver such documents. *(MTP 2 Marks Mar 19, Oct'19, SM)*

Answer 13

The Companies Act, 2013 vide section 380 provides that every foreign company is required to deliver to the Registrar for registration, within 30 days of the establishment of office in India, documents which have been specified therein. According to *the Companies (Registration of Foreign Companies) Rules, 2014*, any document which any foreign company is required to deliver to the Registrar shall be delivered to the Registrar having jurisdiction over New Delhi.

Question 14

LDR

Delegate Limited, incorporated in Singapore desires to establish a place of business at Mumbai. You being a practicing Chartered Accountant have been appointed by the company as a liaison officer, for compliance of legal formalities on behalf of the company. Examining the provisions of the Companies Act, 2013, state the documents you are required to furnish on behalf of the company, on the establishment of a place of business at Mumbai. *(MTP 8 Marks, Mar'21, RTP May'19, SM)*

Answer 14

Under section 380(1) of the Companies Act, 2013 every foreign company shall, within 30 days of the establishment of place of business in India, deliver to the Registrar for registration the following documents:

(a) a **certified copy of the charter, statutes or memorandum and articles**, of the company or other instrument constituting or defining the constitution of the company. If the instruments are not in the English language, a certified translation thereof in the English language;

(b) the full **address of the registered or principal office** of the company;

(c) a **list of the directors and secretary** of the company containing such particulars as prescribed under the Companies (Registration of Foreign Companies) Rules,2014,

(1) personal name and surname in full;
(2) any former name or names and surname or surnames in full;
(3) father's name or mother's name and spouse's name;
(4) date of birth;
(5) residential address;
(6) nationality;
(7) if the present nationality is not the nationality of origin, his nationality of origin;
(8) passport Number, date of issue and country of issue; (if a person holds more than one passport then details of all passports to be given)
(9) income-tax permanent account number (PAN), if applicable;
(10) occupation, if any;
(11) whether directorship in any other Indian company, (Director Identification Number(DIN), Name and Corporate Identity Number (CIN) of the company in case of holding directorship);
(12) other directorship or directorships held by him;
(13) Membership Number (for Secretary only); and
(14) e-mail ID.

(d) the name and address or the names and addresses of one or more persons resident in India authorised to accept on behalf of the company service of process and any notices or other documents required to be served on the company;
(e) the full address of the office of the company in India which is deemed to be its principal place of business in India;
(f) particulars of opening and closing of a place of business in India on earlier occasion or occasions;
(g) declaration that none of the directors of the company or the authorised representative in India has ever been convicted or debarred from formation of companies and management in India or abroad; and
(h) any other information as may be prescribed.

According to the Companies (Registration of Foreign Companies) Rules, 2014, any document which any foreign company is required to deliver to the Registrar shall be delivered to the Registrar having jurisdiction over New Delhi.

Sec 381- Accounts of Foreign Company

Question 15

Explain the provisions of the Companies Act, 2013 [read along with the Companies (Registration of Foreign Companies) Rules, 2014] in respect of 'Audit of accounts of foreign company'.*(MTP 5 Marks July'24)*

Answer 15

Audit of accounts of foreign company

According to the Companies (Registration of Foreign Companies) Rules, 2014,

(i) Every foreign company shall get its accounts, pertaining to the Indian business operations prepared in accordance with section381(1) of the Companies Act, 2013 and Rules thereunder, shall be audited by a practicing Chartered Accountant in India or a firm or limited liability partnership of practicing chartered accountants.
(ii) The provisions of Chapter X i.e. Audit and Auditors and rules made there under, as far as applicable, shall apply, *mutatis mutandis*, to the foreign company.

<u>**Case based**</u>

Question 16

MNO Ltd., a foreign Joint Venture Company having its established place of business in India and following International Financial Reporting Standards (IFRS) and its financial statement being prepared in German language desires to know the following with regard to submission of its financial statements to the Registrar of Companies in India. Its area office is located at Mumbai:

(i) **Submission of financial statements in German Language;**
(ii) **Format of financial statements as per IFRS;**
(iii) **How authentication of its financial statements is to be done?**
(iv) **Whether the documents can be submitted at the Registrar's office at Mumbai?** ***(PYP 4 Marks July 21)***

Answer 16

In the light of the given facts, following are the answers:

(i) All the documents required to be filed with the Registrar by the foreign companies shall be in **English language**. If the financial statements are in German language and not in the English language, a certified translation thereof in the English language shall be annexed and submitted to Registrar [Section 381 (2)]

(ii) Format of Financial statement as per IFRS:
Rule 6 of the Companies (Accounts) Rules, 2014 provides for the consolidation of accounts of companies in the following manner:
Manner of consolidation of Accounts: The consolidation of financial statements of the company shall be made in accordance with the provisions of Schedule III of the Act and the applicable accounting standards.

(iii) Authentication of translated financial statements [Rule 10 of the Companies (Registration of Foreign Companies) Rules, 2014]:
(1) All the documents required to be filed with the Registrar by the foreign companies shall be in English language and where any such document is not in English language, there shall be attached a translation thereof in English language duly certified to be correct in the manner given in these rules.
(2) Where any such translation is made outside India, it shall be authenticated by the signature and the seal, if any, of—
(a) the official having custody of the original; or
(b) a Notary (Public) of the country (or part of the country) where the company is incorporated:
Provided that where the company is incorporated in a country outside the Commonwealth, the signature or seal of the person so certifying shall be authenticated by a diplomatic or consular officer empowered under section 3 of the Diplomatic and Consular Officers (Oaths and Fees) Act, 1948, or, where there is no such officer, by any of the officials mentioned in section 6, of the Commissioners of Oaths Act, 1889, or in any relevant Act for the said purpose.
(3) Where such translation is made within India, it shall be authenticated by—
(a) an advocate, attorney or pleader entitled to appear before any High Court; or
(b) an affidavit, of a competent person having, in the opinion of the Registrar, an adequate knowledge of the language of the original and of English.

(iv) According to the Companies (Registration of Foreign Companies) Rules, 2014, any document which any foreign company is required to deliver to the Registrar shall be delivered to the Registrar having jurisdiction over New Delhi. Hence, the documents of MNO Ltd. cannot be submitted at the Registrar's office at Mumbai.

[Following assumptions drawn within the provided informations:

1. With respect to part (iii), an answer has been given in reference to part (i) of the question. Here, authentication is being considered to be asked of translated financial statements (from German language to English Language) as nothing is specified in the question.
2. In order to answer part (iii) of the question, it may be considered in independent situation, then only the authentication of its financial statement can be answered according to the Companies (Registration of Foreign Companies) Rules, 2014. According to which every foreign company shall prepare financial statement of its Indian business operations in accordance with Schedule III or as near thereto as possible for each financial year including documents that are required to be annexed should be in accordance with Chapter IX i.e. Accounts of Companies.]

EXAM INSIGHTS: The Performance of the examinees was average. Majority of the examinees have answered this question in a generalized manner without referring the provisions of section381(2) of the Companies Act, 2013 for filing of documents by foreign companies and Rule 6 of the Companies (Accounts) Rules, 2014 for consolidation of accounts and Rule 10 of the Companies (Registration of Foreign Companies) Rules, 2014 for authentication of translated financial statements.

Question 17

Phil Heath Systems Incorporated (PHSI), is a foreign Company registered in Australia and has established a place of business in India. The financial statements pertaining to the Indian business operations for the year ended 31st March, 2020 were prepared by the Company. Referring to the provisions of the Companies Act, 2013, advise the Company on the following matters:

(i) Whether the accounts of the Company pertaining to Indian business operations shall be audited ? If yes, by whom ?

(ii) What is the due date for filing the audited financial statements with the Registrar of Companies (RoC)?

(iii) What is the effect of the contracts entered by an Indian Company with PHSI in case PHSI has not filed financial statements with the RoC?

(iv) In which e-forrn and within what period, the annual return of the Indian operations of the foreign company shall be filed with the Registrar of Companies? *(PYP 4 Marks Jan '21)*

Answer 17

Phil Health Systems Incorporated (PHSI), a foreign company, is registered outside India and has a place of business in India. As it has prepared financial statements pertaining to the Indian business operations, it reflects conducts of business activity in India. Therefore, provisions related to companies incorporated outside India shall be applicable to it. Following are the answer in line with said nature of the company:

(i) According to the Companies (Registration of Foreign Companies) Rules, 2014, PHSI shall get its accounts, pertaining to the Indian business operations, audited by a practicing Chartered Accountant in India or a Firm or Limited Liability Partnership of practicing Chartered Accountants.

(ii) The audited financial statements of Indian business operations of PHSI shall be delivered to the Registrar within a period of six months of the close of the financial year of the foreign company to which the documents relate i.e., latest by 30 th September 2020.
Provided that the Registrar may, for any special reason, and on application made in writing by the foreign company concerned, extend the said period by a period not exceeding three months i.e. latest by 31st December 2020.

(iii) According to Section 393 of the Companies Act, 2013, any failure by a company to comply with the provisions of Chapter XXII of the Companies Act, 2013 (chapter XXII deals with 'Companies incorporated Outside India'), shall not affect the validity of any contract, dealing or transaction entered into by the company or its liability to be sued in respect thereof.
In the instant case, non-filing of financial statements by PHSI shall not invalidate the contracts entered by Indian companies with PHSI.
However, PHSI shall not be entitled to bring in any suit, claim any set off, make any counter claim or institute any legal proceeding in respect of any such contract until the company has filed the financial statements.

(iv) According to the Companies (Registration of Foreign Companies) Rules, 2014, every foreign company shall prepare and file an annual return in Form FC-4 along with prescribed fees, within a period of 60 days from the last day of its financial year i.e. by 30th May 2020, to the Registrar containing the particulars as they stood on the close of the financial year.

Question 18

Gato Limited dealing in coloured contact lenses, is a company incorporated in Singapore. The said company is operating in India through its branch office in Kolkata. The company has approached its legal department to state the relevant provisions of the Companies Act, 2013 and rules made thereunder relating to preparation and filing of financial statements in case of such a company.*(MTP 5 Marks Mar'24, New SM)*

Answer 18

Preparation and filing of financial statements by a foreign company According to section 381 of the Companies Act, 2013:

(i) Every foreign company shall, in every calendar year, —

(a) make out a balance sheet and profit and loss account in such form, containing such particulars and including or having attached or annexed thereto such documents as may be prescribed, and

(b) deliver a copy of those documents to the Registrar.

According to the Companies (Registration of Foreign Companies) Rules, 2014, every foreign company shall prepare financial statement of its Indian business operations in accordance with Schedule III or as near thereto as possible for each financial year including:

(1) documents that with Chapter IX i.e. Accounts of Companies.

(2) The documents relating to copies of latest consolidated financial statements of the parent foreign company, as submitted by it to the prescribed authority in the country of its incorporation under the applicable laws there.

(ii) The Central Government is empowered to direct that, in the case of any foreign company or class of foreign companies, the requirements of clause (a) of section 381(1) shall not apply, or shall apply subject to such exceptions and modifications as may be specified in notification in that behalf.

(iii) If any of the specified documents are not in the English language, a certified translation thereof in the English language shall be annexed. [Section 381 (2)]

(iv) Every foreign company shall send to the Registrar along with the documents required to be delivered to him, a copy of a list in the prescribed form, of all places of business established by the company in India as at the date with reference to which the balance sheet referred to in section 381(1) is made.

According to the Companies (Registration of Foreign Companies) Rules, 2014, every foreign company shall file with the Registrar, along with the financial statement, in Form FC-3 with such fee as provided under Companies (Registration Offices and Fees) Rules, 2014 a list of all the places of business established by the foreign company in India as on the date of balance sheet.

Sec 382- Display of Name etc of Foreign Company

Case based

Question 19

A company incorporated in France, with limited liability, established an office in Baroda, and started conducting business activity from its place of business. In compliance of Section 382 of the Companies Act, 2013, it conspicuously exhibited a name board outside its office, with the name of the company in English in big block letters. In three days, the company received a notice from the Registrar stating that it had not properly complied with the requirements of Section 382 of the Companies Act, 2013. Mention the areas of lapses of the foreign company, which would be mentioned in the notice. *(MTP 4 Marks Sep '22)*

Answer 19

According to Section 382 of the Companies Act, 2013,

- every foreign company shall conspicuously exhibit on the outside of every office or place where it carries on business in India, the name of the company and the country in which it is incorporated, in letters easily legible in English characters, and also in the characters of the language or one of the languages in general use in the locality in which the office or place is situate;

- if the liability of the members of the company is limited, cause notice of that fact—
  (I) to be stated in every such prospectus issued and in all business letters, bill -heads, letter paper, notices, advertisements and other official publications of the company, in legible English characters; and
  (II) to be conspicuously exhibited on the outside of every office or place where it carries on business in India, in legible English characters and also in legible characters of the language or one of the languages in general use in the locality in which the office or place is situated.

  After taking into account the provisions of Section 382 of the Companies Act, 2013, the following are the lapses by the company:
  (i) The company has exhibited the name of the company in English but it has not displayed the name of the Country where it was incorporated, name of the country. Further, it has not displayed both the facts in the local language or one of the languages in general use in the locality in which the office or place is situated. i.e. Baroda.
  (ii) Further the company is one where the liability of members is limited. The fact that the members

liability is limited has not been conspicuously exhibited on the outside of every office or place i.e. in Baroda, in legible English characters and also in legible characters of the language or one of the languages in general use in the locality i.e. Baroda

The above lapses would have given rise to the notice from the Registrar.

Sec 387- Dating of Prospectus & Particulars to be contained therein

Case based

Question 20

Blue Star Inc. is a company incorporated in USA, four years back and has no established place of business in India. The company has entered into following contracts:-

Particulars	Contracts entered in the ordinary course of business	Material Contracts
F.Y. 2017-18	4	2
F.Y. 2018-19	6	1
F.Y. 2019-20	5	3
F.Y. 2020-21	3	4

Apart from above, one contract has been entered into with its manager. The company intended to offer its securities in India. For that purpose, the secretary of the company, Mr. Berry Christan prepared the prospectus along with annexing the required documents and got it registered. Expert's consent was issued in a separate statement, the reference of which was given in the prospectus.

Few application forms for securities of Blue Star Inc. were issued to prospective investors without the prospectus out of which one such form was issued in connection with bona fide invitation to the person to enter into an underwriting agreement with respect to securities of Blue Star Inc.

In the context of aforesaid case, please answer to the following questions:-

(i) Whether the expert's statement can be considered to be included in the prospectus?

(ii) What copy of contracts would have been annexed with the prospectus by Mr. Berry?

(iii) Whether it is valid on the part of Blue Star Inc. for issuing few application forms without prospectus? ***(RTP May 22)***

Answer 20

(i) According to section 388(2) of the Companies Act, 2013, a statement shall be deemed to be included in a prospectus, if it is contained in any report or memorandum appearing on the face thereof or by reference incorporated therein or issued therewith.

In the given case, the reference of expert's consent statement was given in the prospectus. Thus, the expert's statement shall be deemed to be included in a prospectus.

(ii) According to the Companies (Registration of Foreign Companies) Rules, 2014, the following documents shall be annexed to the prospectus, inter-alia, namely:-

(a) a copy of contracts for appointment of managing director or manager and in case of a contract not reduced into writing, a memorandum giving full particulars thereof;

(b) a copy of any other material contracts, not entered in the ordinary course of business, but entered within preceding 2 years.

In the given case, during the preceding 2 years, i.e. F.Y. 2019 -20 and F.Y. 2020-21, respectively, the material contracts entered into by Blue Star Inc. are 3 + 4 = 7 and apart from it, one contract has been entered into with its manager. So, in total 8 copies of contracts would have been annexed with the prospectus by Mr. Berry.

(iii) According to section 387(3) of the Companies Act, 2013, no person shall issue to any person in India a form of application for securities of such a company or intended company as is mentioned in section 387(1), unless the form is issued with a prospectus which complies with the provisions of this Chapterand such issue does not contravene the provisions of section 388:

Exception: If it is shown that the form of application was issued in connection with a bona fide invitation to a person to enter into an underwriting agreement with respect to securities.

Blue Star Inc. has, thus, violated provisions of section 387(3) by issuing few application forms without prospectus. However, the application form issued in connection with bona fide invitation to the person to enter into an underwriting agreement with respect to securities of Blue Star Inc. can be considered as valid as such a case is covered by the exception to the said sub-section.

Sec 389- Registration of Prospectus

Theory

Question 21

What are the documents that must be annexed to a prospectus offering for subscription in securities of a company incorporated or to be incorporated outside India, as per the Companies (Registration of Foreign Companies) Rules, 2014? *(MTP 5 Marks Apr'24)*

Answer 21

According to section 389 of the Companies Act, 2013:

No person shall issue, circulate or distribute in India any prospectus offering for subscription in securities of a company incorporated or to be incorporated outside India, whether the company has or has not established, or when formed will or will not establish, a place of business in India, unless before the issue, circulation or distribution of the prospectus in India;

- ✓ a copy thereof certified by the chairperson of the company and two other directors of the company as having been approved by resolution of the managing body has been delivered for registration to the Registrar; and
- ✓ the prospectus states on the face of it that a copy has been so delivered, and
- ✓ there is endorsed on or attached to the copy, any consent to the issue of the prospectus required by section 388 and such documents as may be prescribed.

According to the Companies (Registration of Foreign Companies) Rules, 2014, the following documents shall be annexed to the prospectus, namely:

(1) any consent to the issue of the prospectus required from any person as an expert;

(2) a copy of contracts for appointment of managing director or manager and in case of a contract not reduced into writing, a memorandum giving full particulars thereof;

(3) a copy of any other material contracts, not entered in the ordinary course of business, but entered within preceding 2 years;

(4) a copy of underwriting agreement; and

(5) a copy of power of attorney, if prospectus is signed through duly authorized agent of directors.

Case based

Question 22

Shaltom Ltd., an international corporation headquartered outside Japan, is interested in expanding its investor base and thus is planning to issue a prospectus for the subscription of its securities to potential investors in India. However, the company has not yet established a physical place of business within India. As a consultant for Shaltom Ltd., you have been asked to provide guidance on the legal procedures and compliance requirements that the company must follow to issue this prospectus in India.

(MTP 5 Marks Aug'24, SM)

Answer 22

As per section 389 of the Companies Act, 2013, no person shall issue, circulate or distribute in India any prospectus offering for subscription in securities of a company incorporated or to be incorporated outside India, whether the company has or has not established, or when formed will or will not establish, a place of business in India, unless before the issue, circulation or distribution of the prospectus in India, a copy thereof certified

by the chairperson of the company and two other directors ofthe company as having been approved by resolution of the managing body has been delivered for registration to the Registrar and the prospectus states on the face of it that a copy has been so delivered,and there is endorsed on or attached to the copy, any consent to theissue of the prospectus required by section 388 and such documents as may be prescribed under Rule 11 of the Companies (Incorporated outside India) Rules, 2014.
Accordingly, the Shaltom Ltd. a foreign company shall proceed with the issue of prospectus in compliance with the above stated provisions of section 379 of the Act.

Question 23

(i) Tokyo Ferro Alloys Limited, a company registered in Japan, started its operations in India by establishing a Marketing Division in Mumbai on 1st April, 2021. Recently, the Company decided to issue certain securities in India and therefore, is planning to circulate in India, a prospectus offering for subscription in securities of the Company. Assuming that all the other formalities in this respect have been complied with, advise the person in-charge of Indian operations regarding the other documents required to be annexed to the prospectus in order to registered the same, referring to the relevant provisions of the Companies Act, 2013 and the rules made thereunder,

(ii) Vibav Pte, a company incorporated in Singapore is having a liaison office in Delhi. The Liaison office seeks your advice regarding the documents to be filed with the Registrar along with the financial statement under the Companies Act, 2013 read with the Companies (Registration of Foreign Companies) Rules, 2014. *(PYP 4 Marks Dec '21)*

Answer 23

(i) According to this Section 389 of the Companies Act, 2013 read with Rule 11 of the Companies (Registration of Foreign Companies) Rules, 2014,
The Following documents shall be annexed to the prospectus, namely:
(a) any consent to the issue of the prospectus required from any person as an expert;
(b) a copy of contracts for appointment of managing director or manager and in case of a contract not reduced into writing, a memorandum giving full particulars thereof;
(c) a copy of any other material contracts, not entered in the ordinary course of business, but entered within preceding 2 years;
(d) A copy of underwriting agreement; and
(e) A copy of power of attorney, if prospectus is signed through duly authorized agent of directors.
Accordingly, the person in charge of the Indian operations shall be advised in accordance with the above provisions.

(ii) According to Rule 4 of the Foreign Companies (Registration of Foreign Companies) Rules, 2014, every foreign company, shall, along with the financial statement required to be filed with the Registrar, attach thereto the following documents; namely:-
1. Statement of related party transaction
2. Statement of repatriation of profits
3. Statement of transfer of funds (including dividends, if any).

The above statement shall include such other particulars as are prescribed in the Companies (Registration of Foreign Companies) Rules, 2014.

Exam Insights: The Performance of the examinees was poor. Most of the examinees have not answered correctly the provisions of Section 389 of the Companies Act, 2013 read with Rule 11 of the Companies (Registration of Foreign Companies) Rules 2014 regarding the documents to be annexed with the prospectus and Rule 4 of the Foreign Companies (Registration of Foreign Companies) Rules 2014 regarding documents to be annexed with the financial statement. They have answered in general the documents to be delivered on establishment of foreign companies in India. This had a negative impact on the performance of the examinees.

Sec 392- Punishment for Contravention

Theory

Question 24

In case, a foreign company does not deliver its documents to the Registrar of Companies as required under section 380 of the Companies Act, 2013, state the penalty prescribed under the said Act, which can be levied.

Answer 24

The Companies Act, 2013 lays down the governing provisions for foreign companies in Chapter XXII which is comprised of sections 379 to 393. The penalties for non- filing or for contravention of any provision for this chapter including for non-filing of documents with the Registrar as required by section 380 and other sections in this chapter are laid down in section 392 of the Act which provides that if a foreign company contravenes the provisions of this Chapter, the foreign company shall be punishable with a fine which shall not be less than 1,00,000 but which may extend to 3,00,000 and in the case of a continuing offence, with an additional fine which may extend to 50,000 for every day after the first during which the contravention continues and every officer of the foreign company who is in default shall be punishable with fine which shall not be less than 25,000 but which may extend to 5,00,000.

Sec 379- Application o the Act to Foreign Companies

Question 25

Beauty Cosmetics, a company incorporated in Korea has established its branch office in Chennai for conducting its business in India. The structure of paid-up share capital of Beauty Cosmetics as at 31st March 2024 is as below:

The company does not have any Preference Share Capital.

Equity share capital held by Mr. L, an Indian citizen: 10%

Equity share capital held by Mr. R, an Indian Citizen: 20%

Equity share capital held by Fairness Cosmetics Limited, an Indian company: 20%

You being a Chartered Accountant are asked to explain with reference to the provisions of the Companies Act, 2013:

(i) Whether Beauty Cosmetics shall be deemed to be a Foreign Company or an Indian Company for the business carried on by it in India, and

(ii) for the business carried on by it in India, will it be required to comply with the relevant provisions of the Companies Act, 2013 as if it is an Indian Company? *(PYP 5 Marks Sep'24)*

Answer 25

(i) Whether Beauty Cosmetics shall be deemed to be a foreign company or an Indian company?

As per section 2(42) of the Companies Act, 2013, a 'foreign company' means any company or a body corporate incorporated outside India which has:

(a) a place of business in India whether by itself or through an agent physically or through electronic mode and

(b) conducts any business activity in India in any other manner.

In the given question, Beauty Cosmetics, a Korean company has established a place of business in India (branch office in Chennai) and also carries on the business in India. Hence, Beauty Cosmetics shall be deemed to be a foreign company under the Companies Act, 2013 forthe business carried on by it in India.

Further, according to section 379(2) of the Companies Act, 2013, where not less than 50% of the paid-up share capital, whether equityor preference or partly equity and partly preference, of a foreign company incorporated outside India is held by:

(i) one or more citizens of India; or

(ii) by one or more companies or bodies corporate incorporated in India; or

(iii) by one or more citizens of India and one or more companies or bodies corporate incorporated in India, whether singly or in the aggregate, such foreign company shall also comply with the provisions of Chapter XXII and other prescribed provisions of the Companies Act, 2013, with regard to the business carried on by it in India as if it were a company incorporated in India.

In the given question, 50% (10% + 20% + 20%) of the share capital of Beauty Cosmetics (incorporated in Korea) is held by Mr. L (Indian Citizen), Mr. R (Indian Citizen) and Fairness Cosmetics Limited (Indian Company) respectively.

Hence, Beauty Cosmetics shall be deemed to an Indian company forthe business carried on by it in India.

(ii) Whether Beauty Cosmetics, for the business carried on by it in India, be required to comply with the provisions of the Act?

Since, Beauty Cosmetics shall be deemed to an Indian company forthe business carried on by it in India, it is required to comply with the relevant provisions of the Companies Act, 2013, as if it is an Indian company.

Sec 381- Accounts of Foreign Company

Question 26

Explain the provisions of the Companies Act, 2013 [read along with the Companies (Registration of Foreign Companies) Rules, 2014] in respect of 'Audit of accounts of foreign company'. *(MTP 5 Marks Nov'24)*

Answer 26

Audit of accounts of foreign company

According to the Companies (Registration of Foreign Companies) Rules, 2014,

(i) Every foreign company shall get its accounts, pertaining to the Indian business operations prepared in accordance with section 381(1) of the Companies Act, 2013 and Rules thereunder, shall be audited by a practicing Chartered Accountant in India or a firm or limited liability partnership of practicing chartered accountants.

(ii) The provisions of Chapter X i.e. Audit and Auditors and rules made there under, as far as applicable, shall apply, mutatis mutandis, to the foreign company.

Sec 393- Co's failure to comply with provisions to not affect validity of contracts

Question 27

XYZ Limited, a company incorporated outside India and to which provisions of Chapter XXII of the Companies Act, 2013 are applicable, entered into a contract with ABC Limited, an Indian company, for the supply of machinery. After the machinery was delivered, ABC Limited failed to make the payment citing defects in the machinery.

XYZ Limited discovered that it had failed to comply with certain provisions of Chapter XXII of the Companies Act, 2013, relating to the registration of foreign companies in India. Despite this, XYZ Limited intends to file a suit against ABC Limited for payment.

Discuss whether XYZ Limited can initiate legal proceedings against ABC Limited in light of the non-compliance with Chapter XXII of the Companies Act, 2013.

Give your answer as per the provisions of the Companies Act, 2013 [read along with the Companies (Registration of Foreign Companies) Rules, 2014]. (MTP 5 Marks Dec'24) (Chapter Companies Incorporated Outside India).

Answer 27

According to section 393 of the Companies Act, 2013, any failure by a company to comply with the provisions of Chapter XXII of the Companies Act, 2013, shall not affect the validity of any contract, dealing or transaction entered into by the company or its liability to be sued in respect thereof. However, the company shall not be entitled to bring any suit, claim any set-off, make any counter-claim or institute any legal proceeding in respect of any such contract, dealing or transaction, until the company has complied with the provisions of the Companies Act, 2013, applicable to it.

In this given question, XYZ Limited, a company incorporated outside India, has failed to comply with certain provisions of Chapter XXII of the Companies Act, 2013, which governs the registration and compliance requirements for foreign companies operating in India.

According to the Companies Act, 2013, non-compliance with Chapter XXII does not affect the validity of any contract, dealing, or transaction entered into by the company. Therefore, the contract between XYZ Limited and ABC Limited remains valid, and ABC Limited is still legally bound to fulfill its contractual obligations, including the payment for the machinery supplied.

Further, XYZ Limited cannot bring a suit, claim any set-off, make any counter-claim, or institute any legal proceeding related to the contract as it has not complied with certain provisions of Chapter XXII.

MULTIPLE CHOICE QUESTIONS MCQ

Sec 2(42)- Foreign Company

1. Radix Healthcare Ltd., a company registered in Thailand, although has no place of business established in India, yet it is engaged in online business through remote delivery of healthcare services in India. Select the incorrect statement from those given below as to the nature of the Radix Healthcare Ltd. in the light of the applicable provisions of the Companies Act, 2013:

(a) Radix Healthcare Ltd. is not a foreign company as it has no place of business established in India.
(b) Radix Healthcare Ltd. is a foreign company being involved in business activity through telemedicine.
(c) Radix Healthcare Ltd. is a foreign company for conducting business through electronic mode.
(d) Radix Healthcare Ltd. is a foreign company as it conducts business activity in India.

Ans: (a)

2. Modern Books Publishers plc., a company incorporated in United Kingdom (UK) has a wholly owned subsidiary by the name Beta Periodicals Limited whose Registered Office is situated at Mumbai and which is engaged in publishing scientific, technical and specialty magazines, periodicals and journals. Beta Periodicals Limited considers itself to be a foreign company since it is a wholly owned subsidiary of Modern Books Publishers plc. which is a foreign company. From the four options given below, you are required choose the one which appropriately indicates whether Beta Periodicals Limited can be considered as a foreign company: .(MTP 2 Marks, March'22)

(a) Beta Periodicals Limited cannot be considered as a foreign company even if it is a wholly owned subsidiary of Modern Books Publishers plc. which is a foreign company.
(b) Beta Periodicals Limited shall be considered as a foreign company since it is a wholly owned subsidiary of Modern Books Publishers plc. which is a foreign company.
(c) Beta Periodicals Limited can be granted the status as a foreign company, if its ho lding company Modern Books Publishers plc. makes an application to the Regional Director having jurisdiction over New Delhi for considering its wholly owned subsidiary Beta Periodicals Limited a foreign company.
(d) Beta Periodicals Limited can be granted the status as a foreign company, if its holding company Modern Books Publishers plc. makes an application to the New Delhi Bench of National Company Law Tribunal for considering its wholly owned subsidiary Beta Periodicals Limited a foreign company

Ans: (a)

Sec 380- Documents to be delivered to Registrar by Foreign Companies

3. 5K Cosmetic Shop plc., a company incorporated in Switzerland, is involved in digital supply services through electronic mode, the server of which is located outside India. The company follows calendar year as its financial year. Every year the company is required to prepare a balance sheet and profit and loss account. You are required to choose the correct timeline within which such documents shall be filed with the Registrar of Companies considering the provisions of Chapter XXII of the Companies Act, 2013:

(a) Within a period of 30 days from the close of the financial year of 5K Cosmetic Shop plc.
(b) Within a period of 3 months from the close of the financial year of 5K Cosmetic Shop plc.
(c) Within a period of 60 days from the close of the financial year of 5K Cosmetic Shop plc.
(d) Within a period of 6 months from the close of the financial year of 5K Cosmetic Shop plc.

Ans: (d)

4. **Druk Software Company Inc., a company incorporated in Australia, proposes to establish a place of business at Mumbai. The list of the Directors includes (i) Mr. Arun – Managing Director, (ii) Mr. Ranveer – Director, (iii) Mr. Ramesh Malik - Director and (iv) Mr. Navaaz - Director. Ms. Lavina has been appointed as the Secretary of Druk Software Company Inc. It is to be noted that Mr. Ramesh Malik and Mr. Navaaz, resident in India, are the persons who have been authorised by Druk Software Company Inc. to accept on behalf of the company service of process, notices or other documents required to be served on Druk Software Company Inc. In relation to the company's establishment, you are required to enlighten the Druk Company Inc. with respect to whose, a declaration will be required to be submitted to the Registrar of Companies by Druk Software Company Inc. for not being convicted or debarred from formation of companies in or outside India. *(RTP May '24, SM, MTP 1 Mark Nov 21)***
   (a) Mr. Arun, Mr. Ranveer, Mr. Ramesh Malik, Mr. Navaaz and Ms. Lavina
   (b) Mr. Arun, Mr. Ramesh Malik, Mr. Navaaz and Ms. Lavina
   (c) Mr. Ramesh Malik and Mr. Navaaz
   (d) Mr. Arun, Mr. Ranveer, Mr. Ramesh Malik and Mr. Navaaz

Ans: (d)

5. **Jackson Communications LLC, incorporated in Arizona, USA, has established a principal place of business at Kolkata, West Bengal. It is required to deliver requisite documents to the specified authority. You are required to select an appropriate option from the four given below which indicates the number of days within which such documents shall be delivered:**
   (a) Jackson Communications LLC shall, within 10 days of the establishment of a principal place of business in India, deliver the requisite documents to the specified authority.
   (b) Jackson Communications LLC shall, within 15 days of the establishment of a principal place of business in India, deliver the requisite documents to the specified authority.
   (c) Jackson Communications LLC shall, within 30 days of the establishment of a principal place of business in India, deliver the requisite documents to the specified authority.
   (d) Jackson Communications LLC shall, within 45 days of the establishment of a principal place of business in India, deliver the requisite documents to the specified authority.

Ans: (c)

Sec 381- Accounts of Foreign Company

6. **Lavender International Entertainment Inc., headquartered and registered in New York City and a prominent name in lifestyle audio innovations, professional audio and lighting solutions, and digital transformation, is present in more than seventy countries including India. Due to certain mis- happenings, the company was unable to file its financial statements along with necessary documents for the year 2023 with the Registrar of Companies (in India) within the stipulated time as permitted by the Companies Act, 2013. Itis observed that the ROC may, for any special reason and on an application made in writing by Lavender International Entertainment, extend the 'filing time' maximum up to a certain period. From the following options, choose the correct one in this respect: (*MTP 2 Marks Jul'24)***
   (a) 'Filing time' in respect of filing of financial statements along with necessary documents by Lavender International Entertainment Inc. can be extended by ROC maximum by one month beyond the stipulated time period.
   (b) 'Filing time' in respect of filing of financial statements along with necessary documents by Lavender International Entertainment Inc. can be extended by ROC maximum by two months beyond the stipulated time period.
   (c) 'Filing time' in respect of filing of financial statements along with necessary documents by Lavender International Entertainment Inc. can be extended by ROC maximum by three months beyond the stipulated time period.
   (d) 'Filing time' in respect of filing of financial statements along with necessary documents by Lavender International Entertainment Inc. can be extended by ROC maximum by six months beyond the stipulated time period.

Ans: (c)

7. Morgen Stern Digi Cables GmbH incorporated in Berlin, Germany, established a place of business at Mumbai to conduct its business of data interchange and other digital supply transactions online. However, Morgen Stern Digi Cables GmbH failed to deliver certain documents to the jurisdictional Registrar of Companies within the prescribed time period in compliance with the respective statutory provisions. Which option, out of the four given below, shall correctly indicate the amount of fine with which Morgen Stern Digi Cables GmbH shall be punishable for its failure to deliver certain documents:

(a) Morgen Stern Digi Cables GmbH is punishable with fine which shall not be less than 50,000 rupees but which may extend to 5,00,000 rupees and in the case of a continuing offence, with an additional fine upto 25,000 rupees for every day after the first during which the contravention continues.

(b) Morgen Stern Digi Cables GmbH is punishable with fine which shall not be less than 1,00,000 rupees but which may extend to 5,00,000 rupees and in the case of a continuing offence, with an additional fine upto 20,000 rupees for every day after the first during which the contravention continues.

(c) Morgen Stern Digi Cables GmbH is punishable with fine which shall not be less than 2,00,000 rupees but which may extend to 5,00,000 rupees and in the case of a continuing offence, with an additional fine upto 50,000 rupees for every day after the first during which the contravention continues.

(d) Morgen Stern Digi Cables GmbH is punishable with fine which shall not be less than 1,00,000 rupees but which may extend to 3,00,000 rupees and in the case of a continuing offence, with an additional fine upto 50,000 rupees for every day after the first during which the contravention continues.

Ans: (d)

CA INTERMEDIATE

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PAPER 3

Taxation Reviewer

Chapter-wise compilation RTP, MTP and PYP questions

APPLICABLE FOR MAY'25, SEPT'25 AND JAN'26

KEY HIGHLIGHTS

- Easy to Hard Difficulty Level
- Importance levels marked as A, B or C
- Reference to all questions
- Quick recap of important concepts
- Exam Insights
- Last Day Revision Questions Marked

TAXATION
REVIEWER

CA Intermediate
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Head Office: 202, Professional Plaza,
17 Punit Nagar, Near Punit Nagar
Old Padra road, Vadodara, 390007
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This book belongs to future,

CA Finalist ______________________________

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YOU MUST BE WONDERING

How to Read this book?

Step 1
Prioritize more time for 'A' chapters in the ABC analysis

Step 2
Identify key concepts in each chapter.

Step 3
Solve questions in order, from easy to difficult.

Step 4
Focus on solving LDR questions during the final revision

01 02 03 04

Step 1: Prioritize your chapters

Chapters in the index are categorized as A, B, or C based on their importance. Focus more on 'A' chapters, as they carry the most weight, and give adequate attention to 'B' chapters. While all chapters must be covered, this approach helps manage time efficiently for better results.

Step 2: Identify key concept

Identify the key concepts for each chapter using the list provided at the start of the chapter. Ensure you understand them thoroughly. If you struggle with a question, revisit the concepts, review them, and strengthen your understanding before moving forward.

Step 3: Start easy

Start with Question 1, as they progress from easy to difficult, helping you build confidence throughout the chapter. Pay close attention to the “EXAM INSIGHTS” to avoid common mistakes. Questions are segregated topic wise where possible.

Step 4: Last Day Revision (LDR)

Focus on solving LDR questions during the final revision. In the 1.5 days before the exam, prioritize these questions as they cover the most critical concepts from each chapter. You'll find a quick summary of LDR question numbers listed right before each chapter for easy reference.

A

CHAPTER 3.4: CAPITAL GAINS

CONCEPTS OF THIS CHAPTER

- Scope of income chargeable under capital gains
- Assets classified as "capital assets" for tax purposes
- Meaning of short-term vs long-term capital assets
- Computing holding period to determine asset type
- Transactions considered as transfer for capital gains
- Transactions not regarded as transfer
- Computing capital gains from asset transfer
- Determining cost of acquisition and indexed cost for long-term assets
- Capital gains on depreciable assets
- Capital gains on market-linked debentures and specified securities
- Capital gains on slump sale
- Exemption on investment of capital gains/net consideration
- Calculating capital gains after exemptions
- Concessional tax treatment for short-term/long-term gains on listed shares/equity funds
- Tax liability on short-term/long-term capital gains applying special tax rates

LDR Questions
Q 13
Q 17
Q 21
Q 22

QUICK REVIEW OF IMPORTANT CONCEPTS

Short-term capital asset/ long-term capital asset

Capital Asset	STCG, if held for	LTCG, if held for
In case transfer takes place before 23.7.2024		
• Security (other than unit) listed in a recognize stock exchange • Unit of equity-oriented fund/unit of UTI • Zero coupon bond	≤ 12 Months immediately preceding the date of its transfer	> 12 Months immediately preceding the date of its transfer
• Unlisted shares	≤ 24 Months immediately preceding the date of its transfer	> 24 Months immediately preceding the date of its transfer
• Unlisted securities other than shares • Other capital assets	≤ 36 Months immediately preceding the date of its transfer	> 36 Months immediately preceding the date of its transfer
In case transfer takes place on or after 23.7.2024		
• Security listed in a recognize stock exchange	≤ 12 Months immediately preceding the date of its transfer	> 12 Months immediately preceding the date of its transfer
• Unity of equity-oriented fund/unit of UTI • Zero Coupon bond		
• Other capital assets	≤ 24 Months immediately preceding the date of its transfer	> 24 Months immediately preceding the date of its transfer

Transactions not regarded as transfer [Section 47]:

- distribution of capital total or partial partition of a HUF

- transfer of capital asset by an individual or HUF under a gift or will or an irrevocable trust (by any person up-to A.Y. 2024-25)
- holding company to its 100% subsidiary Indian company or by a subsidiary company to its 100% holding Indian company
- Issue of shares by the resulting company, in a scheme of demerger
- By a Shareholder in a scheme of amalgamation
- of conversion of bonds, debentures, debenture stock, deposit certificates of a company, into shares or debentures of that company.
- Conversation of preference share of a company into equity shares
- Transaction of reverse mortgage

Capital Gains: Special Provisions

50	Any Income From transfer of depreciable assets is deemed to be capital gains arising from transfer of short – term capital assets, irrespective of the period of holding	
50B	Net worth is deemed to be the cost of acquisition and the cost of improvement – 'Net worth' shall be aggregate value of total assets minus value of liabilities of such undertaking as per books of account.	
	Fair market value is deemed to be the full value of consideration	
	Fair market value (FMV) of capital assets would be the higher of -	
	(i) **FMV 1**, being the fair market value of capital assets transferred by way of slump sale	
	(ii) **FMV 2,** being the fair market value of the consideration received or accruing as a result of transfer by way of slump sale **Capital gains = Fair market value – Net worth**	
50C	1. Stamp duty value > actual consideration	
	If Stamp duty value > 110% of actual consideration	Stamp Duty Value
	If Stamp duty value $\leq$ 110% of actual consideration	Actual sale consideration
	2. Actual consideration > stamp Duty value	Actual sale consideration
	3. Value ascertained by valuation officer > stamp duty value	Stamp Duty Value
	4. Value ascertained by valuation officer < stamp duty value	Value ascertained by valuation officer
51	**Advance money received and forfeited up-to 31.3.2014**	
	the advance money forfeited by the assessee has to be reduced from the cost of acquisition	
	Advance money received and forfeited on or after 1.4.2014	
	Therefore, advance money received and forfeited on or after 1.4.2014 should not be deducted from the cost for determining the indexed cost of acquisition while computing capital gains arising on transfer of the asset.	

Cost of Acquisition [Section 55]

1	Good will - Self-generated	NIL
	- Acquired from previous owner	Purchase price
2	**Bonus shares** If bonus shares are allotted before 1.4.2001 If bonus shares are allotted on or after 1.4.2001 Bonus shares allotted before 1.2.2018, on which STT has been paid at the time of transfer	FMV on 1.4.2001 Nil The higher of – Actual cost of acquisition Nil, on or after 1.4.2001 FMV on 1.4.2001 Lower of- (a) FMV as on 31.1.2018 and (b) Actual sale consideration
3	**Rights Shares** Original shares Rights shares subscribed for by the assessee Right entitlement	Amount actually paid for acquiring the original shares Amount actually paid for acquiring the rights shares Nil
4	Long term capital assets equity shares unit of equity oriented fund acquired before 1st February, 2018	Cost of acquisition shall be the higher of - (i) cost of acquisition of such

		(ii) lower of - the FMW of such asset on 31.1.2018 - the full value of consideration recd or accruing as a result of the transfer of the capital asset.
5	**Any other capital asset** Capital asset became the property of the assesses before 1.4.2001	Cost of the asset to the assessee, or FMV as on 1.4.2001, at the option of the assessee. However, in case of capital asset being land or building, FMV as on 1.4.2001 shall not exceed stamp duty value as on 1.4.2001.

Exemption of Capital Gains [Sections 54 to 54F]

S. No.	Particulars	Section 54	Section 54B	Section 54D	Section 54EC	Section 54F
1	**Eligible Assessee**	Individual/ HUF	Individual/ HUF	Any assessee	Any assessee	Individual/ HUF
2	**Asset transferred**	Residential House (LTCA)	Urban Agricultural Land	Land & building forming part of an industrial undertaking	Land or building or both (LTCA)	Any LTCA other than Residential House.
3	**Other Conditions**	Income from such house should be chargeable under the head "Income from house property"	Land used for agricultural purposes by assessee or his parents or HUF for 2 years immediately preceding the date of transfer	Land & building have been used for business of undertaking for at least 2 years immediately preceding the date of transfer. The transfer by way of compulsory acquisition of the industrial undertaking	-	Assessee should **not** own more than one residential house on the date of transfer. He should **not** purchase within 2 years or construct within 3 years after the date of transfer, another residential house.
4	**Qualifying asset i.e., Asset in which capital gains has to be invested**	One Residential House/Two residential houses in India, at the option of the assessee, where capital gains does **not** exceed ₹ 2 crore	Land for being used for agricultural purpose (Urban/ Rural)	Land or Building or right in land or building	Bonds of NHAI or RECL or any other bond notified by C.G. (Redeemable after 5 years)	One Residential House situated in India
5	**Time limit for purchase/ construction**	Purchase within 1 year before or 2 years after the date of transfer **(or)** construct within 3 years after the date of transfer	Purchase within a period of 2 years after the date of transfer	Purchase/ construct within 3 years after the date of transfer, for shifting or re-establishing the existing undertaking or setting up a new industrial undertaking.	Purchase within a period of 6 months after the date of transfer	Purchase within 1 year before or 2 years after the date of transfer **(or)** Construct within 3 years after the date of transfer

6	**Amount of Exemption**	Cost of new Residential House or two houses, as the case may be or Capital Gain, whichever is lower, is exempt. 10 Cr limit on exemption	Cost of new Agricultural Land or Capital Gain, whichever is lower, is exempt	Cost of new asset or Capital Gain, whichever is lower.	Capital Gain or amount invested in specified bonds, whichever is lower. Maximum Investment is ₹ 50 lakhs.	Cost of new Residential House ≥ Net sale consideration of original asset, entire Capital gain is exempt. 10 Cr limit on exemption

Section	Income	Rate of Tax
112	(i) Long term capital gains (a) From transfer of capital asset which takes place before 23.7.2024 (b) From transfer of capital asset which takes place on or after 23.7.2024 - From transfer of any land or building or both by an individual or a HUF, Being a resident acquired before 23.7.2024 - From transfer of other capital asset	20% with indexation Lower of 20% with indexation or 12.5% without indexation 12.5% without indexation
	(ii) Long-term capital gains arising from transfer of unlisted securities or share of company in which public are not substantially interested by non-resident assesses - If transfer takes place before 23.7.2024 - If transfer takes place on or after 23.7.2024	 10% without indexation 12.5% without indexation
112A	Long term capital gains on transfer of – • Equity share in a company • Unit of an equity oriented fund • Unit of business trust Condition for availing the benefit of this concessional rate is that securities transaction tax (STT) should have been paid	10% on LTCG > ₹ 1.25 lakhs if transfer takes place before 23.7.2024 12.5% on LTCG > ₹ 1.25 lakhs if transfer takes place on or after 23.7.2024
111A	Short-term capital gains on transfer of – • Equity shares in a company • Unit of an equity oriented fund • Unit of business trust conditions for availing the benefit of this concessional rate are – (i) the transaction of the transaction of sale of such equity share or unit should be entered into on or after 1.10.2004; and (ii) such transaction should be chargeable STT.	15% if transfer takes place before 23.7.2024 20% if transfer takes place on or after 23.7.2024

Questions & Answers

Question 1

Aggarwal & Sons, HUF purchased a house property in the year 1950 for ₹50,000. On 31.10.2024, the HUF was totally partitioned and the aforesaid house property was given to Mr. Subhash Aggarwal, a member of the family. Fair Market value of the house as on 31.10.2024 was ₹21,00,000. FMV of the house as on 1.4.2001 was ₹3,50,000. What will be the tax implications in the hands of Mr. Subhash Aggarwal and the HUF? *(MTP 3 Marks, Oct'21)*

Answer 1

Tax implications in the hands of HUF

As per section 47, any distribution of capital assets on the total or partial partition of a HUF would not be regarded as transfer for the purpose of capital gains tax.

In this case, Aggarwal & Sons, HUF transferred the asset to Mr. Subhash Aggarwal, a member of HUF on total partition of the HUF. Hence, the transaction would not be regarded as transfer.

Tax implications in the hands of Mr. Subhash Aggarwal

If an immovable property is received by any person without consideration, the stamp duty value of such property would be taxed as the income of the recipient under section 56(2)(x), if it exceeds ₹50,000. However, it would not be taxable as income if the transfer is by way of a transfer, inter alia, on total or partial partition of a HUF.

In the give case, since Mr. Subhash Aggarwal received the house property on total partition of the HUF, it would not be taxable in his hand.

Question 2

(Includes concepts from Income from Other Sources)

Mrs. Neha transferred 100 shares of ABC (P) Ltd. to M/s. XYZ Co. (P) Ltd. on 10.9.2024 for ₹ 3,00,000 when the market price was ₹ 5,00,000. The indexed cost of acquisition of shares for Mrs. Neha was computed at ₹ 4,30,000. The transfer was not subjected to securities transaction tax.

Determine the income chargeable to tax in the hands of Mrs. Neha and M/s. XYZ Co. (P) Ltd. because of the above said transaction. ***(MTP 2 Marks, Nov'21)***

Answer 2

Any movable property received for inadequate consideration by any person is chargeable to tax under section 56(2)(x), if the difference between aggregate Fair Market Value of the property and consideration exceeds ₹ 50,000.

Thus, share received by M/s XYZ (P) Ltd. from Mrs. Neha for inadequate consideration is chargeable to tax under section 56(2)(x) to the extent of ₹ 2,00,000.

As per section 50CA, since, the consideration is less than the fair market value of unquoted shares of ABC (P) Ltd., fair market value of shares of the company would be deemed to be the full value of consideration. It is presumed that the shares of ABC (P) Ltd are unquoted shares.

The full value of consideration (₹ 5,00,000) less the indexed cost of acquisition (₹ 4,30,000) would result in a long term capital gains of ₹ 70,000 in the hands of Mrs. Neha.

Question 3

Aarav converts his plot of land purchased in July, 2004 for ₹ 80,000 converted into stock-in-trade on 31st March, 2024. The fair market value as on 31.3.2024 was ₹ 3,00,000. The stock-in-trade was sold for ₹ 3,25,000 in the month of January, 2025.

Find out the taxable income, if any, and if so under which head of income andfor which Assessment Year?

Cost Inflation Index: ***2004-05:113; F.Y. 2023-24: 348; F.Y. 2024-25: 363. (SM)***

Answer 3

Conversion of a capital asset into stock-in-trade is a transfer within the meaning of section 2(47) in the previous year in which the asset is so converted. However, the capital gains will be charged to tax only in the yearin which the stock-in-trade is sold.

The cost inflation index of the financial year in which the conversion took place should be considered for computing indexed cost of acquisition. Further, the fair market value on the date of conversion would be deemedto be the full value of consideration for transfer of the asset as per section 45(2). The sale price less the fair market value on the date of conversion would be treated as the business income of the year in which the stock-in- trade is sold.

Therefore, in this problem, both capital gains and business income would be charged to tax in the A.Y. 2025-26.

Particulars	₹	
Profits & Gains of Business or Profession		
Sale price of stock-in-trade	3,25,000	
Less: Fair market value on the date of conversion	3,00,000	
Capital Gains		**25,000**
Full value of consideration (Fair market value on the date of conversion)	**3,00,000**	
Less: Indexed cost of acquisition (₹ 80,000 × 348/113)	**2,46,372**	
Long-term Capital gain		**53,628**
Taxable income		**78,628**

Question 4

Mr. Gyaanchand purchased 1200 shares of "A" limited at ₹ ₹130 per share on 26.02.1979. "A" limited issued him 600 bonus shares on 20.02.2005. The fair market value of these shares at Mumbai Stock Exchange as on 1.04.2001 was ₹900 per share and ₹2,000 per share as on 31.01.2018. On 07.07.2024 Mr. Gyaanchand sold all 1800 shares @ ₹ 2,400 per share at Mumbai Stock Exchange and securities transaction tax was paid. Compute capital gain chargeable to tax in the hands of Mr. Gyaanchand for the A.Y.2025-26. *(MTP 4 Marks, Oct'21)*

Answer 4

Computation of capital gain of Mr. Gyaanchand for the A.Y.2025-26

Particulars	₹	₹
Capital Gains		
In respect of 600 shares (bonus shares)		
Full value of consideration [600 shares x ₹2,400 per share]	14,40,000	
Less: Cost of acquisition [600 shares x ₹2,000]	12,00,000	2,40,000
Higher of (I) and (ii), below		
(I) Nil, being cost of acquisition		
(ii) ₹2,000 per share, being the lower of FMV as on 31.1.2018 - ₹2,000 per share		
Sale consideration – ₹2,400 per share		
In respect of 1,200 original shares		
Full value of consideration [1,200 shares x ₹2,400]	28,80,000	
Less: Cost of acquisition [1,200 shares x ₹2,000]	24,00,000	4,80,000
Higher of (I) and (ii), below		
(I) ₹900, being original cost of acquisition (₹ 130) or FMV as on 1.4.2001 (₹900), at the option of the assessee		
(ii) ₹2,000 per share, being the lower of		
FMV as on 31.1.2018 - ₹2,000 per share		
Sale consideration – ₹2,400 per share		
Long term capital gain		**7,20,000**

Question 5

Mr. Raj is carrying on business of manufacture and sale of art-silk cloth. He purchased machinery worth ₹ 4 lacs on 1.5.2021 and insured it with United India Assurance Ltd against fire, flood, earthquake etc., The written down value of the asset as on 01.04.2024 was ₹ 1,87,850. The insurance policy contained a reinstatement clause requiring the insurance company to pay the value of the machinery, as on the date of fire etc., in case of destruction of loss. A fire broke out in August, 2024 causing extensive damage to the machinery of the assessee rendering them totally useless. The assessee company received a sum of ₹ 4 lacs from the insurance company on 15th March, 2025. Examine the issues arising on account on the transactions and their tax treatment. (Cost inflation index for financial year 2020-21 & 2024-25 are 301 and 363 respectively) *(MTP 4 Marks, Nov'21)*

Answer 5

As per section 45(1A), where any person receives any money or other assets under an insurance from an insurer on account of damage to or destruction of capital asset as a result of, inter alia, accidental fire then, any profits and gains arising from the receipt of such money or other assets, shall be chargeable to income tax under the head "Capital Gains" and shall be deemed to be the income of such person of the previous year in which such money or asset was received.

For the purpose of section 48, the money received or the market value of the asset shall be deemed to be the full value of the consideration accruing as a result of the transfer of such capital asset. Since the asset was destroyed and the money from the insurance company was received in the previous year, there will be a liability to compute capital gains in respect of the insurance moneys received by the assessee.

Under section 45(1A) any profits and gains arising from receipt of insurance moneys is chargeable under the head "Capital gains". For the purpose of section 48, the moneys received shall be deemed to be the full value of the consideration accruing or arising. Under section 50 the capital gains in respect of depreciable assets had to be computed in the following manner (assuming it was the only asset in the block).

The computation of capital gain and tax implication is given below:

Full value of the consideration	₹ 4,00,000
Less: Written down value as on April 1st, 2024	₹ 1,87,850
Short term capital gains	₹ 2,12,150

Question 6

Examine the taxability of capital gains in the following scenarios for the Assessment Year 2025-26, determine the taxable amount and rate of tax applicable:

(i) On 20th December, 2024 5,000 shares of AB Ltd., a listed company are sold by Mr. Wiwsu @ 500 per share and STT was paid at the time of sale of shares. These shares were acquired by him on 5th June, 2017 @ ₹ 425 per share by paying STT at the time of purchase. On 31st January, 2018, the shares of AB Ltd. were traded on a recognized stock exchange at the Fair Market Value of ₹ 450 per share.

(ii) Mr. Satish is the owner of a residential house which was purchased on 1st July, 2017 for ₹ 10,50,000. He sold the said house on 14th October, 2024 for ₹ 25,00,000. Valuation as per stamp valuation authorities was ₹ 45,00,000. He invested ₹ 15,00,000 in RECL Bonds on 20th March, 2025.

The Cost Inflation index for-

F.Y.	**2017-18**	**272**
F.Y.	**2024-25**	**363**

(MTP 2 Marks, Sep'22, PYP 4 Marks July 21)

Answer 6

(i)	**Long-term capital gain on transfer of 5,000 shares of AB Ltd. [taxable u/s 112A @12.5% on amount exceeding ₹ 1,25,000]**		
	Full value of consideration [5,000 x ₹ 500]		25,00,000
	Less: Cost of acquisition		
	Higher of		
	Cost of acquisition [5,000 x ₹ 425]	21,25,000	
	Lower of fair market value per share as on 31.1.2018	22,50,000	
	i.e., ₹ 450 per share and sale consideration i.e., ₹ 500 per share [5,000 x ₹ 450]		22,50,000
	Long term capital gain taxable u/s 112A		2,50,000
	Long-term capital gain exceeding ₹ 1.25 lakh i.e., ₹ 1,25,000 would be taxable @12.5%		
(ii)	**Sale of residential house [long-term capital asset, since held for more than 24 months]**		
a	**20% with Indexation Benefits**		
	Full value of consideration [stamp duty value, since it exceeds 110% of actual sale consideration]		45,00,000
	Less: Indexed Cost of acquisition (10,50,000 x 363/272]		14,01,287
			30,98,713
	Less: Deduction under section 54EC		15,00,000
	Since ₹ 15,00,000 is invested in RECL bonds on 20th March 2025 i.e.,		
	before six months from the date of transfer		
	Long-term capital gain		15,98,713
	Long-term capital gain taxable u/s 112 @ 20%		**3,19,743**
b	**12.5% without Indexation Benefits**		
	Full value of consideration [stamp duty value, since it exceeds 110% of actual sale consideration]		45,00,000
	Less: Cost of acquisition (Read Note)		10,50,000

		34,50,000
	Less: Deduction under section 54EC	15,00,000
	Since ₹ 15,00,000 is invested in RECL bonds on 20th March 2025 i.e.,	
	before six months from the date of transfer	
	Long-term capital gain	19,50,000
	Long-term capital gain taxable u/s 112 @ 12.5%	2,43,750

***Hence* 12.5% without Indexation Benefits is more beneficial for the Asseessee.**

Note:

(i) As transfer is after 23.07.2024, tax rates will be LTCG on equity shares 112A= 12.5%

(ii) When transfer takes place after 23.07.2024 Land or building or both if acquired before 23.7.2024 then the individual can choose between 12.5% without indexation or 20% with indexation benefit, whichever is more beneficial to the assessee.

Question 7

Mr. Aryan, a resident individual aged 58 years, sells (unlisted) shares in a private sector company on May 17, 2024 for ₹ 10,00,000. The shares were bought on 01.08.2012 for a consideration of ₹ 2,00,000. Mr Aryan paid ₹ 2,000 as brokerage on sale of shares.

Mr. Aryan deposited ₹ 5,00,000 in Capital Gain Account Scheme on 15.06.2025 (Before filing the return of income for the Assessment Year 2025-26).

On April 30, 2026 he withdraws ₹ 4,50,000 and purchases a residential house properly at Delhi on May 1, 2026 for ₹ 4,50,000.

Cost Inflation Index (CII) – F.Y. 2012-13 - 200, F.Y. 2024-25 - 363.

Ascertain –

(i) The amount of Capital Gain chargeable to tax for the A.Y. 2025-26.

(ii) Tax treatment (with mention of relevant assessment year) of the unutilized amount. ***(PYP 4 Marks Nov'23)***

Answer 7

(i) Computation of Capital Gains on sale of unlisted shares for A.Y.2025-26

Particulars	**₹**
Net Sales Consideration [₹ 10,00,000 – ₹ 2,000]	9,98,000
Less: Indexed cost of acquisition [₹ 2,00,000 x 363/200]	3,63,000
	6,35,000
Less: **Exemption u/s 54F**	
Deposit in Capital Gains Accounts Scheme on or before the due date of filing return of income would be deemed to be cost of new asset.	
Accordingly, exemption u/s 54F would be ₹ 3,34,168 [₹ 5,00,000 x ₹ 6,35,000 / ₹ 9,98,000]	3,18,136
Capital Gains chargeable to tax	**3,16,864**

Note: Since the sale is before 23.07.2024 indexation benefit will be allowed.

(ii) Tax treatment of unutilized amount in Capital Gains Accounts Scheme

The unutilized amount will be chargeable to tax as capital gains on proportionate basis in the previous year in which the 3 years period from the date of transfer expires. In this case, the 3 year period from 17.5.2024 expires on 16.5.2027. Consequently, the proportional capital gains on the unutilized amount will be taxable in the A.Y. 2028- 29, relevant to the P.Y. 2027-28.

The amount of capital gains for A.Y. 2028-29 would be ₹ 30,541 [₹ 3,16,864 – ₹ 2,86,323 (₹ 4,50,000 x ₹ 6,35,000 / ₹ 9,98,000).

EXAM INSIGHTS: Many examinees failed to compute the amount of exemption under section 54F correctly and the tax treatment of unutilized amount lying in Capital Gain Accounts Scheme.

Question 8

Mr. Mithun purchased 100 equity shares of M/s Good money Co. Ltd. on 01- 04-2007 at rate of ₹ 1,000 per share in public issue of the company by paying securities transaction tax.

Company allotted bonus shares in the ratio of 1:1 on 01.12.2023. He has also received dividend of ₹ 10 per share on 01.05.2024.

He has sold all the shares on 01.10.2024 at the rate of ₹ 4,000 per share through a recognized stock exchange and paid brokerage of 1% and securities transaction tax of 0.02%.

Compute his total income and tax liability for A.Y. 2025-26 if Mr. Mithunpays tax under default tax regime, assuming that he is having no income other than given above. Fair market value of shares of M/s Goodmoney Co. Ltd. on 31.1.2018 is ₹ 2,000. *(SM)*

Answer 8

Computation of total income & tax liability of Mr. Mithun for A.Y. 2025-26

Particulars		**₹**
Long term capital gains on sale of original shares		
Gross sale consideration (100 x ₹ 4,000)		4,00,000
Less: Brokerage@1%		4,000
Net sale consideration		3,96,000
Less: Cost of acquisition (100 x ₹ 2,000) **(Refer Note 1)**		2,00,000
Long term capital gains		**1,96,000**
Short term capital gains on sale of bonus shares		
Gross sale consideration (100 x ₹ 4,000)		4,00,000
Less: Brokerage@1%		4,000
Net sale consideration		3,96,000
Less: Cost of acquisition of bonus shares [Nil as such shares are allotted after 1.04.2001]		NIL
Short term capital gains [Since bonus shares are held for less than 12 months before sale]		**3,96,000**
Income from other sources		
Dividend received from M/s Goodmoney Co. Ltd. is taxable in the hands of shareholders [200 shares x 10 per share]		2,000
Other income		8,00,000
Total Income		**13,94,000**
Tax Liability		
Tax on STCG u/s 111A 20% of ₹ 3,96,000		79,200
Tax on LTCG u/s 112A 12.5% of (₹ 1,96,000 - ₹ 1,25,000) since it is transferred on or after 23.7.2024		8,875
Tax on other income of ₹ 8,02,000		
₹ 3,00,000 to ₹ 7,00,000@5%	20,000	
₹ 7,00,000 to ₹ 8,02,000 @10%	10,200	30,200
		1,18,275

Notes:

(1) Cost of acquisition of such equity shares acquired before 1.2.2018 is higher of

- Cost of acquisition i.e., ₹ 1,000 per share and
- lower of Fair market value of such asset i.e., ₹ 2,000 per share and Full value of consideration i.e., ₹ 4,000 per share.

Therefore, the cost of acquisition of original share is ₹ 2,000 per share.

(2) Securities transaction tax is not allowable as deduction.

Question 9

Mr. Kalyan has a residential house property which was acquired on 12-08-2005 for ₹ 2,00,000. The property is sold for ₹ 22,00,000 in December 2024. The sub-registrar refused to register the documents for the said value, as according to him, stamp duty value based on State Government guidelines was ₹ 28,00,000. Mr. Kalyan preferred an appeal to the revenue divisional officer who fixed the value of the house ₹ 25,00,000. He acquired another residential house on 31 -03-2025 for ₹ 17,00;000 for self-occupation. On 01-03-2026, he sold such new residential house for ₹ 30,00,000.

Compute his capital gain for the A.Y. 2025-26 and 2026-27. (Cost Inflation Index: 2001-02; 2005- 06 and 2024-25 are, 100; 117 and 363)*(MTP 4 Marks, Oct'23)*

Answer 9

Computation of capital gain in the hands of Mr. Kalyan for A.Y. 2025-26

When transfer takes place after 23.07.2024 Land or building or both if acquired before 23.7.2024 then the individual can choose between 12.5% without indexation or 20% with indexation benefit, whichever is more beneficial to the assessee.

(i) 20% with Indexation Benefits

Particulars	**₹**
Full value of consideration	25,00,000
[As per section 50C, in case the actual sale consideration (i.e., ₹ 22 lakhs, in this case) is less than the stamp duty value (i.e., ₹ 28 lakhs, in this case) assessed by the stamp valuation authority (Sub-registrar, in this case), the stamp duty value shall be deemed as the full value of consideration if it exceeds 110% of the sale consideration However, if assessee has preferred an appeal to the Valuation Officer (i.e., revenue divisional officer, in this case) and the Valuation Officer has fixed the value of the house (i.e., ₹ 25 lakh, in this case) less than stamp duty value (i.e., ₹ 28 lakh, in this case), such value determined by the Valuation Officer shall be deemed as the full value of consideration.]	
Less: Indexed cost of acquisition [₹ 2,00,000 x 363/117]	6,20,513
Long-term capital gain [Since the residential house is held for more than 24 months]	18,79,487
***Less:* Exemption under section 54**	
Purchase of new residential house property on 31.3.2025 (i.e., within two years from the date of transfer of residential house)	17,00,000
Taxable long term capital gain	**1,79,487**
LTCG Tax	**35,897**

(ii) 12.5% without Indexation Benefits

Particulars	**₹**
Full value of consideration (Same as above)	25,00,000
Less: Cost of Acqusition	2,0,000
Long-term capital gain [Since the residential house is held for more than 24 months]	23,00,000
***Less:* Exemption under section 54**	
Purchase of new residential house property on 31.3.2025 (i.e., within two years from the date of transfer of residential house)	17,00,000
Taxable long term capital gain	**6,00,000**
LTCG Tax	**75,000**

Hence 20% with indexation is more beneficial for the the Assessee.

Computation of capital gains in the hands of Mr. Kalyan for A.Y. 2026-27

Particulars	**₹**
Full value of consideration	30,00,000
Less: Cost of acquisition [As per section 54, if the new residential house purchased (i.e., on	

31.3.2025, in this case) is transferred within 3 years of its purchase (i.e., on 1.3.2026, in this case), and the cost of acquisition of the new house (i.e., ₹ 17 lakhs, in this case) is lower than the long-term capital gain (i.e., ₹ 18,79,487, in this case), the cost of acquisition of such new residential house shall be taken as Nil, while computing capital gains on sale of the new residential house]	Nil
Short term capital gain [Since the residential house is held for a period less than 24 months]	**30,00,000**

Question 10

Determine the capital gains/loss on transfer of listed equity shares (STT paid both at the time of acquisition and transfer of shares) and units of equity oriented mutual fund (STT paid at the time of transfer of units) for the A.Y.2025-26 and tax, if any, payable thereon, in the following cases, assuming that these are the only transactions covered under section 112A during the P.Y.2024-25 in respect of these assessees:

(i) Mr. Shagun purchased 300 shares in A Ltd. on 20.5.2017 at a cost of ₹ 400 per share. He sold all the shares of A Ltd. on 31.5.2024 for ₹ 1200. The price at which these shares were traded in National Stock Exchange on 31.1.2018 is as follows –

Particulars	Amount in ₹
Highest Trading Price	700
Average Trading Price	680
Lowest Trading Price	660

(ii) Mr. Raj purchased 200 units of equity oriented fund, Fund A on 1.2.2017 at a cost of ₹ 550 per unit. The units were not listed at the time of purchase. Subsequently, units of Fund A were listed on 1.1.2018 on the National Stock Exchange. Mr. Raj sold all the units on 3.4.2024 for ₹ 900 each. The details relating to quoted price on National Stock Exchange and net asset value of the units are given hereunder:

Particulars	Fund A
	Amount in ₹
Highest Trading Price	750 (on 31.1.2018)
Average Trading Price	700 (on 31.1.2018)
Lowest Trading Price	650 (on 31.1.2018)
Net Asset Value on 31.1.2018	800

(MTP 4 Marks, Jul'24)

Answer 10

For the purpose of computation of long-term capital gains chargeable to tax under section 112A, the cost of acquisition in relation to the long- term capital asset, being an equity share in a company or a unit of an equity oriented fund or a unit of a business trust acquired before 1st February, 2018 shall be the higher of

(a) cost of acquisition of such asset, i.e., actual cost; and

(b) lower of

  (i) the fair market value of such asset as on 31.1.2018; and

  (ii) the full value of consideration received or accruing as a result of the transfer of the capital asset.

(i) The fair market value of listed equity shares as on 31.1.2018 is the highest price quoted on the recognized stock exchange as on that date.

Accordingly, long-term capital gain on transfer of STT paid listed equity shares by Mr. Shagun would be determined as follows:

The FMV of shares of A Ltd. would be ₹ 700, being the highest price quoted on National Stock Exchange on 31.1.2018. The cost of acquisition of each equity share in A Ltd. would be ₹ 700, being higher of actual cost i.e., ₹ 400 and ₹ 700 [being the lower of FMV of ₹ 700 as on 31.1.2018 (i.e., the highest trading price) and actual sale consideration of ₹ 1,200]. Thus, the long-term capital gain would be ₹ 1,50,000 i.e., (₹ 1,200 – ₹ 700) x 300 shares. The long-term capital gain of ₹ 25,000 (i.e., the amount in excess of ₹ 1,25,000) would be subject to tax@10% under section 112A (plus cess@4%), without benefit of indexation. The tax on capital gain @10.4% would be ₹ 2,600 (₹ 25,000 x 10.4%)

(ii) In the case of units listed on recognized stock exchange on the date of transfer, the FMV as on 31.1.2018 would be the highest trading price on recognized stock exchange as on 31.1.2018 (if units are listed on that date), else, it would be the net asset value as on 31.1.2018 (where units are unlisted on that date).

Accordingly, the FMV of units of Fund A as on 31.1.2018 would be ₹ 750 (being the highest trading price on 31.1.2018, since the units of Fund A are listed on that date).
The cost of acquisition of a unit of Fund A would be ₹ 750, being higher of actual cost i.e., ₹ 550 and ₹ 750 (being the lower of FMV of ₹ 750 as on 31.1.2018 and actual sale consideration of ₹ 900). Thus, the long-term capital gains on sale of units of Fund A would be ₹ 30,000 (₹ 900 – ₹ 750) x 200 units.
Since the long term capital gains on sale of units of Fund A is ₹ 30,000, which is less than ₹ 1,25,000, the said sum is not chargeable to tax under section 112A.

Question 11

Calculate the amount chargeable to tax under the head 'Capital Gains' and also calculate tax on such gains for A.Y. 2025-26 from the following details provided by Mr. Naveen with respect to sale of certain securities during F.Y. 2024-25, assuming that the other incomes of Mr. Naveen exceed the maximum amount not chargeable to tax. (Ignore surcharge and chess):

(i) Sold 10,000 shares of Y Ltd. on 05-04-2024 @ ₹ 650 per share
Y Ltd. is a listed company. These shares were acquired by Mr. Naveen on 05-04-2017 @₹ 100 per share. STT was paid both at the time of acquisition as well as at the time of transfer of such shares which was affected through a recognized stock exchange.
On 31-01-2018, the shares of Y Ltd. were traded on a recognized stock exchange as under:
Highest price - ₹ 300 per share
Average price - ₹ 290 per share
Lowest price - ₹ 280 per share

(ii) Sold 1,000 units of AB Mutual Fund on 20-05-2024 @ ₹ 50 per unit
AB Mutual Fund is an equity oriented fund. These units were acquired by Mr. Naveen on 10- 03-2017 @ ₹ 10 per unit. STT was paid only at the time of transfer of such units. On 31 - 01-2018, the Net Asset Value of the units of AB Mutual Fund was ₹ 55 per unit. The units of AB Mutual Fund were not listed on the stock exchange as on 31.1.2018.

(iii) Sold 100 shares of C Ltd. on 27-09-2024 @ ₹ 200 per share.
C Ltd. is an unlisted company. These shares were issued by the company as bonus shares on 30-09-1997. The Fair Market Value of these shares as on 01-04-2001 was ₹ 50 per share.
Cost Inflation Index for various financial years are as under *(MTP 7 Marks, Apr'21, PYP 6 Marks Nov 19)*

2001-02	100
2016-17	264
2017-18	272
2020-21	301
2024-25	363

Answer 11

Computation of amount chargeable to tax under the head "Capital Gains" in the hands of Mr. Naveen

	Particulars		₹
(i)	**Sale of 10,000 shares of Y Ltd. on 5.4.2024 @ 650 per share**		
	Sales consideration (10,000 x ₹ 650)		65,00,000
	Less: Cost of acquisition Higher of:	₹	30,00,000
	- Actual cost (10,000 x ₹ 100)	10,00,000	
	- Lower of:	30,00,000	
	• ₹ 30,00,000 (₹ 300 x 10,000), being fair market value as on 31.1.2018 (Highest price of the shares traded on 31.1.2018); and • ₹ 65,00,000, being full value of consideration on transfer Long-term capital gain under section 112A [Since shares held for more than 12 months and STT is paid both at the time of purchase and sale. Benefit of indexation is, however, not available on LTCG taxable u/s 112A].		35,00,000

(ii)	**Sale of 1,000 units of AB Mutual Fund on 20.5.2024 @ ₹ 50 per unit**		
	Sale consideration (1,000 x ₹ 50)		50,000
	Less: Cost of acquisition - Higher of -		50,000
	- Actual cost (1,000 x ₹ 10)	10,000	
	- Lower of:	50,000	
	• ₹ 55,000 (₹ 55 x 1,000), FMV, being Net Asset Value as on 31.1.2018; and • ₹ 50,000, being full value of consideration on transfer Long-term capital gain under section 112A [Since shares are held for more than 12 months and STT is paid at the time of sale]		Nil
(iii)	**Sale of 100 shares of C Ltd. on 27.9.2024 @ 200 per share**		
	Sale consideration (100 x ₹ 200)		20,000
	Less: Cost of acquisition [100 x ₹ 50 (being FMV on 1.4.2001) (No indexation as transfer is after 23.07.2024)		***5,000***
	Long-term capital gain under section 112 [Since shares are unlisted and held for more than 24 months]		15,000

Computation of tax on such capital gains for A.Y. 2024-25

Particulars	**₹**
Tax under section 112A @ 10% on long-term capital gains of ₹ 34,00,000 [LTCG of ₹ 35,00,000 (-) ₹ 1,00,000] arising on sale of shares of Y Ltd.	3,40,000
Tax under section 112 @ 20% on long-term capital gains of ₹ 2,600 arising on sale of unlisted shares of C Ltd.	520
Total tax payable	**3,40,520**

EXAM INSIGHTS: This question requires computation of "Capital Gains" on transfer of listed shares of A Ltd., units of B Mutual Fund and unlisted shares of C Ltd. However, many examinees could not correctly compute the cost of acquisition of 10,000 listed shares of A Ltd.

Question 12

Mr. Ramesh entered into an agreement with Mr. Vivitzu to sell a plot on 5.4.2024 for ₹ 45 lakhs. He received an advance of ₹ 15 lakhs from him on the date of agreement by account payee cheque. Transfer took place on 10-9-2024. The valuation determined by the stamp valuation authority on the date of agreement and transfer was ₹ 49 lakhs and ₹ 53 lakhs, respectively.

Mr. Vivitzu has sold this plot to Ms. Babli on 21-3-2025 for ₹ 55 lakhs.

The valuation as per stamp valuation authority was ₹ 54 lakhs on 21-3-2025.Discuss the tax consequences of above, in the hands of Mr. Ramesh and Mr. Vivitzu. Also, compute the capital gain in the hands of Mr. Vivitzu.

Note: None of the parties viz Mr. Ramesh, Mr. Vivitzu & Ms. Babli are related to each other; the transactions are between outsiders. ***(MTP 7 Marks, Apr'23, RTP Nov 22)***

Answer 12

I.	**Tax consequences in the hands of Mr. Ramesh**
	As per section 50C, where the actual sale consideration is less than the value adopted by the Stamp Valuation Authority for the purpose of charging stamp duty, and such stamp duty value exceeds 110% of the actual sale consideration, then, the value adopted by the Stamp Valuation Authority shall be taken to be the full value of consideration. In a case where the date of agreement is different from the date of registration, stamp duty value on the date of agreement can be considered provided the whole or part of the consideration is received by way

	of account payee cheque/bank draft or by way of ECS through bank account or through such other electronic mode as may be prescribed, on or before the date of agreement. In this case, since ₹ 15 lakhs is received through account payee cheque on the date of agreement, stamp duty value on the date of agreement would be considered for determining the full value of consideration. Accordingly, in this case, capital gains would be computed in the hands of Mr. Ramesh, for A.Y.2025-26, taking the actual consideration of ₹ 45 lakh of plot as the full value of consideration arising on transfer of such plot, since the stamp duty value on the date of agreement does not exceed 110% of the actual consideration. **Note –** If it is assumed that Mr. Ramesh is a property dealer, the income would be taxable as his business income under section 43CA
II.	**Tax consequences in the hands of Mr. Vivitzu**
	In case, immovable property is received for inadequate consideration, the difference between the stamp duty value and actual consideration would be taxable under section 56(2)(x) in the hands of the recipient, if such difference exceeds the higher of ₹ 50,000 or 10% of actual sales consideration. In a case where the date of agreement is different from the date of registration, stamp duty value on the date of agreement can be considered provided the whole or part of the consideration is paid by way of account payee cheque/bank draft or by way of ECS through bank account or through such other electronic mode as may be prescribed, on or before the date of agreement. In this case, since ₹ 15 lakhs is paid through account payee cheque on the date of agreement, stamp duty value on the date of agreement would be considered. Therefore, nothing would be taxable in the hands of Mr. Vivitzu under the head "Income from Other Sources" in A.Y.2025-26 since the difference between stamp duty value on the date of agreement and actual consideration does not exceed ₹ 4,50,000, being the higher of ₹ 50,000 and 10% of consideration. At the time of subsequent sale of property by Mr. Vivitzu to Ms. Babli (on 21.3.2025), short-term capital gains would arise in the hands of Mr. Vivitzu in A.Y.2025-26, since the property is held by him for less than 24 months.

Particulars	₹
Full value of consideration (Since actual consideration of ₹ 55 lakh is higher than stamp duty value of ₹ 54 lakh)	55 lakh
Less: Cost of acquisition	45 lakh
Short-term capital gains	**10 lakh**

Question 13 — LDR

Mr. Riyaan owned a residential house in Noida. It was acquired on 09.09.2014 for ₹ 30,00,000. He sold it for ₹ 1,57,00,000 on 07.01.2022.

Mr. Riyaan utilized the sale proceeds of the above property to acquire a residential house in Panchkula for ₹ 2,05,00,000 on 20.07.2022. The said house property was sold on 31.10.2024 and he purchased another residential house in Delhi for ₹ 2,57,00,000 on 02.03.2025. The property at Panchkula was sold for ₹ 3,25,00,000.

Calculate capital gains chargeable to tax for the assessment year 2022-23 and 2025-26. All workings should form part of your answer: Cost inflation index for various financial years are as under:

(MTP 7 Marks, Sep'23, PYP 6 Marks May'19)

2014-15	**-**	**240**
2021-22	**-**	**317**
2022-23	**-**	**331**
2024-25	**-**	**363**

Answer 13

Computation of capital gains chargeable to tax for A.Y. 2022-23

Particulars	₹
Full value of consideration received on sale of residential house in Noida	1,57,00,000
Less: Indexed cost of acquisition [₹ 30,00,000 x **317/240**]	**39,62,500**
Long-term capital gain	1,17,37,500
***Less:* Exemption under section 54**	
Purchase of new residential house property at Panchkula for ₹ 2,05,00,000 on 20.7.2022 i.e., within two years from the date of transfer of residential house in Noida; exemption restricted to long term capital gain, since cost of new house exceeds long-term capital gain	1,17,37,500
Taxable long term capital gain	Nil

Computation of capital gains chargeable to tax for A.Y. 2025-26

Particulars	₹
(i) 20% with Indexation Benefits	
Full value of consideration received on sale of residential house at Panchkula	3,25,00,000
Less: Indexed cost of acquisition [As per section 54, if the new residential house purchased (i.e., on 20.7.2022, in this case) is transferred within 3 years of its purchase (i.e., on 31.10.2024, in this case), and the cost of acquisition of the new house (i.e., ₹ 2,05,00,000) is higher than the long-term capital gain (i.e., ₹ 1,17,37,500,) then, the cost of acquisition of such new residential house shall be reduced by long term capital gain exempted earlier, while computing capital gains on sale of the new residential house] [₹ 85,62,500 (₹ 2,05,00,000 – ₹ 1,17,37,500) x 363/331]	96,09,630
Long-term capital gain [Since the residential house is held for more than 24 months]	**2,28,90,370**
Less: Exemption under section 54	
Purchase of new residential house property in Delhi for ₹ 2,57,00,000 on 2.3.2025 i.e., within two years from 31.10.2024, being the date of transfer of residential house at Panchkula; exemption restricted to long term capital gain, since cost of new house exceeds long-term capital gains	2,28,90,370
Taxable long term capital gain	Nil
(ii) 12.5% without Indexation Benefits	
Full value of consideration received on sale of residential house at Panchkula	3,25,00,000
Less: Cost of acquisition ((₹ 2,05,00,000 – ₹ 1,17,37,500)	87,62,500
	2,37,37,500
Less: Exemption under section 54	2,37,37,500
Taxable long term capital gain	Nil

Hence Long term Capital Gains is Nil irrespective of 20% with indexation or 12.5% without indexation.

Question 14

Mr. Patel is a proprietor of Star Stores since 20-05-2022. He has transferred his shop by way of slump sale for a total consideration of ₹ 40 Lakh. The professional fees & brokerage paid for this sale are ₹ 80,000. His Balance Sheet as on 31-03-2025 is as under

Liabilities	₹	Assets	₹
Own Capital	10,50,000	Building·	5,00,000
Bank Loan	5,00,000	Furniture	5,00,000
Trade Creditors	2,50,000	Debtors	2,00,000

Unsecured Loan	2,00,000	Other Assets	8,00,000
	20,00,000		20,00,000

Other Information:

1. No individual value of any asset is considered in the transfer deed.
2. Other assets include trademarks valuing ₹ 2,00,000 as on 01-04-2024 on which no depreciation has been provided.
3. Furniture of ₹ 1,50,000 purchased on 05-11-2024 on which no depreciation has been provided.
4. Unsecured loan includes ₹ 50,000 as advance received from his wife, which she has agreed to waive off.

Compute the capital gain for A.Y. 2025-26. *(PYP 4 Marks, Jul'21)*

Answer 14

Computation of capital gains on slump sale of shop

Particulars		₹
*Sale value		40,00,000
Less: Expenses on sale [professional fees & brokerage]		80,000
Net sale consideration		39,20,000
Less: Net worth **(See Working Note below)**		10,42,500
Short-term capital gain [Since shop is held for not more than 36 months immediately preceding the date of transfer]		**28,77,500**
Working Note:		
Computation of net worth of shop		
Building		5,00,000
Furniture	5,00,000	
Less: Deprecation on ₹1,50,000 @ 5%, being 50% of 10% since furniture is put to use for less than 180 days during the previous year	7,500	4,92,500
Debtors		2,00,000
Other assets	8,00,000	
Less: Deprecation on ₹ 2,00,000, being intangible asset @ 25%	50,000	7,50,000
Total assets		**19,42,500**
Less: Bank loan	5,00,000	
Trade creditors	2,50,000	
Unsecured loan ₹ 2,00,000 less ₹ 50,000, being the amount waived off by his wife	1,50,000	9,00,000
Net worth		**10,42,500**

Question 15

Mr. Surinder furnishes the following particulars for the previous year ending 31.03.2025. He had a Residential House, inherited from his father in December 2009, the Fair Market Value of which on 01.04.2001 is ₹ 13 lakhs. In the year 2013-2014, further construction and improvements costing of ₹ 10 lakhs. The House was originally purchased by his father on 01.03.2000 for ₹ 10 Lakhs. On 10.05.2024, the House was sold for ₹ 75 Lakhs. Expenditure in connection with transfer is ₹ 50,000. On 20.12.2024, he purchased a Residential House for ₹ 12 lakhs and he does not own any other house. Compute the taxable Capital Gain for the assessment year 2025-26.

(Cost Inflation Index: F.Y. 2013-14=220, F.Y.2024-25=363, F.Y. 2009-10 = 148 and F.Y. 2001-02=100)

(PYP 4 Marks, May'24)

Answer 15

Computation of Taxable Capital Gains for A.Y.2025-26

Particulars	₹
Full Value of Consideration	75,00,000
Less: Expenditure in connection with transfer	50,000

Net Sales Consideration	74,50,000
Less: Indexed cost of acquisition [₹ 13,00,000 (higher of actual cost to the previous owner of ₹ 10 lakhs and Fair market value as on 1.4.2001 of ₹ 13 lakhs) x 363/100]	47,19,000
Less: Indexed cost of improvements [₹ 10 lakhs x 363/220]	16,50,000
	10,81,000
Less: Exemption u/s 54 – in respect of residential house purchased on 20.12.2024 of Rs 12L	10,81,000
Taxable Long Term Capital Gains	NIL

Note – The above answer is on the basis of the view expressed by Bombay High Court in CIT v. Manjula J. Shah 16 Taxman 42, wherein it was held that Indexed cost of acquisition in case of gifted asset has to be computed with reference to the year in which the previous owner first held the asset and not the year in which the assessee became the owner of the asset.

Alternative answer is possible on basis of the plain reading of the provisions of section 48 wherein the indexed cost of acquisition would be determined by taking the Cost Inflation Index (CII) for the year in which the asset is first held by the assessee i.e. F.Y.2009-10. In such a case, the Indexed cost of acquisition would ₹ 31,88,514 (₹ 13,00,000 x 363/148) and taxable long term capital gains would be ₹ 14,11,486.

Question 16

Mrs. Harshita purchased a land at a cost of ₹ 35 lakhs in the F.Y. 2004-05 andheld the same as her capital asset till 20th March, 2024.

She started her real estate business on 21st March, 2024 and converted the said land into stock-in-trade of her business on the said date, when the fair market value of the land was ₹ 210 lakhs.

She constructed 15 flats of equal size, quality and dimension. Cost of construction of each flat is ₹ 10 lakhs. Construction was completed in February, 2025. She sold 10 flats at ₹ 30 lakhs per flat in March, 2025. The remaining 5 flats were held in stock as on 31st March, 2025.

She invested ₹ 50 lakhs in bonds issued by National Highways Authority of India on 31st March, 2024 and another ₹ 50 lakhs in bonds of Rural Electrification Corporation Ltd. in April, 2025.

Compute the amount of chargeable capital gain and business income in the hands of Mrs. Harshita arising from the above transactions for A.Y. 2025-26 indicating clearly the reasons for treatment for each item. [Cost Inflation Index: *F.Y. 2004-05: 113; F.Y. 2023-24: 348; F.Y. 2024-25: 363*]. *(SM)*

Answer 16

Computation of capital gains and business income of Harshita for A.Y. 2025-26

Particulars	₹
Business Income	
Sale price of flats [10 × ₹ 30 lakhs]	3,00,00,000
Less: Cost of flats	
Fair market value of land on the date of conversion [₹ 210 lacs × 2/3]	1,40,00,000
Cost of construction of flats [10 × ₹ 10 lakhs]	1,00,00,000
Business income chargeable to tax for A.Y.2025-26	**60,00,000**
Capital Gains	
Fair market value of land on the date of conversion deemed as the full value of consideration for the purposes of section 45(2)	2,10,00,000
Less: Indexed cost of acquisition [₹ 35,00,000 × 348/113]	1,07,78,761
	1,02,21,239
Proportionate capital gains arising during A.Y. 2025-26 [₹ 1,02,21,239 x 2/3]	68,14,159
Less: Exemption under section 54EC	50,00,000
Capital gains chargeable to tax for A.Y.2025-26	**18,14,159**

Notes:

(1) The conversion of a capital asset into stock-in-trade is treated as a transfer under section 2(47). It would be treated as a transfer in the year in which the capital asset is converted into stock-in-trade (i.e.,

P.Y.2023-24, in this case).

(2) As per section 45(2), the capital gains arising from the transfer by way of conversion of capital assets into stock-in-trade will be chargeable to tax only in the year in which the stock-in-trade is sold.

(3) The indexation benefit for computing indexed cost of acquisition would, however, be available only up to the year of conversion of capital asset into stock-in-trade (i.e., P.Y.2023-24) and not up to the year of sale of stock-in-trade (i.e., P.Y.2024-25).

(4) For the purpose of computing capital gains in such cases, the fair market value of the capital asset on the date on which it was converted into stock-in-trade shall be deemed to be the full value of consideration received or accruing as a result of the transfer of the capital asset.

In this case, since only 2/3rd of the stock-in-trade (10 flats out of 15 flats) is sold in the P.Y.2024-25, only proportionate capital gains (i.e., 2/3rd) would be chargeable to tax in the A.Y.2025-26.

(5) On sale of such stock-in-trade, business income would arise. The business income chargeable to tax would be the difference between the price at which the stock-in-trade is sold and the fair market value on the date of conversion of the capital asset into stock-in-trade.

(6) In case of conversion of capital asset into stock-in-trade and subsequent sale of stock-in-trade, the period of 6 months is to be reckoned from the date of sale of stock-in-trade for the purpose of exemption under section 54EC [*CBDT Circular No.791 dated 2.6.2000*]. In this case, since the investment in bonds of NHAI has been made within 6 months of sale of flats, the same qualifies for exemption under section 54EC. With respect to long-term capital gains arising on land or building or both in any financial year, the maximum deduction under section 54EC would be ₹ 50 lakhs, whether the investment in bonds of NHAI or RECL are made in the same financial year or next financial year or partly in the same financial year and partly in the next financial year.

Therefore, even though investment of ₹ 50 lakhs has been made in bonds of NHAI during the P.Y. 2024-25 and investment of ₹ 50 lakhs has been made in bonds of RECL during the P.Y. 2025-26, both within the stipulated six month period, the maximum deduction allowable for A.Y. 2025-26, in respect of long-term capital gain arising on sale of long-term capital asset(s) during the P.Y. 2024-25, is only ₹ 50 lakhs.

Question 17 LDR

Mr. Aditya is a proprietor of Star Stores having 2 units. On 1.4.2024, he has transferred Unit 2, which he started in 2004-05, by way of slump sale for a total consideration of ₹ 18 lakhs. The professional fees & brokerage paid for this transfer are ₹ 78,000. His Balance Sheet as on 31-03-2024 is as under:

Liabilities	₹	Assets	Unit 1 ₹	Unit 2 ₹	Total
Own Capital	20,50,000	Land	12,75,000	7,50,000	20,25,000
Revaluation reserve	2,50,000	Furniture	2,00,000	5,00,000	7,00,000
Bank Loan (70% for Unit 1)	8,50,000	Debtors	2,00,000	3,50,000	5,50,000
Trade Creditors (20% for Unit 2)	4,50,000	Patents	-	7,25,000	7,25,000
Unsecured Loan (30% for Unit 2)	4,00,000				
	40,00,000		16,75,000	23,25,000	40,00,000

Other Information:

1. **Land of Unit 2 was purchased at ₹ 5,00,000 in the year 2005 and revalued at ₹ 7,50,000 as on 31.3.2024.**
2. **No individual value of any asset is considered in the transfer deed.**
3. **Patents were acquired on 01-12-2022 on which no depreciation has been provided.**
4. **Furniture of Unit 2 of ₹ 5,00,000 were purchased on 01-12-2023 on which no depreciation has been provided.**
5. **Fair market value of capital asset transferred by way of slump sale of Unit 2 is ₹ 18,10,000.**

Compute the capital gain for A.Y. 2025-26. ***(RTP May'22)***

Answer 17

As per section 50B, any profits and gains arising from the slump sale effected in the previous year shall be chargeable to income-tax as capital gains arising from the transfer of capital assets and shall be deemed to be the income of the previous year in which the transfer took place.

If the assessee owned and held the undertaking transferred under slump sale for more than 36 months before slump sale, the capital gain shall be deemed to be long-term capital gain. Indexation benefit is not available in case of slump sale as per section 50B(2).

Computation of capital gain on slump sale of Unit 2

Particulars	₹
Full value of consideration for slump sale of Unit 2 [Fair market value of capital asset transferred by way of slump sale (i.e., ₹ 18,10,000) or fair market value of the consideration received (value of the monetary consideration received i.e., ₹ 18,00,000) whichever is higher]	18,10,000
Less: Expenses on sale [professional fees & brokerage]	78,000
Net full value of consideration	17,32,000
Less: Cost of acquisition, being the net worth of Unit 2 (Note 1)	13,35,781
Long term capital gains arising on slump sale (The capital gains is long-term as the Unit 2 is held for more than 36 months)	**3,96,219**

Notes

1. **Computation of net worth of Unit 2**

Particulars		**₹**
(1) Book value of non-depreciable assets		
(i) Land (Revaluation not to be considered)		5,00,000
(ii) Debtors		3,50,000
(2) Written down value of depreciable assets under section 43(6)		
(i) Furniture **(See Note 2)**		4,75,000
(ii) Patents **(See Note 3)**		4,75,781
Aggregate value of total assets		18,00,781
Less: Current liabilities of Unit 2		
Bank Loan [₹ 8,50,000 x 30%]	2,55,000	
Trade Creditors [₹ 4,50,000 x 20%]	90,000	
Unsecured Loan [₹ 4,00,000 x 30%]	1,20,000	4,65,000
Net worth of unit 2		**13,35,781**

2. **Written down value of furniture as on 1.4.2024**

Value of patents	**₹**
Cost as on 1.12.2023	5,00,000
Less: Depreciation @ 10% x 50% for Financial Year 2023-24	25,000
WDV as on 1.4.2024	**4,75,000**

3. **Written down value of patents as on 1.4.2024**

Value of patents	**₹**
Cost as on 1.12.2022	7,25,000
Less: Depreciation @ 25% x 50% for Financial Year 2022-23	90,625
WDV as on 1.4.2023	6,34,375
Less: Depreciation@25% for Financial Year 2023-24	1,58,594
WDV as on 1.4.2024	**4,75,781**

Question 18

Determine the capital gains/loss and tax liability in the following scenarios for the A.Y. 2024-25 assuming the assessees does not have any other source of income:

(i) On 12th December, 2024, 1,200 shares of X Ltd., a listed company are sold by Mr. Vishal, a non-resident, @ ₹ 1,550 per share and STT was paid at the time of sale of shares. These shares were acquired by him on 25th May, 2017 @ ₹ 425 per share by paying STT at the time of purchase. The price at which these shares were traded in National Stock Exchange on 31st January, 2018 is as follows –

Particulars	Amount in ₹
Highest Trading Price	680
Average Trading Price	610
Lowest Trading Price	540

(ii) Mr. Kabir, a resident aged 45 years, is the owner of residential house which was purchased on 1st August, 2021 for ₹ 19,00,000. He sold the said house on 25th September, 2024 for ₹ 24,50,000. Valuation as per stamp valuation authorities was ₹ 25,50,000 as on the date of sale. CII – 2021-22: 317; 2024-25: 363 *(RTP Nov'23)*

Answer 18

	Particulars		Amount ₹
(i)	**Long-term capital gain on transfer of 1,200 shares of X Ltd. [Taxable u/s 112A @12.5% on amount exceeding ₹ 1,25,000]**		
	Full value of consideration [1,200 x ₹ 1,550]		18,60,000
	Less: Cost of acquisition		8,16,000
	Higher of		
	(i) Cost of acquisition [1,200 x ₹ 425]	5,10,000	
	(ii) Lower of fair market value of such shares as on 31.1.2018 and sale consideration [1,200 x 680]	8,16,000	
	Fair market value of listed equity shares as on 31.1.2018 [Highest price quoted on the recognized stock exchange i.e., ₹ 680 per share sale consideration ₹ 1,550 per share		
	Long term capital gain taxable u/s 112A/ Total Income		10,44,000
	Tax on long-term capital gain exceeding ₹ 1.25 lakh i.e., ₹ 9,19,000 @12.5%		1,14,875
	Add: Health and Education Cess @ 4%		4,595
	Tax liability		1,19,470
	Tax liability (Rounded off)		1,19,470
	Since Mr. Vishal is a non-resident, benefit of unexhausted basic exemption limit would not be available to him.		
(ii)	**Sale of residential house [Long-term capital asset, since held for more than 24 months]**		
	(i) 20% with indexation benefits		
	Full value of consideration [Actual consideration, since stamp duty value does not exceeds 110% of actual sale consideration]		24,50,000
	Less: Indexed cost of acquisition [₹ 19,00,000 x 363/317]		21,75,710
	Long term capital gain/ Total Income		**2,74,290**
	Long-term capital gain taxable u/s 112 @20% on NIL[₹ 2,74,290 – ₹ **3,00,000**, being unexhausted basic exemption limit]		**NIL**
	(ii) 12.5% with indexation benefits		
	Full value of consideration		24,50,000
	Less: cost of acquisition		19,00,000

	Long term capital gain/ Total Income		**5,50,000**
	Long-term capital gain taxable u/s 112 @12.5% on 2,50,000 [₹ 5,50,000 – ₹ **3,00,000**, being unexhausted basic exemption limit]		**31,250**
	Hence 20% with indexation is more beneficial for the the Assessee		

Question 19

Mrs. Yuvika bought a vacant land for ₹ 80 lakhs in May 2005. Registration and other expenses were 10% of the cost of land. She constructed a residential building on the said land for ₹ 100 lakhs during the financial year 2007-08.

She entered into an agreement for sale of the above said residential house with Mr. Johar (not a relative) in April 2015. The sale consideration was fixed at ₹ 700 lakhs and on 23-4-2015, Mrs. Yuvika received ₹ 20 lakhs as advance in cash by executing an agreement. However, due to failure on part of Mr. Johar, the said negotiation could not materialise and hence, the said amount of advance was forfeited by Mrs. Yuvika.

Mrs. Yuvika, again entered into an agreement on 01.05.2024 for sale of this house at ₹ 810 lakhs. She received ₹ 80 lakhs as advance by RTGS. The stamp duty value on the date of agreement was ₹ 890 lakhs. The sale deed was executed and registered on 14-07-2024 for the agreed consideration. However, the State stamp valuation authority had revised the values, hence, the value of property for stamp duty purposes was ₹ 900 lakhs. Mrs. Yuvika paid 1% as brokerage on sale consideration received.

Subsequent to sale, Mrs. Yuvika made following acquisition/investments:

(i) Acquired two residential houses at Delhi and Chandigarh for ₹ 130 lakhs and ₹ 50 lakhs, respectively, on 31.1.2025 and 15.5.2025

(ii) Acquired a residential house at UK for ₹ 180 lakhs on 23.3.2025.

(iii) Subscribed to NHAI capital gains bond (approved under section 54EC) for ₹ 50 lakhs on 30-11-2024 and for ₹ 40 lakhs on 9-1-2025.

Compute the income chargeable under the head 'Capital Gains' of Mrs. Yuvika for A.Y.2025-26. The choice of exemption must be in the manner most beneficial to the assessee.

Cost Inflation Index: F.Y. 2005-06 – 117; F.Y. 2007-08 – 129; F.Y. 2024-25 - 363. *(SM)*

Answer 19

Computation of income chargeable under the head "Capital Gains" of Mrs. Yuvika for A.Y.2025-26

Particulars	**Rs. (in lakhs)**	**Rs (in lakhs)**
Capital Gains on sale of residential building		
Actual sale consideration Rs.810 lakhs		
Value adopted by Stamp Valuation Authority Rs.890 lakhs		
[Where the actual sale consideration is less than thevalue adopted by the Stamp Valuation Authority for the purpose of charging stamp duty, and such stamp duty value exceeds 110% of the actual sale consideration, then, the value adopted by the Stamp Valuation Authority shall be taken to be the full value of consideration as per section 50C.		
However, where the date of agreement is different fromthe date of registration, stamp duty value on the date of agreement can be considered provided the whole or part of the consideration is received by way of account payee cheque/bank draft or by way of ECS through bank account or through prescribed electronic modes on orbefore the date of agreement.		
In this case, since advance of Rs. 80 lakh is received by RTGS, i.e., one of the prescribed modes, stamp duty value on the date of agreement can be adopted as thefull value of consideration. However, in the present case since stamp duty value on the date of agreement does not exceed 110% of the actual consideration, actual sale consideration would be taken as the full value of consideration)		
Gross Sale consideration (actual consideration, since stamp duty value on the date		810.00

of agreement does notexceed 110% of the actual consideration)		
Less: Brokerage @1% of sale consideration (1% of Rs.810 lakhs)		8.10
Net Sale consideration		801.90
Less: Indexed cost of acquisition		
- Cost of vacant land, Rs. 80 lakhs, *plus* registration and other expenses i.e., Rs. 8 lakhs, being 10% of cost of land [₹ 88 lakhs × 363/117]	273.03	
- Construction cost of residential building(₹100 lakhs x 363/129)	281.40	554.43
Long-term capital gains		**247.47**
Since the residential house property was held by Mrs. Yuvika for more than 24 months immediatelypreceding the date of its transfer, the resultant gain is a long-term capital gain]		
***Less:* Exemption under section 54**		130.00
Where long-term capital gains exceed Rs. 2 crore, the capital gain arising on transfer of a long-term residential property shall not be chargeable to tax to the extent such capital gain is invested in the purchase of one residential house property in India, one year before or two years after the date of transfer of original asset. Therefore, in the present case, the exemption would be available only in respect of the one residential house acquired in India and not in respect of the residential house in UK. It would be more beneficial for her to claim the cost of acquisition of residential house at Delhi, i.e., Rs. 130 lakhs as exemption.		
***Less:* Exemption under section 54EC**		50.00
Amount invested in capital gains bonds of NHAI within six months after the date of transfer (i.e., on or before 13.1.2025), of long-term capital asset, being land or building or both, would qualify for exemption, to the maximum extent of Rs. 50 lakhs, whether such investment is made in the current financial year or subsequent financial year. Therefore, in the present case, exemption can be availed only to the extent of Rs. 50 lakh out of Rs. 90 lakhs, even if the both the investments are made on or before 13.1.2025(i.e., within six months after the date of transfer).		
Long term capital gains chargeable to tax		**67.47**

Note: Advance of ₹ 20 lakhs received from Mr. Johar, would have been chargeable to tax under the head "Income from other sources", in the A.Y. 2016-17, as per section 56(2)(ix), since the same was forfeited on or after 01.4.2014 as a result of failure of negotiation. Hence, the same should not be deducted while computing indexed cost of acquisition.

Question 20

(To keep the essence of the question we have not changed the AY to 2024 – 25)

Ms. Mishika has entered into an agreement with M/s CVM Build Limited on 25.04.2017 in which she agrees to allow such Company to develop a shopping mall on land owned by her in New Delhi. She purchased such land on 05.05.2009 for ₹ 15,00,000. In consideration, M/s CVM Build Limited will provide 20% share in shopping mall to Mishika. The certificate of completion of shopping mall was issued by authority as on 26.12.2020. On such date, Stamp duty value of shopping mall was ₹ 4,14,00,000. Subsequently on 18.03.2021, she sold her 15% share in shopping mall to Mr. Ketav in consideration of ₹ 65,00,000.

She has also purchased a house on 09.05.2020 in consideration of ₹ 46,00,000 and occupied for own residence. Punjab National Bank has sanctioned a loan of ₹ 35,50,000 (80% of stamp value) at the interest rate of 12% per annum on 01.05.2020 and disbursement was made on 01.06.2020. She does not own any other residential house on the date of sanction of loan. Principal amount of ₹ 1,30,000 was paid during the financial year 2020-21.Cost Inflation Indices: 2020-21: 301, 2009-10: 148

Compute total income of Ms. Mishika for the assessment year 2021 -22 assuming that she has not opted for the provisions under section 115BAC. *(PYP 7 Marks, Dec'21)*

Answer 20

Computation of total income of Ms. Mishika for the A.Y.2021 -22

Particulars	Amount (₹)	Amount (₹)
Income from house property [Self-occupied]		
Net Annual Value	Nil	
Less: Interest on housing loan of ₹ 3,55,000 [₹ 35,50,000 x 12% x 10/12 months] restricted to₹ 2,00,000/-	2,00,000	
	(2,00,000)	
Less: Set-off of loss against long-term capital gains	2,00,000	Nil
Long-term capital gains on transfer of land under specified agreement Since Ms. Mishika transferred her share in the project after issue of completion certificate, capital gains on transfer of land handed over to developer under specified agreement in the P.Y. 2017-18 would be taxable in the previous year 2020-21, being the year in which certificate of completion is issued as per section 45(5A). Accordingly, capital gain arising in respect of land would be-		
Full value of consideration, being 20% share in shopping mall [Stamp duty value on the date of issue of completion certificate (₹ 4,14,00,000 x 20%)]	82,80,000	
Less: Indexed of cost of acquisition [₹ 15,00,000 x 301/148]	30,50,676	
Long-term capital gain	52,29,324	
***Less:* Deduction under section 54F**		
Deduction in respect of amount invested for purchase of a residential house acquired within one year prior to date of transfer would be allowable proportionately, since amount invested is less than the net consideration. Accordingly, deduction would be ₹ 29,05,180 (₹ 52,29,324 x ₹46,00,000 / ₹ 82,80,000)	29,05,180	
Long-term capital gains	23,24,144	
Less: Set-off of loss from house property [It is beneficial to set-off loss from house property against long-term capital gains, since in case of Ms. Mishika total income comprises of LTCG taxable@20% and STCG taxable at normal slab rates; and she can claim deduction of ₹ 2,80,000 under Chapter VI-A against STCG of ₹ 2,90,000. Moreover, the remaining STCG would also not be taxable since it would be below the basic exemption limit]	2,00,000	
		21,24,144
Short-term capital gains		
Sale of 15% share in shopping mall [short-term capital asset, since held for not more than 24 months]		
Net Sales consideration	65,00,000	
Less: Cost of acquisition, being the full value of consideration taxable on transfer of land [₹ 4,14,00,000 x 15%]	62,10,000	
Short-term capital gains		2,90,000
Gross Total Income		24,14,144
***Less:* Deductions under Chapter VI-A** (allowable against short-term capital gains of ₹ 2,90,000)		
Deduction under section 80C – repayment of principal amount of housing loan	1,30,000	
Deduction under section 80EEA – Ms. Mishika would be eligible for deduction of interest on housing loan (₹ 3,55,000 - ₹ 2,00,000 = ₹ 1,55,000) to the extent of ₹ 1,50,000, since stamp duty value of the house does not exceed ₹ 45,00,000 [being ₹ 44,37,500 (₹ 35,50,000 x 100/80)] and she does not own any other residential house on the date of sanction of loan.	1,50,000	2,80,000

Total Income		**21,34,144**
Total Income (rounded off)		**21,34,140**

Note -

As per section 45(5A), any capital gains arising from the transfer of a capital asset, being land or building or both, under a specified agreement, is chargeable to income-tax as income of the previous year in which the certificate of completion is issued by the competent authority. In the above solution, the CII of F.Y.2020-21 has been considered on the basis of parity, since, as per section 45(5A), it is the stamp duty value of the developed property (shopping mall, in this case) on the date of issue of certificate of completion (26.12.2020), which is deemed as the
full value of consideration for transfer of land handed over to the developer.

Alternate view -

The definition of transfer, inter alia, includes any arrangement or transaction where any rights are handed over in execution of part performance of contract, even though the legal title has not been transferred. Hence, in case of 'specified agreement(s)', 'transfer' takes place at the time when the owner of the immovable property hands over the same to the developer i.e., in F.Y.2017-18 in this case.

As per the plain reading of definition of 'indexed cost of acquisition', the CII of the year in which the asset (land, in this case) is transferred has to be considered. Accordingly, as per this interpretation, CII of F.Y. 2017-18 i.e., 272 can be considered for computing indexed cost of acquisition. If the CII of F.Y.2017-18 is considered on the basis of this line of reasoning, the figures of long-term capital gains and total income would accordingly change. However, the CII of F.Y.2017-18 has not been given in the question for the purpose of making such computation.

EXAM INSIGHTS: Examinees failed to provide for deduction under section 54F while computing taxable long-term capital gains, set-off of loss from house property against long-term capital gains and deduction under section 80EEA while computing total income of Ms. Mishika.

Question 21

LDR

Mr. Shiva purchased a house property on February 15, 1979 for ₹ 3,24,000. In addition, he has also paid stamp duty value @10% on the stamp duty valueof ₹ 3,50,000.

In April, 2008, Mr. Shiva entered into an agreement with Mr. Mohan for saleof such property for ₹ 14,35,000 and received an amount of ₹ 1,11,000 as advance. However, the sale consideration did not materialize and Mr. Shiva forfeited the advance. In May 2015, he again entered into an agreement for sale of said house for ₹ 20,25,000 to Ms. Deepshikha and received ₹ 1,51,000as advance. However, as Ms. Deepshikha did not pay the balance amount, Mr. Shiva forfeited the advance. In August, 2015, Mr. Shiva constructed the firstfloor by incurring a cost of ₹ 3,90,000.

On November 15, 2024, Mr. Shiva entered into an agreement with Mr. Manish for sale of such house for ₹ 30,50,000 and received an amount of ₹ 1,50,000 as advance through an account payee cheque. Mr. Manish paid the balance entire sum and Mr. Shiva transferred the house to Mr. Manish on February 20, 2025. Mr. Shiva has paid the brokerage @1% of sale consideration to the broker.

On April 1, 2001, fair market value of the house property was ₹ 11,85,000 and Stamp duty value was ₹ 10,70,000. Further, the Valuation as per Stamp duty Authority of such house on 15th November, 2024 was ₹ 39,00,000 and on 20thFebruary, 2025 was ₹ 41,00,000.

Compute the capital gains in the hands of Mr. Shiva for A.Y.2025-26.Also, Compute the tax liability under section 112, assuming that the basic exemption limit has been fully exhausted against other income.

CII for F.Y. 2001-02: 100; F.Y. 2008-09: 137; F.Y. 2015-16: 254; F.Y. 2024-25: 363 *(SM, MTP 7 Marks, Mar'23 & Aug '18,)*

Answer 21

Computation of Capital gains in the hands of Mr. Shiva for A.Y. 2025-26

Particulars	Amount (₹)	Amount (₹)
Actual sale consideration	30,50,000	
Valuation as per Stamp duty Authority on the date of agreement	39,00,000	

(Where the actual sale consideration is less than the value adopted by the Stamp Valuation Authority for the purpose of charging stamp duty, and such stamp duty value exceeds 110% of the actual sale consideration then, the value adopted by the Stamp Valuation Authority shall be taken to be the full value of consideration as per section 50C.		
However, where the date of agreement is different from the date of registration, stamp duty value on the date of agreement can be considered, provided the whole or part of the consideration is received by way of account payee cheque/bank draft or by way of ECS through bank account or such other electronic mode as may be prescribed on or before the date of agreement. In the present case, since part of the payment is made by account payee cheque on the date of agreement, the stamp duty value on the date of agreement would be considered as full value of consideration)		
Deemed Full value of consideration [Since stamp duty value on the date of agreement exceeds 110% of the actual consideration, stamp duty value would be deemed as Full Value of Consideration]		39,00,000
Less: Expenses on transfer (Brokerage @1% of ₹ 30,50,000)		30,500
Net sale consideration		38,69,500
Less: Cost of acquisition (Note 1)	9,59,000	
Less: Cost of improvement	3,90,000	13,49,000
Long term capital gain		25,20,500

Computation of tax liability u/s 112

Particulars		Amount (₹)
On LTCG of ₹ 25,20,500 x 12.5%		3,15,063
Add: Health and Education cess @4%		12,603
On LTCG with indexation benefit		3,27,666
Net Sale consideration	38,69,500	
Less: Indexed cost of acquisition (₹ 9,59,000 x 363/100)	34,81,170	
Less: Indexed cost of Improvement [₹ 3,90,000 x 363/254]	5,57,362	
Long-term capital loss	(1,69,032)	
Since the computation results in a long term capital loss, if indexation benefit is given, the tax u/s 112 would be Nil. However, this computation is only for determining tax liability, the said loss can neither be set-off nor carried forward.		

Notes:

(1) Computation of cost of acquisition

Particulars	Amount (₹)	Amount (₹)
Cost of acquisition,		10,70,000
Being the higher of		
(i) lower of Fair market value i.e., ₹ 11,85,000 and Stamp duty value i.e., ₹ 10,70,000, on April 1, 2001	10,70,000	
(ii) Actual cost of acquisition (₹ 3,24,000 + ₹ 35,000, being stamp duty @10% of ₹ 3,50,000)	3,59,000	
Less: Advance money taken from Mr. Mohan and forfeited		1,11,000
Cost of acquisition		9,59,000

(2) Where advance money has been received by the assessee, and retained by him, as a result of failure of the negotiations, section 51 will apply. The advance retained by the assessee will go to reduce the cost of acquisition. Accordingly, cost of acquisition after reducing the advance money

forfeited would be ₹ 9,59,000 [i.e. ₹ 10,70,000 – ₹ 1,11,000 (being the advance money forfeited during the P.Y. 2008-09)]. However, where the advance money is forfeited during the previous year 2014-15 or thereafter, the amount forfeited would be taxable under the head "Income from Other Sources" and such amount will not be deducted from the cost of acquisition of such asset while calculating capital gains. Hence, ₹ 1,51,000, being the advance received from Ms. Deepshikha and retained by him, would have been taxable under the head "Income from other sources" in the hands of Mr. Shiva in A.Y.2016-17.

Question 22 LDR

Mr. Sarthak entered into an agreement with Mr. Jaikumar to sell his residential house located at Kanpur on 16.08.2024 for ₹ 1,50,00,000.

The sale proceeds were to be paid in the following manner:

(i) 20% through account payee bank draft on the date of agreement.

(ii) 60% on the date of the possession of the property.

(iii) Balance after the completion of the registration of the title to the property.

Mr. Jaikumar was handed over the possession of the property on 15.12.2024 and the registration process was completed on 14.01.2025. He paid the sale proceeds as per the sale agreement.

The value determined by the Stamp Duty Authority-

(a) on 16.08.2024 was ₹ 1,70,00,000;

(b) on 15.12.2024 was ₹ 1,71,00,000; and

(c) on 14.01.2025 was ₹ 1,71,50,000.

Mr. Sarthak had acquired the residential house at Kanpur on 01.04.2001 for ₹ 30,00,000. After recovering the sale proceeds from Jaikumar, he purchased two residential house properties, one in Kanpur for ₹ 20,00,000 on 24.3.2025 and another in Delhi for ₹ 35,00,000 on 28.5.2025.

Compute the income chargeable under the head "Capital Gains" of Mr. Sarthak for the Assessment Year 2025-26.

Cost Inflation Index for Financial Year(s): 2001-02 - 100; 2024-25 – 363 *(SM) (Same concepts different figures RTP May'24, MTP 7 Marks Oct'19, MTP Aug'24, MTP 6 Marks, Oct'22, RTP Nov'18)*

Answer 22

Computation of income chargeable under the head "Capital Gains" of Mr. Sarthak for A.Y. 2025-26

Particulars		₹
Capital Gains on sale of residential house		
Actual sale consideration	₹ 1,50,00,000	
Value adopted by Stamp Valuation Authority on the date of agreement	₹ 1,70,00,000	
[As per section 50C, where the actual sale consideration is less than the value adopted by the Stamp Valuation Authority for the purpose of charging stamp duty, and such stamp duty value exceeds 110% of the actual sale consideration, then, the value adopted by the Stamp Valuation Authority shall be taken to be the full value of consideration. In a case where the date of agreement is different from the date of registration, stamp duty value on the date of agreement can be considered provided the whole or part of the consideration is paid by way of account payee cheque/bank draft or by way of ECS through bank account or through such other electronic mode as may be prescribed, on or before the date of agreement. In this case, since 20% of ₹ 150 lakhs is paid through account payee bank draft on the date of agreement, stamp duty value on the date of agreement would be considered for determining the full value of consideration]		

Full value of sale consideration [Stamp duty value on the date of agreement, since it exceeds 110% of the actual sale consideration]	1,70,00,000
Less: Cost of acquisition of residential house	30,00,000
Long-term capital gains [Since the residential house property was held by Mr. Sarthak for more than 24 months immediately preceding the date of its transfer]	**1,40,00,000**
Less: **Exemption u/s 54**	55,00,000
Since, long-term capital gains does not exceed ₹ 2 crore, he would be eligible for exemption in respect of both the residential house properties purchased in India. The capital gain arising on transfer of a long-term residential property shall not be chargeable to tax to the extent such capital gain is invested in the purchase of these residential house properties in India within one year before or two years after the date of transfer of original asset. Thus, he would be eligible for exemption of ₹ 55,00,000 being ₹ 20,00,000 and ₹ 35,00,000 invested on acquisition of residential house property in Kanpur and Delhi, respectively.	
Long term capital gains chargeable to tax	**85,00,000**

Note: It may be noted that since Sarthak has transferred residential house property on or after 23.7.2024 which was acquired before the said date, he can opt to pay tax @20% on LTCG (computed with indexation) or 12.5% on LTCG (computed without indexation) whichever is beneficial to him.

Question 23

Mr. Asif bought a vacant land for ₹ 80 lakhs in March 2005. Registration and other expenses were 10% of the cost of land. He constructed a residential building on the said land for ₹ 100 lakhs during the financial year 2006-07.

He entered into an agreement for sale of the above said residentialhouse with Mr. Hari (not a relative) on 1st July 2024. The sale consideration was fixed at ₹ 600 lakhs and on the date of agreement, Mr. Asif received ₹ 20 lakhs as advance in cash. The stamp duty value on that date was ₹620 lakhs.

The sale deed was executed and registered on 20-7-2024 for the agreed consideration. However, the State stamp valuation authority had revised the values, hence, the value of property for stamp duty purposes was ₹ 670 lakhs. Mr. Asif paid 1% as brokerage on sale consideration received.

Subsequent to sale, Mr. Asif made investments in NHAI bond: ₹ 45 lakhs on 29-10-2024 and ₹15 lakhs on 12-12-2024.

Compute the Capital Gain chargeable to tax for A.Y. 2024-25. Cost Inflation Index:

F.Y. 2004-05 113
F.Y. 2006-07 122
F.Y. 2024-25 363 (MTP 4 Marks Nov'24)

Answer 23

Computation of income chargeable under the head "CapitalGains" for A.Y.2025-26

Particulars	₹ (in lakhs)	₹ (in lakhs)
Capital Gains on sale of residential building		
Actual sale consideration ₹600 lakhs		
Value adopted by Stamp ValuationAuthority ₹670 lakhs		
Full Value of Consideration		670.00
[In case the actual sale considerationdeclared by the assessee is less than the value adopted by the Stamp Valuation Authority for the purpose of charging stamp duty, then, the value adopted by the Stamp Valuation Authority shall be taken to be the full value of consideration as per section 50C. In a case where the date of agreement is different from the date of registration,stamp duty value on the date of agreement can be considered provided the whole or part of the consideration is paid by way of account		

payee cheque/bank draft or by way of ECS through bank account on or before the date of agreement. However, where the stamp duty value does not exceed 110% of the sale consideration received or accruing as a result of the transfer, the consideration so received or accruing shall be deemed to be the full value of the consideration. In this case, since advance of ₹ 20 lakh is paid by cash, stamp duty value of ₹ 620 lakhs on the date of agreement cannot be adopted as the full value of consideration and stamp duty value on the date of registration would be considered. However, since stamp duty value on the date of registration exceeds 110% of the actual consideration, stamp duty value on the date of registration would be the full value of consideration]		
Less: Brokerage@1% of saleconsideration (1% of ₹600 lakhs)		6.00
Net Sale consideration		664.00
Less: Indexed cost of acquisition - Cost of vacant land, ₹ 80 lakhs,*plus* registration and other expenses i.e., ₹ 8 lakhs, being 10% of cost of land [₹ 88 lakhs × 363/113]	282.69	
- Construction cost of residentialbuilding (₹100 lakhs x 363/122)	297.54	580.23
Long-term capitalgains before exemption		**83.77**
Less: **Exemption under section 54EC**		50.00
Amount deposited in capital gains bonds of NHAI within six months from the date of transfer (i.e., on or before 20.01.2025) would qualify for exemption, to the maximum extent of ₹50 lakhs. Therefore, in the present case,exemption can be availed only to the extent of ₹ 50 lakh out of ₹ 60 lakhs, even if the both the investments are made on or before 20.01.2025 (i.e.,within six months from the date of transfer).		
Long Term Capital Gains [Since it washeld for more than 24 months]		**33.77**

Question 24

Mr. Soham, a builder, entered into an agreement on 1.4.2024 with Mr. Aman to transfer 4th Floor in Tower A of a new project for ₹ 1,50,00,000. He received ₹ 25 lakhs as advance in cash on 1.4.2024. The stamp duty value of such floor on that date was ₹ 1,70,00,000. The sale deed was executed and registered on 15.6.2024 for the agreed consideration. However, the stamp duty value on that date was ₹ 1,75,00,000. Discuss the tax consequences of above, in the hands of Mr. Soham and Mr. Aman. ***(MTP 5 Marks Dec'24) (Same concepts different figures MTP 7 Marks, Apr'22)***

Answer 24

I	<u>**Tax consequences in the hands of Mr. Soham**</u>
	As per section 43CA, where the consideration received or accruing is less than the stamp duty value of an asset (other than capital asset), being land or building or both and such stamp duty value exceeds 110% of the consideration received or accruing, then the stamp duty value shall be deemed to be the full value of the consideration. However, where the date of agreement is different from the date of registration, stamp duty value on the date of agreement can be considered provided whole or part of the considered is received by way of account payee cheque/ bank draft/ ECS or through any other prescribed modes on or before the date of agreement. In this case, since ₹ 25 lakhs is received by cash on the date of agreement, stamp duty value on the date of registration is to be considered. Since such stamp duty value (₹ 1.75 crores) exceed 110% of the consideration received (₹ 1.50 crores), business income would be computed in the hands of Mr. Soham, for A.Y.2025-26, taking sale consideration of ₹ 1,75,00,000 as the full value of consideration arising on transfer.

II	**Tax consequences in the hands of Mr. Aman**
	In case, immovable property is received for inadequate consideration, the difference between the stamp duty value and actual consideration would be taxable under section 56(2)(x) in the hands of the recipient, if such difference exceeds the higher of ₹ 50,000 and 10% of actual sales consideration. Where the date of agreement is different from the date of registration, stamp duty value on the date of agreement can be considered provided whole or part of the considered is received by way of account payee cheque/ bank draft/ ECS or through any other prescribed modes on or before the date of agreement. In this case, since ₹ 25 lakhs is received by cash on the date of agreement, stamp duty value on the date of registration is to be considered. Accordingly, ₹ 25,00,000 would be taxable in the hands of Mr. Aman under the head "Income from Other Sources" in A.Y.2025-26 since the difference of ₹ 25,00,000 exceed ₹ 15,00,000, being the higher of ₹ 50,000 and ₹ 15,00,000 (10% of consideration).

Question 25

Mr. Raj a resident individual, aged 69 years sold an urban agricultural landfor ₹ 75,00,000 to Mr. Vipul on December 15, 2024 when the stamp dutyvalue of agricultural land was ₹ 95 lakhs. However, the "agreement to sell" the agricultural land was entered on July 15, 2024 and Mr. Vipul gave ₹ 4 lakhs as advance through IMPS. The stamp duty value at the time of agreement was ₹ 85 lakhs. Mr. Raj paid 1% of sale consideration as commission to a broker. The land was purchased by him on May 15, 2002 for ₹ 10.85 lakhs and it was being used for agricultural purposes by him since its purchase.

Mr. Raj purchased another agricultural land in rural area on January 1, 2025 for ₹ 40 lakhs and this land was sold by him on March 12, 2025 for ₹ 45 lakhs and he invested the entire sale proceeds in fixed deposits with a nationalized bank on the same day.

Compute capital gain for assessment year 2025-26 if Mr. Raj exercises the option of shifting out of the default tax regime provided under section 115BAC(1A).

Cost Inflation Index for: F.Y. 2002-03 = 105; F.Y. 2024-25-363 (PYP 4 Marks Sep'24)

Answer 25

Computation of Capital Gains of Mr. Raj for A.Y.2025-26

Particulars		**₹**
Capital gain on sale of urban agricultural land		
(i) 20% with indexation benefits		
Actual sale consideration	75,00,000	
Stamp duty value as on date of agreement i.e., on 15.7.2024 [Since part consideration is received through IMPS on the date of agreement]	85,00,000	
Full Value of Consideration [Stamp duty value on the dateof agreement since it exceeds 110% of the actual sale consideration]		85,00,000
Less: Expenditure in connection with transfer [1% of saleconsideration i.e., ₹75 lakhs]		75,000
Net Sales Consideration		84,25,000
Less: Indexed cost of acquisition [₹10,85,000 x 363/105]		37,51,000
		46,74,000
Less: Exemption u/s 54B – In respect of rural agricultural land purchased on 1.1.2025. Mr. Raj is eligible to claimexemption u/s 54B since he has used the urban agricultural land for agricultural purposes for more than 2 years preceding the date of its transfer. **[See Note for alternative answer]**		40,00,000
Long term capital gain		**6,74,000**
(ii) 12.5% without indexation benefits		
Net Sales Consideration		84,25,000
Less: cost of acquisition		10,85,000
		73,40,000
Less: Exemption u/s 54B		40,00,000
Long term capital gain		**33,40,000**
Hence 20% with indexation is more beneficial for the the Assessee		

Capital gain on sale of rural agricultural land
As per section 54B, if the new agricultural land istransferred within 3 years from the date of its purchase, while computing the capital gains on transfer of such new agricultural land, the cost of acquisition of such land would be reduced by the amount of capital gain claimed as exempted. However, since rural agricultural is not a capital asset, no capital gain would arise on sale of such land even though it is transferred within 3 years from the date of its purchase.

Note [Alternative answer] – Mr. Raj transferred urban agricultural land on 15.12.2024 and purchased rural agricultural land on 1.1.2025 which is soldon 12.3.2025. Since the rural agricultural land is sold within the same previous year in which original asset was transferred i.e., P.Y. 2024-25, a view can be taken that the exemption under section 54B would not be availableas at the time of filing return of income such acquired land does not exist. In such case, long term capital gain would be ₹ 46,74,000.

MULTIPLE CHOICE QUESTIONS (MCQS)

1. In P.Y. 2024-2025, Mr. A has transferred the following assets:

Asset transferred	Full Value of Consideration (₹)	Indexed Cost of Acquisition (₹)	Transfer Date
Residential house property	8 crores	6 crores	25.11.2024
Jewellery	3 crores	2 crores	05.01.2025

Mr. A bought a new residential house property on 01.04.2023 for ₹ 1 crore and on 28.02.2025 deposited ₹ 3 crores in a capital gains deposit account scheme. On 30.07.2025, Mr. A has withdrawn ₹ 3 crores from capital gains deposit account and acquired a residential house property worth ₹ 2.5 crore. What would be the capital gains in the hands of Mr. A for A.Y. 2025-26, if the expenses in connection with transfer of jewellery were ₹ 2,00,000? *(MTP 2 Marks, Mar'22)*

(a) ₹ 80,50,000
(b) ₹ 81,55,705
(c) ₹ 98,00,000
(d) ₹ 48,00,000

Ans: (b)

2. A building was acquired on 1.4.1995 for ₹ 20,00,000 and sold for ₹ 80,00,000 on 01.06.2024. The stamp duty value on the date of transfer was ₹ 85,00,000. The fair market value of the building on 1.4.2001 was ₹ 25,00,000. Its stamp duty value on the same date was ₹ 22,00,000. Determine the capital gains on sale of such building for the A.Y. 2024-25?
Cost Inflation Index for F.Y. 2001-02: 100; F.Y. 2023-24: 363 *(RTP Nov'21)*

(a) ₹ 14,000
(b) (₹ 10,75,000)
(c) ₹ 7,40,000
(d) ₹ 4,75,000

Ans: (a)

3. Mr. Kashyap, CEO of SHY Ltd., purchased a BMW of ₹ 1.15 crores on 23rd September, 2021 for his personal use. On 28.2.2025, he sold this car for ₹ 1 crore and incurred an expenditure of ₹ 2.74 lakhs for transferring the ownership of car. Compute the taxable capital gain/loss, if any, to Mr. Kashyap for
the A.Y. 2024-25.
CII-2020-21: 301; 2022-23: 331; 2024-25: 363 *(RTP Nov'23)*

(a) Short term capital loss of ₹ 0.1774 crores
(b) Long term capital loss of ₹ 0.3445 crores
(c) Nil
(d) Long term capital loss of ₹ 0.317 crores

Ans: (c)

4. Mr. Vivitzu transferred 600 unlisted shares of XYZ (P) Ltd. to ABC (P) Ltd. on 15.07.2024 for ₹ 3,50,000 when the market price was ₹ 5,15,000. The indexed cost of acquisition of shares for Mr. Vivitzu was computed at ₹ 4,25,000.

Determine the income chargeable to tax in the hands of Mr. Vivitzu and ABC (P) Ltd. in respect of the above transaction. ***(RTP May'21, MTP 2 Marks, Oct'23)***

(a) ₹ 90,000 chargeable to tax in the hands of Mr. Vivitzu as long-term capital gains and nothing is taxable in the hands of ABC (P) Ltd.

(b) ₹ 75,000 chargeable to tax in the hands of Mr. Vivitzu as long-term capital gains and nothing is taxable in the hands of ABC (P) Ltd.

(c) ₹ 90,000 chargeable to tax in the hands of Mr. Vivitzu as long-term capital gains and ₹ 1,65,000 is taxable under the head "Income from other sources" in the hands of ABC (P) Ltd.

(d) ₹ 75,000 chargeable to tax in the hands of Mr. Vivitzu as long-term capital gains and ₹ 1,65,000 is taxable under the head "Income from other sources" in the hands of ABC (P) Ltd.

Ans: (c)

5. **Mr. A, aged 45 years sold an agricultural land for ₹ 52 lakhs on 04.10.2024 acquired at a cost of ₹ 49.25 lakhs on 13.09.2023 situated at 7 kms from the jurisdiction of municipality having population of 4,00,000 and also sold another agricultural land for ₹ 53 lakhs on 12.12.2024 acquired at a cost of ₹ 46 lakhs on 15 02.2023 situated at 1.5 kms from the jurisdiction of municipality having population of 12,000. What would be the amount of capital gain chargeable to tax in the hands of Mr. A for the assessment year 2025-26? Cost inflation index for F.Y. 2017-18: 272; 2018-19: 280; 2019-20:289; F.Y. 2024-25- 363.** ***(RTP Nov'20, MTP 2Marks, Apr'23)***

(a) Short-term capital gain of ₹ 9.75 lakhs

(b) Short-term capital gain of ₹ 7 lakhs

(c) Long-term capital gain of ₹ 4,12,500

(d) Long-term capital gain of ₹ 5,29,196

Ans: (b)

B

CHAPTER 19: REGISTRATION

CONCEPTS OF THIS CHAPTER	LDR Questions
• Concept of a taxable person. • Liability for GST registration. • Scenarios for compulsory registration. • Persons exempt from registration. • GST registration procedure. • Registration amendment process. • Cancellation and revocation of registration.	LDR **LDR Questions** Q 9 Q 23

QUICK REVIEW OF IMPORTANT CONCEPTS

Taxable Supplies +	Exempt supplies +	Exports +	Inter State supplies =	**Aggregate Turnover**

Applicable threshold limit

States with threshold limit of ₹ 10 lakh for supplier of goods and/or services	Manipur, Mizoram, Nagaland and Tripura
States with threshold limit of ₹ 20 lakh for supplier of goods and/or services	Arunachal Pradesh, Meghalaya, Sikkim, Uttarakhand, Puducherry and Telangana
States with threshold limit of ₹ 20 lakh for supplier of services/both goods and services and threshold limit of ₹ 40 lakh for supplier of goods (Intra-State)	Jammu and Kashmir, Assam, Himachal Pradesh, All other States

Compulsory registration in certain cases

- Persons making any inter-State taxable supply
- Casual taxable person who does not have a fixed place of business in the State or Union Territory from where he wants to make supply
- A person receiving supplies on which tax is payable by recipient on reverse charge basis
- Those e-commerce operators who are notified as liable for tax payment under section 9(5)
- Non-resident taxable persons who do not have a fixed place of business in India
- Persons who are required to deduct tax under section 51 (TDS)
- A person who supplies on behalf of some other taxable person (i.e. an Agent of some Principal)
- Suppliers other than notified undersection 9(5) who supply through an e-commerce operator
- Every e-commerce operator who is required to collect TCS
- Every person supplying OIDAR services from a place outside India to a person in India other than a registered person
- Input Service Distributor, whether or not separately registered
- Person supplying online money gaming from a place outside India to a person in India
- Person/ class of persons notified by the Central/ State Government

Persons not liable for registration

- Person engaged exclusively in supplying goods/ services/ both not liable to tax/ wholly exempt from tax
- Agriculturist limited to supply of produce out of cultivation of land
- Persons making only reverse charge supplies
- Persons making inter-State supplies of taxable services up to ₹ 20 lakh**

- Persons making inter-State taxable supplies of notified handicraft goods and notified hand-made goods up to ₹ 20 lakh**
- Casual Taxable Persons making inter-State taxable supplies of notified handicraft goods and notified hand-made goods up to ₹ 20 lakh**
- Persons making intra-State supplies of goods through an ECO with aggregate turnover not exceeding threshold limit and not making supply in more than one State/UT, with one enrolment no.
- Persons making supplies of services through an ECO [other than supplies specified under section 9(5)] with aggregate turnover up to ₹ 20 lakh**
- **₹10 lakh in case of Special Category States of Mizoram, Tripura, Manipur and Nagaland

Where and by when to apply for registration?

Person who is liable to be registered under section 22 or section 24	**A casual taxable person or a non-resident taxable person**
• in every such State/UT in which he is so liable	• in every such State/UT in which he is so liable
• within 30 days from the date on which he becomes liable to registration	• at least 5 days prior to the commencement of business

Effective date of registration

Application submitted **within 30 days** of the applicant becoming liable to registration= Effective date is the date on which he becomes liable to registration

Application submitted after **30 days** of the applicant becoming liable to registration =Effective date is date of grant of registration

Amendment of Registration

1. Changes in non-core registration details can be made by the taxable person without tax authority approval.
2. For core information changes, the taxable person must apply within 15 days of the change, and the Proper Officer will approve it within 15 days
3. Non-core field amendments require no officer approval and can be made directly on the portal.

Cancellation or suspension of registration and revocation of cancellation of registration

Registration Cancellation

Can be initiated by the registered person or the Proper Officer. Reasons include:

- Business discontinued, transferred, amalgamated, demerged, or otherwise disposed of.
- Change in business constitution.
- Taxable person no longer required to register or opts out of voluntary registration.

Cancellation by Proper Officer

- Registered person violates prescribed provisions.
- Non-filing of returns for 6 consecutive months or 2 tax periods (over 3 months delay for composition taxpayers).
- Voluntarily registered person fails to commence business within 6 months of registration.
- Registration obtained through fraud, misstatement, or suppression of facts.

Suspension of Registration

The Proper Officer may suspend registration while cancellation proceedings are pending

Revocation of cancellation

1. If registration is cancelled Suo-motu, the taxable person may apply for revocation within 90 days (extendable by 180 days by a Commissioner or authorized officer) of the cancellation order.
2. Before applying, the person must rectify defaults, file pending returns, and pay dues.
3. The officer may revoke the cancellation if satisfied.
4. If rejecting the request, the officer must issue notice and provide a hearing.
5. Revocation is deemed upon filing pending GST returns unless cancelled under Rule 22 of the CGST Rules.

Question & Answers

Question 1

What is the validity period of the registration certificate issued to a casual taxable person and non-resident taxable person?*(MTP 5 Marks, Mar'22, SM)*

Answer 1

In terms of section 27(1) of the CGST Act, 2017 read with proviso thereto, the certificate of registration issued to a "casual taxable person" or a "non-resident taxable person" shall be valid for a period specified in the application for registration or 90 days from the effective date of registration, whichever is earlier. However, the proper officer, at the request of the sa id taxable person, may extend the validity of the aforesaid period of 90 days by a further period not exceeding 90 days.

Question 2

Under the provision of section 29(1) of CGST Act, 2017 read with rule 21A of CGST Rules, 2017 related to suspension of registration if the registered person has applied for cancellation of registration, what is the period and manner of suspension of registration ? *(PYP 5 Marks, Jan'21)*

Answer 2

Where a registered person has applied for cancellation of registration, the registration shall be deemed to be suspended from:

(a) the date of submission of the application or

(b) the date from which the cancellation is sought, whichever is later, pending the completion of proceedings for cancellation of registration.

Such person shall not make any taxable supply during the period of suspension and shall not be required to furnish any return.

The expression "shall not make any taxable supply" mean that the registered person shall not issue a tax invoice and, accordingly, not charge tax on supplies made by him during the suspension period.

Question 3

Answer the following, after reading the below given paragraph:

(i) Briefly discuss the relevant provision

(ii) decide the correct conclusion and

(iii) determine the validity of the given advice (Correct/Incorrect)

Dharun provides service as a business facilitator to Zio Bank Limited by facilitating in opening of bank accounts to villagers in its rural branches in Punjab and earned a commission of ₹ 22 lakh in the month of April, 20XX. So far he is not registered under GST. Dharun's tax consultant advised him that he is liable for registration under GST as his gross receipts exceeded ₹ 20 lakh. Dharun has no other receipt/ business activity other than the above.*(PYP 2 Marks, Nov'22)*

Answer 3

Services by a business facilitator to a banking company with respect to accounts in its rural area branch is exempt from GST.

Since in the given case, Dharun is engaged exclusively in providing the exempt services, it is not liable to obtain registration even though his aggregate turnover exceeds ₹ 20 lakh.

Thus, the advice given by his tax consultant is not correct.

EXAM INSIGHTS: Service by a business facilitator to a banking company with respect to accounts in its rural area branch has been wrongly considered as taxable on reverse charge basis by large number of examinees. However, the said service is exempt under GST law.

Question 4

Does cancellation of registration impose any tax obligations on the person whose registration is so cancelled?
(MTP 5 Marks, Apr'22, MTP 3 Marks, Aug'18, SM)

Answer 4

Yes, as per section 29(5) of the CGST Act, 2017, every registered person whose registration is cancelled shall pay an amount, by way of debit in the electronic credit ledger or electronic cash ledger, equivalent to the credit of input tax in respect of inputs held in stock and inputs contained in semi-finished or finished goods held in stock or capital goods or plant and machinery on the day immediately preceding the date of such cancellation or the output tax payable on such goods, whichever is higher.

Question 5

Determine the effective date of registration in following cases:

(a) The aggregate turnover of Dhampur Footwear Industries of Delhi has exceeded the applicable threshold limit of ₹ 40 lakh on 1st September. It submits the application for registration on 20th September. Registration certificate is granted to it on 25 th September.

(b) Mehta Teleservices is an architect in Lucknow. Its aggregate turnover exceeds ₹ 20 lakh on 25th October. It submits the application for registration on 27th November. Registration certificate is granted to it on 5th December.

(MTP 6 Marks, Mar'23, MTP 6 Marks May'20, MTP 4 Marks Oct'19, SM)

Answer 5

(a) Every supplier becomes liable to registration if his turnover exceeds the applicable threshold limit [₹ 40 lakh in this case] in a finacial year. Since in the given case, the turnover of Dhampur Industries exceeded ₹ 40 lakh on 1st September, it becomes liable to registration on said date.
Further, since the application for registration has been submitted within 30 days from such date, the registration shall be effective from the date on which the person becomes liable to registration. Therefore, the effective date of registration is 1st September.

(b) Since in the given case, the turnover of Mehta Teleservices exceeds the applicable threshold limit [₹ 20 lakh] on 25th October, it becomes liable to registration on said date.
Further, since the application for registration has been submitted after 30 days from the date such person becomes liable to registration, the registration shall be effective from the date of grant of registration. Therefore, the effective date of registration is 5th December.

Question 6

Viv Tsu Limited, a registered entity under GST has demerged its operations with effect from 31st October, 2024. The registration of Viv Tsu Limited has been cancelled suo-motu by the Proper Officer. The order of cancellation of registration was passed on 4th November, 2024 and was served on 7th November, 2024.
Viv Tsu Limited wishes to apply for revocation of cancellation of registration on 4th February, 2025. The tax consultant of Viv Tsu Limited advised that application for revocation of cancellation or registration is time barred and hence not valid in law.
You are required to examine the technical veracity of the advice given by Tax Consultant of Viv Tsu Limited.
(RTP Sep'24)

Answer 6

A registered person, whose registration is cancelled by the proper officer on his own motion, may, subject to the provisions of rule 10B of the CGST Rules, 2017, submit an application for revocation of cancellation of registration, in prescribed form, to such proper officer, within a period of 90 days from the date of the service of the order of cancellation of registration.
However, such period may, on sufficient cause being shown, and for reasons to be recorded in writing, be extended by the Commissioner or an officer authorised by him in this behalf, not below the rank of Additional Commissioner or Joint Commissioner, as the case may be, for a further period not exceeding 180 days.

Thus, in the given case, Viv Tsu Limited can apply for revocation of cancellation of registration within a period of 90 days from the date of the service of the order of cancellation of registration, i.e. within 90 days from 7th November, 2024.

The application submitted for revocation of cancellation of registration is valid in law as the same has been submitted within the prescribed time limits.

Thus, the advice given by Tax Consultant of Viv Tsu Limited is not valid in law.

Question 7

Examine whether the supplier is liable to get registered in the following independent cases: -

(i) Aadi of Assam is exclusively engaged in intra-State supply of taxable services. His aggregate turnover in the current financial year is ₹ 25 lakhs.

(ii) Atri of Assam is engaged in intra-State supply of both taxable goods and services. His aggregate turnover in the current financial year is ₹ 30 lakhs. *(MTP 6 Marks, Apr'21)(SM)*

Answer 7

As per section 22 of the CGST Act, 2017 read with Notification No. 10/2019 CT dated 07.03.2019, a supplier is liable to be registered in the State/Union territory from where he makes a taxable supply of goods and/or services, if his aggregate turnover in a financial year exceeds the threshold limit. The threshold limit for a person making exclusive taxable supply of services or supply of both goods and services is as under: -

(a) ₹ 10 lakhs for the Special Category States of Mizoram, Tripura, Manipur and Nagaland.

(b) ₹ 20 lakhs for the rest of India.

(i) Though Audi is dealing in Assam, he is not entitled for higher threshold limit for registration as the same is applicable only in case of exclusively supply of goods and he is exclusively engaged in providing services. Thus, the applicable threshold limit for registration in this case is ₹ 20 lakhs and hence, Audi is liable to get registered under GST.

(ii) Since Atri is engaged in supply of both taxable goods and services, the applicable threshold limit for registration in his case is Rs. 20 lakhs. Thus, Atri is liable to get registered under GST as his turnover is more than the threshold limit.

Question 8

Examine whether the liability to register compulsorily under section 24 of the CGST Act, 2017 arises in each of the independent cases mentioned below:

(1) Heera, a supplier in Haryana, is exclusively engaged in supply of potatoes produced out of cultivation of his own land, within Haryana and also outside Haryana.

(2) Aanya of Telangana is exclusively engaged in intra-State supply of toys. Its aggregate turnover in the current financial year is ₹ 22 lakh.*(RTP Nov'21)*

Answer 8

(1) Section 24 of the CGST Act, 2017 provides that persons making any inter -State taxable supply of goods are required to obtain registration compulsorily under GST laws irrespective of the quantum of aggregate turnover.

However, as per section 23 of the CGST Act, 2017, an agriculturist, to the extent of supply of produce out of cultivation of land, is not liable to registration.

Heera is exclusively engaged in cultivation and supply of potatoes. Thus, he is not liable to registration irrespective of the fact that he is engaged in making inter -State supply of goods. Further, Heera will not be liable to registration, in the given case, even if his turnover exceeds the threshold limit.

(2) As per section 22 of the CGST Act, 2017 read with Notification No. 10/2019 CT dated 07.03.2019, a supplier is liable to be registered in the State/Union territory from where he makes a taxable supply of goods and/or services, if his aggregate turnover in a financial year exceeds the threshold limit. The threshold limit for a person making exclusive intra-State taxable supplies of goods is as under:-

(a) ₹ 10 lakh for the Special Category States of Mizoram, Tripura, Manipur and Nagaland.

(b) ₹ 20 lakh for the States, namely, States of Arunachal Pradesh, Meghalaya, Puducherry, Sikkim, Telangana and Uttarakhand.

(c) ₹ 40 lakh for rest of India except persons engaged in making supplies of ice cream and other edible ice, whether or not containing cocoa, Pan masala and Tobacco and manufactured tobacco substitutes.

Since Aanya is making taxable supplies from Telangana, she will not be eligible for higher threshold limit available in case of exclusive supply of goods. The applicable threshold limit for registration for Aanya in the given case is ₹ 20 lakh. Thus, she is liable to get registered under GST.

Question 9 — LDR

Mr. Raj of Rajasthan intends to start business of supply of building material to various construction sites in Rajasthan. He has taken voluntary registration under GST in the month of April. However, he has not commenced the business till December due to lack of working capital. The proper officer suo-motu cancelled the registration of Mr. Raj. You are required to examine whether the action taken by proper officer is valid in law?

Mr. Raj has applied for revocation of cancellation of registration after 40 days from the date of service of the order of cancellation of registration. Department contends that application for revocation of cancellation of registration can only be made within 30 days from the date of service of the order of cancellation of registration. You are required to comment upon the validity of contentions raised by Department.

(MTP 5 Marks, Apr'24, RTP May '22)

Answer 9

The proper officer may cancel the registration of a person from such date, including any retrospective date, as he may deem fit, where,-

(a) a registered person has contravened the prescribed provisions; or

(b) a person paying tax under composition scheme has not furnished returns for a financial year beyond 3 months from due date of furnishing retun; or

(c) any registered person, other than a person specified in clause (b), has not furnished returns for a prescribed period; or

(d) any person who has taken voluntary registration has not commenced business within six months from the date of registration; or

(e) registration has been obtained by means of fraud, wilful misstatement, or suppression of facts:

Thus, in view of the above-mentioned provisions, suo-motu cancellation of registration of Mr. Raj by proper officer is valid in law since Mr. Raj, a voluntarily registered person, has not commenced his business within 6 months from the date of registration.

Further, where the registration of a person is cancelled suo-motu by the proper officer, such registered person may, subject to the provisions of rule 10B, apply for revocation of the cancellation of registration to such proper officer, within 90 days from the date of service of the order of cancellation of registration.

However, the said period of 90 days may, on sufficient cause being shown and for reasons to be recorded in writing, be extended by the Commissioner or an officer authorised by him in this behalf, not below the rank of Additional Commissioner or Joint Commissioner, as the case may be, for a further period not exceeding 180 days.

Thus, considering the above provisions, the contention of Department is not valid in law as he has applied for revocation within the time limit of 90 days.

Question 10

Examine whether the supplier of goods is liable to get registered in the following independent cases:

(i) Rudra Builders of Rohini, Delhi is exclusively engaged in intra-State taxable supply of building bricks. It's aggregate turnover in the current financial year is ₹ 23 lakh.

(ii) Heera of Himachal Pradesh is exclusively engaged in intra-State taxable supply of footwear. His turnover in the current financial year (FY) from Himachal Pradesh showroom is ₹ 32 lakh. He has another showroom in Nagaland with a turnover of ₹ 11 lakh in the current FY.

(RTP Nov'22, MTP 5 Marks, Mar'24)

Answer 10

As per section 22 of the CGST Act, 2017 read with Notification No. 10/2019 CT dated 07.03.2019, a supplier is liable to get registered in the State/Union territory from where he makes a taxable supply of goods and/or services, if his aggregate turnover in a financial year exceeds the threshold limit. The threshold limit for a person making exclusive intra-State taxable supplies of goods is as under: -

(a) ₹ 10 lakh for the Special Category States of Mizoram, Tripura, Manipur and Nagaland.

(b) ₹ 20 lakh for the States, namely, States of Arunachal Pradesh, Meghalaya, Puducherry, Sikkim, Telangana and Uttarakhand.

(c) ₹ 40 lakh for rest of India except persons engaged in making supplies of fly ash bricks/blocks, building bricks, bricks of fossil meals, earthen/roofing tiles, ice cream and other edible ice, whether or not containing cocoa, Pan masala and Tobacco and manufactured tobacco substitutes.

In the light of the afore-mentioned provisions, the answer to the independent cases is as under:

(i) The benefit of enhanced threshold limit of registration of ₹ 40 lakh is not applicable for Rudra's brothers even though it is exclusively engaged in intra-State taxable supply of goods in Delhi as it is engaged in making supplies of building bricks. Thus, the applicable threshold limit for registration for Rudra Builders in the given case is ₹ 20 lakh. Thus, it is liable to get registered under GST as it's turnover is more than the threshold limit.

(ii) Heera could have been eligible for enhanced threshold limit of turnover for registration, i.e. ₹ 40 lakh as he is exclusively engaged in intra-State supply of goods. However, since Heera is engaged in supplying footwear from a Special Category State i.e. Nagaland, the threshold limit gets reduced to ₹ 10 lakh. Thus, Heera is liable to get registered under GST as his turnover exceeds ₹10 lakh. Further, he is required to obtain registration in both Himachal Pradesh and Nagaland as he is making taxable supplies from both the States.

Question 11

Examine the following cases and explain with reasons whether the supplier of goods is liable to get registered in GST:

(i) Krishna of Himachal Pradesh is exclusively engaged in intra-State taxable supply of readymade suits. His turnover in the current financial year from Himachal Pradesh showroom is 25 lakh. He has two more showrooms one in Manipur & another in Sikkim with a turnover of ₹ 15 lakh and ₹ 18 lakh respectively in the current financial year.

(ii) Viwitsu of Telangana is exclusively engaged in intra-State taxable supply of footwears. His aggregate turnover in the current financial year is ₹ 25 lakh:

(iii) Aakash of Uttar Pradesh is exclusively engaged in intra-State supply of pan masala. His aggregate turnover in the current financial year is ₹ 30 lakh. ***(PYP 5 Marks, Jul'21)***

Answer 11

Every person engaged in making a taxable supply is required to obtain registration if his aggregate turnover exceeds ₹ 20 lakh in a financial year. An enhanced threshold limit for registration of ₹ 40 lakh is available to persons engaged exclusively in intra-State supply of goods in specified States.

(i) The applicable threshold limit for registration gets reduced to ₹ 10 lakh in case a person is engaged in making taxable supply from a Special Category State.
Since Krishna is making taxable supply from Manipur – a Special Category State, the applicable threshold limit will get reduced to ₹ 10 lakh. Thus, it is liable to be registered under GST as its aggregate turnover exceeds the said threshold limit.

(ii) Since Viwitsu is exclusively engaged in intra-State supply of goods in Telangana, which is not a specified State for enhanced threshold limit, the applicable threshold limit for registration is ₹ 20 lakh.
Thus, Viwitsu is liable to be registered under GST as its aggregate turnover exceeds the said threshold limit.

(iii) Though the enhanced threshold limit for registration of ₹ 40 lakh is available to Uttar Pradesh, the same will not be applicable if the person is engaged in supply of pan masala.
In view of the same, the applicable threshold limit for Aakash is ₹ 20 lakh. Thus, it is liable to be registered under GST as its aggregate turnover exceeds the said threshold limit.

Question 12

Q Ltd. is engaged exclusively in supply of taxable goods from the following states. The particulars of intra-state supplies for the month of May are as follows:

State	Turnover (₹)
Madhya Pradesh	5,00,000
Gujarat	14,00,000
Tripura	12,00,000

(i) Q Ltd. seeks to know whether it is liable for registration under GST. Give your explanation.
(ii) Will your answer be different if Q Ltd. supplies only petrol & diesel from Tripura instead of any other taxable goods? *(PYP 4 Marks, Dec'21)*

Answer 12

Every person engaged in making a taxable supply is required to obtain registration if his aggregate turnover exceeds ₹ 20 lakh in a financial year. An enhanced threshold limit for registration of ₹ 40 lakh is available to persons engaged exclusively in intra-State supply of goods in specified States. However, the applicable threshold limit for registration gets reduced to ₹ 10 lakh in case a person is engaged in making supply from a specified Special Category State provided such supply is a taxable supply.

(i) Since Q Ltd. is making supply of taxable goods5from Tripura – a specified Special Category State, the applicable threshold limit will get reduced to ₹ 10 lakh.
Thus, it is liable to be registered under GST as its aggregate turnover [₹ 31 lakh] exceeds the said threshold limit.

(ii) In case Q Ltd. is making supply of non-taxable goods [petrol and diesel] from Tripura, the applicable threshold limit will not be reduced to ₹ 10 lakh; enhanced threshold limit of ₹ 40 lakh will be applicable.

Thus, it is not liable to be registered under GST as its aggregate turnover [₹ 31 lakh] does not exceed the said threshold limit.

[5]It has been assumed that Q Ltd. is not engaged in making supplies of ice cream and other edible ice, whether or not containing cocoa [2105 00 00], Pan masala [2106 90 20] and all goods of Chapter 24, i.e. Tobacco and manufactured tobacco substitutes

Question 13

Mr. Q, a casual taxable person of Gujarat state is a trader of taxable notified handicraft goods. It makes supplies to the states of Maharashtra, Rajasthan and Andhra Pradesh. Turnover for October is ₹ 18 Lakh.
(i) Explain the provisions of registration for casual taxable person under GST. Examine whether Mr. Q is liable for registration or not?
(ii) What will be the answer if Mr. Q makes trading in taxable notified products instead of taxable notified handicraft goods which involves 75% making on machine and 25% by hand?
(PYP 5 Marks, Dec'21)

Answer 13

(i) A casual taxable person is required to obtain compulsory registration under GST irrespective of the quantum of its aggregate turnover.

However, a threshold limit of ₹ 20 lakh (₹ 10 lakh in case of specified Special Category States) is available for registration to a casual taxable person who:

(i) is making inter-State taxable supplies of notified handicraft goods and notified hand-made goods,
(ii) is availing the benefit of exemption from registration available to inter-State supply of above-mentioned goods upto the aggregate turnover of ₹ 20 lakh (₹ 10 lakh in case of specified Special Category States), and
(iii) has obtained a PAN and
(iv) has generated an e-way bill.

In the given case, since Mr. Q is engaged in supplying notified handicraft goods and its aggregate turnover6 does not exceed ₹ 20 lakh, he will not be liable to registration provided he fulfills other conditions specified herein.

(ii) In case Mr. Q is engaged in trading of notified products which are predominantly made by machine, he will not be eligible for the exemption from registration under aforesaid provisions and needs to take compulsory (mandatory) registration.[6]It has been assumed that Mr. Q has started supply of goods in October itself.

Question 14

State any five circumstances under which the proper officer can cancel the registration on his own under the CGST Act, 2017. *(PYP 5 Marks, May'22, Jan'21)*

Answer 14

Answer to Alternative

Circumstances under which the proper officer can cancel the registration on his own under the CGST Act, 2017:

(i) A registered person has contravened any of the following prescribed provisions of the GST law:
- (a) he does not conduct any business from the declared place of business.
- (b) he issues invoice/bill without supply of goods/services in violation of the provisions of GST law.
- (c) he violates the provisions of anti-profeetering.
- (d) he violates the provisions relating to furnishing of bank details.
- (e) he avails ITC in violation of the provisions of the GST law.
- (f) furnishes the details of outward supplies in GSTR-1 for one or more tax periods which is in excess of the outward supplies declared by him in his valid return for the said tax periods.
- (g) he violates the provision relating to restrictions on use of amount available in electronic credit ledger

(ii) A person paying tax under composition levy has not furnished returns for 3 consecutive tax periods.

(iii) A registered person paying tax under regular scheme has not furnished returns for continuous period of 6 months.

(iv) Voluntarily registered person has not commenced the business within 6 months from the date of registration.

(v) Registration was obtained by means of fraud, wilful misstatement or suppression of facts.

Question 15

Explain the procedure for revocation of cancellation of registration where the registration of a person is cancelled suo-motu by the proper officer as per the provisions of CGST Act, 2017.
(PYP 5 Marks, Nov'23)

Answer 15

Where the registration of a person is cancelled suo-motu by the proper officer, such registered person may apply for revocation of the cancellation of registration to such proper officer, within 90 days (or within extended time period) from the date of service of the order of cancellation of registration.

If the proper officer is satisfied that there are sufficient grounds for revocation of cancellation, he may revoke the cancellation of registration, by an order within 30 days of receipt of application and communicate the same to applicant.

Otherwise, he may reject the revocation application. However, before rejecting the application, he has to first issue SCN to the applicant who shall furnish the clarification within 7 working days of service of SCN.

The proper officer shall dispose the application (accept/reject the same) within 30 days of receipt of clarification.

> **EXAM INSIGHTS:** Question requires the examinees to mention the exceptions to rule 86B of CGST Rules, 2017. However, some examinees ended up in writing general answers instead of correct legal provisions.

Question 16

Examine whether the supplier of goods is liable to get registered in the following independent cases: -

(i) Aryabhatt of Assam is exclusively engaged in intra-State taxable supply of readymade garments. His turnover in the current financial year (FY) from Assam showroom is ₹ 12 lakh. He has another showroom

in Manipur with a turnover of ₹ 11 lakh in the current FY.

(ii) **Bharat of Panjim, Goa is exclusively engaged in intra-State taxable supply of shoes. His aggregate turnover in the current financial year is ₹ 22 lakh.**

(iii) **Vikramaditya of Himachal Pradesh is exclusively engaged in intra-State supply of bricks of fossil meals. His aggregate turnover in the current financial year is ₹ 24 lakh.** ***(MTP 6 Marks, Sep'22)***

Answer 16

A supplier is liable to get registered in the State/Union territory from where he makes a taxable supply of goods and/or services, if his aggregate turnover in a financial year exceeds the threshold limit. The threshold limit for a person making exclusive intra-State taxable supplies of goods is as under: -

(a) ₹ 10 lakh for the Special Category States of Mizoram, Tripura, Manipur and Nagaland.

(b) ₹ 20 lakh for the States, namely, States of Arunachal Pradesh, Meghalaya, Puducherry, Sikkim, Telangana and Uttarakhand.

(c) ₹ 40 lakh for rest of India except persons engaged in making supplies of fly ash bricks/blocks, building bricks, bricks of fossil meals, earthen/roofing tiles, ice cream and other edible ice, whether or not containing cocoa, Pan masala and Tobacco and manufactured tobacco substitutes.

In the light of the afore-mentioned provisions, the answer to the independent cases is as under**: -**

(i) Aryabhatt is eligible for enhanced threshold limit of turnover for registration, i.e. ₹ 40 lakh as he is exclusively engaged in intra-State supply of goods. However, since Aryabhatt is engaged in supplying readymade garments from a specified Special Category State i.e. Manipur also, the threshold limit gets reduced to ₹ 10 lakh.

Thus, Aryabhatt is liable to get registered under GST as his turnover exceeds ₹ 10 lakh. Further, he is required to obtain registration in both Assam and Manipur as he is making taxable supplies from both the States.

(ii) The applicable threshold limit for registration for Bharat in the given case is ₹ 40 lakh as he is exclusively engaged in intra-State taxable supply of goods in Goa. Thus, he is not liable to get registered under GST as his turnover is less than the applicable threshold limit.

(iii) Vikramaditya being exclusively engaged in supply of bricks of fossil meals is not eligible for enhanced threshold limit of ₹ 40 lakh. The applicable threshold limit for registration in this case is ₹20 lakh. Thus, Vikramaditya is liable to get registered under GST as his aggregate turnover exceeds the threshold limit for registration.

Question 17

"Aadhaar authentication is not required for persons who are already registered under GST." Examine and discuss the correctness of the statement. You are required to elaborate the relevant legal provisions.
(RTP Nov'22)

Answer 17

The given statement is incorrect. Aadhaar authentication has been made mandatory for the new registrants as well as for the existing registrants. With regard to existing registrants, section 25(6A) of the CGST Act, 2017 stipulates that every registered person shall undergo authentication, or furnish proof of possession of Aadhaar number, in the prescribed form, manner and time. New rule 10B of the CGST Rules, 2017 prescribes the manner in which aadhaar authentication needs to be done by a registered person.

A registered person, who has been issued a certificate of registration under GST, shall undergo authentication of the Aadhaar number of :-

- Proprietor, in the case of proprietorship firm,
- Any partner, in the case of a partnership firm,
- Karta, in the case of a Hindu undivided family,
- Managing director or any whole-time director, in the case of a company,
- Any of the Members of the Managing Committee of an Association of persons or body of individuals or a Society, or
- Trustee in the Board of Trustees, in the case of a Trust; and of the Authorized Signatory,

In order to be eligible for the following purposes:

- for filing of application for revocation of cancellation of registration [Rule 23]
- for filing of refund application in Form RFD-01 [Rule 89]

- for refund of the IGST paid on goods exported out of India [Rule 96]

First proviso to section 25(6A) of the CGST Act, 2017 provides that if an Aadhaar number is not assigned to an existing registered person, such person shall be offered alternate and viable means of identification in the prescribed manner. Such manner has been prescribed by rule 10B of the CGST Rules, 2017 as follows:

If Aadhaar number has not been assigned to the person required to undergo authentication of the Aadhaar number, such person shall furnish the following identification documents, namely: –

(a) his/ her Aadhaar Enrolment ID slip; and

(b) (i) Bank passbook with photograph; or

  (ii) Voter identity card issued by the Election Commission of India; or

  (iii) Passport; or

  (iv) Driving license issued by the Licensing Authority

However, once Aadhaar number is allotted to such person, he shall undergo the authentication of Aadhaar number within a period of 30 days of the allotment of the Aadhaar number.

The afore-said rule 10B shall not be applicable to persons notified under section 25(6D) of the CGST Act, 2017, i.e. to persons exempt from aadhaar authentication.

Question 18

Briefly enumerate the contraventions which make a registered person liable to cancellation of registration, as prescribed under rule 21 of the CGST Rules, 2017. *(RTP May'23)*

Answer 18

Rule 21 of the CGST Rules, 2017 prescribes the contraventions which make a registered person liable to cancellation of registration. As per said rule, the registration granted to a person is liable to be cancelled, if the said person -

(a) does not conduct any business from the declared place of business.

(b) issues invoice/bill without supply of goods/services in violation of the provisions of this Act, or the rules made thereunder.

(c) violates the provisions of section 171 of the CGST Act. Section 171 contains provisions relating to anti-profeetering measure.

(d) violates the provision of rule 10A of the CGST Rules relating to furnishing of bank account details.

(e) avails input tax credit in violation of the provisions of section 16 of the CGST Act or the rules made thereunder.

(f) furnishes the details of outward supplies in Form GSTR-1 as amended in Form GSTR-1A if any, under section 37 of the CGST Act for one or more tax periods which is in excess of the outward supplies declared by him in his valid return under section 39 for the said tax periods.

(g) Violates the provisions of 86B

(h) violates the provisions of third or fourth proviso to rule 23(1).

(i) being a registered person required to file return under section 39(1) of the CGST Act for each month or part thereof (i.e. monthly return filer), has not furnished returns for a continuous period of 6 months.

(j) being a registered person required to file return under proviso to section 39(1) of the CGST Act for each quarter or part thereof (i.e. quarterly return filer), has not furnished returns for a continuous period of 2 tax periods.

Question 19

B Enterprises started its business activities in the month of January, in the State of Karnataka. It provides the following information:

Sr. No.	Particulars	Amount (₹)
1.	**Value of intra-State outward taxable supply of goods**	**7,00,000**
2.	**Value of inter-State outward taxable supply of services**	**6,00,000**
3.	**Value of intra-State outward supply on which tax is payable under reverse charge mechanism.**	**1,00,000**

4.	Value of intra-State outward supply of exempted good from its other place of business in the State of Manipur (under same PAN)	5,00,000

From the information given above, you are required to calculate the aggregate turnover of B Enterprises with necessary explanations and also, specify with reason whether it is liable to get registered under CGST Act or not. *(MTP 6 Marks, Apr'23)*

Answer 19

Computation of aggregate turnover of B Enterprises, Karnataka, for January

Particulars	(₹)
Intra-State outward taxable supply of goods [Aggregate turnover includes value of all taxable supplies.]	7,00,000
Inter-State outward taxable supply of services [Aggregate turnover includes value of inter-State supplies.]	6,00,000
Intra-State outward supply on which tax is payable under reverse charge mechanism [Aggregate turnover includes value of all taxable supplies whether taxable under reverse charge or forward charge.]	1,00,000
Intra-State outward supply of exempted goods from Manipur [Aggregate turnover includes value of exempt supplies made in all the States under the same PAN]	5,00,000
Aggregate turnover	**19,00,000**
Persons making any inter-State taxable supply of goods are required to obtain compulsory registration, but in case of inter-State supply of taxable services, threshold limit of ₹ 20 lakh is available. Such threshold limit gets reduced to ₹ 10 lakh in case of specified Special Category State provided taxable supply is being made therefrom. Since B Enterprises is making exempt supplies from Manipur - a specified Special Category State, the applicable threshold limit of registration for B Enterprises is ₹ 20 lakh. Thus, it is not liable to be registered as its aggregate turnover does not exceed the threshold limit.	

Question 20

P Ltd, a registered person provided following information for the month of October, 20XX:

Particulars	Amount (₹)
Intra-State outward supply	8,00,000
Inter-State exempt outward supply	4,00,000
Turnover of exported goods	20,00,000
Payment of IGST	1,20,000
Payment of CGST and SGST	45,000 each
Payment of custom duty on export	40,000
Payment made for availing GTA services	3,00,000

GST is payable on Reverse Charge for GTA services. Explain the meaning of aggregate turnover u/s 2(6) of the CGST Act and compute the aggregate turnover of P Ltd. for the month of October 20XX. All amounts are exclusive of GST. *(PYP 5 Marks, Jul'21)*

Answer 20

The term aggregate turnover means the aggregate value of:

(i) all taxable supplies

(ii) exempt supplies,

(iii) exports of goods or services or both and

(iv) inter-State supplies of persons having the same Permanent Account Number, to be computed on all India basis but excluding

- **(i)** central tax, State tax, Union territory tax, integrated tax and cases.
- **(ii)** the value of inward supplies on which tax is payable by a person on reverse charge basis

Computation of aggregate turnover of P Ltd. for the month of October, 20XX

Particulars	Amount (₹)
In terms of the definition of the aggregate turnover given above, the aggregate turnover of P Ltd. has been computed as follows:	
Intra-State outward supply	8,00,000
Inter-State exempt outward supply	4,00,000
Turnover of exported goods	20,00,000
Payment of IGST	Nil
Payment of CGST and SGST	Nil
Payment of customs duty on export	40,000
Payment made under reverse charge for availing GTA services	Nil
Aggregate turnover	**32,40,000**

Question 21

Wiwtsu started his business activities in the month of February 20XX in the State of Orissa. He provided the following details:

Particulars	Amount in ₹
(i) Outward supply of petrol (Intra State)	**4,00,000**
(ii) Transfer of exempt goods to his branch in Rajasthan (Inter- State)	**2,00,000**
(iii) Outward supply of taxable goods by his branch in Uttar Pradesh (Intra State)	**5,00,000**
(iv) Outward supply of services on which tax is payable under RCM by the recipient of services (Intra-State)	**6,00,000**
(v) Inward supply of services on which tax is payable under RCM (Intra- State)	**2,00,000**

From the information given above, compute the aggregate turnover of Wiwtsu and also decide whether he is required to get registration under GST. Assume that the amounts given above are exclusive of taxes. ***(PYP 5 Marks, Nov'22)***

Answer 21

Particulars	**Amount (₹)**
Computation of aggregate turnover of Wiwtsu	
Outward supply of petrol [Supply of petrol being a non-taxable supply is an exempt supply. Value of exempt supply is includible in aggregate turnover.]	4,00,000
Inter-State stock transfer of exempt goods [Supply of taxable/exempt goods between distinct persons is includible.]	2,00,000
Outward supply of taxable goods from Uttar Pradesh branch [Value of outward supplies under same PAN are includible.]	5,00,000
Outward supply of services taxable under reverse charge [Includible in aggregate turnover.]	6,00,000
Inward supply of services taxable under reverse charge [Excludible from the aggregate turnover.]	--
Aggregate turnover	**17,00,000**

For a supplier engaged in supply of goods and services from the States of Orissa and Uttar Pradesh, the threshold limit of aggregate turnover to obtain registration is ₹ 20 lakh. However, a person required to pay tax under reverse charge has to obtain registration compulsorily irrespective of the quantum of turnover.

Since in the given case, Wiwtsu is required to pay tax under reverse charge, it is liable to obtain registration compulsorily irrespective of his quantum of turnover.

EXAM INSIGHTS: Although aggregate turnover was correctly worked out by most of the examinees but registration requirements were not correctly stated by them. They were ignorant of the provision that a person required to pay tax under reverse charge has to obtain registration compulsorily irrespective of the quantum of turnover.

Question 22

Examine whether the supplier of goods is liable to get registered in the following independent cases:

(i) Raghav of Assam is exclusively engaged in intra-State taxable supply of readymade garments. His turnover in the current financial year (FY) from Assam showroom is ₹ 33 lakh. He has another showroom in Tripura with a turnover of ₹ 11 lakh in the current FY.

(ii) Pulkit of Panjim, Goa is exclusively engaged in intra-State taxable supply of shoes. His aggregate turnover in the current financial year is ₹ 22 lakh.

(iii) Harshit of Himachal Pradesh is exclusively engaged in intra-State supply of pan masala. His aggregate turnover in the current financial year is ₹ 24 lakh. ***(MTP 6 Marks, Nov'21 & Oct '23, SM)***

Answer 22

As per section 22 read with Notification No. 10/2019 CT dated 07.03.2019, a supplier is liable to be registered in the State/Union territory from where he makes a taxable supply of goods and/or services, if his aggregate turnover in a financial year exceeds the threshold limit. The threshold limit for a person making exclusive intra-State taxable supplies of goods is as under: -

(a) ₹10lakh for the Special Category States of Mizoram, Tripura, Manipur and Nagaland.

(b) ₹ 20 lakh for the States, namely, States of Arunachal Pradesh, Meghalaya, Puducherry, Sikkim, Telangana and Uttarakhand.

(c) ₹ 40 lakh for rest of India except persons engaged in making supplies of ice cream and other edible ice, whether or not containing cocoa, Pan masala and Tobacco and manufactured tobacco substitutes.

In the light of the afore-mentioned provisions, the Answer to the independent cases is as under: -

(i) Raghav is eligible for a higher threshold limit of turnover for registration, i.e. ₹ 40 lakh as he is exclusively engaged in intra-State supply of goods. However, since Raghav is engaged in supplying readymade garments from a Special Category State i.e. Tripura, the threshold limit gets reduced to ₹ 10 lakh. Thus, Raghav is liable to get registered under GST as his turnover exceeds ₹10 lakh. Further, he is required to obtain registration in both Assam and Tripura as he is making taxable supplies from both the States.

(ii) The applicable threshold limit for registration for Pulkit in the given case is ₹ 40 lakh as he is exclusively engaged in intra-State taxable supply of goods in Goa. Thus, he is not liable to get registered under GST as his turnover is less than the threshold limit.

(iii) Harshit being exclusively engaged in supply of pan masala is not eligible for higher threshold limit of ₹40 lakh. The applicable threshold limit for registration in this case is ₹20 lakh. Thus, Harshit is liable to get registered under GST.

Question 23

LDR

Right Oils, an unregistered entity located in U.P. is engaged in supply of machine oil and high-speed diesel. During the month of April, it supplied machine oil in U.P. amounting to ₹ 15,00,000. Also, it supplied high speed diesel in U.P. amounting to ₹ 10,00,000. Further, it supplied machine oil in Punjab from its branch located in Punjab amounting to ₹ 10,00,000.

Note: All the amounts mentioned above are excluding GST.

(i) Determine whether Right Oils is liable for registration.

(ii) What will be your answer if, Right Oils supplies the high speed diesel in U.P. in the capacity of an agent of Center Oils Ltd., (non- registered), where invoices to customers are issued in name of Right oils? Would your answer be different in case if Center Oils Ltd. is registered entity? ***(MTP 5 Marks Nov'24, SM)***

Answer 23

(i) A supplier is liable to be registered in the State/Union territory from where he makes a taxable supply of goods and/or services, if his aggregate turnover in a financial year exceeds the threshold limit. The threshold limit for a person making exclusive intra-State taxable supplies of goods is as under:-

(a) ₹ 10 lakh for the Special Category States of Mizoram, Tripura, Manipur and Nagaland.

(b) ₹ 20 lakh for the States, namely, States of Arunachal Pradesh,Meghalaya, Puducherry, Sikkim, Telangana and Uttarakhand.

(c) ₹ 40 lakh for rest of India except persons engaged in making supplies of ice cream and other edible ice, whether or not containing cocoa, pan masala and tobacco and manufactured tobacco substitutes, fly ash bricks; fly ash aggregates; fly ash blocks, bricks of fossil meals or similar siliceous earths, building bricks, earthen or roofing tiles.

The threshold limit for a person making exclusive taxable supply of services or supply of both goods and services is as under:-

(a) ₹10 lakh for the Special Category States of Mizoram, Tripura,Manipur and Nagaland.

(b) ₹20 lakh for the rest of India.

Aggregate turnover includes the aggregate value of:

1. all taxable supplies,
2. all exempt supplies,
3. exports of goods and/or services and
4. all inter-State supplies of persons having the same PAN.

The above aggregate turnover is computed on all India basis. Further, the aggregate turnover excludes central tax, State tax, Union territory tax, integrated tax and cess. Moreover, the value of inward supplies on which tax is payable under reverse charge is not taken into account for calculation of 'aggregate turnover'.

CGST is not leviable on five petroleum products i.e. petroleum crude, motor spirit (petrol), high speed diesel, natural gas and aviation turbine fuel. Exempt supply includes non-taxable supply. Thus, supply of high speed diesel in U.P., being a non-taxablesupply, is an exempt supply and is, therefore, includible while computing the aggregate turnover.

In the backdrop of the above-mentioned discussion, the aggregate turnover of Right Oils for the month of April is computed as under:

S. No.	Particulars	Amount (in ₹)
(i)	Supply of machine oils in U.P.	15,00,000
(ii)	Add: Supply of high speed diesel in U.P.	10,00,000
(iii)	Add: Supply of machine oil made by RightOils from its branch located in Punjab	10,00,000
	Aggregate Turnover	35,00,000

Right Oils is making exclusive supply of goods and hence the threshold limit for registration would be ₹ 40,00,000. Since the aggregate turnover does not exceed ₹ 40,00,000, Right Oils is not liable to be registered till April. However, if in remaining months of the financial year, its turnover exceeds the said limit, then it wouldbe liable to be registered.

(ii) In case Right Oils makes the supply in capacity of an agent of Center Oils Ltd.:

Section 24 of the CGST Act, 2017 provides that an agent who is engaged in making taxable supplying of goods on behalf of other taxable persons, shall be liable to obtain registration irrespective of the threshold turnover limit. However, in the present case, if Right Oils supply high speed diesel on behalf of Center Oil Ltd. in U.P. as its agent where invoices to customers are issued in name of Right Oils, it shall still not be liable to obtain registration in U.P.since section 24 comes into play only when agent or in other capacity is making taxable supply of goods on behalf of taxable persons (principal) whereas in the given case, Right Oils is supplying non-taxable goods on behalf of Center Oils Ltd., who is non-registered.

In case if Center Oils Ltd. is registered entity, then also the answer would remain unchanged as attraction of section 24 of the CGSTAct, 2017, inter-alia, requires that there should be taxable supply by agent and here, Right Oils is supplying non-taxable goods on behalf of Center Oils Ltd.

MULTIPLE CHOICE QUESTIONS (MCQS)

1. **Aanya, an individual, based in Gujarat, is in employment and earning ₹ 10 lakh as salary. She is also providing consultancy services to different organizations on GST implications of business. Her turnover from the supply of such services is ₹ 12 lakh. Determine whether Aanya is liable for taking registration as per provisions of the CGST Act? *(MTP 2 Marks, Apr'22)***

   (a) Yes, as her aggregate turnover is more than ₹ 20 lakh.

   (b) No, as her aggregate turnover is less than ₹ 40 lakh.

   (c) No, as services in the course of employment does not constitute supply and therefore, aggregate turnover is less than ₹ 20 lakh.

(d) Yes, since she is engaged in taxable supply of services.

Ans: (c)

2. Riya & Co., a partnership firm, is engaged in retail trade since 1st April. The firm became liable for registration on 1st October. However, it applied for registration on 10th October and was granted certificate of registration on 5th November.
Determine the effective date of registration of Riya & Co.? (MTP 1 Mark, Jul'24)

(a) 1st April
(b) 1st October
(c) 10th October
(d) 5th November

Ans: (b)

3. Miss Gyati, a jeweller registered under GST in Mumbai, wants to sell her jewellery in a Trade Expo held in Delhi. Which of the following statements is false in his case? (MTP 1 Mark, Aug'24)

(a) She needs to get registration in Delhi as casual taxable person.
(b) She needs to pay advance tax on estimated tax liability.
(c) She needs to mandatorily have a place of business in Delhi.
(d) She needs to file GSTR-1/ IFF and GSTR-3B for Delhi GSTIN for the month or quarter, as the case may be, when she gets registered in Delhi.

Ans: (c)

4. Mr. Jambulal of Himachal Pradesh starts a new business and makes following supplies in the first month-
(i) Intra-State supply of taxable goods amounting to ₹ 17 lakh
(ii) Supply of exempted goods amounting to ₹ 1 lakh
(iii) Inter-State supply of taxable goods amounting to ₹ 1 lakh
Whether he is required to obtain registration? *(MTP 2 Marks, Apr'24) (RTP May'21)*

(a) Mr. Jambulal is liable to obtain registration as the threshold limit of ₹ 10 lakh is crossed.
(b) Mr. Jambulal is not liable to obtain registration as he makes exempted supplies.
(c) Mr. Jambulal is liable to obtain registration as he makes the inter-State supply of goods.
(d) Mr. Jambulal is not liable to obtain registration as the threshold limit of ₹ 20 lakh is not crossed.

Ans: (c)

5. Rama Ltd. has provided following information for the month of September:
(i) Intra-State outward supply ₹ 8,00,000/-
(ii) Inter-State exempt outward supply ₹ 5,00,000/-
(iii) Turnover of exported goods ₹ 10,00,000/-
(iv) Payment made for availing GTA services ₹ 80,000/- Calculate the aggregate turnover of Rama Ltd. *(MTP 2 Marks, Mar'19, RTP Nov'21)*

(a) ₹ 8,00,000/-
(b) ₹ 23,80,000/-
(c) ₹ 23,00,000/-
(d) ₹ 18,00,000/-

Ans: (c)

CA INTER GROUP 2 REVIEWER SAMPLES MAY'25

VIVITSU
STRIVING TOWARDS KNOWLEDGE

SUBJECTS — **PG NO**

CA INTERMEDIATE

VIVITSU

PAPER 4

Cost & Management Accounting Reviewer

Chapter-wise compilation
RTP, MTP and PYP questions

KEY HIGHLIGHTS

- Easy to Hard Difficulty Level
- Importance levels marked as A, B or C
- Reference to all questions
- Quick recap of important concepts
- Exam Insights
- Last Day Revision Questions Marked

APPLICABLE FOR MAY'25, SEPT'25 AND JAN'26

VIVITSU
STRIVING TOWARDS KNOWLEDGE

This book belongs to future,

CA Finalist ______________________________

"You become what you believe."

-Oprah Winfrey

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YOU MUST BE WONDERING

How to Read this book?

Step 1 (01)
Prioritize more time for 'A' chapters in the ABC analysis

Step 2 (02)
Identify key concepts in each chapter.

Step 3 (03)
Solve questions in order, from easy to difficult.

Step 4 (04)
Focus on solving LDR questions during the final revision

Step 1: Prioritize your chapters

Chapters in the index are categorized as A, B, or C based on their importance. Focus more on 'A' chapters, as they carry the most weight, and give adequate attention to 'B' chapters. While all chapters must be covered, this approach helps manage time efficiently for better results.

Step 2: Identify key concept

Identify the key concepts for each chapter using the list provided at the start of the chapter. Ensure you understand them thoroughly. If you struggle with a question, revisit the concepts, review them, and strengthen your understanding before moving forward.

Step 3: Start easy

Start with Question 1, as they progress from easy to difficult, helping you build confidence throughout the chapter. Pay close attention to the “EXAM INSIGHTS” to avoid common mistakes. Questions are segregated topic wise where possible.

Step 4: Last Day Revision (LDR)

Focus on solving LDR questions during the final revision. In the 1.5 days before the exam, prioritize these questions as they cover the most critical concepts from each chapter. You'll find a quick summary of LDR question numbers listed right before each chapter for easy reference.

Table of Contents

ABC Analysis

A Very Important, Read on priority

B Moderately Important

C Less critical but still essential

Ensure you thoroughly read all chapters without skipping any. The ABC analysis is designed to help you prioritize based on past trends, but it should not replace comprehensive preparation.

CHAPTER 4: OVERHEADS-ABSORPTION COSTING METHOD

CONCEPTS OF THIS CHAPTER	LDR Questions
• Overheads: production, administrative, selling & distribution. • Allocation, apportionment, and absorption of overheads. • Under-absorption and over-absorption of overheads; apply in cost computation. • Accounting and control of administrative, selling, and distribution overheads. • Methods to calculate overhead rate.	Q 12 Q 19 Q 23 Q 24

QUICK REVIEW OF IMPORTANT CONCEPTS

I. Classification of Overheads

Overheads are the expenditure which cannot be identified with a particular cost unit. Overheads can be classified as under.

By Function	By Nature,	By Element	By Control
• Factory or Manufacturing or Production Overhead	• Fixed Overheads Overhead	• Indirect Materials	• Controllable costs
• Office and Administrative Overheads	• Variable Overheads Overhead	• Indirect employee cost	• Uncontrollable costs
• Selling and Distribution Overheads	• Semi-Variable Overheads	• Indirect expenses	

II. Methods for Re-apportionment of Overheads

The re-apportionment of service department expenses over the production departments may be carried out by using any one of the following methods:

➢ Methods for Re-apportionment

• Direct re-distribution method • Step method or non-reciprocal method.	• Reciprocal Service method. – Simultaneous Equation method – Trial and error method – Repeated distribution method

III. The steps involved in determining of Machine hour rate is as follows:

- Step 1: Calculate total of overheads apportioned to a production department.
- Step 2: Apportion further these overheads to machines or group of machines in the department.
- Step 3: Allocate machine specific costs (directly identifiable with the machine)
- Step 4: Estimate total productive hours for the machine
- Step 5: Aggregate overheads as apportioned in step-2 and allocated in step-3 and divide it by Estimated total productive hours The resultant figure is machine hour rate
- The resultant figure is machine hour rate

Questions & Answers

Theory Questions

Question 1

EXPLAIN the treatment of over and under absorption of overheads in cost accounts.
(MTP 5 Marks Mar'24,RTP Nov'23)

Answer 1

(a) Treatment of over and under absorption of overheads are:-

(i) Writing off to costing P&L A/c: – Small difference between the actual and absorbed amount should simply be transferred to costing P&L A/c, if difference is large then investigate the causes and after that abnormal loss/ gain shall be transferred to costing P&L A/c.

(ii) Use of supplementary Rate: Under this method the balance of under and over absorbed overheads may be charged to cost of W.I.P., finished stock and cost of sales proportionately with the help of supplementary rate of overhead.

(iii) Carry Forward to Subsequent Year: Difference should be carried forward in the expectation that next year the position will be automatically corrected.

Question 2

Explain Blanket Overhead Rate and Departmental Overhead Rate. How they are calculated? State the conditions required for the application of Blanket Overhead Rate. ***(PYP 5 Marks, Jan'21, SM)***

Answer 2

Blanket Overhead Rate: Blanket overhead rate refers to the computation of one single overhead rate for the whole factory.

This overhead rate is computed as follows:

$$\text{Blanket Rate} = \frac{\text{Total overheads for the factory}}{\text{Total number of units of base for the factory}}$$

Departmental Overhead Rate: It refers to the computation of one single overhead rate for a particular production unit or department.

This overhead rate is determined by the following formula:

$$\text{Departmental overhead Rate} = \frac{\text{Overheads of department or cost centre}}{\text{Corresponding base}}$$

Conditions required for the Application of Blanket Overhead:

A blanket rate should be applied in the following cases:

(1) Where only one major product is being produced.

(2) Where several products are produced, but

  (a) All products pass through all departments; and

  (b) All products are processed for the same length of time in each department.

Question 3

Describe briefly idle time and explain the treatment of idle time in cost accounts in following situations:

(i) The setting up time for the machine in case of Direct Worker Mr. A.

(ii) Normal break time for lunch in case of Indirect Worker Mr. B.

(iii) Time lost due to breakdown of machine in case of Worker Mr. C. ***(PYP 4 Marks May '24)***

Answer 3

The time during which no production is carried-out because the worker remains idle but are paid. In other words, it is the difference between the time paid and the time booked. Idle time can be normal or abnormal.

Situation	Idle Time	Treatment
The setting up time for the machine in case of Direct Worker Mr. A	Normal idle time	It is treated as a part of cost of production. It is to be considered while setting of standard hours or standard rate.
Normal rest time, break time for lunch in case of Indirect Worker Mr. B	Normal idle time	It is to be considered for the computation of overhead rate.
Time lost due to break- down of machines in case of Worker Mr. C	Abnormal idle time	It is to be shown as a separate item in the Costing Profit and Loss Account.

Practical Questions

Question 4

A machine costing ₹ 10 lakhs, was purchased on 01-04-2021. The expected life of the machine is 10 years. At the end of this period its scrap value is likely to be ₹ 10,000. The total cost of all the machines including new one was ₹ 90 lakhs.

The other information is given as follows:

(i) Working hours of the machine for the year was 4,200 including 200 non-productive hours.

(ii) Repairs and maintenance for the new machine during the year was ₹ 6,000.

(iii) Insurance Premium was paid for all the machine ₹ 9,000.

(iv) New machine consumes 8 units of electricity per hour, the rate per unit being ₹ 3.75

(v) The new machine occupies 1/10th area of the department. Rent of the department is Rs.2,400 per month.

(vi) Depreciation is charged on straight line basis.

COMPUTE machine hour rate for the new machine. ***(MTP 5 Marks, Oct'21)***

Answer 4

Computation of machine hour rate of new Machine

	Total (₹)	Per hour (₹)
A. Standing Charges I. Insurance Premium ₹ 9,000 × $\frac{1}{9}$	1,000	
II. Rent $\frac{1}{10}$ × ₹ 2,400 ×12 months	2,880	
	3,880	**0.97***
B. Machine expenses		
I. Repairs and Maintenance (₹ 6,000 ÷ 4,000 hours)		1.50
II. Depreciation = $\left(\frac{10,00,000-10,000}{10\text{ years}*4000\text{ hrs}}\right)$		24.75
III. Electricity (8 units x ₹ 3.75)		30.00
Machine hour rate		57.22

Working Note

Calculation of productive Machine hour rate

Total hours	4,200
Less: Non-Productive hours	200
Effective machine hours	4,000

* ₹ 3,880 ÷ 4,000 hours = ₹ 0.97

Question 5

SNS Trading Company has three Main Departments and two Service Departments. The data for each department is given below:

Departments	Expenses (in ₹)	Area in (Sq. Mtr)	Number of Employees
Main Department:			
Purchase Department	5,00,000	12	800
Packing Department	8,00,000	15	1700

Distribution Department	3,50,000	7	700
Service Departments:			
Maintenance Department	6,40,000	4	200
Personnel Department	3,20,000	6	250

The cost of Maintenance Department and Personnel Department is distributed on the basis of 'Area in Square Metres' and 'Number of Employees' respectively.

You are required to:

(i) Prepare a Statement showing the distribution of expenses of Service Departments to the Main Departments using the "Step Ladder method" of Overhead Distribution.

(ii) Compute the Rate per hour of each Main Department, given that, the Purchase Department, Packing Department and Distribution Department works for 12 hours a day, 24 hours a day and 8 hours a day respectively. Assume that there are 365 days in a year and there are no holidays.

(PYP 5 Marks Jul'21)

Answer 5

(i) Schedule Showing the Distribution of Expenses of Service Departments using Step ladder method.

	Main Department			Service Department	
	Purchase (₹)	**Packing (₹)**	**Distribution (₹)**	**Maintenance (₹)**	**Personnel (₹)**
Expenses	5,00,000	8,00,000	3,50,000	6,40,000	3,20,000
Distribution of Maintenance Department (12:15:7:-:6)	1,92,000	2,40,000	1,12,000	(6,40,000)	96,000
Distribution of Personnel Department (800:1700:700:-:-)	1,04,000	2,21,000	91,000	-	(4,16,000)
Total	7,96,000	12,61,000	5,53,000	-	-

(ii) Calculation of Expenses rate per hour of Main Department

	Purchase	Packing	Distribution
Total apportioned expenses (₹)	7,96,000	12,61,000	5,53,000
Total Hours worked	4,380 (12 x 365)	8,760 (24 x 365)	2,920 (8 x 365)
Expenses rate per hour (₹)	**181.74**	**143.95**	**189.38**

EXAM INSIGHTS: This practical problem was based on distribution of overheads by using step ladder method and calculation of rate per hour. Many examinees faced hardship to understand the concept of step ladder method; hence the overhead distribution was not done correctly leading to wrong calculation of overhead rate per hour. Performance of the examinees was below average.

Question 6

Mix Soap Pvt. Ltd., manufactures three brands of soap – Luxury, Herbal and Beauty. The following information has been obtained for the period from June 1 to June 30, 2021 relating to three brands:

	Luxury	Herbal	Beauty
Actual Production (units)	6,750	14,000	77,500
Wages paid (Rs.)	7,500	18,750	1,15,000
Raw materials consumed (Rs.)	20,000	47,000	2,40,000
Selling price per unit (Rs.)	25	15	8

Other data are:

Factory overheads	Rs. 80,000
General & administration overheads (equal for all)	Rs. 48,000
Selling overheads	20% of Works cost

If the company limits the manufacture to just one brand of soap adopting a single brand production, then monthly production will be:

	Units
Luxury	5,000
Herbal	15,000
Beauty	30,000

Further, factory overheads are to be allocated to each brand on the basis of the units which could have been produced when single brand production was in operation.

You are required to:

(i) FIND out the Factory overhead rate for all the brands.

(ii) PREPARE a cost statement for the month of June showing the various elements of cost and also the profit earned. *(MTP 10 Marks, Apr'21)*

Answer 6

(i) Calculation of Factory overhead rate.

If the single brand production was in operation, then

1 unit of Luxury = 3 units of Herbal = 6 units of Beauty. Therefore, the factory overhead ratio in the reverse order would be 5,000:15,000: 30,000 or 1:3:6.

The overhead rate will be lowest in case of brand which will be produced in high number. Therefore, in case of Beauty soap brand, the overhead rate will be:

$$= \frac{80,000}{6\times6,750+3\times14,000+1\times77,500} = \frac{80,000}{40,500+42,000+77,500}$$

$$= \frac{80,000}{1,60,000} = 0.5$$

So, the overhead rate will be:

Luxury = 0.5 x 6 = Rs. 3

Herbal = 0.5 x 3 = Rs. 1.5

Beauty = 0.5 x 1 = Rs. 0.5

(ii) Statement of Cost of Mix Soap Pvt. Ltd. for the month of June 2021:

	Luxury (Rs.)	Herbal (Rs.)	Beauty (Rs.)	Total (Rs.)
Raw material consumed	20,000	47,000	2,40,000	3,07,000
Add: Wages paid	7,500	18,750	1,15,000	1,41,250
Prime cost	27,500	65,750	3,55,000	4,48,250
Add: Factory overheads	20,250 (Rs.3 x 6,750)	21,000 (Rs.1.5 x 14,000)	38,750 (Rs.0.5 x 77,500)	80,000
Works cost	47,750	86,750	3,93,750	5,28,250
Add: General S& administration overheads (1:1:1)	16,000	16,000	16,000	48,000
Add: Selling expenses	9,550 (Rs.47,750 x 0.20)	17,350 (Rs.86,750 x 0.20)	78,750 (Rs. 3,93,750 x 0.20)	1,05,650
Cost of sales	73,300	1,20,100	4,88,500	6,81,900
Profit (Balancing figure)	95,450	89,900	1,31,500	3,16,850
Sales	1,68,750 (Rs.25 x 6,750)	2,10,000 (Rs.15 x 14,000)	6,20,000 (Rs.8 x 77,500)	9,98,750

Question 7

M/s Avyukt Automobile Parts has four identical machines in its factory. Cost of each machine is ₹ 5,00,000 with expected scrap value of 10% at the end of its effective life (9 years). The expected annual running hours of machine is expected to run for 2,200 hours. The other details in respect of the machine shop are:

(i) Factory Rent ₹ 5,000 per month

(ii) Lighting of Factory ₹ 3,000 per month

(iii) Operator Wages (Two operators and each operator is in charge of two machines) ₹10,000 per month (per Operator)

(iv) Fixed repairs and maintenance charges per machine ₹ 2,000 per quarter
(v) Insurance premium for the machine (Annual) 3% of cost
(vi) Forman's salary (Devoted 1/6th of his time to this factory)
₹ 2,500 per month
(vii) Other factory overhead (Annual) ₹40,000
(viii) Power Consumption per machine per hour 80 units
(ix) Rate of Power ₹ 150 for 100 units
(x) Unproductive Hours lost during repairs 50 per annum
(xi) Unproductive Hours Lost while Job Setting 650 per annum

You are required to COMPUTE a comprehensive machine hour rate assuming power is used during operating time only. *(MTP 10 Marks Apr'22)*

Answer 7

Computation of Comprehensive Machine Hour Rate per Machine

Particulars	**Per Annum (₹)**	**Per Hour (₹)**
Standing Charges:		
Depreciation (Working Note 2)	50,000	
Factory Rent (₹ 5,000 x 12 months / 4)	15,000	
Lighting of Factory (₹ 3,000 x 12 months / 4)	9,000	
Operator Wages (₹ 10,000 x 12 months / 2)	60,000	
Repairs and maintenance (₹ 2,000 x 4)	8,000	
Insurance premium (₹ 5,00,000 x 3%)	15,000	
Forman's salary (₹ 2,500 x 12 x ⅙ / 4)	1,250	
Other factory overhead (₹ 40,000 / 4)	10,000	
	1,68,250	
Standing Charges per hour (₹ 1,68,250 / 1,500 hours)		112.17
Running Charges:		
Power (80 units x ₹ 150 / 100)		120.00
Comprehensive Machine Hour Rate		232.17

Working Notes:

1. **Computation of Total Operative Hours**

Total Running Hours:	2,200
Less: Unproductive hours lost during repairs	50
Less: Unproductive hours Lost while Job Setting	650
Total Operative Hours	**1,500 per annum**

2. **Calculation of Annual Depreciation**

Annual Depreciation = $\frac{Purchase\ Cost - Estimated\ Scrap\ Value}{Effective\ life\ in\ years}$

$= \frac{Rs.5,00,000 - Rs.50,000}{9\ Years}$

= Rs. 50,000

Question 8

A manufacturing unit has purchased and installed a new machine at a cost of Rs. 24,90,000 to its fleet of 5 existing machines. The new machine has an estimated life of 12 years and is expected to realize Rs. 90,000 as scrap value at the end of its working life.

Other relevant data are as follows:

(i) Budgeted working hours are 2,496 based on 8 hours per day for 312 days. Plant maintenance work is carried out on weekends when production is totally halted. The estimated maintenance hours are 416. During the production hours machine set -up and change over works are carried out. During the set-up hours no production is done. A total 312 hours are required for machine set-ups and change overs.

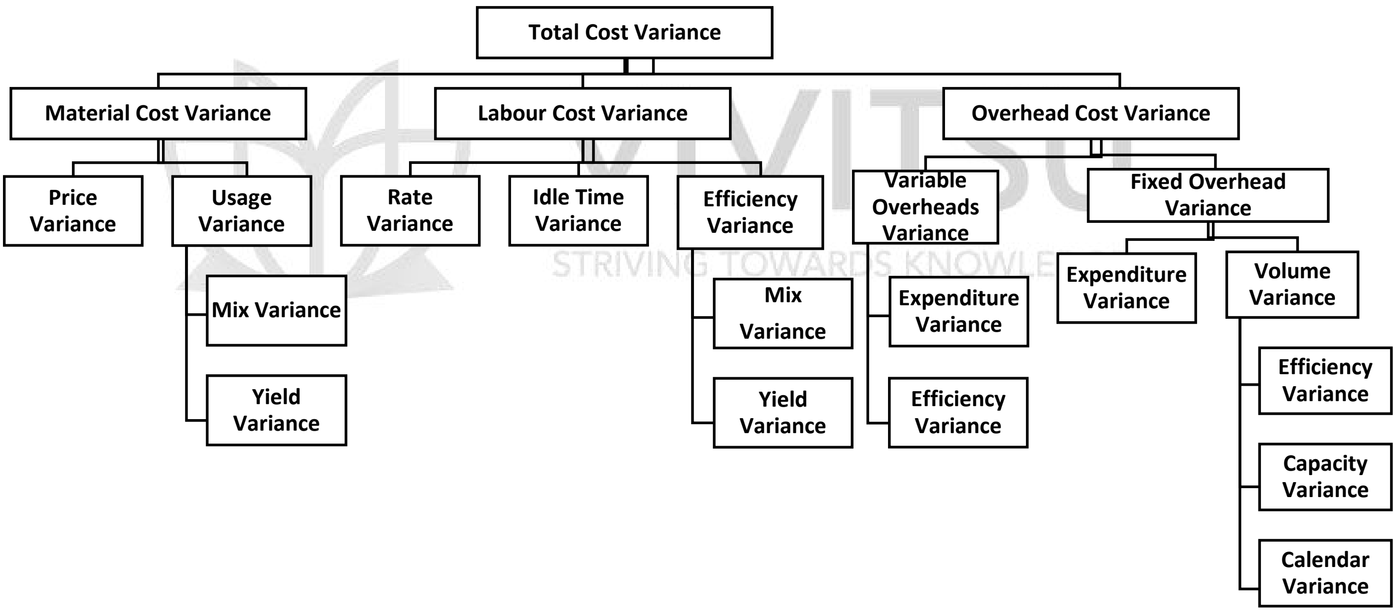
(ii) An estimated cost of maintenance of the machine is Rs. 2,40,000 p.a.

(iii) The machine requires a component to be replaced every week at a cost of Rs. 2,400.

CHAPTER 13: STANDARD COSTING

CONCEPTS OF THIS CHAPTER	LDR Questions
• Meaning of standard cost and variances. • Difference between controllable and uncontrollable variances. • Analyse and compute variances for material, labour, and overheads.	Q7 Q10 Q 14 Q20 Q 25

QUICK REVIEW OF IMPORTANT CONCEPTS



Variance Analysis

Material Cost Variance

[Standard Cost – Actual Cost]

(The difference between the Standard Material Cost of the actual production volume and the Actual Cost of Material)

[(SQ × SP) – (AQ × AP)]

Material Price Variance	Material Usage Variance
[Standard Cost of Actual Quantity – Actual Cost] (The difference between the Standard Price and Actual Price for the Actual Quantity Purchased) [(SP – AP) × AQ] Or [(SP × AQ) – (AP × AQ)]	[Standard Cost of Standard Quantity for Actual Production – Standard Cost of Actual Quantity] (The difference between the Standard Quantity specified for actual production and the Actual Quantity used, at Standard Price) [(SQ – AQ) × SP] Or [(SQ × SP) – (AQ × SP)]

Material Mix Variance	Material Yield Variance
[Standard Cost of Actual Quantity in Standard Proportion – Standard Cost of Actual Quantity] (The difference between the Actual Quantity in standard proportion and Actual Quantity in actual proportion, at Standard Price) [(RSQ – AQ) × SP] Or [(RSQ × SP) – (AQ × SP)]	[Standard Cost of Standard Quantity for Actual Production – Standard Cost of Actual Quantity in Standard Proportion] (The difference between the Standard Quantity specified for actual production and Actual Quantity in standard proportion, at Standard Purchase Price) [(SQ – RSQ) × SP] Or [(SQ × SP) – (RSQ × SP)]

Labour Cost Variance

[Standard Cost – Actual Cost]

(The difference between the Standard Labour Cost and the Actual Labour Cost incurred for the production achieved)

[(SH × SR) – (AH* × AR)]

Labour Rate Variance	**Labour Idle Time Variance**	**Labour Efficiency Variance**
[Standard Cost of Actual Quantity – Actual Cost] (The difference between the Standard Rate per Hour and Actual Rate per Hour for Actual Hours Paid) [(SR – AR) × AH*] Or [(SR × AH) – (AR × AH*)]	[Standard Rate per Hour x Actual Idle Hours] (The difference between the Actual Hours paid and Actual Hours worked at Standard Rate) [(AH* – $AH^{\#}$) × SR] Or [(AH* × SR) – ($AH^{\#}$ × SR)]	[Standard Cost of Standard Time for Actual Production – Standard Cost of Actual Time] (The difference between the Standard Hours specified for actual production and Actual Hours worked at Standard Rate) [(SH – $AH^{\#}$) × SR] Or [(SH × SR) – ($AH^{\#}$ × SR)]

Labour Mix Variance Or Gang Variance	**Labour Yield Variance Or Sub-Efficiency Variance**
[Standard Cost of Actual Time Worked in Standard Proportion – Standard Cost of Actual Time Worked] (e difference between the Actual Hours worked in standard proportion and Actual Hours worked in actual proportion, at Standard Rate) [(RSH – $AH^{\#}$) × SR] Or [(RSH × SR) – ($AH^{\#}$ × SR)]	[Standard Cost of Standard Time for Actual Production – Standard Cost of Actual Time Worked in Standard Proportion] (The difference between the Standard Hours specified for actual production and Actual Hours worked in standard proportion, at Standard Rate) (SH – RSH) × SR Or (SH × SR) – (RSH × SR)

Variable Overhead Cost Variance

(Standard Variable Overheads for Production – Actual Variable Overheads)

Variable Overhead Expenditure (Spending) Variance	**Variable Overhead Efficiency Variance**
(Standard Variable Overheads for Actual Hours#) Less (Actual Variable Overheads) [(SR – AR) × $AH^{\#}$] Or [(SR × $AH^{\#}$) – (AR × $AH^{\#}$)]	(Standard Variable Overheads for Production) Less (Standard Variable Overheads for Actual Hours#) [(SH – $AH^{\#}$) × SR] Or [(SH × SR) – ($AH^{\#}$ × SR)]

Fixed Overhead Cost Variance

(Absorbed Fixed Overheads) Less (Actual Fixed Overheads)

Fixed Overhead Expenditure Variance	**Fixed Overhead Volume Variance**
(Budgeted Fixed Overheads) Less (Actual Fixed Overheads) Or (BH × SR) – (AH × AR)	(Absorbed Fixed Overheads) Less (Budgeted Fixed Overheads) Or (SH × SR) – (BH × SR)

Fixed Overhead Capacity Variance	**Fixed Overhead Calendar Variance**	**Fixed Overhead Efficiency Variance**
SR (AH – BH) Or (AH × SR) – (BH × SR)	Std. Fixed Overhead rate per day (Actual no. of Working days – Budgeted Working days)	SR (AH – SH) Or (AH × SR) – (SH × SR)

AH* - Actual Hours paid

$AH^{\#}$ - Actual Hours worked

Questions & Answers

Theory Questions

Question 1

Define the following terms:

(i) Controllable Variance

(ii) Uncontrollable Variance *(PYP 2 Marks Sep'24, MTP 5 Marks, Mar '21)*

Answer 1

(i) **Controllable variances:** Controllable variances are those which can be controlled under the normal operating conditions if a responsibility centre takes preventive measures and acts prudently. Responsibility centres are answerable for all adverse variances which could have been controlled.

(ii) **Uncontrollable variances:** Uncontrollable variances are those whichoccurs due to conditions which are beyond the control of a responsibility centre and cannot be controlled even though all preventive measures are in place.

Question 2

"Calculation of variances in standard costing is not an end in itself, but a means to an end." DISCUSS. *(MTP 4 Marks Dec'24)*

Answer 2

The crux of standard costing lies in variance analysis. Standard costing is the technique whereby standard costs are predetermined and subsequently compared with the recorded actual costs. It is a technique of cost ascertainment and cost control. It establishes predetermined estimates of the cost of products and services based on management's standards of efficient operation. It thus lays emphasis on "what the cost should be". These should be costs are when compared with the actual costs. The difference between standard cost and actual cost of actual output is defined as the variance.

The variance in other words in the difference between the actual performance and the standard performance. The calculations of variances are simple. A variance may be favourable or unfavourable. If the actual cost is less than the standard cost, the variance is favourable but if the actual cost is more than the standard cost, the variance will be unfavourable. They are easily expressible and do not provide detailed analysis to enable management of exercise control over them. It is not enough to know the figures of these variances from month to month. We in fact are required to trace their origin and causes of occurrence for taking necessary remedial steps to reduce / eliminate them.

A detailed probe into the variance particularly the controllable variances helps the management to ascertain:

(i) the amount of variance

(ii) the factors or causes of their occurrence

(iii) the responsibility to be laid on executives and departments and

(iv) corrective actions which should be taken to obviate or reduce the variances.

Mere calculation and analysis of variances is of no use. The success of variance analysis depends upon how quickly and effectively the corrective actions can be taken on the analysed variances. In fact variance gives information. The manager needs to act on the information provided for taking corrective action. Information is the means and action taken on it is the end. In other words, the calculation of variances in standard costing is not an end in itself, but a means to an end.

Question 3

Discuss briefly some of the criticism which may be levelled against the Standard Costing System. *(PYP 5 Marks, May'22)*

Answer 3

Criticism of Standard Costing

(i) **Variation in price:** One of the chief problem faced in the operation of the standard costing system is the precise estimation of likely prices or rate to be paid. The variability of prices is so great that even actual prices are not necessarily adequately representative of cost. But the use of sophisticated forecasting techniques should be able to cover the price fluctuation to some extent. Besides this, the system provides for isolating uncontrollable variances arising from variations to be dealt with separately.

(ii) **Varying levels of output:** If the standard level of output set for pre-determination of standard costs is not achieved, the standard costs are said to be not realised. However, the statement that the capacity utilisation cannot be precisely estimated for absorption of overheads may be true only in some industries of jobbing type. In vast majority of industries, use of forecasting techniques, market research, etc., help to estimate the output with reasonable accuracy and thus the variation is unlikely to be very large. Prime cost will not be affected by such variation and, moreover, variance analysis helps to measure the effects of idle time.

(iii) **Changing standard of technology:** In case of industries that have frequent technological changes affecting the conditions of production, standard costing may not be suitable. This criticism does not affect the system of standard costing. Cost reduction and cost control is a cardinal feature of standard costing because standards once set do not always remain stable. They have to be revised.

(iv) **Attitude of technical people:** Technical people are accustomed to think of standards as physical standards and, therefore, they will be misled by standard costs. Since technical people can be educated to adopt themselves to the system through orientation courses, it is not an insurmountable difficulty.

(v) **Mix of products:** Standard costing presupposes a pre-determined combination of products both in variety and quantity. The mixture of materials used to manufacture the products may vary in the long run but since standard costs are set normally for a short period, such changes can be taken care of by revision of standards.

(vi) **Level of Performance:** Standards may be either too strict or too liberal because they may be based on (a) theoretical maximum efficiency, (b) attainable good performance or (c) average past performance. To overcome this difficulty, the management should give thought to the selection of a suitable type of standard. The type of standard most effective in the control of costs is one which represents an attainable level of good performance.

(vii) **Standard costs cannot possibly reflect the true value in exchange:** If previous historical costs are amended roughly to arrive at estimates for ad hoc purposes, they are not standard costs in the strict sense of the term and hence they cannot also reflect true value in exchange. In arriving at standard costs, however, the economic and technical factors, internal and external, are brought together and analysed to arrive at quantities and prices which reflect optimum operations. The resulting costs, therefore, become realistic measures of the sacrifices involved.

(viii) **Fixation of standards may be costly:** It may require high order of skill and competency. Small concerns, therefore, feel difficulty in the operation of such system.

Exam Insights: This theory question was based on criticism against standard costing system. Majority other examinees had not answered it on the correct line. Performance of the examinees was poor.

Practical Questions

Material Variances

Question 4

Y Lid manufactures "Product M" which requires three types of raw materials - "A", "B" & "C". Following information related to 1st quarter of the F.Y. 2022-23 has been collected from its books of accounts. The standard material input required for 1,000 kg of finished product 'M' are as under:

Material	Quantity (Kg.)	Std. Rate per Kg. (₹)
A	500	25
B	350	45
C	250	55
	1100	
Standard Loss	100	
Standard Output	1000	

During the period, the company produced 20,000 kg of product "M" for which the actual quantity of materials consumed and purchase prices are as under:

Material	Quantity (Kg.)	Purchase price per Kg. (₹)
A	11,000	23

B	7,500	48
C	4,500	60

You are required to calculate:

(i) Material Cost Variance

(ii) Material Price Variance for each raw material and Product 'M'

(iii) Material Usage Variance for each raw material and Product 'M'

(iv) Material Yield Variance

Note: Indicate the nature of variance i.e. Favorable or Adverse. *(PYP 10 Marks, Nov'22)*

Answer 4

Basic Calculations:

	Standard for 20,000 kg.			Actual for 20,000 kg.		
	Qty.	Rate	Amount	Qty.	Rate	Amount
	Kg.	(₹)	(₹)	Kg.	(₹)	(₹)
A	10,000	25	2,50,000	11,000	23	2,53,000
B	7,000	45	3,15,000	7,500	48	3,60,000
C	5,000	55	2,75,000	4,500	60	2,70,000
Total	22,000		8,40,000	23,000		8,83,000

Calculation of Variances:

(i)	Material Cost Variance = Std. Cost for actual output– Actual cost	
	MCV=8,40,000 – 8,83,000	= ₹ 43,000(A)
(ii)	Material Price Variance	= (SP–AP) × AQ
	A = (25 - 23) x 11,000	= 22,000 (F)
	B = (45 – 48) x 7,500	= 22,500 (A)
	C = (55 – 60) x 4,500	= <u>22,500 (A)</u>
		= <u>23,000 (A)</u>
(iii)	Material Usages Variance	= (SQ–AQ) × SP
	A = (10,000 – 11,000) x 25	= 25,000 (A)
	B = (7,000 – 7,500) x 45	= 22,500 (A)
	C = (5,000 – 4,500) x 55	= <u>27,500 (F)</u>
		= <u>20,000 (A)</u>
(iv)	Material Yield Variance	= (SQ–RSQ*) × SP
	A = (10,000 – 10,454.54) x 25	= 11,363.5(A)
	B = (7,000 – 7,318.18) x 45	= 14,318.1(A)
	C = (5,000 – 5,227.27) x 55	= <u>12,500(A)</u>
		= <u>38,181.6(A)</u>
	*Revised Standard Quantity (RSQ)	
	A = $\frac{10,000}{22,000}$ X 23,000	= 10,454.54
	B = $\frac{7,000}{22,000}$ X 23,000	= 7,318.18
	C = $\frac{5,000}{22,000}$ X 23,000	= 5,227.17

Material Yield Variance can also be Calculated as below

Material yield variance = Standard cost per unit (Actual yield – Standard yield)

Standard Cost per unit = $\frac{\text{Rs.}8,40,000}{20,000}$ = Rs. 42

New Standard Yield = $\frac{20,000}{22,000}$ X 23,000 = 20,909

Material yield variance = ₹ 42 (20,000 – 20,909)= = ₹ 38,178 (A)

Exam Insights: This Numerical question tested the basic knowledge of examinees on the topic of standard costing. The examinees were required to calculate various material cost variances for raw materials A, B & C and also for Finished Product M. Most of the examinees calculated material cost and price variances correctly. Several examinees were unable to calculate material yield variance. Overall performance of the examinees was above average.

Question 5

Following data is extracted from the books of XYZ Ltd. for the month of January, 2020:

(i) Estimation-

Particulars	Quantity (kg.)	Price (₹)	Amount (₹)
Material-A	800	?	--
Material-B	600	30.00	18,000
			--

Normal loss was expected to be 10% of total input materials.

(ii) Actuals- 1480 kg of output produced.

Particulars	Quantity (kg.)	Price (₹)	Amount (₹)
Material-A	900	?	--
Material-B	?	32.50	--
			59,825

(iii) Other Information-

Material Cost Variance	= ₹ 3,625 (F)
Material Price Variance	= ₹ 175 (F)

You are required to CALCULATE:

(i) Standard Price of Material-A;

(ii) Actual Quantity of Material-B;

(iii) Actual Price of Material-A;

(iv) Revised standard quantity of Material-A and Material-B; and

(v) Material Mix Variance; *(MTP 10 Marks, Oct'20 & Mar'23, SM)*

Answer 5

(i)	Material Cost Variance (A + B)	= {(SQ × SP) – (AQ × AP)}
	₹ 3,625	= (SQ × SP) – ₹ 59,825
	(SQ × SP)	= ₹ 63,450
	$(SQ_A \times SP_A) + (SQ_B \times SP_B)$	= ₹ 63,450
	(940 kg × SP_A) + (705 kg × ₹ 30)	= ₹ 63,450
	(940 kg × SP_A) + ₹ 21,150	= ₹ 63,450
	(940 kg × SP_A)	= ₹ 42,300
	SP_A	= ₹ 42,300 / 940kg
	Standard Price of Material-A	**= ₹ 45**
Working Note:		
SQ i.e. quantity of inputs to be used to produce actual output		
		= $\frac{1,480 \text{ kg}}{90\%}$ = 1,645kg
	SQ_A	= $\frac{800\text{kg}}{(800+600)} \times 1,645$ kg. = 940kg
	SQ_B	= $\frac{600\text{kg}}{(800+600)} \times 1,645$ kg. = 705kg
(ii)	Material Price Variance (A + B)	= {(AQ × SP) – (AQ × AP)}
	₹ 175	= (AQ × SP) – ₹ 59,825
	(AQ × SP)	= ₹ 60,000
	$(AQ_A \times SP_A) + (AQ_B \times SP_B)$	= ₹ 60,000
	[900 kg × ₹ 45 (from (i) above)] + (AQ_B × ₹30)	= ₹ 60,000

	₹ 40,500 + (AQ_B × ₹ 30)	= ₹ 60,000
	(AQ_B × ₹ 30)	= ₹ 19,500
	AQ_B	= 19,500 / 30 = 650 kg
	Actual Quantity of Material B	= 650 kg
(iii)	(AQ × AP)	= ₹ 59,825
	(AQ_A × AP_A) + (AQ_B × AP_B)	= ₹ 59,825
	(900 kg × APA) + (650 kg (from (ii) above) × ₹ 32.5)	= ₹ 59,825
	(900 kg × APA) + ₹ 21,125	= ₹ 59,825
	(900 kg × AP_A)	= ₹ 38,700
	AP_A	= 38,700 / 900 = 43
	Actual Price of Material-A	= ₹ 43
(iv)	Total Actual Quantity of Material-A and Material-B	
	= AQ_A + AQ_B	= 900 kg + 650 kg (from (ii) above)
		= 1,550 kg
	Now,	
	Revised SQ_A	= 800kg /800+600 X 1,550kg. = 886kg.
	Revised SQ_B	= 600kg/(800+600)X 1,550kg. = 664kg.
(v)	Material Mix Variance (A + B)	= {(RSQ × SP) – (AQ × SP)}
	= {(RSQA × SPA) + (RSQB × SPB) – 60,000}	
	= (886 kg (from (iv) above) × ₹ 45 (from (i) above))+ (664 kg (from (iv) above) × ₹ 30) - ₹ 60,000	
	= (39,870 + 19,920) – 60,000 = ₹ 210 (A)	

Question 6

WEPL operates in coal mining through open cast mining method. Explosives and detonators are used for excavation of coal from the mines. The following are the details of standard quantity of explosives materials used for mining:

Particulars	Rate (₹)	Standard Qty.for Iron ore	Standard Qty. forOverburden (OB)
SME	40.00 per kg.	2.4 kg per tonne	1.9 kg per cubic-meter
Detonators	20.00 per piece	2 pcs per tonne	2 pcs per cubic- meter

The standard stripping ratio is 3:1 (means 3 cubic- meter of overburden soil to be removed to get one tonne of coal).

During the month of December 2023, the company produces 20,000 tonnes of coal and 58,000 cubic- meter of OB. The quantity of explosive materials used and paid for the month is as below:

Material	Quantity	Amount (₹)
SME	1,67,200 kg.	63,53,600
Detonators	1,18,400 pcs	24,27,200

Explosive suppliers are paid for the explosive materials on the basis of performance of the explosives which is termed as powder factor. One of the suppliers has presented their bill for explosive supplied for the month of December 2023. You being a bill passing officer of WEPL is required to COMPUTE the material price variance, material quantity variance and material cost variance.

(RTP May'24, MTP 10 Marks April '22 & Sep '23)

Answer 6

Workings:

1. Calculation of Standard Qty. of Explosives and Detonators foractual output:

	Particulars	Coal	Overburden (OB)	Total
SME:				
A	Actual Output	20,000 tonne	58,000 M^3	
B	Standard Qty per unit	2.4 kg. / tonne	1.9 kg. /M^3	
C	**Standard Qty. for actual production [A×B]**	**48,000 kg.**	**1,10,200 kg.**	**1,58,200 kg.**
Detonators:				
D	Standard Qtyper unit	2 pcs/ tonne	2 pcs/ M^3	

E	Standard Qty.for actual production [A × D]	40,000 pcs.	1,16,000 pcs	1,56,000 pcs

2. Calculation of Actual Price per unit of materials:

Material	Quantity [A]	Amount (₹) [B]	Rate (₹) [C = B÷A]
SME	1,67,200 kg.	63,53,600	38.00
Detonators	1,18,400 pcs	24,27,200	20.50

Computation of material price variance:

Material Price Variance	= Actual Qty. × (Std. Price - Actual Price)
SME	= 1,67,200 kg. × (₹40 – ₹38) = ₹3,34,400 (F)
Detonators	= 1,18,400 pcs × (₹20 – ₹20.5) = ₹59,200 (A)
Total	**= ₹2,75,200 (F)**

Computation of material quantity variance:

Material Qty. Variance	= Std. Price × (Std. Qty for actual output – Actual Qty.)
SME	= ₹40 × (1,58,200 kg. - 1,67,200 kg.) = ₹3,60,000 (A)
Detonators	= ₹20 × (1,56,000 pcs -1,18,400 pcs) = ₹7,52,000 (F)
Total	= ₹3,92,000 (F)

Computation of material cost variance:

Material cost variance	= Std. cost – Actual Cost
Or,	(Std. Price × Std. Qty) – (Actual Price × Actual Qty.)
SME	= (₹ 40 × 1,58,200 kg) – (₹ 38 × 1,67,200 kg.)
	= ₹ 63,28,000 – ₹ 63,53,600 = ₹ 25,600 (A)
Detonators	= (₹ 20 × 1,56,000 pcs) – (₹ 20.50 × 1,18,400 pcs)
	= ₹31,20,000 – ₹24,27,200 = 6,92,800 (F)
Total	**= ₹6,67,200 (F)**

Question 7

LDR

Banku manufacturing Ltd. is engaged in producing a item named 'ABC'. It produces 'ABC' in a batch of 100 kgs. Standard material inputs required for 100 kgs. of 'ABC' are as below:

Material	Quantity (in kgs.)	Rate per kg. (in ₹)
A	50	110
B	30	320
C	30	460

During the month of April, 2024, actual production was 50,000 kgs. of 'ABC' for which the actual quantities of material used for a batch and the prices paid thereof are as under:

Material	Quantity (in kgs.)	Rate per kg. (in ₹)
A	60	115
B	25	330
C	20	405

You are required to CALCULATE the following variances based on the above given information for the month of April, 2024 for Banku manufacturing Ltd.:

(i) Material Cost Variance;
(ii) Material Price Variance;
(iii) Material Usage Variance;
(iv) Material Mix Variance;
(v) Material Yield Variance. *(RTP Jan'25)*

Answer 7

Material	SQ* × SP (₹)	AQ** × SP (₹)	AQ** × AP (₹)	RSQ*** × SP (₹)
A	27,50,000	33,00,000	34,50,000	26,24,600
	(25,000 kg. × ₹110)	(30,000 kg. × ₹110)	(30,000 kg. × ₹115)	(23,860 kg. × ₹110)
B	48,00,000	40,00,000	41,25,000	45,82,400
	(15,000 kg. × ₹320)	(12,500 kg. × ₹320)	(12,500 kg. × ₹320)	(14,320 kg. × ₹320)
C	69,00,000	46,00,000	40,50,000	65,87,200
	(15,000 kg. × ₹460)	(10,000 kg. × ₹460)	(10,000 kg. × ₹405)	(14,320 kg. × ₹460)

Total	1,44,50,000	1,19,00,000	1,16,25,000	1,37,94,200

* Standard Quantity of materials for actual output:

A	$= \frac{50\ \text{Kgs.}}{100\ \text{Kgs}} \times$ 50,000 kgs. = 25,000 Kgs.
B	$= \frac{30\ \text{Kgs.}}{100\ \text{Kgs}} \times$ 50,000 kgs. = 15,000 Kgs.
C	$= \frac{30\ \text{Kgs.}}{100\ \text{Kgs}} \times$ 50,000 kgs. = 15,000 Kgs.

** Actual Quantity of Material used for actual output:

A	$= \frac{60\ \text{Kgs.}}{100\ \text{Kgs}} \times$ 50,000 kgs. = 30,000 Kgs.
B	$= \frac{25\ \text{Kgs.}}{100\ \text{Kgs}} \times$ 50,000 kgs. = 12,500 Kgs.
C	$= \frac{20\ \text{Kgs.}}{100\ \text{Kgs}} \times$ 50,000 kgs. = 10,000 Kgs.

***Revised Standard Quantity (RSQ):

A	$= \frac{50\ \text{Kgs.}}{110\ \text{Kgs}} \times$ 52,500 kgs. = 23,860 Kgs.
B	$= \frac{30\ \text{Kgs.}}{110\ \text{Kgs}} \times$ 52,500 kgs. = 14,320 Kgs.
C	$= \frac{30\ \text{Kgs.}}{110\ \text{Kgs}} \times$ 52,500 kgs. = 14,320 Kgs.

(i) Material cost variance = (Std. Qty. × Std. Price) – (Actual Qty. × Actual Price)

Or = (SQ × SP) – (AQ × AP)

A = ₹27,50,000 - ₹34,50,000 = ₹7,00,000 (A)
B = ₹48,00,000 - ₹41,25,000 = ₹6,75,000 (F)
C = ₹69,00,000 - ₹40,50,000 = ₹28,50,000 (F)
= ₹28,25,000 (F)

(ii) Material Price Variance = Actual Quantity (Std. Price – Actual Price)

= (AQ × SP) – (AQ × AP)

A = ₹33,00,000 - ₹34,50,000 = ₹1,50,000 (A)
B = ₹40,00,000 - ₹41,25,000 = ₹1,25,000 (A)
C = ₹46,00,000 - ₹40,50,000 = ₹5,50,000 (F)
= ₹2,75,000 (F)

(iii) Material Usage Variance = Std. Price (Std. Qty. – Actual Qty.)

Or = (SQ × SP) – (AQ × SP)

A = ₹27,50,000 - ₹33,00,000 = ₹5,50,000 (A)
B = ₹48,00,000 - ₹40,00,000 = ₹8,00,000 (F)
C = ₹69,00,000 - ₹46,00,000 = ₹23,00,000 (F)
= ₹25,50,000 (F)

(iv) Material Mix Variance = Std. Price (Revised Std. Qty. – Actual Qty.)

Or = (RSQ × SP) – (AQ × SP)

A = ₹26,24,600 - ₹33,00,000 = ₹6,75,400 (A)
B = ₹45,82,400 - ₹40,00,000 = ₹5,82,400 (F)
C = ₹65,87,200 - ₹46,00,000 = ₹19,87,200 (F)
= ₹18,94,200 (F)

(v) Material Yield Variance = Std. Price (Std. Qty. – Revised Std. Qty.)

Or = (SQ × SP) – (RSQ × SP)

A = ₹27,50,000 - ₹26,24,600 = ₹1,25,400 (F)
B = ₹48,00,000 - ₹45,82,400 = ₹2,17,600 (F)
C = ₹69,00,000 - ₹65,87,200 = ₹3,12,800 (F)

Question 8

The following information has been provided by a company:

Number of units produced and sold	**9,000**
Standard labour rate per hour	**₹ 12**
Standard hours required for 9,000 units	**-**
Actual hours required	**25,641 hours**
Labour efficiency	**105.3%**
Labour rate variance	**₹ 1,53,846 (A)**

You are required to CALCULATE:

(i) Actual labour rate per hour

(ii) Standard hours required for 9,000 units

(iii) Labour Efficiency variance

(iv) Standard labour cost per unit

(v) Actual labour cost per unit. *(MTP 10 Marks, Oct'21 RTP Nov'23)*

Answer 8

SR – Standard labour Rate per Hour

AR – Actual labour rate per hour

SH – Standard Hours

AH – Actual hours

(i)	Labour rate Variance	= AH (SR – AR)
	- 1,53,846	= 25,641 (12 – AR)
	- 6	= 12 – AR
	AR	= ₹ 18
(ii)	Labour Efficiency	$= \frac{SH}{AH} \times 100 = 105.3$
	SH	$\frac{AH \times 105.3}{100} = \frac{25{,}641 \times 105.3}{100}$
	SH	= 26,999.973
	SH	= 27,000 hours
(iii)	Labour Efficiency Variance	= SR (SH – AH)
		= 12 (27,000 – 25,641)
		= ₹ 16,308 (F)
(iv)	Standard Labour Cost per Unit	$= \frac{27{,}000 \times 12}{9{,}000} =$ ₹ 36
(v)	Actual Labour Cost Per Unit	$= \frac{25{,}641 \times 18}{9{,}000} =$ ₹ 51.282

Question 9

A manufacturing department of a company has employed 120 workers. The standard output of product "NPX" is 20 units per hour and the standard wage rate is ₹ 25 per labour hour.

In a 48 hours week, the department produced 1,000 units of 'NPX' despite 5% of the time paid being lost due to an abnormal reason. The hourly wages actually paid were ₹ 25.70 per hour.

Calculate:

(i) Labour Cost Variance

(ii) Labour Rate Variance

(iii) Labour Efficiency Variance

(iv) Labour Idle time Variance *(PYP 5 Marks, May'22)*

Answer 9

Working Notes:

1. **Calculation of standard man hours**

   When 120 worker works for 1 hr., then the std. output is 20 units.

Std. man hour per unit= $\frac{120 \text{ hours}}{20 \text{ units}}$ = 6 hours

2. Calculation of std. man hours for actual output

Total std. man hours = 1,000 units × 6 hrs. = 6,000 hrs.

Standard for actual			Actual				
Hours	**Rate (₹)**	**Amount(₹)**	**Actual hrs. Paid**	**Idle time hrs.**	**Production hrs.**	**Rate (₹)**	**Amount paid (₹)**
6,000	25	1,50,000	5,760 (48 hrs. x 120 workers)	288	5,472	25.70	1,48,032

(i) Labour cost variance

= Std. labour cost – Actual labour cost

= 1,50,000 – 1,48,032 = ₹ 1,968 F

(ii) Labour rate variance

= (SR – AR) × AHPaid

= (25 - 25.70) × 5,760 = ₹ 4,032 A

(iii) Labour efficiency variance

= (SH – AH) × SR

= (6,000 – 5,472) × 25 = ₹ 13,200 F

(iv) Labour Idle time variance

= Idle Hours × SR

= 288 × 25 = ₹ 7,200 A

Note: Variances can also be calculated for one worker instead of 120.

EXAM INSIGHTS: This numerical question tested the basic knowledge of examinees on the topic of standard costing. The examinees had to calculate various labour variances. The crux of question was to calculate actual number of hours worked and actual number of hours paid. Some of the examinees failed to calculate Labour efficiency variance and Labour Idle time variance. Performance of the examinees was above average.

Question 10 — LDR

The standard output of a Product 'D' is 50 units per hour in manufacturing department of a Company employing 100 workers. In a 40 hours week, the department produced 1,920 units of product 'D' despite 5% of the time paid was lost due to an abnormal reason. The hourly wage rates actually paid were ₹ 12.40, ₹ 12.00 and ₹ 11.40 respectively to Group 'A' consisting 10 workers, Group 'B' consisting 30 workers and Group 'C' consisting 60 workers. The standard wage rate per labour is same for all the workers. Labour Efficiency Variance is given ₹ 480 (F).

You are required to COMPUTE:

(i) Total Labour Cost Variance.

(ii) Total Labour Rate Variance.

(iii) Total Labour Gang Variance.

(iv) Total Labour Yield Variance, and

(v) Total Labour Idle Time Variance.*(RTP May'22, PYP 10 Marks Jul'21)*

Answer 10

Working Notes:

1. Calculation of Standard Man hours

When 100 workers work for 1 hour, the standard output is 50 units.

Standard man hours per unit = $\frac{100 \text{ hours}}{50 \text{ Units}}$ = **2 hours per unit**

2. Calculation of standard man hours for actual output:

= 1,920units x 2 hours **= 3,840 hours.**

3. Calculation of actual cost

Type of Workers	No of Workers	Actual Hours Paid	Rate (₹)	Amount (₹)	Idle Hours (5% of hours paid)	Actual hours Worked
Group 'A'	10	400	12.40	4,960	20	380

Labour Cost Variance = (SH X SR – AH X AR)

= 9,600 hrs x ₹20 – {(6,000 hrs x ₹25) + (4,000 hrs x ₹20)}

= ₹1,92,000 – ₹2,30,000 = **₹ 38,000 (A)**

Labour Rate Variance = (SR – AR) X AH

= (₹20 -₹25) x 6,000 hrs = **₹ 30,000 (A)**

Efficiency Variance = (SH – AH worked) x SR

= (9,600 hrs – 9,500 hrs) x ₹20 = **₹ 2,000 (F)**

Idle time Variance = Idle Hours X SR

= (AH – AH#) × SR

= (10,000 hours – 9,500 hours) x ₹20 = **₹ 10,000 (A)**

AH# refers to Actual Hours Worked

Multiple Choice Questions (MCQ)

1. Which of the following variance arises when more than one material is used in the manufacture of a product: *(SM)*

(a) Material price variance
(b) Material usage variance
(c) Material yield variance
(d) Material mix variance

Ans: (d)

2. Idle time variance is obtained by multiplying: *(SM)*

(a) The difference between standard and actual hours by the actual rate of labour per hour
(b) The difference between actual labour hours paid and actual labour hours worked by the standard rate
(c) The difference between standard and actual hours by the standard rate of labour per hour
(d) None of the above.

Ans: (b)

3. Overhead cost variances is: *(SM)*

(a) The difference between overheads recovered on actual output - actual overhead incurred.
(b) The difference between budgeted overhead cost and actual overhead cost.
(c) Obtained by multiplying standard overhead absorption rate with the difference between standard hours for actual output and actual hours worked.
(d) None of the above

Ans: (a)

4. Under standard cost system the cost of the product determined at the beginning of production is its *(SM)*

(a) Direct cost
(b) Pre-determined cost
(c) Historical cost
(d) Actual cost

Ans: (b)

5. The deviations between actual and standard cost is known as: *(SM)*

(a) Multiple analysis
(b) Variable cost analysis
(c) Variance analysis
(d) Linear trend analysis

Ans: (c)

6. The standard which is attainable under favourable conditions is: *(SM)*

(a) Theoretical standard
(b) Expected standard
(c) Normal standard
(d) Basic standard

Ans: (a)

7. **The Standard most suitable from cost control point of view is: *(SM)***
   (a) Normal standard
   (b) Theoretical standard
   (c) Expected standard
   (d) Basic standard

Ans: (c)

8. **Controllable variances are best disposed-off by transferring to: *(SM)***
   (a) Cost of goods sold
   (b) Cost of goods sold and inventories
   (c) Inventories of work–in–progress and finished goods
   (d) Costing profit and loss account

Ans: (d)

9. **Basic standards are: *(SM)***
   (a) Those standards, which require high degree of efficiency and performance.
   (b) Average standards and are useful in long term planning.
   (c) Standards, which can be attained or achieved
   (d) Assuming to remain unchanged for a long time.

Ans: (d)

10. **A furniture company uses premium wood for sofa. Standard quantity of premium wood per sofa is 5 sq. ft. Standard price per sq. ft. of premium wood is ₹ 10. Actual production of sofa is 1,000. Premium wood actually used is 5,300 sq. ft. Actual purchase price of premium wood per sq. ft. is ₹ 10. What is material cost variance? *(MTP 2 Marks July'24)***
   (a) ₹ 3,000 (A)
   (b) ₹ 4,300 (A)
   (c) ₹ 7,300 (A)
   (d) ₹ 5,300 (F)

Ans: (a)

11. **If standard hours for 100 units of output are 400 @ ₹ 2 per hour and actual hours taken are 380 @ ₹ 2.25 per hour, then the labour rate variance is: *(SM)***
   (a) ₹ 95 (adverse)
   (b) ₹ 100 (adverse)
   (c) ₹ 25 (favourable)
   (d) ₹ 120 (adverse)

Ans: (a)

12. **The wages budget for the last period was based on a standard repair time of 30 minutes per unit and a standard wage rate of ₹ 50 per hour. The actual data for the last period are as follows:**
   Number of units = 30,000
   Labour rate variance = 7,500 (A)
   Labour efficiency variance = Nil
   From the information find out the actual rate of wages per unit *(MTP 2 Marks, Mar'24)*
   (a) ₹ 50
   (b) ₹ 25.50
   (c) ₹ 50.50
   (d) ₹ 25.25

Ans: (d)

CA INTERMEDIATE

VIVITSU

PAPER 5

Auditing and Ethics Reviewer

Chapter-wise compilation

RTP, MTP and PYP questions

KEY HIGHLIGHTS

- Easy to Hard Difficulty Level
- Importance levels marked as A, B or C
- Reference to all questions
- Quick recap of important concepts
- Exam Insights
- Last Day Revision Questions Marked

APPLICABLE FOR MAY'25, SEPT'25 AND JAN'26

VIVITSU

STRIVING TOWARDS KNOWLEDGE

This book belongs to future,

CA Finalist ________________________________

"You become what you believe."

-Oprah Winfrey

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YOU MUST BE WONDERING

How to Read this book?

01 — Step 1
Prioritize more time for 'A' chapters in the ABC analysis

02 — Step 2
Identify key concepts in each chapter.

03 — Step 3
Solve questions in order, from easy to difficult.

04 — Step 4
Focus on solving LDR questions during the final revision

Step 1: Prioritize your chapters

Chapters in the index are categorized as A, B, or C based on their importance. Focus more on 'A' chapters, as they carry the most weight, and give adequate attention to 'B' chapters. While all chapters must be covered, this approach helps manage time efficiently for better results.

Step 2: Identify key concept

Identify the key concepts for each chapter using the list provided at the start of the chapter. Ensure you understand them thoroughly. If you struggle with a question, revisit the concepts, review them, and strengthen your understanding before moving forward.

Step 3: Start easy

The questions are segregated concept & SA wise. Start with Question 1, as they progress from easy to difficult, helping you build confidence throughout the chapter. Pay close attention to the “EXAM INSIGHTS” to avoid common mistakes.

Step 4: Last Day Revision (LDR)

Focus on solving LDR questions during the final revision. In the 1.5 days before the exam, prioritize these questions as they cover the most critical concepts from each chapter. You'll find a quick summary of LDR question numbers listed right before each chapter for easy reference.

Table of Contents

ABC Analysis

A Very Important, Read on priority

B Moderately Important

C Less critical but still essential

Ensure you thoroughly read all chapters without skipping any. The ABC analysis is designed to help you prioritize based on past trends, but it should not replace comprehensive preparation.

ABBREVIATIONS : -

TCWG= Those Charged with Governance

FRF= Financial Reporting Framework

EOM= Emphasis of Matter Paragraph

SAAE= Sufficient Appropriate Audit Evidence

FS= Financial Statements

RPT= Related Party Transactions

OMP= Other Matters Paragraph

KAM= Key Audit Matters

B

CHAPTER 3: RISK ASSESSMENT & INTERNAL CONTROL

CONCEPTS OF THIS CHAPTER	LDR Questions
• Audit Risk and influencing Variables • Risk Assessment Procedures • Materiality in Audit Planning and Execution • Understanding the Entity and its Environment • Internal Control: Meaning, Objectives, Benefits, Limitations, Components • Relevance of controls to Audits • Understanding and Evaluating relevant Controls • Risks needing Special Audit Focus • Internal Control Evaluation: Benefits and Methods • Testing Internal Controls • Key features of Automated Environments • IT System Risks • Control types in Automated Settings • Role of Data Analytics in Audit • Internal Financial Controls as per laws • Auditor's Response to Assessed Risks	LDR Q 18 Q 21 Q 30 Q 38 Q 52 Q 54 Q 80

QUICK REVIEW OF IMPORTANT CONCEPTS

Audit Risk

Audit Risk	=	**Risk of Material Misstatement**	X	**Detection Risk**
		Risk of material Misstatement = Inherent risk X Control risk.		Detection Risk= Sampling Risk X Non- Sampling Risk

Risk Assessment Procedures

- Inquiries of management and of others within the entity who in the auditor's judgment may have information that is likely to assist in identifying risks of material misstatement due to fraud or error.
- Analytical procedures.
- Observation and inspection.

Risks That Require Special Audit Consideration

- Determine if the risk involves potential fraud.
- Assess if the risk arises from recent significant changes in the economic, accounting, or regulatory environment.
- Evaluate the complexity of the transactions.
- Consider if significant related-party transactions are involved.
- Assess the degree of subjectivity in financial measurements, especially with high uncertainty.
- Identify significant transactions outside normal business operations or those appearing unusual.

Auditor's responses to assessed risks

- Tests of Controls
- Substantive Procedures
  - Tests of Details
    - Tests of transactions i.e. Vouching
    - Tests of balances i.e. Verification

– Substantive analytical procedures

Materiality

Performance Materiality

In order to perform audit of financial statements, auditor needs to set a level of materiality after selecting appropriate benchmark.

However during the course of audit, auditor intends to lower the risk of not detecting a material misstatement and hence he may verify certain transactions or financial items which may be below the set level of materiality however such transactions appear to be important.

Such level (which is below the materiality level) at which auditor performs his procedures is known as performance materiality level.

Revision of Materiality

(a) Materiality for the financial statements as a whole or for particular class of transactions may need to be revised as a result of a change in circumstances that occurred during the audit (for example, a decision to dispose of a major part of the entity's business), new information, or a change in the auditor's understanding of the entity and its operations as a result of performing further audit procedures.

(b) If the auditor concludes a lower materiality for the same, then he should consider the fact that whether it is necessary to revise performance materiality and whether the nature, timing and extent of the further audit procedures remain appropriate.

Use of benchmark in determining Materiality

A percentage is applied to a chosen benchmark as a starting point in determining materiality for the F.S. as a whole.

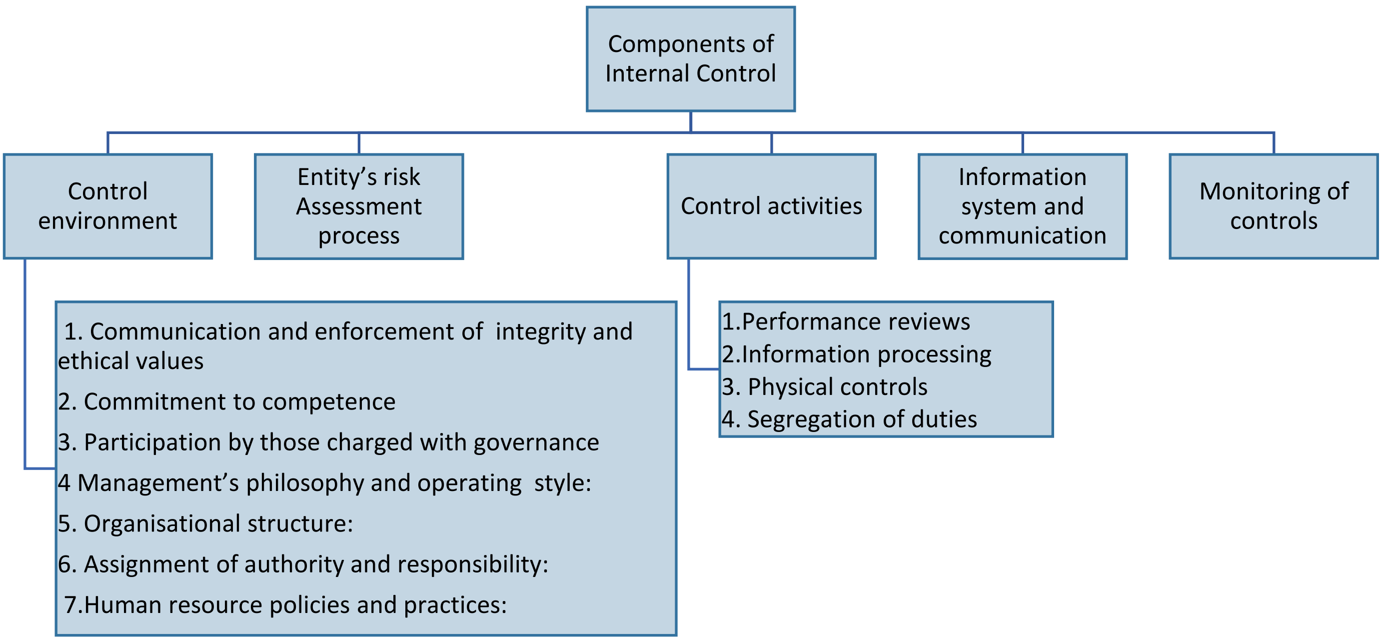
Factors affecting identification of appropriate benchmark

1. The elements of the financial statements;
2. Items on which the attention of the users of the particular entity's financial statements tends to be focused;
3. The nature of the entity, where the entity is at in its life cycle, and the industry and economic environment in which the entity operates;
4. The entity's ownership structure and the way it is financed; and
5. The relative volatility of the benchmark.

Internal Control

Internal control is designed, implemented and maintained to address identified business risks that threaten the achievement of any of the entity's objectives that concern:

- The reliability of the entity's financial reporting
- The effectiveness and efficiency of its operations
- Its compliance with applicable laws and regulations; and
- Safeguarding of assets.



Methods of evaluation of Internal control

1. Narrative Record | 2. Questionnaire | 3. Check List | 4. Flow chart

Internal Financial Controls

- Reliability of financial reporting
- Compliance with applicable laws and regulations
- Prevention and detection of frauds
- Effectiveness and efficiency of operations
- Safeguarding of assets

Understanding of Entity & its Environment

1. Relevant Industry, Regulatory & other External Factors including Financial Reporting Framework.
2. Nature of Entity
3. Selection & Application of Accounting Policies & reasons for changes thereto
4. Entity objectives, strategies and business risks
5. Measurement & review of Financial Performance
6. Internal control relevant to audit

Automated Environment

Understanding and documenting automated environment

- Information systems being used
- Architecture
- In-house vs Packaged
- Their purpose
- Version
- Outsourced activities
- Location of IT systems - local vs global
- Interfaces within systems
- Key persons

Risks arising from use of IT Systems

- Inaccurate processing of data, processing inaccurate data, or both
- Unauthorized access to data.
- Lack of adequate segregation of duties.
- Excessive access / Privileged access (super users).
- Direct data changes (backend changes).
- Unauthorized changes to systems or programs.
- Failure to make necessary changes to systems or programs
- Loss of data.

Types of Controls

- General IT controls
  - Controls over Data centre and network operations
  - Program Change
  - Application system acquisition, development, and maintenance
  - Access Security
- Application controls
- IT-dependent controls

Data Analytics For Audit

- Check completeness of data and population that is used in either test of controls or substantive audit tests.
- Selection of audit samples – random sampling, systematic sampling.
- Re-computation of balances – reconstruction of trial balance from transaction data.
- Reperformance of mathematical calculations – depreciation, bank interest calculation.
- Analysis of journal entries
- Fraud investigation.
- Evaluating impact of control deficiencies

Audit Risk & Risk Assessment Procedures

True & False- Examine with reasons (in short) whether the following statement is correct or incorrect

Question 1

If the auditor assesses a risk of material misstatement regarding litigation or claims that have been identified, the auditor need not seek direct communication with the entity's external legal counsel. *(RTP Nov '21)*

Answer 1

Incorrect: If the auditor assesses a risk of material misstatement regarding litigation or claims that have been identified, or when audit procedures performed indicate that other material litigation or claims may exist, the auditor shall, in addition to the procedures required by other SAs, seek direct communication with the entity's external legal counsel.

Question 2

According to SA 315, the objective of the auditor is to identify and assess the risk of material misstatement, whether due to fraud or error, only at assertion level. ***(RTP May '23)***

Answer 2

Incorrect: According to SA 315, the objective of the auditor is to identify and assess the risk of material misstatement, whether due to fraud or error, at the financial statement and assertion levels, through understanding the entity and its environment, including the entity's internal control.

Question 3

Pervasive is a term used, in the context of misstatements, to describe the effects on the financial statements of misstatements or the possible effects on the financial statements of misstatements, if any, that are detected by obtaining sufficient appropriate audit evidence. .*(PYP 2 Marks May'22)*

Answer 3

Incorrect: Pervasive is a term used, in the context of misstatements, to describe the effects on the financial statements of misstatements or the possible effects on the financial statements of misstatements, if any, that are undetected due to an inability to obtain sufficient appropriate audit evidence.

> **Exam insights:** Meaning of Pervasive: Most of the examinees did not have knowledge of the concept of pervasive.

Question 4

For an auditor, the Risk assessment procedure provides sufficient appropriate audit evidence to base the audit opinion. ***(PYP 2 Marks Nov '19, MTP 2 Marks Apr'23)***

Answer 4

Incorrect: The auditor shall perform risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels. Risk assessment procedures by themselves, however, do not provide sufficient appropriate audit evidence on which to base the audit opinion.

Question 5

There is an inverse relationship between detection risks and the combined level of inherent and control risks. ***(MTP 2 Marks April 22, RTP Nov '22 & Nov '23)***

Answer 5

Correct: There is an inverse relationship between detection risks and the combined level of inherent and control risks. For example, when inherent and control risks are high. acceptable detection risks need to be low to reduce audit risk to an acceptably low level. On the other hand, when inherent and control risks are low, an auditor can accept a higher detection risk and still reduce audit risks to an acceptably low level.

Question 6

Misstatements in the financial statements can arise from either fraud or error. ***(MTP 2 Marks Sep'22, Aug '18, Oct'18 & March '18, PYP 2 Marks July '21)***

Answer 6

Correct: Misstatements in the financial statements can arise from either fraud or error. The distinguishing factor between fraud and error is whether the underlying action that results in the misstatement of the financial statements is intentional or unintentional. Hence misstatement can arise from error or fraud.

Alternative solution: Misstatement refers to a difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Hence misstatement can arise from error or fraud.

Question 7

Control risk is the susceptibility of an account balance or class of transactions to misstatement that could be material either individually or, when aggregated with misstatements in other balances or classes, assuming that there were no related internal controls. ***(MTP 2 Marks Oct'23, RTP May'18, SM)***

Answer 7

Incorrect: Inherent risk is the susceptibility of an account balance or class of transactions to misstatement that could be material either individually or, when aggregated with misstatements in other balances or classes, assuming that there were no related internal controls. Control risk, on the other hand is the risk that a misstatement that could occur in an assertion about a class of transaction, account balance or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control.

Questions & Answers

Question 8

While conducting the audit of Smart TV Ltd, engagement team of HTR& Co, has considered materiality and audit risk throughout the audit. Discuss explaining the meaning of audit risk. ***(RTP May '22)***

Answer 8

Audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of the risks of material misstatement and detection risk. Materiality and audit risk are considered throughout the audit, in particular, when:

(a) Identifying and assessing the risks of material misstatement;

(b) Determining the nature, timing and extent of further audit procedures; and

(c) Evaluating the effect of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report.

Question 9

CA L is in the process of finalizing his Risk Assessment Procedures of Effluent Limited which include observation and inspection that may support inquiries of management and others. Discuss few examples of audit procedures which include observation or inspection of the entity's operations. ***(PYP 3 Marks, July'21)***

Answer 9

Observation and inspection may support inquiries of management and others, and may also provide information about the entity and its environment.

Examples of audit procedures which include observation or inspection of the entity's operations are:

(1) Documents (such as business plans and strategies), records, and internal control manuals.

(2) Reports prepared by management (such as quarterly management reports and interim financial statements) and those charged with governance (such as minutes of board of director's meetings)

(3) The entity's premises and plant facilities.

EXAM INSIGHTS: Examples of audit procedure: Many examinees did not understand the requirement of the question and their answer was not relevant to the topic. Some examinees just explained about observation and inspection which was not required.

Question 10

Satranga Foods Private Limited is engaged in manufacturing of pickles. The auditors of the company have planned audit procedures in respect of recognition of revenues of the company. Despite that, there is a possibility that misstatements in revenue recognition are not identified by planned audit procedures. Identify and explain that particular risk in detail. ***(RTP May'24, SM)***

Answer 10

There is a possibility that planned audit procedures may not achieve desired result and fail to detect

misstatements in revenue recognition.Such a risk is referred to as "detection risk".
SA 200 defines detection risk as the risk that the procedures performedby the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements.
For example, auditor of a company uses certain audit procedures for the purpose of obtaining audit evidence and reducing audit risk, but still there will remain a risk that audit procedures used by the auditor may not be able to detect a misstatement which by nature is material, thenthat risk is known as detection Risk.
Detection risk comprises sampling and non-sampling risk.

(a) **Sampling risk** is the risk that the auditor's conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure. It simply means that the sample was not representative of the populationfrom which it was chosen.

(b) **Non-sampling risk** is the risk that the auditor reaches an erroneous conclusion for any reason not related to sampling risk. Like an auditor may reach an erroneous conclusion due to application to some inappropriate audit procedure.

Question 11

You are appointed as an auditor of Wiwitsu Ltd. Your audit assistant wants to understand the meaning of Audit Risk. Explain him the meaning of Audit Risk with example. Also guide him as to what is not included in Audit Risk. *(PYP 4 Marks May '23)*

Answer 11

Audit risk means the risk that the auditor gives an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of the risks of material misstatement and detection risk. Thus, it is the risk that the auditor may fail to express an appropriate opinion in an audit assignment.

Example

Wiwitsu Limited purchased a Plant and Machinery for ` 2 Crores in the financial year 2021-2022. The accountant of Wiwitsu limited debited ` 2 crores in the repair and maintenance account in the statement of Profit and loss instead of taking it to the balance sheet as PPE and claim depreciation on it. While auditing the accounts of this company the auditor may not notice this and consequently may not report anything regarding the plant and machinery. Therefore, opinion given by the auditor would be inappropriate resulting in audit risk.

What is not included in Audit Risk?

(i) Audit risk does not include the risk that the auditor might express an opinion that the financial statements are materially misstated when they are not. This risk is ordinarily insignificant.

(ii) Further, audit risk is a technical term related to the process of auditing. It does not refer to the auditor's business risks such as loss from litigation, adverse publicity, or other events arising in connection with the audit of financial statements.

> **<u>Exam Insights:</u> Audit Risk:** Many examinees correctly wrote the meaning of audit risk but did not give the example of audit risk which was required to be given. Also, some examinees were not aware of as to what is not included in the audit risk.

Question 12

Risk of material misstatement refers to the risk that the financial statements are materially misstated prior to audit. Discuss the levels at which this risk exists. *(RTP Nov '23 & Nov '20)*

Answer 12

The risks of material misstatement may exist at two levels:

(i) The overall financial statement level - Risks of material misstatement at the overall financial statement level refer to risks of material misstatement that relate pervasively to the financial statements as a whole and potentially affect many assertions.

(ii) The assertion level for classes of transactions, account balances, and disclosures - Risks of material misstatement at the assertion level are assessed in order to determine the nature, timing, and extent of further audit procedures necessary to obtain sufficient appropriate audit evidence. This evidence enables the auditor to express an opinion on the financial statements at an acceptably low level of audit risk.

Question 13

For the purpose of Identifying and assessing the risks of material misstatement, the auditor shall identify risks throughout the process of obtaining an understanding of the entity and its environment. Explain in detail along with other relevant points. *(RTP Nov'20)*

OR

Discuss the steps to be taken by the auditor for the purpose of Identifying and assessing the risks of material misstatement as per SA 315. *(MTP 4 Marks Sep'22)*

or

The objective of an auditor in accordance with SA 315 is to identify and assess risks of material misstatement at financial statement level and assertion level. Which specific activities an auditor is required to perform for the purpose of identifying and assessing risks of material misstatement? *(MTP 4 Marks Mar'24)*

Answer 13

For Identifying and assessing the risks of material misstatement, the auditor shall:

(A) Identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, and by considering the classes of transactions, account balances, and disclosures in the financial statements;

(B) Assess the identified risks, and evaluate whether they relate more pervasively to the financial statements as a whole and potentially affect many assertions;

(C) Relate the identified risks to what can go wrong at the assertion level, tak ing account of relevant controls that the auditor intends to test; and

(D) Consider the likelihood of misstatement, including the possibility of multiple misstatements, and whether the potential misstatement is of a magnitude that could result in a material misstatement.

Question 14

Risks of material misstatement may be greater for significant non-routine transactions arising from matters such as complex calculations. Also, risks of material misstatement may be greater for significant judgmental matters that require the development of accounting estimates, arising from matters such as accounting principles for accounting estimates may be subject to differing interpretation etc. Explain in detail. *(MTP 3 Marks Oct'23, RTP Nov '21)*

OR

Examine with reasons whether the following statements are correct or incorrect. Risks of material misstatement may be greater for significant judgmental matters that require the development of accounting estimates. *(PYP 2 Marks, Nov'20)*

Answer 14

Risks of Material Misstatement– Greater for Significant Non-Routine Transactions

Risks of material misstatement may be greater for significant non-routine transactions arising from matters such as the following:

- Greater management intervention to specify the accounting treatment.
- Greater manual intervention for data collection and processing.
- Complex calculations or accounting principles.
- The nature of non-routine transactions, which may make it difficult for the entity to implement effective controls over the risks.

  Risks of material misstatement– Greater for Significant Judgmental Matters

  Risks of material misstatement may be greater for significant judgmental matters that require the development of accounting estimates, arising from matters such as the following:
- Accounting principles for accounting estimates or revenue recognition may be subject to differing interpretation.
- Required judgment may be subjective or complex, or require assumptions about the effects of future events, for example, judgment about fair value.

A

CHAPTER 4: AUDIT EVIDENCE

Chapter 4.1: SA 500- Audit Evidence

QUICK REVIEW OF IMPORTANT CONCEPTS

Scope

Design and perform audit procedures in such a way as to enable the auditor to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion.

Audit Evidence

- Relevant & Reliable
- Sufficent & Appropriate

Methods to obtain Audit Evidence

- Inspection
- Reperformance
- External Confirmation
- Recalculation
- Inquiry
- Observation
- Analytical procedures

Using the Work of management's expert

a. Evaluate the competence, capabilities and objectivity of that expert;
b. Obtain an understanding of the work of that expert; and
c. Evaluate the appropriateness of that expert's work as audit evidence for the relevant assertion.

Audit procedures to obtain audit evidence

1. Risk Assessment procedures
2. Further audit procedures comprising of: Test of controls and Substantive procedures.

Assertions evaluated

Transaction Occurrence during the year	Account balances at period end	Presentation & Disclosures
Occurence	Existence	Occurrence
Completeness	Rights & Obligations	Completeness
Accuracy	Completeness	Classification
Cut-Off	Valuation & Disclosure	Accuracy & Valuation
Classification		

True & False- Examine with reasons (in short) whether the following statement is correct or incorrect

Question 1

Inquiry alone ordinarily does not provide sufficient audit evidence. ***(MTP 2 Marks Nov '21 & March '22)***

Answer 1

Correct: Most of the auditor's work in forming the auditor's opinion consists of obtaining and evaluating audit evidence. Audit procedures to obtain audit evidence can include inspection, observation, confirmation, recalculation, re-performance and analytical procedures, often in some combination, in addition to inquiry. Although inquiry may provide important audit evidence, and may even produce evidence of a misstatement, inquiry alone ordinarily does not provide sufficient audit evidence of the absence of a material misstatement at the assertion level, nor of the operating effectiveness of controls.

Question 2

While auditing the books of accounts of XYZ Ltd., the auditor of the company was involved in examining records and documents in paper form, electronic form etc. and was also conducting physical examination of assets. In the present case, audit procedure used by the auditor is known as "Observation". ***(MTP 2 Marks Sep '23 & Oct '23)***

Answer 2

Incorrect: The audit procedure used by the auditor of XYZ Ltd. is known as "Inspection". Whereas Observation consists of looking at a process or procedure being performed by others.

Question 3

Negative assertions, encountered in the financial statements, may be expressed or implied. ***(MTP 2 Marks Oct '23, RTP Nov '22)***

Answer 3

Correct: Negative assertions are also encountered in the financial statements and the same may be expressed or implied. For example, if it is stated that there is no contingent liability, it would be an expressed negative assertion. On the other hand, if in the balance sheet there is no item as "building", it would be an implied negative assertion that the entity did not own any building on the balance sheet date.

Question 4

While auditing the books of accounts of XYZ Ltd., the auditor of the company looked at the inventory counting process to obtain audit evidence. In the present case, audit procedure used by the auditor is known as "Inspection". (*RTP May '23, PYP 2 Marks Dec '21)*

Answer 4

Incorrect: The audit procedure used by the auditor of XYZ Ltd. is known as "observation". Whereas inspection involves examining records or documents, whether internal or external, in paper form, electronic form, or other media, or a physical examination of an asset.

> **EXAM INSIGHTS:** Presence of auditor in inventory counting process: Many examinees could not recognize audit procedure as "Observation". Also, most of the examinees did not write about "inspection" to make comparison between the two, which was required to be given.

Question 5

Appropriateness is the measure of the quantity of audit evidence. ***(PYP 2 Marks May '23)***

Answer 5

Incorrect: Appropriateness is the measure of the quality of audit evidence, that is, its relevance and its reliability in providing support for the conclusions on which the auditor's opinion is based. Sufficiency is the measure of quantity of audit evidence.

Question 6

Sales invoice is an example of external evidence. *(PYP 2 Marks Nov'23)*

Answer 6

Incorrect: Evidence which originates within the organisation being audited is called as internal evidence. The evidence that originates outside the client's organization is known as external evidence.

In view of above, sales invoice is an example of internal evidence because it originates within the organisation.

Question 7

Sufficiency is the measure of the quantity of audit evidence. *(PYP 2 Marks Jan'21, SM)*

Answer 7

Correct: Sufficiency is the measure of the quantity of audit evidence. The quantity of audit evidence is affected by the auditors assessment of the risks of misstatement. (Higher the assessed risks the more audit evidence is likely to be required.

Question 8

Assertions refer to the representations by the auditor to consider the different types of the potential misstatements that may occur. *(MTP 2 Marks Oct 20 & March '23, RTP May '23, PYP 2 Marks July '21, SM)*

Answer 8

Incorrect: Assertions refer to representations by management that are embodied in the financial statements as used by the auditor to consider the different types of the potential misstatements that may occur.

> **EXAM INSIGHTS**: Assertions refer to the representations by the auditor: In general most of the examinees wrote the definition of assertions correctly. However, some examinees wrote about the names of various assertions which was not required of the question.

Questions & Answers

Question 9

Discuss the following:

Name the assertions for the following audit procedures:

(i) Year end inventory verification.

(ii) Depreciation has been properly charged on all assets.

(iii) The title deeds of the lands disclosed in the Balance Sheet are held in the name of the company.

(iv) All liabilities are properly recorded in the financial statements.

(v)* Related party transactions are shown properly. *(MTP 5 Marks April '21 PYP 5 Marks, May '18)

Answer 9

(i) Yearend inventory verification: Existence Assertion.

(ii) Depreciation has been properly charged on all assets: Valuation Assertion.

(iii) Title deeds of the lands disclosed in the Balance Sheet are held in the name of the Company: Rights & Obligations Assertion.

(iv) All liabilities are properly recorded in the financial statements: Completeness.

(v) Related party transactions are shown properly: Presentation & Disclosure.

Question 10

The objective of auditing is to design and perform audit procedures in such a way as to enable the auditor to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion. This can be obtained by performing which procedures? Name the types of audit procedures the auditor can perform to obtain audit evidence? *(PYP 4 Marks Nov 22)*

Answer 10

Audit Procedures to Obtain Audit Evidence: Audit evidence to draw reasonable conclusions on which to base the auditor's opinion is obtained by performing:

(I) Risk assessment procedures; and

(II) Further audit procedures, which comprise:

  i. Test of controls, when required by the SAs or when the auditor has chosen to do so; and
  ii. Substantive procedures, including tests of details and substantive analytical procedures.

Audit procedures to obtain audit evidence can include

(a) Inspection
(b) Observation
(c) External Confirmation
(d) Recalculation
(e) Reperformance
(f) Analytical Procedures
(g) Inquiry

Question 11

Management is often in the best position to perpetrate fraud. As an auditor you are suspecting existence or suspicion of fraud from management. Give any three examples of "others within the entity" to whom direct inquiries can be made. ***(PYP 3 Marks May '23)***

Answer 11

Examples of others within the entity to whom the auditor may direct inquiries about the existence or suspicion of fraud include:

1. Operating personnel not directly involved in the financial reporting process.
2. Employees with different levels of authority.
3. Employees involved in initiating, processing or recording complex or unusual transactions and those who supervise or monitor such employees.
4. In-house legal counsel.
5. Chief ethics officer or equivalent person.
6. The person or persons charged with dealing with allegations of fraud.

EXAM INSIGHTS: Direct Inquiries from others within the entity about the existence or suspicion of fraud: Examinees understood the question in wrong manner and wrote inquiries to be made with management, those charged with governance, debtors, creditors and mentioned general points instead of giving specific examples.

Question 12

Maintaining accounts using accounting software having a feature of recording audit trail can be useful for an auditor. Discuss some of the advantages for such a feature in accounting software for auditors. ***(SM)***

Answer 12

An audit trail is a documented flow of a transaction. It is used to investigate how a source document was translated into an account entry and from there it was inserted into financial statement of an entity. It is used as audit evidence to establish authentication and integrity of a transaction. Audit trails help in maintaining record of system and user activity. Like, in case of banks, there is an audit trail keeping track of log-on activity detailing record of log-on attempts and device used.

It is a step-by-step record by which accounting, trade details, or other financial data can be traced to their source. Audit trails are used to verify and track many types of transactions including accounting and financial transactions. Audit trails (or audit logs) act as record-keepers that document evidence of certain events, procedures or operations, because their purpose is to reduce fraud, material errors, and unauthorized use. Audit trails help to enhance internal controls and data security. Audit trails can help in fixing responsibility, rebuilding events and in thorough analysis of problem areas. For example, audit trails can track activities of users thus fixing responsibility for users. These can also be used to rebuild events upon occurring of some problem. Audit trail analysis can specify reason of the problem. It can also help in ensuring operation of system as intended. In this way, audit trails can

help entities in their regular system operations.
Systems which have a feature of audit trail inspires confidence in auditors. It helps auditors in verifying whether controls devised by the management were operating effectively or not. It aids in verification whether a transaction was indeed performed by a person authorised to do it. Since audit trails also enhance data security, these can be used by auditor while performing audit procedures thus increasing reliability of audit evidence obtained.

Question 13

The reliability of information to be used as audit evidence, and therefore of the audit evidence itself, is influenced by its source, its nature and the circumstances under which it is obtained. Explain and elucidate the guiding principles which are useful in assessing the reliability of audit evidence. *(MTP 3 Marks March 22, RTP May '18)*

OR

The reliability of audit evidence depends on its source, nature, and the circumstances under which it is obtained, including the controls over its preparation and maintenance. Although exceptions may exist, few generalisations can be made about reliability of audit evidence. Considering above discuss such generalisations that can be made about the reliability of audit evidence. *(MTP 5 Marks Nov'24)*

Answer 13

Reliability of Audit Evidence: As per SA 500 on "Audit Evidence", the reliability of information to be used as audit evidence, and therefore of the audit evidence itself, is influenced by its source and its nature, and the circumstances under which it is obtained, including the controls over its preparation and maintenance where relevant. Therefore, generalisations about the reliability of various kinds of audit evidence are subject to important exceptions.
While recognising that exceptions may exist, the following guiding principles about the reliability of audit evidence may be useful:

(i) The reliability of audit evidence is increased when it is obtained from independent sources outside the entity.
(ii) The reliability of audit evidence that is generated internally is increased when the related controls, including those over its preparation and maintenance, imposed by the entity are effective.
(iii) Audit evidence obtained directly by the auditor (for example, observation of the application of a control) is more reliable than audit evidence obtained indirectly or by inference (for example, inquiry about the application of a control).
(iv) Audit evidence in documentary form, whether paper, electronic, or other medium, is more reliable than evidence obtained orally (for example, a contemporaneously written record of a meeting is more reliable than a subsequent oral representation of the matters discussed).
(v) Audit evidence provided by original documents is more reliable than audit evidence provided by photocopies or facsimiles, or documents that have been filmed, digitized or otherwise transformed into electronic form, the reliability of which may depend on the controls over their preparation and maintenance.

Question 14

While conducting the audit of Pummy Limited, the statutory auditors collected written representations from the Management. The audit was finalized in addition to other audit procedures but, without making any inquiries, as the statutory auditors were short of time. In the light of this information, state the importance of inquiry as one of the methods of collecting Audit Evidence.
(RTP May '22)

Answer 14

Inquiry: As per SA 500 Audit Evidence: -

(i) Inquiry consists of seeking information of knowledgeable persons, financial and non- financial, within the entity or outside the entity. Inquiry is used extensively throughout the audit in addition to other audit procedures. Inquiries may range from formal written inquiries to informal oral inquiries. Evaluating responses to inquiries is an integral part of the inquiry process.
(ii) Responses to inquiries may provide the auditor with information not previously possessed or with corroborative audit evidence. Alternatively, responses might provide information that differs

significantly from other information that the auditor has obtained, for example, information regarding the possibility of management override of controls. In some cases, responses to inquiries provide a basis for the auditor to modify or perform additional audit procedures.

(iii) Although corroboration of evidence obtained through inquiry is often of particular importance, in the case of inquiries about management intent, the information available to support management's intent may be limited. In these cases, understanding management's past history of carrying out its stated intentions, management's stated reasons for choosing a particular course of action, and management's ability to pursue a specific course of action may provide relevant information to corroborate the evidence obtained through inquiry.

(iv) In respect of some matters, the auditor may consider it necessary to obtain written representations from management and, where appropriate, those charged with governance to confirm responses to oral inquiries

Question 15

Auditing is a logical process. An auditor is called upon to assess the actualities of the situation, review the statements of account and give an expert opinion about the truth and fairness of such accounts. This he cannot do unless he has examined the financial statements objectively. He needs evidence to obtain information for arriving at his judgment. Discuss explaining clearly the meaning of audit evidence in detail. *(MTP 4 Marks Oct'23, RTP Nov '19, RTP Nov'22)*

Answer 15

Auditing is a logical process. An auditor is called upon to assess the actualities of the situation, review the statements of account and give an expert opinion about the truth and fairness of such accounts. This he cannot do unless he has examined the financial statements objectively.

Objective examination connotes critical examination and scrutiny of the accounting statements of the undertaking with a view to assessing how far the statements present the actual state of affairs in the correct context and whether they give a true and fair view about the financial results and state of affairs. An opinion founded on a rather reckless and negligent examination and evaluation may expose the auditor to legal action with consequential loss of professional standing and prestige.

He needs evidence to obtain information for arriving at his judgment.

Audit evidence may be defined as the information used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Audit evidence includes both information contained in the accounting records underlying the financial statements and other information.

Explaining this further, audit evidence includes:-

(1) Information contained in the accounting records: Accounting records include the records of initial accounting entries and supporting records, such as checks and records of electronic fund transfers; invoices; contracts; the general and subsidiary ledgers, journal entries and other adjustments to the financial statements that are not reflected in journal entries; and records such as work sheets and spreadsheets supporting cost allocations, computations, reconciliations and disclosures.

(2) Other information that authenticates the accounting records and also supports the auditor's rationale behind the true and fair presentation of the financial statements: Other information which the auditor may use as audit evidence includes, for example minutes of the meetings, written confirmations from trade receivables and trade payables, manuals containing details of internal control etc. A combination of tests of accounting records and other information is generally used by the auditor to support his opinion on the financial statements.

Question 16

The auditor carries out his work by obtaining audit evidence through performance of audit procedures. However, there are practical and legal limitations on ability of auditor to obtain audit evidence. Give one example each for such practical and legal limitations. *(MTP 3 Marks Mar'24)*

Answer 16

Example of practical limitation on ability of auditor to obtain audit evidence

An auditor does not test all transactions and balances. He forms his opinion only by testing samples. It is an example of practical limitation on auditor's ability to obtain audit evidence.

Example of legal limitation on ability of auditor to obtain audit evidence

Management may not provide complete information as requested by auditor. There is no way by which auditor can force management to provide complete information as may be requested by auditor. In case he is not provided with required information, he can only report. It is an example of legal limitation on auditor's ability to obtain audit evidence.

Question 17

Manya Textiles is manufacturer of bed sheets, curtain cloths, other handloom items etc. having its plant at Panipat. Auditors SJ & Co. is having doubts over the reliability of information given to him as audit evidence. Also, auditors observed inconsistent information while conducting audit. Guide the auditor as to how they should proceed in the given situation. *(RTP Nov'22)*

Answer 17

If:

(a) audit evidence obtained from one source is inconsistent with that obtained from another; or

(b) the auditor has doubts over the reliability of information to be used as audit evidence,

the auditor shall determine what modifications or additions to audit procedures are necessary to resolve the matter, and shall consider the effect of the matter, if any, on other aspects of the audit.

Question 18

In the course of audit of WIVITSU Limited for the financial year ended 31st March, 2020 you have observed as an auditor that the company has provided a sum of ` 20 Lakhs in the books of account as Gratuity payable to employees based on certificate obtained from an actuary. Give your comments with reference to the Standard on Auditing. *(MTP 3 Marks Nov '21)*

Answer 18

Certificate from a Management's Expert: In the given case, WIVITSU Limited has provided a sum of 20 lakh in the books of accounts as gratuity payable on the basis of certificate obtained from an actuary. The liability towards gratuity payable to the employees at the time of cessation of service should be ascertained and provided for in the accounts when the employees are in service, it is an ascertained present liability accruing over the period of service but payable upon cessation of service.

The auditor should check the quantification of the gratuity liability. He should ascertain whether the same had been actuarially determined. The auditor should treat the actuary as managements' expert and conduct procedures relevant to checking the opinion of an expert in accordance with SA 500.

As per SA 500, "Audit Evidence", when information to be used as audit evidence has been prepared using the work of a management's expert, the auditor shall, to the extent necessary, having regard to the significance of that expert's work for the auditor's purposes:

1. Evaluate the competence, capabilities and objectivity of that expert;
2. Obtain an understanding of the work of that expert; and
3. Evaluate the appropriateness of that expert's work as audit evidence for the relevant assertion.

Question 19

CA Kanika audited books of accounts of Engineering Ltd. for the financial year 2022-2023. The auditor used an audit procedure according to which all the documents and records maintained by the company were checked in detail to obtain audit evidence. Explain the audit procedure used by the auditor. Comment on reliability of audit evidence obtained by performing such an audit procedure in some situations. *(RTP May'24 PYP 3 Marks, Dec'21)*

Answer 19

Inspection involves examining records or documents, whether internal or external, in paper form, electronic form, or other media, or a physical examination of an asset. In view of above, it can be concluded that CA Kanika used Inspection as an audit procedure.

Inspection of records and documents provides audit evidence of varying degrees of reliability, depending on their nature and source and, in the case of internal records and documents, on the effectiveness of the controls over their production.

allowed to follow the external auditor's instructions, and that the entity will not intervene in the work the internal auditor performs for the external auditor and

(b) Obtain written agreement from the internal auditors that they will keep confidential specific matters as instructed by the external auditor and inform the external auditor of any threat to their objectivity.

Examples of procedures in which CA Mukul shall not use internal auditor to provide direct assistance to him are: -

(a) Procedures which involve making significant judgments in the audit;

(b) Procedures relating to higher assessed risks of material misstatement where the judgment required in performing the relevant audit procedures or evaluating the audit evidence gathered is more than limited.

(c) Procedures relating to work with which the internal auditors have been involved and which has already been, or will be, reported to management or those charged with governance by the internal audit function; or

(d) Procedures relating to decisions the external auditor makes in accordance with this SA regarding the internal audit function andthe use of its work or direct assistance.

Multiple Choice Questions (MCQ)

1. Which of the following is not one of functions of internal auditor of an organization? (SM)

(a) Performing assurance activities

(b) Performing consulting activities to improve governance of organization

(c) Performing risk management activities

(d) Expressing independent opinion on financial statements of organization

Ans: (d)

2. CA M is internal auditor of Crayon Products Limited. Which of the following is not TRUE about scope of internal audit? (MTP 1 Marks Oct'22)

(a) Internal audit is an independent assurance activity.

(b) Internal audit helps in improving internal control of the company.

(c) Internal audit cannot review non-financial activities of company.

(d) Internal audit can review compliance of company with various laws and regulations.

Ans: (c)

Chapter 4.3: SA 530- Audit Sampling

QUICK REVIEW OF IMPORTANT CONCEPTS

Meaning of Sampling Risk

Risk that auditor's conclusion based on a sample is different from the conclusion if the entire population were subjected to same audit procedure.

Characteristics of Population

- Appropriateness
- Completeness
- Reliable

Approaches to Sampling

- Statistical Samplling
- Non- Statistical Samplling

Methods of selection of sample size:

(1) Random Sampling:
- Simple Random Sampling
- Stratified Sampling

(2) Interval Sampling or Systematic Sampling
(3) Monetary Unit Sampling
(4) Haphazard Sampling
(5) Block Sampling

Sampling Process

- Sample Design
- Sample Size
- Sample Selection
- Audit Procedures
- Nature and Cause of Deviation
- Projecting
- Evaluating Results of Audit

Requirements relating to Sample design, Sample size and Selection of items for testing

- **Sample Design**: The auditor considers the purpose of the audit procedure and the population characteristics when designing the sample.
- **Sample Size**: The auditor determines a sample size that reduces sampling risk to an acceptably low level.
- **Item Selection**: The auditor selects sample items to ensure each unit in the population has a chance of being chosen

Nature and Cause of Deviations and Misstatements

- Investigate the nature and cause of deviations to assess their potential impact on audit procedures and other audit areas.
- If a misstatement or deviation is considered an anomaly, the auditor must obtain a high degree of certainty that it is not representative of the population by performing additional audit procedures.

Evaluating Results of Audit Sampling

- The results of the sample; and
- Whether the use of audit sampling has provided a reasonable basis for conclusions about the population that has been tested.

True & False- Examine with reasons (in short) whether the following statement is correct or incorrect

Question 1

Systematic sampling means dividing heterogeneous population into homogeneous sub population, where samples are drawn from each sub population. *(MTP 2 Marks Oct'22)*

Answer 1

Incorrect: Stratification means dividing heterogeneous population into homogeneous sub population, where samples are drawn from each sub population. Systematic sampling is a selection method in which the number of sampling units in the population is divided by the sample size to give a sampling interval, for example 50, and having determined a starting point within the first 50, each 50th sampling unit thereafter is selected.

Question 2

The higher the auditor's assessment of the risk of material misstatement, the smaller the sample size needs to be. *(MTP 2 Marks Oct'22)*

Answer 2

Incorrect: The higher the auditor's assessment of the risk of material misstatement, the larger the sample size needs to be. The auditor's assessment of the risk of material misstatement is affected by inherent risk and control risk. Therefore, in order to reduce audit risk to an acceptably low level, the auditor needs a low detection risk and will rely more on substantive procedures. The more audit evidence that is obtained from tests of details (that is, the lower the detection risk), the larger the sample size will need to be.

Question 3

The level of sampling risk that the auditor is willing to accept will not affect the sample size. *(MTP 2 Marks April 22, RTP Nov '22)*

Answer 3

Incorrect: As per SA 530, "Audit Sampling" the level of sampling risk that the auditor is willing to accept affects the sample size required. The lower the risk the auditor is willing to accept, the greater the sample size will need to be.

Question 4

Low acceptable sampling risk requires larger sample size. *(MTP 2 Marks March '23, SM)*

Answer 4

Correct: Sampling risk arises from possibility that the auditor's conclusion based upon sample may be different from conclusion that would have been reached if same audit procedures were applied on the entire population. If acceptable sampling risk is low, large sample size is needed.

Question 5

Block sampling does not involve judgement, does not even use the random number tables and has no structured approach. *(PYP 2 Marks Nov'23)*

Answer 5

Incorrect: Haphazard sampling has no structured approach, does not involve judgment and does not even use the random number tables.

On the other hand, Block sampling involves selection of a block(s) of contiguous items from within population. Such selection has a risk of bias and of establishing a pattern of selection. Therefore, block sampling involves use of judgment.

Question 6

In case of stratified sampling, the conclusions are drawn on the stratum. *(MTP 2 Marks Sep'22, PYP 2 Marks July'21, SM)*

Answer 6

Correct: In case of stratified sampling, the conclusions are drawn on the stratum. The combination of all the conclusions on stratum together will be used to determine the possible effect of misstatement or deviation. Hence the samples are used to derive conclusion only on the respective stratum from where they are drawn and not the whole population

Question 7

Statistical sampling being more scientific and without personal bias will always be appropriate to use under all circumstances. *(MTP 2 Marks April '23 & Oct '23, PYP 2 Marks Dec '21)*

Answer 7

Incorrect: Statistical sampling is widely accepted way of sampling as it is more scientific, without personal bias and the result of sample can be evaluated and projected in more reliable way.

Under some audit circumstances, statistical sampling methods may not be appropriate. The auditor should not attempt to use statistical sampling when another approach is either necessary or will provide satisfactory information in less time or with less effort. For instance, when exact accuracy is required or in case of legal requirements etc.

Chapter 4.4: SA 501- Audit Evidence-Specific Considerations for Selected Items

QUICK REVIEW OF IMPORTANT CONCEPTS

Evidence About Existence Condition Of Inventory

- Inspecting the inventory
- Observing compliance with management's instructions for recording and controlling results of physical inventory count
- Obtaining audit evidence as to the reliability of management's count procedures
- Performing audit procedures over the entity's final inventory records

Special Procedures

1. Inventory counting conducted at date other than Balancesheet date - Perform audit procedures to obtain audit evidence / about whether changes in inventory between the count date and the date of the F.S. are properly recorded.
2. Auditor unable to attend Inventory Count - Make or observe some physical counts on an alternative date and perform audit procedures on intervening transactions.
3. Attendance at inventory count is impracticable - Perform alternative audit procedures to obtain evidence regarding existence and condition of inventory. If it is not possible to do so, modify the opinion in the auditor's report in accordance with SA 705.
4. Inventory under custody and control of Third Party -Request confirmation from third party and perform other audit procedures.

Litigation & Claims

Audit Procedures

- Inquiry of management
- Reviewing minutes of meetings
- Reviewing legal expense accounts

If management refuses to permit auditor to communicate with legal counsel / external legal counsel refuses / auditor unable to collect SAAE by performing alternate procedures modify opinion in accordance with SA 705.

Segment Reporting

The auditor shall obtain sufficent and appropriate audit evidence regarding presentation and disclosure of segment information in accordance with applicable Financial Reporting Framework by:

(a) Obtaining understanding of such methods used by management in determining segment information in accordance with applicable Financial Reporting Framework.

(b) Performing analytical procedures or other audit procedures appropriate in the circumstance.

Inventories

True & False- Examine with reasons (in short) whether the following statement is correct or incorrect

Question 1

When inventory under the custody and control of a third party is material to the financial statements, the auditor cannot obtain sufficient appropriate audit evidence regarding the existence and condition of that inventory by taking written representation from management. (*MTP 2 Marks Sep '23, RTP May '23, SM)*

Answer 1

Correct: When inventory under the custody and control of a third party is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of that inventory by performing one or both of the following:

(a) Request confirmation from the third party as to the quantities and condition of inventory held on behalf of the entity.

(b) Perform inspection or other audit procedures appropriate in the circumstances.

Questions & Answers

Question 2

In an initial audit engagement, in the case of inventories, the current period's audit procedures on the closing inventory balance provide little audit evidence regarding inventory on hand at the beginning of the period. Therefore, in such a case, additional audit procedures become necessary so that auditor may obtain sufficient appropriate audit evidence. Discuss those additional audit procedures. ***(MTP 3 Marks Apr'24)***

Answer 2

In an initial audit engagement, in the case of inventories, the current period's audit procedures on the closing inventory balance provide little audit evidence regarding inventory on hand at the beginning of the period. Therefore, additional audit procedures may be necessary, and one or more of the following may provide sufficient appropriate audit evidence:

- Observing a current physical inventory count and reconciling it to the opening inventory quantities.
- Performing audit procedures on the valuation of the opening inventory items.
- Performing audit procedures on gross profit and cut-off.

Question 3

Narrate the audit procedures to be performed by an auditor in order to ascertain that the Raw materials and consumables are valued appropriately and as per generally accepted accounting policies and practices. ***(PYP 4 Marks Nov'23)***

Answer 3

Audit procedures performed by an auditor in order to ascertain that raw material and consumables are valued appropriately in accordance with generally accepted accounting policies and practices are as under:

1. Ascertain what elements of cost are included e.g. carriage inward, non-refundable duties etc.
2. If standard costs are used, enquire into basis of standards; how these are compared with actual costs and how variances are analyzed and accounted for/ treated in accounting records.
3. Test check cost prices used with purchase invoices received in the month(s) prior to counting.
4. Follow up valuation of all damaged or obsolete inventories noted during observance of physical counting with a view to establishing a realistic net realizable value.

> **Exam insights:** Audit Procedures relating to Valuation of Raw materials/consumables: Examinees failed to explain the audit procedure relating to Valuation of raw materials/consumables and mentioned various other types of assertions like completeness, cut-off procedures and external confirmations.

Question 4

While conducting audit of Vee Ltd, CA Aman, auditor of the company, found that some goods are lying with third party for a long period. Advise Aman how will he verify them. ***(MTP 4 Marks Oct '21)***

Answer 4

Goods Lying with Third Party: The auditor should check that the materiality of the item under this caption included in inventories.

(i) He should obtain confirmation of the amount of goods lying with them. The confirmation may be directly obtained by auditor or be produced by client depending upon the situation.

(ii) He should inquire into the necessity of sub contractor retaining the inventory. He should ensure the process that they do are related to the business requirement and there is no ground for suspicion on this score.

(iii) The goods lying with them for the very long period would merit auditors' special attention for making provision.

(iv) The records, voucher/slips for the regulating the movement of inventory into and out of entity for sub-contracting work be reviewed by vouching for few transaction for ensuring existence and working of internal control system for them.

(v) The excise gate pass, entry in such records, information in returns, be also cross-verified.

(vi) The valuation of inventories should be correctly made for including material cost on appropriate inventory valuation formulae and also for inclusion of proportionate processing charges for the work in

CA INTERMEDIATE

VIVITSU

PAPER 6

Financial Management & Strategic Management Reviewer

Chapter-wise compilation

RTP, MTP and PYP questions

KEY HIGHLIGHTS

- Easy to Hard Difficulty Level
- Importance levels marked as A, B or C
- Reference to all questions
- Quick recap of important concepts
- Exam Insights
- Last Day Revision Questions Marked

APPLICABLE FOR MAY'25, SEPT'25 AND JAN'26

VIVITSU

STRIVING TOWARDS KNOWLEDGE

This book belongs to future,

CA Finalist ________________________________

"You become what you believe."

-Oprah Winfrey

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YOU MUST BE WONDERING

How to Read this book?

Step 1
01 — Prioritize more time for 'A' chapters in the ABC analysis

Step 2
02 — Identify key concepts in each chapter.

Step 3
03 — Solve questions in order, from easy to difficult.

Step 4
04 — Focus on solving LDR questions during the final revision

Step 1: Prioritize your chapters

Chapters in the index are categorized as A, B, or C based on their importance. Focus more on 'A' chapters, as they carry the most weight, and give adequate attention to 'B' chapters. While all chapters must be covered, this approach helps manage time efficiently for better results.

Step 2: Identify key concept

Identify the key concepts for each chapter using the list provided at the start of the chapter. Ensure you understand them thoroughly. If you struggle with a question, revisit the concepts, review them, and strengthen your understanding before moving forward.

Step 3: Start easy

Start with Question 1, as they progress from easy to difficult, helping you build confidence throughout the chapter. Pay close attention to the "EXAM INSIGHTS" to avoid common mistakes. Questions are segregated topic wise where possible.

LDR

Step 4: Last Day Revision (LDR)

Focus on solving LDR questions during the final revision. In the 1.5 days before the exam, prioritize these questions as they cover the most critical concepts from each chapter. You'll find a quick summary of LDR question numbers listed right before each chapter for easy reference.

Table of Contents

ABC Analysis

A Very Important, Read on priority

B Moderately Important

C Less critical but still essential

Ensure you thoroughly read all chapters without skipping any. The ABC analysis is designed to help you prioritize based on past trends, but it should not replace comprehensive preparation.

Chapter 4: COST OF CAPITAL

CONCEPTS OF THIS CHAPTER	LDR Questions
• Need and Sources of Finance. • Cost of Capital: Meaning and Sources. • Measure Cost of Individual Capital Components. • Calculate Weighted and Marginal Cost of Capital.	Q 26 Q 27 Q 31 Q 32

QUICK REVIEW OF IMPORTANT CONCEPTS

COST of LONG-TERM DEBT(K_d)

Cost of Irredeemable Debentures

$$K_d = \frac{I}{NP}(1-t)$$

K_d = Cost of debt after tax
I = Annual interest payment
NP = Net proceeds of debentures* (new) or Current market price (existing)
t = Tax rate

*Net proceeds means issue price less issue expenses or floatation cost

Cost of Redeemable Debentures

Using Approximation method

$$\#K_d = \frac{I(1-t) + \frac{(RV-NP)}{n}}{\frac{(RV+NP)}{2}}$$

$$K_d = \frac{I + \frac{(RV-NP)}{n}}{\frac{(RV+NP)}{2}}(1-t)$$

I = Interest payment
NP = Net proceeds (new) or Current market price (existing)
RV = Redemption value of debentures
t = Tax rate applicable to the company
n = Remaining life of debentures

#is formula is used where only interest on debt is tax deductible. Sometime, debts are issued at discount and/ or redeemed at a premium. If such discount on issue and/ or premium on redemption are tax deductible then the second formula is used.

Yield to maturity (YTM) approach

Step-1: Identify the cash flows

Year	Cash flows
0	Net proceeds in case of new issue/ Current market price in case of existing debt (NP or P_O)
1 to n	Interest net of tax [I(1-t)]
n	Redemption value (RV)

Step-2: Calculate NPVs of cash flows as identified above using two discount rates (guessing) to get each a positive NPV (lower rate) and a negative NPV (higher rate).

Step-3: Calculate IRR.

$$IRR = L + \frac{NPV_L}{NPV_L - NPV_H}(H-L)$$

Here, H and L stands for higher discount rate and lower discount rate respectively. It is to be noted that higher the difference between H and L, lower the accuracy of answer.

Amortisation of Bond

Value of Bond VB =

$$V_B = \sum_{t=1}^{n} \frac{C_t}{(1+K_d)^t}$$

COST of PREFERENCE SHARE CAPITAL (K_p)

Cost of Irredeemable Preference Shares

$$K_P = \frac{PD}{P_O}$$

PD= Annual preference dividend

P_O = Net proceeds\$ from issue of preference shares

\$Net proceeds means issue price less issue expenses or floatation cost

Cost of Redeemable Preference Shares

$$K_p = \frac{PD + \frac{(RV - NP)}{n}}{\frac{(RV + NP)}{2}}$$

PD = Annual preference dividend

RV = Redemption value of preference shares

NP = Net proceeds from issue of preference shares

n = Remaining life of preference shares

COST of EQUITY SHARE CAPITAL (K_e)

Dividend Price Approach

$$K_e = \frac{D}{P_0}$$

D = Expected dividend (also written as D_1)

P_0 = Market price of equity (ex- dividend)

Earnings Price Approach

$$K_e = \frac{E}{P}$$

E = Current earnings per share

P = Market price per share

Growth Approach or Gordon's Model

$$K_e = \frac{D_1}{P_0} + g$$

D_1 = [D_0 (1+ g)] i.e. next expected dividend

P_0 = Current Market price per share

g = Constant Growth Rate of Dividend

In case of newly issued equity shares where **floatation cost is incurred**

$$K_e = \frac{D_1}{P_0 - F} + g$$

Where,

F = Flotation cost per share

Estimation of Growth Rate

1. Average Method

   Current Dividend $(D_0) = D_n(1+g)^n$

   D_0 = Current dividend

   D_n = Dividend in n years ago

2. Gordon's Growth Model

   Growth (g) = b × r

   b = earnings retention rate*

   r = rate of return on fund invested

*Proportion of earnings available to equity shareholders which is not distributed as dividend.

Capital Asset Pricing Model (CAPM) Approach

$$K_e = R_f + ß\,(R_m - R_f)$$

K_e = Cost of equity capital

R_f = Risk free rate of return

ß = Beta coefficient (represents systematic risk)

R_m = Rate of return on market portfolio

$(R_m - R_f)$ = Market risk premium

COST of RETAINED EARNINGS (Kr)

Formulas used for calculation of cost of retained earnings are same as formulas used for calculation of cost of equity.

Weighted Average Cost Of Capital (WACC)

Steps to calculate WACC:

Step 1	**Calculate** the **total capital** from all the sources of capital.
Step 2	Calculate the proportion (or %) of each source of capital to the total capital.
Step 3	**Multiply** the **proportion** as calculated in Step 2 above with the respective **cost of capital**.
Step 4	**Aggregate** the **cost of capital** as calculated in Step 3 above**. This is the WACC.**

Choice of Weights

- Book Value (BV)
- Market Value (BV)

Questions & Answers

Theory Questions

Question 1

DISCUSS the dividend-price approach to estimate cost of equity capital
(MTP 2 Marks, Mar'19 & Oct '23 & Mar'24)

Answer 1

In dividend price approach, cost of equity capital is computed by dividing the expected dividend by market price per share. This ratio expresses the cost of equity capital in relation to what yield the company should pay to attract investors. It is computed as:

$$K_e = \frac{D_1}{P_0}$$

Where, $\mathbf{K_e}$ = Cost of equity

D_1 = Expected dividend (also written as $\mathbf{D_1}$)

$\mathbf{P_0}$ = Market price of equity (ex- dividend)

Question 2

"Financing a business through borrowing is cheaper than using equity." Briefly EXPLAIN
(MTP 2 Marks, May'20 & Sep'23)

Answer 2

Financing a business through borrowing is cheaper than using equity"

(i) Debt capital is cheaper than equity capital from the point of its cost and interest being deductible for income tax purpose, whereas no such deduction is allowed for dividends.

(ii) Issue of new equity dilutes existing control pattern while borrowing does not result in dilution of control.

(iii) In a period of rising prices, borrowing is advantageous. The fixed monetary outgo decreases in real terms as the price level increases.

Question 3

EXPLAIN any four Methods for Computation of Cost of Equity Capital. ***(RTP Jan'25)***

Answer 3

Cost of equity capital is the rate of return which equates the present value of expected dividends with the market share price.

Methods for Computation of Cost of Equity Capital

- **Dividend Price Approach (:** Here, cost of equity capital iscomputed by dividing the expected dividend by market price per share.

  $$K_e = \frac{D_1}{P_0}$$

- **Earning/ Price Approach:** The advocates of this approach co- relate the earnings of the company with the market price of its share.

$K_e = \frac{E}{P}$

- **Realized Yield Approach:** According to this approach, the average rate of return realized in the past few years is historically regarded as 'expected return' in the future. The yield of equity for the year is:

  $Y_t = \frac{D_t + P_t}{P_{t-1}}$

- **Capital Asset Pricing Model Approach (CAPM):** CAPM model describes the risk-return trade-off for securities. It describes the linear relationship between risk and return for securities.

  $K_e = R_f + ß (R_m - R_f)$

Practical Questions

Question 4

Theta Limited is expecting an annual earning of Rs. 3 Lakhs before paying any interest and taxes. The company has Rs. 10 lakhs of 10% debentures in its capital structure. The capitalization rate is 12.5%. You are required to calculate the value of Theta Limited as per the NI approach. Also, COMPUTE the overall cost of capital. *(MTP 5 Marks Dec'24)*

Answer 4

EBIT = ₹ 3,00,000

Less: Interest = ₹ 10,00,000 × 10% = ₹ 1,00,000

Earnings available to equity shareholders = ₹ 2,00,000

Equity capitalization rate = 12.5%

Market value of equity = $\frac{₹\ 2,00,000}{12.5\ \%}$ = ₹ 16,00,000

Market value of debt = ₹ 10,00,000

Market value of the firm = ₹ 26,00,000

Overall cost of capital = $\frac{₹\ 3,00,000 \times 100}{₹\ 26,00,000}$ = 11.54 %

Question 5

Answer the following:

The capital structure of a Company is given below:

Source of capital	Book Value (₹)
Equity shares @ ₹ 100 each	24,00,000
9% Cumulative preference shares @ ₹ 100 each	4,00,000
11% Debentures	12,00,000
	40,00,000

The company had paid equity dividend @ 25% for the last year which is likely to grow @ 5% every year. The current market price of the company's equity share is ₹ 200.

Considering corporate tax @ 30%, you are required to CALCULATE:

(i) Cost of capital for each source of capital.

(ii) Weighted average cost of capital. *(MTP 5 Marks, Sep'22)*

Answer 5

i. Calculation of Cost of Capital for each source of capital:

(a) Cost of Equity share capital:

$$K_e = \frac{D_0\ (1+g)}{\text{Market Pr iceper share}(P_0)} + g = \frac{25\% \times ₹100(1+0.05)}{\mathbf{₹200}} + 0.05$$

$$= \frac{₹\ 26.25}{₹\ 200} + 0.05 = 0.18125 \text{ or } \mathbf{18.125\%}$$

(b) Cost of Preference share capital (K_p) = 9%

(c) Cost of Debentures (K_d) = r (1 – t)

= 11% (1 – 0.3) = **7.7%**

ii. Weighted Average Cost of Capital

Source	Amount (₹)	Weights (a)	After tax Cost of Capital (%) (b)	WACC (%) (c) = (a) × (b)
Equity share	24,00,000	0.60	18.125	10.875
9% Preference share	4,00,000	0.10	9.000	0.900
11% Debentures	12,00,000	0.30	7.700	2.310
	40,00,000	1.00		14.085

Question 6

Paarath Limited had recently repurchased 20,000 equity shares at a premium of 10% to its prevailing market price. The book value per share (after repurchasing) is ₹ 193.20.
Other Details of the company are as follows:
Earnings of the company (before buyback) = ₹ 18,00,000
Current MPS is ₹ 270 with a P/E Ratio of 18.
CALCULATE the Book Value per share of the company before the re-purchase. ***(MTP 5 Marks, Aug'24)***

Answer 6

i. No of Eq. Shares (before buyback) = Total Earnings (before buyback)/EPS
= 18,00,000/(270/18)
= 1,20,000 shares

ii. Buyback price = 270 + 10% premium = 297

iii. No of Eq. shares (after buyback) = 1,20,000 (-) 20,000 = 1,00,000 shares

iv. Total Book Value of Equity (after buyback) = 1,00,000 X 193.20
= 1,93,20,000
Now,
Total BV of Eq. (after buyback) = Total BV of Eq. (before buyback) (-) Amt of buyback
1,93,20,000 = x (-) (20,000 X 297)
Therefore x = Total BV (before buyback)
= 2,52,60,000
BV per share (before buyback) = 2,52,60,000 / 1,20,000
= 210.50 per share

Question 7

Development Finance Corporation issued zero interest deep discount bonds of face value of Rs. 1,50,000 each issued at Rs. 3,750 & repayable after 25 years. COMPUTE the cost of debt if there is no corporate tax.
(MTP 3 Marks, Apr'21)

Answer 7

Here,
Redemption Value (RV)= Rs.1,50,000,
Net Proceeds (NP) = Rs. 3,750,
Interest = 0,
Life of bond = 25 years
There is huge difference between RV and NP therefore in place of approximation method we should use trial & error method.
FV = PV x $(1 + r)^n$
1,50,000 = 3,750 x $(1 + r)^{25}$
40 = $(1 + r)^{25}$
Trial 1: r = 15%, $(1.15)^{25}$ = 32.919
Trial 2: r = 16%, $(1.16)^{25}$ = 40.874
Here:

L = 15%; H = 16%

NPV_L = 32.919 - 40 = - 7.081

NPV_H = 40.874 - 40 = + 0.874

IRR = L + $\frac{NPV_L}{NPV_L - NPV_H}$ (H - L)

=15% + $\frac{-7.081}{-7.081-(0.874)} \times (16\% - 15\%) = 15.89\%$

Question 8

Mr. Anand is thinking of buying a Share at ₹ 500 whose Face Value per share is ₹ 100. He is expecting a bonus at the ratio 1: 5 at the end of the fourth year. Annual expected dividend is 20% and the same rate is expected to be maintained on the expanded capital base. He intends to sell the Shares at the end of seventh year at an expected price of ₹ 900 each. Incidental Expenses for purchase and sale of Shares are estimated to be 5% of the Market Price. Assuming a Discount rate of 12% per annum, COMPUTE the Net Present Value from the acquisition of the shares. *(MTP 5 Marks, Aug'24)*

Answer 8

Computation of PV of Future Cash Flows

Year	Nature	Cash Flow	DF @ 12%	DCF
1	Dividends (₹ 100 × 20%)	20	0.893	17.86
2	Dividends (₹ 100 × 20%)	20	0.797	15.94
3	Dividends (₹ 100 × 20%)	20	0.712	14.24
4	Dividends (₹ 100 × 20%)	20	0.636	12.72
5	Dividends (₹ 100 × 1.2 × 20%)	24	0.567	13.61
6	Dividends (₹ 100 × 1.2 × 20%)	24	0.507	12.17
7	Dividends (₹ 100 × 1.2 × 20%)	24	0.452	10.85
7	Net Sale Proceeds (₹ 900 × 1.2 – 5%)	1,026	0.452	463.75
	Present Value of Cash Inflows			561.14
0	Less: Initial Investment (₹ 500 + 5%)	525	1	525.00
	Net Present Value			36.14

Note: At the end of Year 4, Anand will have 1.2 Share i.e. 1 Bought Share + $1/5^{th}$ Bonus Share.

Question 9

The following is the capital structure of Sharda Ltd. as on 31.12.2020:

	(₹)
Equity shares: 2,00,000 shares (of Rs.100 each)	**2,00,00,000**
9% Preference Shares (of Rs.100 each)	**60,00,000**
8% Debentures	**90,00,000**
	3,50,00,000

The market price of the company's share is Rs.120 and it is expected that a dividend of Rs.12 per share would be declared for the year 2021. The dividend growth rate is 5% and the company is in the 30% tax bracket.

(i) CALCULATE the company's weighted average cost of capital.

(ii) Further, in order to finance an expansion plan, the company intends to borrow a fund of ₹ 2 crores bearing 12% rate of interest. In this situation, WHAT will be the company's revised weighted average cost of capital? This financing decision is expected to increase dividend from Rs.12 to Rs.14 per share. However, the market price of equity share is expected to decline from Rs.120 to Rs.115 per share.

In case of both (I) and (ii) above, use market value weight while calculating weighted average cost of capital. *(MTP 5 Marks, Oct'21)*

Answer 9

i. Computation of the weighted average cost of capital

Source of finance (a)	Market Value of capital (₹)	Weight (b)	After tax Cost of capital (%)(c)	WACC (%) (d) = (b) × (c)
Equity share (Working note 1) [₹120 × 2,00,000 shares]	2,40,00,000	0.6154	15	9.231
9% Preference share	60,00,000	0.1538	9	1.3842
8% Debentures	90,00,000	0.2308	5.60	1.2925
	3,90,00,000	1.0000		11.9077

ii. Computation of Revised Weighted Average Cost of Capital

Source of finance (a)	Market Value of capital (₹)	Weight (b)	After tax Cost of capital (%) (c)	WACC (%) (d) = (b) × (c)
Equity shares (Working note 2) [₹115 × 2,00,000 shares]	2,30,00,000	0.3966	17.17	6.8096
9% Preference shares	60,00,000	0.1034	9.00	0.9306
8% Debentures	90,00,000	0.1552	5.60	0.8691
12% Loan	2,00,00,000	0.3448	8.40	2.8963
	5,80,00,000	1.0000		11.5056

Working Notes:

(1) Cost of Equity Shares

K_e = {Dividend Per Share (D_1)/Market Price Share (P_0)} + Growth Rate

= 12/120 + 0.05

= 0.15 or 15%

(2) Revised cost of equity shares (Ke)

Revised K_e = 14/115 + 0.05

= 0.1717 or 17.17%

Question 10

The capital structure of RV Limited as on 31st March, 2022 as per its Balance Sheet is as follows:

Particulars	₹
Equity shares of ₹ 10 each	25,00,000
10% Preference shares of ₹ 100 each	5,00,000
Retained earnings	5,00,000
13% debentures of ₹ 100 each	20,00,000

The market price of equity shares is ₹ 50 per share. Expected dividend on equity shares is ₹ 3 per share. The dividend per share is expected to grow at the rate of 8%.

Preference shares are redeemable after eight years and the current market price is ₹ 80 per share. Debentures are redeemable after five years and are currently selling at ₹ 90 per debenture.

The tax rate applicable to the company is 35%.

CALCULATE weighted average cost of capital using:

(i) Book value proportions

(ii) Market value proportions *(MTP 10 Marks, Apr'22)*

Answer 10

Working Notes:

(i) Cost of Equity (K_e)

$\frac{D_1}{P} + g = \frac{Rs.3}{Rs.50} + 0.08 = 0.14$ i.e. 14%

(ii) Cost of preference Shares (K_p)

$\frac{D+\frac{RV-NP}{n}}{\frac{RV+NP}{2}} = \frac{10+\frac{(100-80)}{8}}{\frac{100+80}{2}} = \frac{12.5}{90} = 0.1389 = 13.89\%$

(iii) Cost of debenture (K_d)

$$\frac{I(1-t)+\frac{RV-NP}{n}}{\frac{RV+NP}{2}} = \frac{13(1-0.35)+\frac{100-90}{5}}{\frac{100+90}{2}} = \frac{8.45+2}{95} = 0.11 \text{ i.e.} 11\%$$

Or,

$$\left[\frac{I+\frac{RV-NP}{n}}{\frac{RV+NP}{2}}\right](1-t) = \left[\frac{13+\frac{100-90}{5}}{\frac{100+90}{2}}\right](1-0.35) = 0.1026 \text{ i.e.} 10.26\%$$

Weighted Average cost of capital (Book Value)

	Amount (₹)	Weight (W)	Cost (K)	W x K
Equity shares	25,00,000	0.4546	0.14	0.0636
Preference shares	5,00,000	0.0909	0.1389	0.0126
Retained Earnings	5,00,000	0.0909	0.14	0.0127
Debentures	20,00,000	0.3636	0.1026	0.0373
	55,00,000			0.1262

Or (if K_d is 11%) the WACC = 0.1289

Thus, WACC (Book value based) = 12.62% or 12.89%

Weighted Average cost of capital (Market Value)

	Amount (₹)	Weight (W)	Cost (K)	W x K
Equity shares	1,25,00,000	0.85	0.14	0.119
Preference shares	4,00,000	0.028	0.1389	0.0039
Debentures	18,00,000	0.122	0.1026	0.0125
	1,47,00,000			0.1354

Or (if K_d is 11%) the WACC = 0.1363

Thus, WACC (Market value based) = 13.54% or 13.63%

Question 11

Kalyanam Ltd. has an operating profit of ₹ 34,50,000 and has employed Debt which gives total Interest Charge of ₹ 7,50,000. The firm has an existing Cost of Equity and Cost of Debt as 16% and 8% respectively. The firm has a new proposal before it, which requires funds of ₹ 75 Lakhs and is expected to bring an additional profit of ₹ 14,25,000. To finance the proposal, the firm is expecting to issue an additional debt at 8% and will not be issuing any new equity shares in the market. Assume no tax culture.

You are required to CALCULATE the Weighted Average Cost of Capital (WACC) of Kalyanam Ltd.:

(i) Before the new Proposal

(ii) After the new Proposal *(RTP Nov'21,SM)*

Answer 11

Workings:

(a) Value of Debt = $\frac{\text{Interest}}{\text{Cost of debt}(K_d)}$

$$= \frac{\text{Rs.}7,50,000}{0.08} = \text{Rs. } 93,75,000$$

(b) Value of equity capital = $\frac{\text{Operating Profit} - \text{Interest}}{\text{Cost of equity }(K_e)}$

$$= \frac{\text{Rs.}34,50,000 - \text{Rs.}7,50,000}{0.16} = \text{Rs. } 1,68,75,000$$

(c) New Cost of equity (K_e) after proposal

$$= \frac{\text{Increased Operating Profit} - \text{Interest on increased debt}}{\text{Equity Capital}}$$

$$= \frac{(Rs.34,50,000+Rs.14,25,000)-(Rs.7,50,000+Rs.6,00,000)}{Rs.1,68,75,000}$$

$$= \frac{\text{Rs.}48,75,000 - \text{Rs.}13,50,000}{\text{Rs.}1,68,75,000} = \frac{\text{Rs.}35,25,000}{\text{Rs.}1,68,75,000} = 0.209 \text{ or } 20.9\%$$

g = Growth rate = 5%

P_0 = Current market price per share = ₹ 500

So, **K_e or K_r** = $\frac{₹\ 30\ (1+0.05)}{₹\ 500}$ + 0.05 = 0.063 + 0.05 = 11.3%

(ii) Computation of overall weighted average after tax cost of additional finance:

Particulars	(₹)	Weights	Cost of funds	Weighted Cost (%)
Equity (including retained earnings)	15,00,000	0.60	11.3%	6.78
Debt	10,00,000	0.40	9.15%	3.66
WACC	25,00,000			**10.44**

Alternative Presentation

Particulars (1)	(₹) (2)	Cost of funds (3)	(2) x (3)
Equity (including retained earnings)	15,00,000	11.3%	1,69,500
Debt	10,00,000	9.15%	91,500
Total	25,00,000		2,61,000

WACC = (Product / Total book value) x 100 = (2,61,000 / 25,00,000) x 100 **= 10.44%**

EXAM INSIGHTS: This is a practical question about the cost of capital. In this, the examinees were asked to calculate cost of debt, cost of equity and retained earnings and weighted **average** of cost of capital. An average performance was observed due to lack of conceptual clarity.

Multiple Choice Questions (MCQ's)

1. Which of the following is not an assumption of the capital asset pricing model (CAPM)? *(SM)*

(a) The capital market is efficient.

(b) Investors lend or borrow at a risk-free rate of return.

(c) Investors do not have the same expectations about the risk and return.

(d) Investor's decisions are based on a single-time period.

Ans: (c)

2. ___________may be defined as the cost of raising an additional rupee of capital: *(SM)*

(a) Marginal cost of capital (b) Weighted Average cost of capital

(c) Simple Average cost of capital (d) Liquid cost of capital

Ans: (a)

3. Which of the following cost of capital requires to adjust taxes? *(SM)*

(a) Cost of Equity Share (b) Cost of Preference Shares

(c) Cost of Debentures (d) Cost of Retained Earnings

Ans: (c)

4. Marginal Cost of capital is the cost of: *(SM)*

(a) Additional Revenue (b) Additional Funds

(c) Additional Interests (d) None of the above

Ans: (b)

5. In order to calculate Weighted Average Cost of Capital, weights may be based on: *(SM)*

(a) Market Values (b) Target Values

(c) Book Values (d) Anyone of the above

Ans: (d)

6. Firm's Cost of Capital is the average cost of: *(SM)*

(a) All sources of finance (b) All Borrowings

(c) All share capital (d) All Bonds & Debentures

Ans: (a)

7. **Given: risk-free rate of return = 5 %; market return = 10%; cost of equity = 15%; value of beta (β) is:** ***(SM)***
   (a) 1.9 (b) 1.8
   (c) 2.0 (d) 2.2

Ans: (c)

8. **A company has a financial structure where equity is 70% of its total debt plus equity. Its cost of equity is 10% and gross loan interest is 5%. Corporation tax is paid at 30%. What is the company's weighted average cost of capital (WACC)?** ***(SM)***
   (a) 7.55% (b) 7.80%
   (c) 8.70% (d) 8.05%

Ans:(d)

9. **The cost of equity capital is all of the following except:** ***(SM)***
   (a) The minimum rate that a firm should earn on the equity-financed part ofan investment.
   (b) A return on the equity-financed portion of an investment that, at worst,leaves the market price of the stock unchanged.
   (c) By far, the most difficult component cost to estimate.
   (d) Generally, lower than the before-tax cost of debt.

Ans:(d)

10. **What is the overall (weighted average) cost of capital when the firm has ₹ 20 crores in long-term debt, ₹ 4 crores in preferred stock, and ₹ 16 crores in equity shares? The before-tax cost for debt, preferred stock, and equity capital are 8%, 9%, and 15%, respectively. Assume a 50% tax rate.** ***(SM)***
    (a) 7.60% (b) 6.90%
    (c) 7.30% (d) 8.90%

Ans: (d)

11. **A company has issued bonds with a face value of ₹ 100,000 at an annual coupon rate of 8%. The bonds are currently trading at 95% of their face value. What is the approximate cost of debt for the company before taxes.** ***(MTP 2 Marks, Aug'24)***
    (a) 9.00% (b) 7.65%
    (c) 8.00% (d) 8.42%

Ans: (d)

12. **Ranu & Co. has issued 10% debenture of face value 100 for ₹ 10 lakh. The debenture is expected to be sold at 5% discount. It will also involve floatation costs of ₹ 10 per debenture. The debentures are redeemable at a premium of 10% after 10 years. Calculate the cost of debenture if the tax rate is 30%.** ***(MTP 2 Marks, Apr'24)***
    (a) 8.97% (b) 9.56%
    (c) 8.25% (d) 10.12%

Ans: (a)

13. **Abhi Ltd is an all equity financed company. It is considering replacing ₹ 275 lakhs equity shares with 15% debentures of the same amount. Current Market value of the company is 1750 lakhs with cost of capital at 20%. Future EBITs are going to be constant and entire earnings are going to be distributed. Corporate Tax Rate can be assumed to be 30%. What will be the new cost of equity of the firm?** ***(RTP Jan'25)***
    (a) 19.11% (b) 17.53%
    (c) 10.50% (d) 20.62%

Ans: (d)

14. **The capital structure of KPS Limited includes 5,00,000 equity shares of ₹ 10 each. The market price of equity share (cum-dividend) is ₹ 75 per share. The company has declared to pay dividend on equity shares @ ₹ 6 per share which will be paid within next three days. The company has a history of consistent growth in its dividends. It has been predicted that in the next year KPS Limited will pay dividend on its equity shares@ ₹ 7.59 per share. The rate of dividend growth will be maintained in foreseeable future. The cost of equity is calculated as:** ***(PYP Sep'24)***
    (a) 36.5% (b) 34.5%
    (c) 37.5% (d) 38.5%

Ans: (c)

CHAPTER 8: DIVIDEND DECISION

CONCEPTS OF THIS CHAPTER	LDR Questions
• Dividend decision: Meaning and Importance. • Forms of Dividend. • Determinants of Dividend. • Theories of Dividend Decisions.	Q 26 Q 28 Q 29

QUICK REVIEW OF IMPORTANT CONCEPTS

Theories of Dividend

- Irrelevance Theory (Dividend is irrelevant)
  - M.M. Approach
- Relevance Theory (Dividend is relevant)
  - Walter's Model
  - Gordon's Model
- Other Models
  - Dividend Discount Model (DDM)
  - Graham & Dodd's Model
  - Lintner's Model

Modigliani and Miller (M.M) Hypothesis- According to MM hypothesis, market value of equity shares depends solely on its earning power and is not influenced by the manner in which its earnings are split between dividends and retained earnings.

Price of shares is calculated as below:

$$P_0 = \frac{P_1 + D_1}{1 + K_e}$$

P_0 = Price in the beginning of the period.
P_1 = Price at the end of the period.
D_1 = Dividend at the end of the period.
K_e = Cost of equity/ rate of capitalization/ discount rate.

As per MM hypothesis, the value of firm will remain unchanged due to dividend decision.

$$V_f \text{ or } nP_0 = \frac{(n + \Delta n)P_1 - I + E}{(1 + K_e)}$$

V_f = Value of firm in the beginning of the period
n = number of shares in the beginning of the period
Δn = number of shares issued to raise the funds required
I = Amount required for investment
E = total earnings during the period

Walter's Model- In the long run, share prices reflect only the present value of expected dividends. Retentions influence stock prices only through their effect on further dividends.
The relationship between dividend and share price based on Walter's formula is shown below

$$\text{Market Price (P)}= \frac{D+\frac{r}{K_e}(E-D)}{K_e}$$

P= Market Price of the share.
E = Earnings per share.
D = Dividend per share.
K_e = Cost of equity/ rate of capitalization/ discount rate
r = Internal rate of return/ return on investment

Conclusion of Walter's Model

Company	Condition of r vs K_e	Correlation between Size of Dividend and Market Price of share	Optimum payout dividend ratio
Growth	$r > K_e$	Negative	Zero
Constant	$r = K_e$	No correlation	Every payout ratio is optimum
Decline	$r < K_e$	Positive	100%

Gordon's Model- When IRR is greater than cost of capital, the price per share increases and dividend pay-out decreases. On the other hand when IRR is lower than the cost of capital, the price per share decreases and dividend pay-out increases.

$$P_0 = \frac{E_1(1-b)}{K_e - br(g)}$$

P_0= Price per share
E_1 = Earnings per share.
b = Retention ratio
1 - b = Payout ratio
K_e = Cost of capital
r = IRR and br = Growth rate (g)

Relationship between Dividend and Share Price on the basis of Gordon's formula

$$\text{Market Price per share } (P_0) = \frac{D_0(1+g)}{K_e - g}$$

P_0= Market price per share (ex-dividend)
D_0 = Current year dividend
g = Constant annual growth rate of dividends
K_e = Cost of equity capital (expected rate of return)

Dividend Discount Model (DDM)- values shares by discounting future dividend payments. The share price is calculated as the present value of expected future dividends, discounted at a risk-adjusted rate. The DDM price represents the stock's intrinsic value.

Intrinsic Value= Sum of PV of future cash flows
Intrinsic value= Sum of PV of Dividends + PV of Stock Sale Price

$$\text{Stock Intrinsic Value}= \frac{D_1}{(1+K_e)} + \frac{D_2}{(1+K_e)} \ldots\ldots\ldots \frac{D_n}{(1+K_e)} + \frac{RV_n}{(1+K_e)^n}$$

Dividend Discount Model (Possible situation)

Zero growth rate: It assumes all dividend paid by a stock remains same.

$$\text{Stock intrinsic Value} = \frac{\text{Annual dividend}}{\text{Required rate of return}}$$

i.e. $P_0 = \frac{D}{K_e}$

D = Annual dividend
K_e= Cost of capital
P_0 = Current Market price of share

Constant Growth Rate (Gordon's Growth Model): It assumes constant growth of dividend

$$(P) = \frac{D_0(1+g)}{K_e - g}$$

P= Market price per share (ex-dividend)
D_0 = Current year dividend
g = growth rate of dividends
K_e = Cost of equity capital /expected rate of return
$g = b \times r$

b = proportion of retained earnings or (1- dividend payout ratio)

Variable Growth Rate- Variable-growth rate models (multi-stage models) often assume three phases: an initial high growth rate, a transition to slower growth, and a steady, sustainable rate. Each phase is calculated using the constant-growth method, with different growth rates for each phase. The present values of each stage are added to determine the stock's intrinsic value. The required rate of return may also vary if projected changes are expected.

Graham & Dodd's Model

$$P = m\left(D + \frac{E}{3}\right)$$

P = Market price per share
D = Dividend per share
E = Earnings per share
m = a multiplier

Lintner's Model

$$D_1 = D_0 + [(EPS \times \text{Target payout}) - D_0] \times Af$$

Where,
D_1 = Dividend in year 1
D_0= Dividend in year 0 (last year dividend)
EPS = Earnings per share
Af = Adjustment factor or Speed of adjustment

Questions & Answers

Theory Questions

Question 1

DISCUSS the parameters of Lintner's Model. ***(MTP 2 Marks, Jul'24)***

Answer 1

Lintner's model has two parameters:

i. The target payout ratio,
ii. The spread at which current dividends adjust to the target.

Question 2

MENTION any one advantage of stock dividend – to the company as well as to the investor ***(MTP 2 Marks Dec'24)***

Answer 2

Advantage to the Company - Stock dividends are suitable in the situation of cash crunch and deficiency faced by the company and suitable when restrictions are imposed by lenders to pay the cash dividend

Advantage to the investor – Improves liquidity in the hands of the investors as bonus shares leads to breaking down of higher priced shares into lower priced shares and hence give a choice to shareholders to sell some of the lower priced shares and get some liquidity.

Question 3

List any four assumptions of Gorden's Model. ***(PYP 4 Marks Sep'24)***

Answer 3

Gordon's model is based on the following assumptions:

- Firm is an all equity firm i.e. no debt.
- IRR will remain constant, because change in IRR will change the growth rate and consequently the value will be affected. Hence this assumption is necessary.
- K_e will remain constant, because change in discount rate will affect the present value.
- Retention ratio (b), once decide upon, is constant i.e. constant dividend payout ratio will be followed.
- Growth rate (g = br) is also constant, since retention ratio and IRR will remain unchanged and growth, which is the function of these two variable will remain unaffected.
- $K_e > g$, this assumption is necessary and based on the principles of series of sum of geometric progression for 'n' number of years.
- All investment proposals of the firm are to be financed through retained earnings only.

Question 4

Briefly explain the assumptions of Walter's Model. ***(PYP 4 Marks, May'22)***

Answer 4

Assumptions of Walter's Model

- All investment proposals of the firm are to be financed **through retained earnings** only.
- **'r'** rate of return & '**K_e**' cost of **capital are constant.**
- **Perfect capital markets**: The firm operates in a market in which all investors are rational and information is freely available to all.
- **No taxes or no tax discrimination** between dividend income and capital appreciation (capital gain). It means there is no difference in taxation of dividend income or capital gain. This assumption is necessary for the universal applicability of the theory, since, the tax rates may be different in different countries.
- **No floatation or transaction cost**: Similarly, these costs may differ country to country or market to market.
- The firm has **perpetual life.**

EXAM INSIGHTS: This theory question was based on Assumptions of Walter's Model. It was again noticed as a poorly answered question. Instead of writing about assumptions of Walter's model, the examinees have answered on how to apply the Walter's model. The overall performance was poor.

Question 5

EXPLAIN the determinants of dividend decisions. ***(MTP 5 Marks, Apr'23)***

Answer 5

The dividend policy is affected by the following factors:

1. **Availability of funds**: If the business is in requirement of funds, then retained earnings could be a good source. The reason being the saving of floatation cost and prevention of dilution of control which happens in case of new issue of equity shares to public.
2. **Cost of capital**: If the financing requirements are to be executed through debt (relatively cheaper source of finance), then it would be preferable to distribute more dividend. On the other hand, if the financing is to be done through fresh issue of equity shares, then it is better to use retained earnings as much as possible.
3. **Capital structure**: An optimum Debt Equity ratio should also be considered for the dividend decision.
4. **Stock price:** Stock price here means market price of the shares. Generally, higher dividends increase market value of shares and low dividends decrease the value.
5. **Investment opportunities in hand:** The dividend decision is also affected if there are investment opportunities in hand. In that situation, the company may prefer to retain more earnings.
6. **Internal rate of return (IRR):** If the internal rate of return (IRR) is more than the cost of retained earnings (Kr), it is better to distribute the earnings as much as possible.
7. **Trend of industry**: The investors depend on some industries for their regular dividend income. Therefore,

in such cases, the firms have to pay dividend in order to survive in the market.

8. **Expectation of shareholders**: The shareholders can be categorised into two categories: (i) those who invests for regular income, & (ii) those who invests for growth. Generally, the investor prefers current dividend over the future growth.
9. **Legal constraints:** Section 123 of the Companies Act, 2013 which provides for declaration of dividend sates that Dividend shall be declared or paid by a company for any financial year only:
   (a) out of the profits of the company for that year arrived at after providing for depreciation in accordance with the relevant provisions, or
   (b) out of the profits of the company for any previous financial year or years arrived at after providing for depreciation in accordance with the relevant provisions and remaining undistributed, or
   (c) out of both, or
   (d) out of money provided by the Central Government or a State Government for the payment of dividend by the company in pursuance of a guarantee given by that Government.
   It may be noted that, while computing the profits for payment of dividends any amount representing unrealised gains, notional gains or revaluation of assets and any change in carrying amount of an asset or of a liability on measurement of the asset or the liability at fair value shall be excluded.
10. **Taxation:** Before 1st April 2020, as per Section 115-O of Income Tax Act, 1961, dividend was subject to dividend distribution tax (DDT) in the hands of the company. Dividend on which DDT was paid, was to be exempted in the hands of the shareholder u/s 10(34). However, as per amendment made by the Finance Act 2020, the exemption u/s 10(34) shall not apply to dividend received on or after 1st April 2020 and the dividend income from shares held as investment shall be taxable under the head of 'Other income' at the applicable slab rate.

Practical Questions

Question 6

A & R Ltd. is a large-cap multinational company listed in BSE in India with a face value of ₹ 100 per share. The company is expected to grow @ 15% p.a. for next four years then 5% for an indefinite period. The shareholders expect 20% return on their share investments. Company paid ₹ 120 as dividend per share for the Financial year. The shares of the company traded at an average price of ₹ 3,122 on last day. FIND out the intrinsic value of per share and state whether shares are overpriced or underpriced. *(SM, MTP 5 Marks, Oct'23)*

Answer 6

As per Dividend discount model, the price of share is calculated as follows:

$$P=\frac{D_1}{(1+K_e)^1}+\frac{D_2}{(1+K_e)^2}+\frac{D_3}{(1+K_e)^3}+\frac{D_4}{(1+K_e)^4}+\frac{D_5}{(K_e-g)}+\frac{1}{(1+K_e)^4}$$

Where,

P = Price per share

K_e = Required rate of return on equity

g = Growth rate

$$P=\frac{₹120\times1.15}{(1+0.2)^1}+\frac{₹\ 138\times1.15}{(1+0.2)^2}+\frac{₹\ 158.7\times1.15}{(1+0.2)^3}+\frac{₹\ 182\times1.15}{(1+0.2)^4}+\frac{₹\ 209.88\times1.05}{(0.2-0.05)^1}+\frac{1}{(1+0.2)^4}$$

P= 115 + 110.2 + 105.6 + 101.2 + 708.51 = ₹1,140.51

Intrinsic value of share is ₹ 1,140.51 as compared to latest market price of ₹3,122.

Market price of a share is overpriced by ₹ 1,981.49

Question 7

HM Ltd. is listed on Bombay Stock Exchange which is currently been evaluated by Mr. A on certain parameters.

Mr. A collated following information:

(a) The company generally gives a quarterly interim dividend. ₹ 2.5 per share is the last dividend declared.

(b) The company's sales are growing by 20% on a 5-year Compounded Annual Growth Rate (CAGR) basis, however the company expects following retention amounts against probabilities mentioned as contention is dependent upon cash requirements for the company. Rate of return is 10% generated by

the company.

Situation	Prob.	Retention Ratio
A	30%	50%
B	40%	60%
C	30%	50%

(c) The current risk-free rate is 3.75% and with a beta of 1.2 company is having a risk premium of 4.25%. You are required to help Mr. A in calculating the current market price using Gordon's formula. *(RTP Nov'23)*

Answer 7

Market price using Gordon's formula

$P_0 = \frac{D_0(1+g)}{K_e - g}$

D_0 = 2.5×4 = 10 per share (annual)

g = br or retention ratio x rate of return

Calculation of expected retention ratio

Situation	Prob.	Retention Ratio	Expected Retention Ratio
A	30%	50%	0.15
B	40%	60%	0.24
C	30%	50%	0.15
Total			**0.54**

g = 0.54 × 0.10= 0.054 or 5.4%

$P_0 = \frac{D_0(1+g)}{K_e - g}$

$P_0 = \frac{10(1+0.054)}{0.0885-0.054} = \frac{10.54}{0.0345}$ = 305.51

K_e= Risk free rate + (Beta x Risk Premium)

= 3.75% + (1.2 x 4.25%) = 8.85%

Question 8

In March, 2021 Tiruv Ltd.'s share was sold for ₹ 219 per share. A long-term earnings growth rate of 11.25% is anticipated. Tiruv Ltd. is expected to pay dividend of ₹ 5.04 per share.

(i) DETERMINE the rate of return an investor can expect to earn assuming that dividends are expected to grow along with earnings at 11.25% per year in perpetuity?

(ii) It is expected that Tiruv Ltd. will earn about 15% on book equity and shall retain 60% of earnings. In this case, whether, there would be any change in growth rate and cost of equity? ANALYSE.

(MTP 5 Marks, Apr'21) (Same concept different figures SM)

Answer 8

(i) According to Dividend Discount Model approach the firm's expected or required return on equity is computed as follows:

$K_e = \frac{D_1}{P_0} + g$

Where,

K_e = Cost of equity share capital

D_1 = Expected dividend at the end of year 1

P_0 = Current market price of the share.

g = Expected growth rate of dividend.

Therefore, K_e

A

CHAPTER 12: STRATEGIC ANALYSIS- EXTERNAL ENVIRONMENT

CONCEPTS OF THIS CHAPTER	LDR Questions
• Strategy & Business Environment • PESTLE Tool to Analyse Macro Environment • Understanding Product & Industry • Product Life Cycle • Value Chain Analysis • Experience Curve • Porter's Five Forces • Market & Customer • Competitive Strategy, Competitive Landscape & Key Success Factors	Q3 Q9 Q17 Q24 Q28

QUICK REVIEW OF IMPORTANT CONCEPTS

Classification of Strategic Risks:

Time

Strategic Risks	Short Time	Long Time
External	Errors in interpreting the environment cause strategic failure	Changes in the environment lead to obsolescence of strategy.
Internal	Organizational capacity is unable to cope up with strategic demands.	Inconsistencies with the strategy are developed on account of changes in internal capacities and preferences

Strategic Analysis

External Analysis	Internal Analysis
Customer Analysis **Competitor Analysis** **Market Analysis** **Environmental Analysis**	**Performance Analysis** **Determinants Analysis**
↓	↓
Opportunities, threats, trends, and Strategic uncertainties	Strategic strengths, weaknesses, problems, constraints, and uncertainties

Strategy and Business Environment		
Strategic Management helps the business in the following ways:		
i Determine opportunities and threats	ii Give direction for growth	iii Continuous Learning
iv Image Building	v Meeting Competition	

Elements of Macro Environment		
i Demographic Environment	ii Socio-Cultural Environment	iii Economic Environment
iv Political-Legal Environment	v Technological Environment	

PESTLE- A Tool to Analyze Macro Environment		
i Political factors	ii Economic factors	iii Social factors
iv Technological factors	v Legal factors	vi Environmental factors

Internationalization of Business

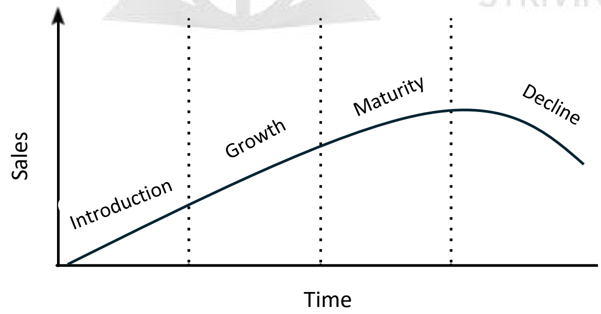
Why do businesses go global?

- Organizations globalize to grow, finding opportunities worldwide.
- Advances in communication, transportation, and technology shrink time and distance.
- Domestic markets may be insufficient, with less competition in international markets.
- Access to cheaper raw materials, labor, and talent motivates global operations.
- Companies set up overseas plants to cut transportation costs and improve efficiency.
- Expanding foreign markets drive overseas manufacturing and sales for higher revenue.
- Growth in services and regional economic integration boosts globalization.
- Lower trade barriers encourage privatization, reduced government interference, and increased business flow.
- Strategic alliances help companies tackle economic and technological challenges globally.

Understanding Product and Industry

Business Products have certain characteristics:	
i Products are either tangible or intangible	ii Product has a price
iii Products have certain features that deliver satisfaction	iv Product is pivotal for business
v A product has a useful life	

Product Life Cycle



Value Chain Analysis

Primary Activities

- Inbound logistics
- Operations
- Outbound logistics
- Marketing and sales
- Service

Support Activities

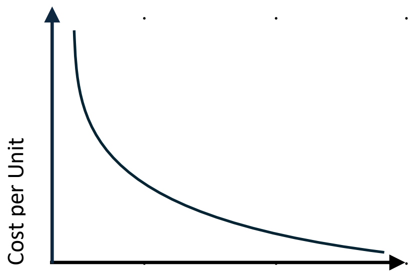
- Procurement
- Technology Develoment
- Human Resource Management
- Firm Infrastructure

Porter's Five Forces Model

1. The Threat of New Entrants		
i Capitals Requirements	ii Economies of Scale	
iii Product Differentiation	iv Switching Costs	
v Brand Identity	vi Access to Distribution Channels	
vii Possibility of Aggressive Retaliation		
2. Bargaining Power of Buyers		
3. Bargaining Power of Suppliers		
4. The Nature of Rivalry in the Industry		
i Industry Leader	ii Number of Competitors	iii Fixed Costs

iv Exit Barriers	v Product Differentiation	vi Slow Growth
vii Threat of Substitutes		

Experience Curve



Value Creation

Value creation is an activity by the firm to create value that increases the worth of goods, services, business processes or the whole business system.

How profitable a company becomes depends on three factors:

1. The value customers place on the company's products;
2. the price that a company charges for its products; and
3. the costs of creating those products.

Customer Behavior	
• External Influences	• Internal Influences
• Decision Making	• Post-decision Processes

Competitive Strategy

Competitive strategy defines how a firm expects to create and sustain a competitive advantage over competitors. Having a competitive advantage over competitors means being more profitable in the long run.

Competitive Landscape

The competitive landscape involves understanding competitors' strengths, weaknesses, and market position to develop strategies that enhance a firm's advantage.

Steps to understand the Competitive Landscape

i	Identify the competitor	ii	Understand the competitors
iii	Determine the strengths of the competitors:	iv	Determine the weaknesses of the competitors:
v	Put all of the information together		

Key factors for competitive success (KSFs)

KSFs are the factors that shape whether a company will be financially and competitively successful.

Questions & Answers

Strategy & Business Environment

Question 1

Yash is planning to launch his new tech start-up. He is exploring different locations across the country to establish his company in the right business environment. One option is the city of Bengaluru, the silicon valley of India, with an engaging network of entrepreneurs, investors, advisors and mentors. Coupled with various subsidies for new ventures and tax benefits, Bengaluru might be an ideal choice for Yash to establish his company and increase the chances of success.

Define the term Business Environment with respect to the above scenario. Explain the different ways in which the interaction of a business with its environment can be helpful in developing a successful strategy.

(PYP 5 Marks May '24)

Answer 1

Business Environment refers to all external factors, influences, or situations that affect business decisions, plans, and operations. In Yash's case, these factors include the dynamic and evolving conditions in Bengaluru, which impact the strategic decisions for his tech start-up.

Benefits of Interaction with the Business Environment

- **Determine Opportunities and Threats:** Interaction with the environment helps Yash identify new consumer needs, emerging trends, and potential market opportunities. This insight can guide the development of innovative products and services that meet market demands. Understanding changes in laws, social behaviors, and competitor actions enables Yash to anticipate and mitigate potential threats, ensuring the start-up remains resilient and adaptive.
- **Give Direction for Growth:** By analyzing the external environment, Yash can pinpoint areas for expansion and growth. Recognizing market trends and technological advancements allows him to strategize effectively, ensuring the start-up scales successfully.
  Awareness of the changes around the business environment facilitates better planning and strategic decisions, aligning the start- up's goals with the market dynamics.
- **Continuous Learning:** Continuous interaction with the environment motivates Yash and his team to update their knowledge, understanding, and skills. Staying informed about industry trends and advancements ensures the start-up remains competitive. This ongoing learning process enhances the start-up's ability to adapt to changes, promoting innovation and responsiveness to market shifts.
- **Image Building:** Understanding and responding to environmental needs help the start-up build a positive image. For instance, adopting sustainable practices or contributing to local initiatives can enhance the company's reputation. Demonstrating sensitivity to the business environment shows that the start-up is responsible and community-focused, attracting customers and partners who value corporate social responsibility.
- **Meeting Competition:** Interaction with the environment allows Yash to analyze competitors' strategies and adapt accordingly. Understanding competitors' strengths and weaknesses helps in crafting strategies that provide a competitive edge. By leveraging insights from the environment, the start-up can position itself uniquely in the market, differentiating its offerings from those of competitors.

PESTLE Tool to Analyse Macro Environment

Question 2

How does the PESTLE framework assist in analyzing the macro- environment? *(MTP 5 Marks Aug'24)*

Answer 2

The PESTLE framework assists in analyzing the macro-environment by systematically evaluating six external factors that impact an organization's operations and strategy.

1. **Political Factors:** This includes government policies, regulations, political stability, and taxation. Understanding these factors helps organizations anticipate regulatory changes and government interventions that could affect their business environment.
2. **Economic Factors:** This involves assessing economic conditions such as interest rates, inflation, exchange rates, and economic growth. These factors influence business costs, consumer purchasing power, and overall market conditions.
3. **Social Factors:** This examines demographic trends, lifestyle changes, cultural norms, and consumer attitudes. Insights into social factors help businesses align their products and services with evolving consumer preferences and societal trends.
4. **Technological Factors:** This includes technological advancements, innovation rates, and technological infrastructure. These factors impact production processes, product development, and competitive positioning.
5. **Legal Factors:** This involves understanding business laws, employment regulations, health and safety standards, and compliance requirements. Legal factors are crucial for ensuring regulatory compliance and avoiding legal risks.
6. **Environmental Factors:** This covers ecological issues, sustainability practices, and environmental regulations. Awareness of environmental factors helps businesses adapt to climate change and meet sustainability goals.
   By analyzing these factors, the PESTLE framework provides a comprehensive understanding of the macro-environment, helping organizations anticipate changes, adapt strategies, and make informed decisions.

Question 3 LDR

WAVE Corp, a multinational consumer electronics company, is planning to expand its operations into a new country. The company's senior management is evaluating the potential risks and opportunities of entering this new market. As part of their analysis, they decide to use the PESTLE framework to assess the external factors that could impact their decision. How can the PESTLE framework help WAVE Corp assess the external factors affecting its decision to expand into a new country? ***(MTP 5 Marks Mar'24)***

Answer 3

The PESTLE framework can help WAVE Corp assess the external factors affecting its decision to expand into a new country by considering the following aspects:

- **Political Factors:** These include the stability of the government, government policies on foreign investment, trade agreements, and regulatory frameworks. By analyzing these factors, WAVE Corp can assess the political risks associated with entering the new market.
- **Economic Factors:** Economic factors such as GDP growth rate, inflation rate, exchange rates, and economic stability can impact WAVE Corp's decision. By analyzing these factors, the company can understand the economic environment of the new market and its potential impact on business operations.
- **Social Factors:** Social factors such as cultural norms, demographics, and lifestyle trends can influence consumer behavior and demand for WAVE Corp's products. Understanding these factors can help the company tailor its marketing strategies to the new market.
- **Technological Factors:** Technological factors such as infrastructure, technological advancements, and the level of technology adoption in the new market can impact WAVE Corp's operations. By assessing these factors, the company can determine the technological requirements for entering the new market.
- **Legal Factors:** Legal factors such as laws and regulations related to foreign investment, intellectual property rights, and labor laws can impact WAVE Corp's decision. By analyzing these factors, the company can ensure compliance with legal requirements in the new market.
- **Environmental Factors:** Environmental factors such as climate change, environmental regulations, and sustainability practices can impact WAVE Corp's operations and reputation. By considering these factors, the company can assess the environmental risks and opportunities in the new market.

  Overall, the PESTLE framework can provide WAVE Corp with a comprehensive analysis of the external factors that could impact its decision to expand into a new country, helping the company make informed and strategic decisions.

Understanding Product & Industry

Question 4

What are the key characteristics of business products that contribute to the overall competitiveness and dynamics of the market? ***(PYP 5 Marks May '24)***

Answer 4

Businesses sell products. A product can be either a good or a service. It might be physical good or a service, an experience.

Following are the key characteristics of business products:

1. **Products are either tangible or intangible.** A tangible product can be handled, seen, and physically felt, such as a car, book, pen, table, mobile handset and so on. Alternatively, an intangible product is not a physical good, such as telecom services, banking, insurance, or repair services.
2. **Product has a price.** Businesses determine the cost of their products and charge a price for them. The dynamics of supply and demand influence the market price of an item or service. The market price is the price at which quantity provided equals quantity desired. The price that may be paid is determined by the market, the quality, the marketing, and the targeted group. In the present competitive world price is often given by the market and businesses have to work on costs to maintain profitability.
3. **Products have certain features that deliver satisfaction .** A product feature is a component of a product that satisfies a consumer need. Features determine product pricing, and businesses alter features during the development process to optimize the user experience. Products should be able to provide value satisfaction to the customers for whom they are meant. Features of the product will distinguish it in terms

of its function, design, quality and experience A customer's cumulative experience with a product from its purchase to the end of its useful life is an important component of a product feature.

4. **Product is pivotal for business.** The product is at the centre of business around which all strategic activities revolve. The product enables production, quality, sales, marketing, logistics and other business processes. Product is the driving force behind business activities.
5. **A product has a useful life**. Every product has a usable life after which it must be replaced, as well as a life cycle after which it is to be reinvented or may cease to exist. We have observed that fixed line telephone instruments have largely been replaced by mobile phones.

Question 5

Reshuffle Corp is a company that manufactures and sells office furniture. They offer a range of products, from desks and chairs to cabinets and shelves. Recently, the company has been facing increased competition from online retailers offering similar products at lower prices. Analyzing the characteristics of products in the furniture industry, discuss how Reshuffle Corp can differentiate its products to maintain a competitive edge in the market. ***(MTP 5 Marks Apr'24, MTP 5 Marks Dec'24)***

Answer 5

To maintain a competitive edge in the face of increased competition, Reshuffle Corp can differentiate its products in several ways:

- **Tangible and Intangible Aspects**: Reshuffle Corp can focus on the tangible aspects of its products, such as using high-quality materials and innovative designs to create furniture that is both functional and aesthetically pleasing. Additionally, they can emphasize the intangible aspects of their products, such as excellent customer service and a strong brand reputation for reliability and durability.
- **Pricing Strategies:** While market prices are often dictated by competition, Reshuffle Corp can work on cost optimization to maintainprofitability. They can also consider offering value-added services, such as free installation or extended warranties, to justify a higher price point.
- **Product Features:** By continually optimizing their product features based on customer feedback and market trends, Reshuffle Corp canensure that their products deliver maximum satisfaction to their target customers. This may include features that enhance functionality, design, quality, and overall user experience.
- **Product Centric Approach:** Reshuffle Corp should keep their products at the center of their strategic activities, ensuring that all business processes, from production to sales and marketing, are aligned to meet customer needs and expectations.
- **Product Life Cycle Management:** Reshuffle Corp should be aware of the life cycle of their products and plan for reinvention or replacement accordingly. They can introduce new product lines or upgrade existing ones to keep up with changing customer preferences and market trends.

Product Life Cycle

Question 6

Write short note on "Phases and significance of Product Life Cycle". ***(MTP 5 Marks April 22, SM)***

Answer 6

Product Life Cycle (PLC) is a useful concept for guiding strategic choice. Essentially, PLC is S- shaped curve which exhibits the relationship of sales with respect of time for a product that passes through the four successive stages of introduction (slow sales growth), growth (rapid market acceptance) maturity (slowdown in growth rate) and decline (sharp downward drift). If businesses are substituted for product, the concept of PLC could work just as well.

The first stage of PLC is the introduction stage in which competition is almost negligible, prices are relatively high, and markets are limited. The growth in sales is at a lower rate because of lack of knowledge on the part of customers.

The second stage of PLC is growth stage. In the growth stage, the demand expands rapidly, prices fall, competition increases, and market expands. The customer has knowledge about the product and shows interest in purchasing it.

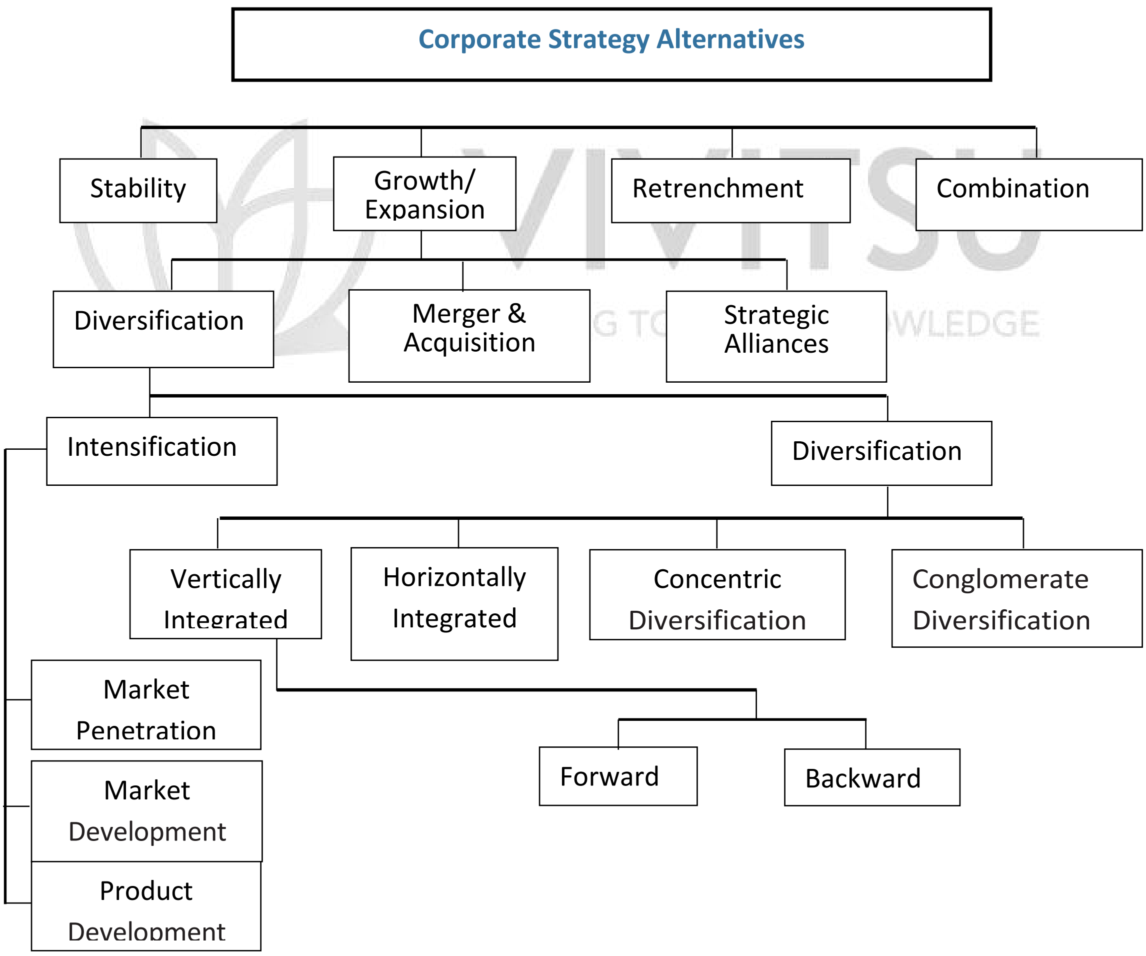
The third stage of PLC is maturity stage. In this stage, the competition gets tough, and market gets stabilised.

A

CHAPTER 14: STRATEGIC CHOICES

CONCEPTS OF THIS CHAPTER	LDR Questions
• Stability Strategy • Growth/Expansion Strategy – Intensification, Diversification, Mergers & Acquisitions and Strategic Alliance Strategies. • Retrenchment Strategy- Turnaround, Divestment & Liquidation Strategy • Combination Strategy • Ansoff's Product Matrix & ADL Matrix • BCG Growth-Share Matrix & General Electric Matrix	Q16 Q19 Q21 Q32 Q36 Q47

QUICK REVIEW OF IMPORTANT CONCEPTS



Strategy	Basic Feature
Stability	The firm stays with its current businesses and product markets; maintains the existing level of effort; and is satisfied with incremental growth
Growth	Here, the firm seeks significant growth-maybe within the current businesses; maybe by entering new business that are related to existing businesses; or by entering new businesses that are unrelated to existing businesses

Retrenchment	The firm retrenches some of the activities in some business (es), or) or drops the business as such through sell-out or liquidation.
Combination	The firm combines the above strategic alternatives in some permutation/ combination so as to suit the specific requirements of the firm.

Strategic Exits

I. Turnaround Strategy

Stage One – Assessment of current problems	*Stage Two* –Analyze the situation and develop a strategic plan
Stage Three -Implementing an emergency action plan	*Stage Four* –Restructuring the business
Stage Five –Returning to normal	

II. Divestment Strategy

Strategic Options

1. Ansoff's Product Market Growth Matrix

	Existing Products	**New Products**
Existing Market	Markets Penetration	Product Development
New Market	Markets Development	Diversification

Market penetration: Strategy where the business focuses on selling existing products into existing markets

Market development: Strategy where the business seeks to sell its existing products into new markets

Product development: Strategy where business aims to introduce new products into existing markets

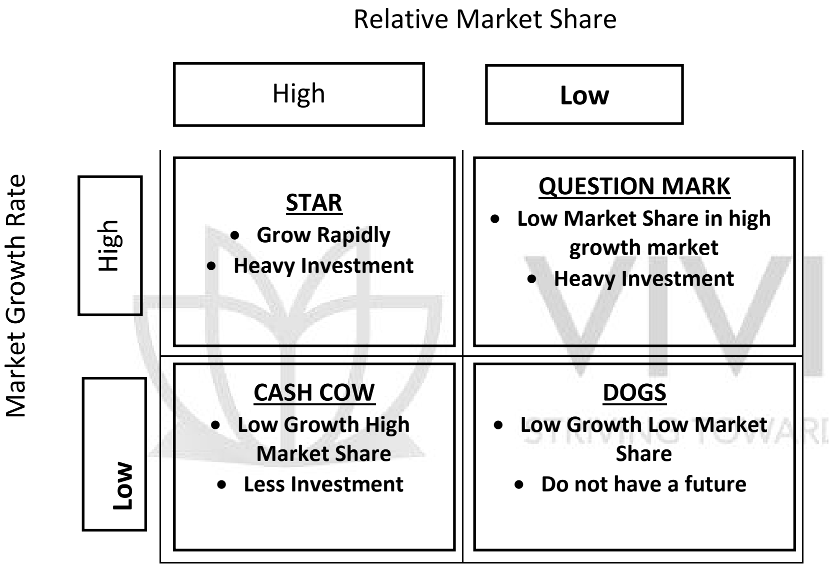
Diversification: refers to a growth strategy where a business markets new products in new markets.

2. ADL Matrix

Stage of industry maturity				
Competitive position	Embryonic	Growth	Mature	Ageing
Dominant	• Fast grow • Build Barriers • Act offensively	• Fast grow • Attend cost leadership • Renew • Defend position • Act offensively	• Defend position • Attend cost Leadership • Renew • Fast grow • Act offensively	• Defend position • Renew • Focus • Consider thdrawal
Strong	• Differentiate • Fast grow	• Differentiate • Lower cost • Attack small firms	• Lower cost • Focus • Differentiate • Grow with industry	• Find niche • Hold niche • Harvest
Favourable	• Differentiate • Focus	• Focus • Differentiate	• Focus • Differentiate	• Harvest • Turnaround

	• Fast grow	• Defend	• Harvest • Find niche • Hold niche • Turnaround • Grow with Industry • Hit smaller firms	
Tenable	• Grow with Industry • Focus	• Hold niche • Turnaround • Focus • Grow with Industry • Withdraw	• Turnaround • Hold niche • Retrench	• Divest • Retrench
Weak	• Find niche • Catch-up • Grow with industry	• Turnaround • Retrench • Niche or withdraw	• Withdraw • Divest	• Withdraw

3. Boston Consulting Group (BCG) Growth-Share Matrix



(a) **Build** with the aim for long-term growth and strong future.

(b) **Hold** or preserve the existing market share.

(c) **Harvest** or maximize short-term cash flows.

(d) **Divest**, sell or liquidate and ensure better utilization of resources elsewhere.

4. General Electric Matrix ["Stop-Light" Strategy Model]

Market Attractiveness	Business strenght		
	Strong	Average	Weak
High	Invest/Expand	Invest/Expand	Select/Earn
Medium	Invest/ Expand	Select/Earn	Harvest/Divest
Low	Select/Earn	Harvest/Divest	Harvest/Divest

The GE Portfolio Matrix

Questions & Answers

Stability Strategy

Question 1

What is stability strategy? What are the reasons to pursue a stability strategy? *(RTP Nov'19 & Nov '23)*

Answer 1

One of the important goals of a business enterprise is stability - to safeguard its existing interests and strengths, to pursue well established and tested objectives, to continue in the chosen business path, to maintain operational efficiency on a sustained basis, to consolidate the commanding position already reached, and to optimize returns on the resources committed in the business. A stability strategy is pursued by a firm when:

- It continues to serve in the same or similar markets and deals in same or similar products and services.
- The strategic decisions focus on incremental improvement of functional performance.

Major reasons for stability strategy are as follows:

- A product has reached the maturity stage of the product life cycle.
- It is less risky as it involves less changes and the staff feels comfortable with things as they are.
- The environment faced is relatively stable.
- Expansion may be perceived as being threatening.
- Consolidation is sought through stabilizing after a period of rapid expansion.

Question 2

Justify the statement "Stability strategy is opposite of Expansion strategy".
(MTP 5 Marks March '21, RTP May'21 & May '24)

Answer 2

Stability strategies, as name suggests, are intended to safeguard the existing interests and strengths of business. It involves organizations to pursue established and tested objectives, continue on the chosen path, maintain operational efficiency and so on. A stability strategy is pursued when a firm continues to serve in the same or similar markets and deals in same products and services. In stability strategy, few functional changes are made in the products or markets, however, it is not a 'do nothing' strategy. This strategy is typical for mature business organizations. Some small organizations also frequently use stability as a strategic focus to maintain comfortable market or profit position. On the other hand, expansion strategy is aggressive strategy as it involves redefining the business by adding the scope of business substantially, increasing efforts of the current business. In this sense, it becomes opposite to stability strategy. Expansion is a promising and popular strategy that tends to be equated with dynamism, vigor, promise and success. Expansion also includes diversifying, acquiring and merging businesses. This strategy may take the enterprise along relatively unknown and risky paths, full of promises and pitfalls.

Question 3

ABC Steel Industries finds out that its products have reached at maturity stage and already has overcapacity. Therefore, it concentrates on maintaining operational efficiency of its plants. Identity the strategy implemented by ABC Steel Industries along with reasons. *(PYP 5 Marks May'22)*

Answer 3

ABC Steel Industries has opted to implement Stability strategy. Stability strategies are intended to safeguard the existing interests and strengths of business. It involves organisations to pursue established and tested objectives, continue on the chosen path, maintain operational efficiency and so on. A stability strategy is pursued when a firm continues to serve in the same or similar markets and deals in same products and services. In stability strategy, few functional changes are made in the products or markets, however, it is not a 'do nothing' strategy. This strategy is typical for mature business organizations. Some small organizations also frequently use stabil ity as a strategic focus to maintain comfortable market or profit position.

Major reasons for Stability strategy are:

- A product has reached the maturity stage of the product life cycle.
- The staff feels comfortable with the status quo as it involves less changes and less risks.
  - **(a)** It is opted when the environment in which an organisation is operating is relatively stable.
  - **(b)** Where it is not advisable to expand as it may be perceived as threatening.
  - **(c)** After rapid expansion, a firm might want to stabilize and consolidate itself.

Exam Insights: Most of the examinees were able to identify the stability strategy and reasons were explained properly. Hence, the performance was good.

Question 4

Start-ups rarely aim for stability strategy. While agreeing with the statement or otherwise, support your point of view by briefly stating as to when the stability strategy is meaningful. State the major reasons for considering stability strategy as one of the corporate strategies by a company. *(PYP 5 Marks Sep'24)*

Answer 4

Agree with the given statement. Start-ups rarely aim for a stability strategy because they are in the **early stages of ideation and development**, where **speed and agility** are critical. Stability strategy is more relevant for businesses that have reached maturity, where maintaining current operations and market share becomes a priority. Start-ups, however, focus on rapid growth and market penetration, and stability is usually considered when a business has expanded to full capacity.

A stability strategy is meaningful in the following scenarios:

- When a firm continues serving the same markets with the same products and services.
- Firms whose products are in the maturity stage of the product life cycle or who have a substantial market share may opt for stability to retain their position.
- Stability helps consolidate gains after rapid expansion, optimize returns on committed resources, and enhance functional efficiencies.

Major reasons for choosing a stability strategy include:

- Maturity of products in the life cycle.
- Comfort of staff with fewer changes and risks.
- Stable external environment.
- A need to consolidate after rapid growth or expansion.
- Where it is not advisable to expand as it may be perceived as threatening.

Growth/Expansion Strategy

Question 5

Which strategy is implemented by redefining the business, by enlarging its scope of business and substantially increasing investment in the business? Explain the major reasons for adopting this strategy. *(PYP 5 Marks Nov'23 MTP 5 Marks Aug'24)*

Answer 5

The strategy in question is the growth/expansion strategy. The Growth/Expansion strategy involves redefining the business, expanding its scope, and significantly increasing investments. This dynamic and vigorous approach is synonymous with promise and success. It entails a substantial reformulation of goals, major initiatives, and strategic moves, including investments, exploration into new products, technologies, and markets, and innovative decision-making. While promising growth, this strategy navigates the enterprise through relatively unknown and risky paths, rich with potential but also pitfalls.

Major Reasons for Adopting Growth/Expansion Strategy:

- It may become imperative when environment demands increase in pace of activity.
- Strategists may feel more satisfied with the prospects of growth from expansion; chief executives may take pride in presiding over organizations perceived to be growth-oriented.
- Expansion may lead to greater control over the market vis-a-vis competitors.
- Advantages from the experience curve and scale of operations may accrue.
- Expansion also includes intensifying, diversifying, acquiring and merging businesses.

> **<u>Exam Insights:</u>** Performance was below average. Examinees were able to identify the correct strategy but were not able to provide the reason for adoption of growth/Expansion strategy.

Intensification Strategy

Question 6

Ajanta & Sons Limited are manufacturers of domestic household security alarms for high income group homeowners in India. The company is currently reviewing two strategic options.

Option 1: Selling the same alarms although with different coverings to smaller and low- income group