



Analysis Of Financial Statements

Direct Taxes Regional Training Institute
Bangalore

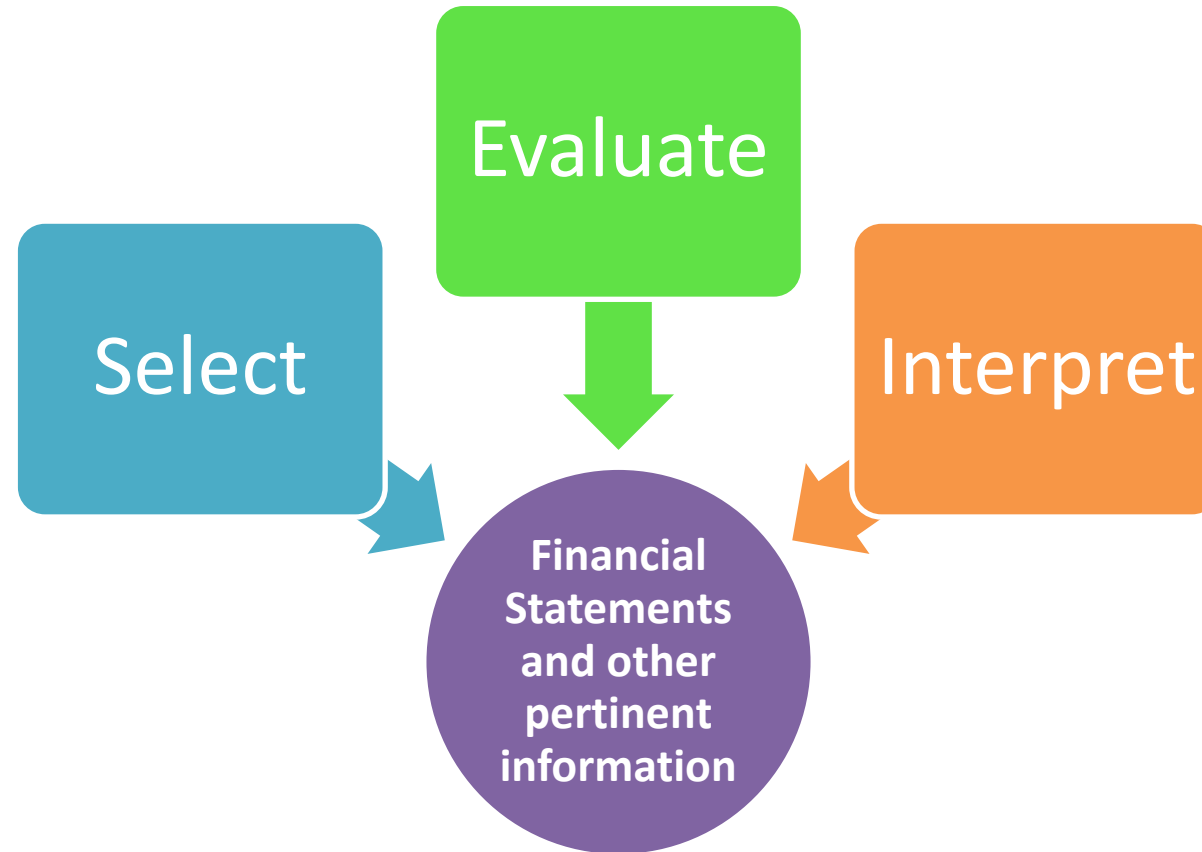
June 9th, 2014

CA. Zain Khan

Components of Financial Statements

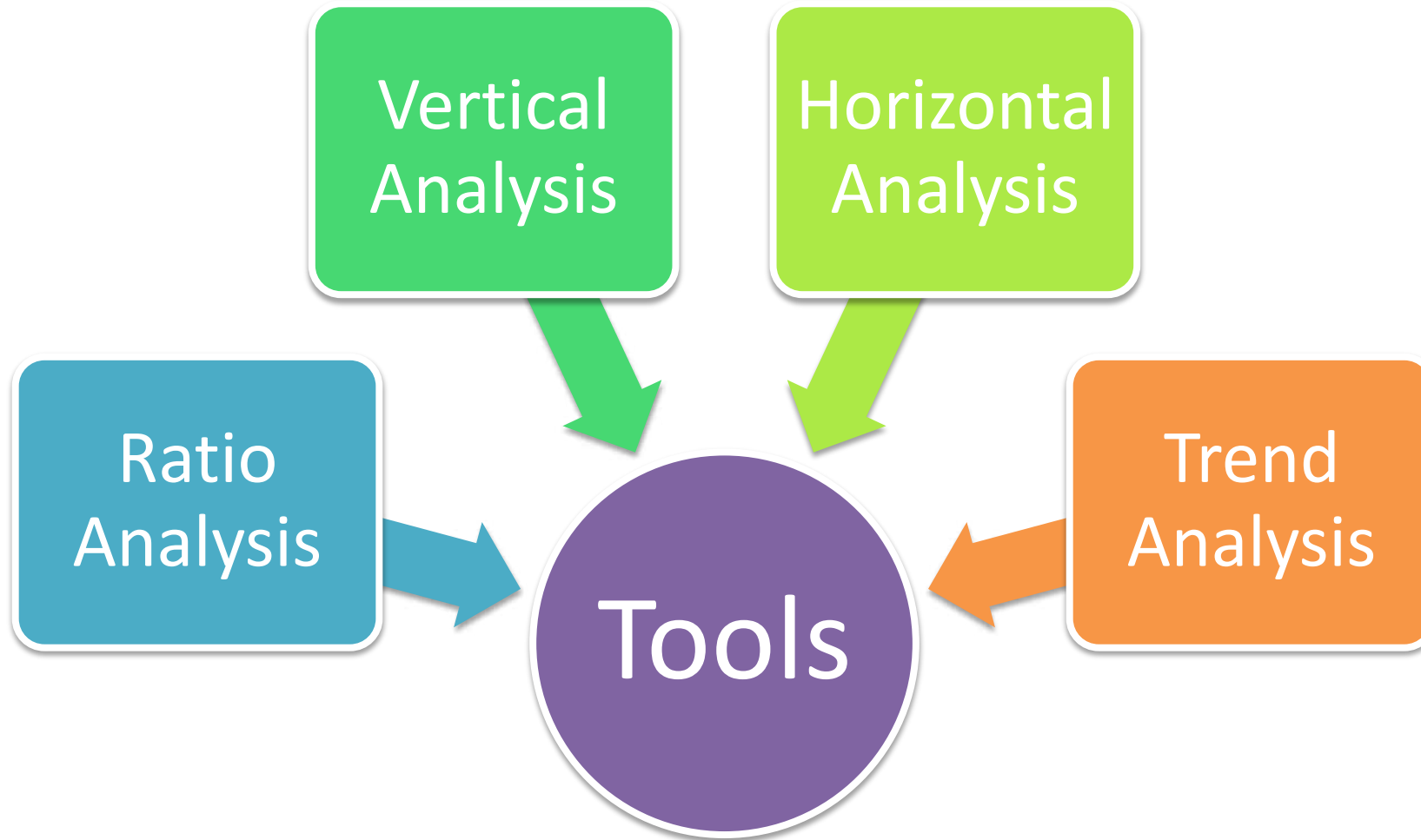


What does analysis of Financial Statements mean?



In order to formulate an assessment of a company's present and future financial condition and performance

Methods of Analysis



Common Size Balance Sheet

Balance Sheet	FY 2013		FY 2012		FY 2011		FY 2010	
	Rs. In Million	%	Rs. In Million	%	Rs. In Million	%	Rs. In Million	%
Cash & Bank Balances	4,288	32.8%	3,098	27.4%	3,951	38.2%	3,476	39.4%
Accounts Receivable	812	6.2%	873	7.7%	753	7.3%	98	1.1%
Loans & Advances	977	7.5%	1,089	9.6%	819	7.9%	1,228	13.9%
Inventories	1,853	14.2%	2,177	19.3%	1,537	14.9%	1,106	12.5%
Current Assets	7,930	60.7%	7,237	64.1%	7,060	68.3%	5,908	66.9%
Fixed Assets	3,826	29.3%	3,238	28.7%	2,633	25.5%	2,531	28.7%
Other Assets	1,311	10.0%	821	7.3%	647	6.3%	389	4.4%
Total Assets	13,067	100.0%	11,296	100.0%	10,340	100.0%	8,828	100.0%
Liability Side								
Accounts Payables	4,666	35.7%	3,690	32.7%	3,785	36.6%	3,740	42.4%
Other Current Liabilities & Provisions	3,148	24.1%	2,944	26.1%	2,435	23.6%	1,781	20.2%
Current Liabilities & Provisions	7,814	59.8%	6,634	58.7%	6,220	60.2%	5,521	62.5%
Long-term Liabilities	357	2.7%	308	2.7%	278	2.7%	46	0.5%
Net Worth	4,896	37.5%	4,354	38.5%	3841	37.2%	3261	36.9%
Total Liabilities	13,067	100.0%	11,296	100.0%	10,339	100.0%	8,828	100.0%

Common Size Profit & Loss

Income Statement	FY 2013		FY 2012		FY 2011		FY 2010	
	Rs. In Million	%	Rs. In Million	%	Rs. In Million	%	Rs. In Million	%
Total Sales	49,070	100.0%	31,638	100.0%	22,206	100.0%	19,625	100.0%
Add: Other Income	932	1.9%	499	1.6%	1,066	4.8%	981	5.0%
Less: Cost of Goods Sold	19,137	39.0%	12,501	39.5%	8,727	39.3%	7,772	39.6%
Gross Profit	30,865	62.9%	19,636	62.1%	14,545	65.5%	12,835	65.4%
Less: Sales, General & Administration Expenses	19,383	39.5%	12,556	39.7%	8,993	40.5%	7,595	38.7%
EBITDA	11,482	23.4%	7,080	22.4%	5,552	25.0%	5,240	26.7%
Less: Interest	491	1.0%	13	0.0%	222	1.0%	196	1.0%
Less: Depreciation & Amortization	736	1.5%	437	1.4%	333	1.5%	373	1.9%
PBT	10,256	22.0%	6,630	21.0%	4,996	23.0%	4,671	25.0%
Less: Tax	2,601	5.3%	1,663	5.3%	1,177	5.3%	608	3.1%
PAT	7,655	16.6%	4,967	15.7%	3,819	18.1%	4,062	21.6%
Dividend to Shareholders	6,183	12.6%	3,808	12.0%	2,998	13.5%	2,728	13.9%

Profitability Ratios

Category	Ratios	Formula
Margin on Sales	Gross Profit Margin	= Gross Profit/Sales
	Operating Profit Margin	= Operating Profit/Sales
	Net Profit Margin	= Net Profit/Sales
Return on Investment	Operating Profit to Operating Assets	= Operating Profit/Average Operating Assets
	Return on Total Assets	= Operating Profit/Average Total Assets
	Return on Equity	= Net Profit/Average Net Worth
Efficiency in use of Assets	Total Assets Turnover	= Sales/Average Total Assets
	Operating Asset Turnover	= Sales/Average Operating Assets
	Working Capital Turnover	= Sales/Average Working Capital Assets
Return per Equity Share	Earning Per Share	= Net Profit/No. of Equity Shares
	Dividends Per Share	= Dividend/No. of Equity Shares
	Dividend Payout Ratio	= Dividend/Net Profit

Where could these ratios be used as an Officer?

Transfer Pricing

Case Study on Application of Operating Ratio

Assessment

Search u/s. 132



Oil Refinery



Suppliers

➤ Purchase invoices did not bear any stamps of Govt. authorities, Check posts or APMC

➤ Suppliers could not be traced at the addresses mentioned on the invoices.

➤ Suppliers were not registered with Sales Tax Department.


➤ The director of Assessee Company and his employees had acted as the Introducer for opening the bank account of suppliers.

➤ Bank Cheques of suppliers was signed by the employees of assessee company

➤ Bank statements of suppliers revealed that withdrawal was made on same day of deposit.

Modus Operandi

An agent supplied the material at the agreed rate and provided invoices of registered dealers along with delivery notes.



After inspection of material, gate pass was issued on the basis of weigh bridge receipt.



Payment is duly made by way of an account payee cheque and handed over to Agent.



The material received is processed and end products are sold.

The AO termed the weigh bridge slips, gate passes and material received notes as self-made documents

Appeal – Observations of Hon'ble ITAT

Purchases were disallowed for the AY 2006-07 & 2007-08

Assessment Year	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11
Sales	43.96	30.47	34.59	45.06	57.02	66.65	56.22
(+)Other Income	0.08	0.12	0.26	0.61	0.36	0.77	0.47
Total Income	44.04	30.58	34.85	45.67	57.38	67.43	56.70
(-)Direct Expenses	40.07	27.66	31.89	41.93	52.64	61.90	52.16
Gross Profit	3.98	2.92	2.96	3.74	4.74	5.53	4.53
GP as %age on Sales	9%	10%	9%	8%	8%	8%	8%
(+)Disallowance of Bogus Purchase			9.87	11.95			
Gross Profit after additions			12.83	15.68			
GP as %age on Sales			37%	35%			

Post disallowance of purchases - GP Ratio of Assessee found to be exorbitantly high as compared to the other years which were also subject to search and scrutiny.

The Gross Profit Margins were at par with the companies carrying on similar business.

Appeal – Observations of Hon'ble ITAT

Particulars	Input Output Ratio - SE Oil to Refined Oil							Industry Standard
	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	
Sunflower Cake	12%	12%	12%	13%	12%	12%	12%	11.00%
Ground nut Cake	7%	7%		7%	6%	6%		7.50%
Soyabean Seeds	18%	17%	17%	18%	16%			17.50%

The input/output ratio at par with the industrial standards

The AO had not rejected the books of accounts and the quantitative statements of the Assessee while on the other hand had treated the purchases as bogus.

The AO did not question the sales but only raised a needle of suspicion on purchases. How could one sell without making any purchases for manufacture?

The purchases were accepted by the Sales Tax Authorities also.

Conclusion of Hon'ble ITAT: The parties may be bogus but the purchases were not bogus

Share Capital – Screenshot

Balance Sheet as at 31st March, 2011					
Particulars	Note No	Figures as at the end of current	Figures as at the end of previous		
Particulars		As on (CY)		As on (PY)	
		No in Crores	Rs in Crores	No in Crores	Rs in Crores
I. EQUITY AND LIABILITIES					
(1) Shareholder's Funds					
(a) Share Capital		xxx	xxx	xxx	xxx
(b) Reserves and Surplus		xxx	xxx	xxx	xxx
(c) Money received against share w					
(2) Share application money pen					
		xxx	xxx	xxx	xxx
		xxx	xxx	xxx	xxx
		(xxx)	(xxx)	(xxx)	(xxx)
		xxx	xxx	xxx	xxx



Share Capital

Shareholders

- Particulars of shareholders – verify authenticity
- Can the source of source be questioned? **YES** in case of Private companies **Proviso to S. 69**
- But what happens in case of Public Companies?

Share application money pending allotment

- Companies Act, 2013 – Need to maintain such money in a Separate bank account – amount must be refunded within 75 days with interest if shares not allotted
- S. 279SS and 269T will not be attracted due to this provision - Loophole plugged

Share Capital – Case Study

Extract Balance Sheet of XYZ (P) Ltd.

Particulars	31.03.2013	31.03.2014
No. of shares of Rs. 10/- each		
- Held by Mr. X & Y	10,000	7,000
- Held by M/s. Best (P) Ltd.	-	3,000
Share Application Money (Rs.)	-	12,00,000
Share Premium Money	-	5,00,000
Accumulated losses eligible for set off	45,00,000	27,00,000



Share Capital

Does the consideration for shares match the FMV?

Section 56 (2) (viib)

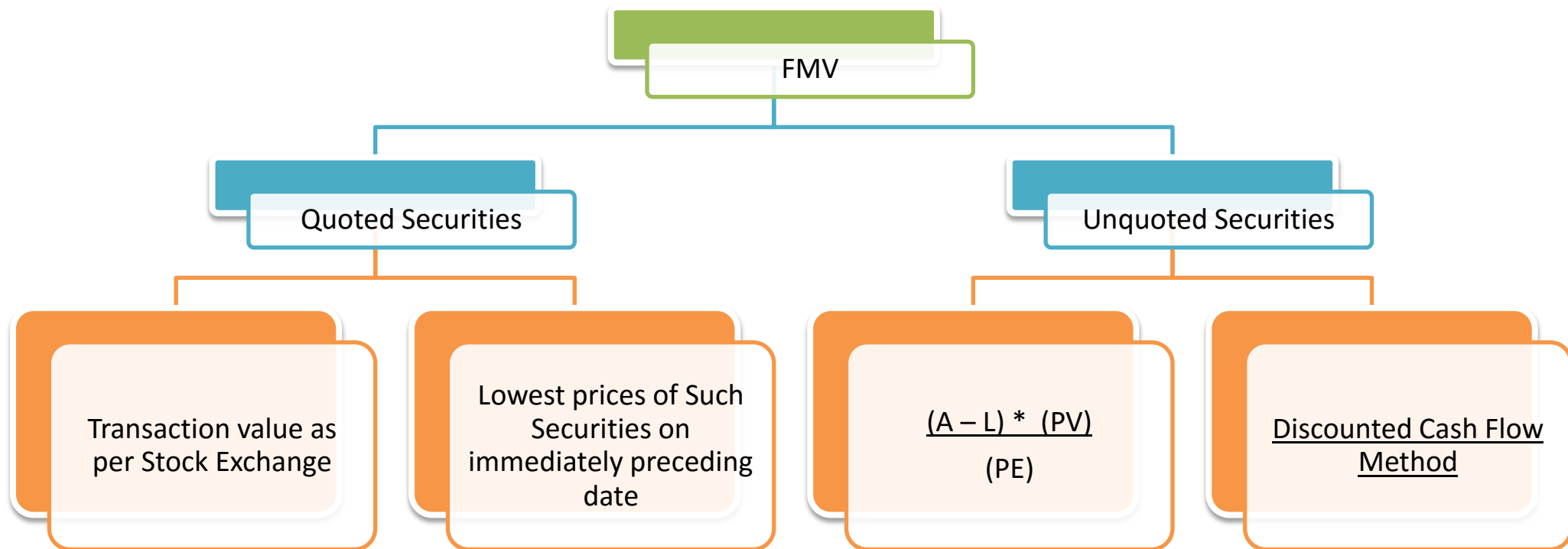
Where a private company receives consideration for issue of shares which exceeds fair value

The aggregate consideration as exceeds the FMV of the shares taxable as IFOS

From a Resident

How is the FMV of shares determined?

Valuation Of Shares And Securities Under Rule 11UA



A = BV of Assets in Balance Sheet – Advance Tax – (Value of Not Actual Asset)

L = BV of Liabilities – Paid up Capital – Profit & Reserves - Provision for Tax

PV = The paid up value of such equity shares

PE = Total amount of paid up equity share capital in Balance Sheet

Expenses on Increase in Share Capital

Allowed?

**ROC Fees,
Stamp Duty**

Disallowed?

**CIT vs General Insurance Corporation
(2006) 286 ITR 232 (SC)**

While bonus shares are issued, no fresh inflow of funds - total funds before and after bonus remain the same – Share issue expenses revenue in nature

**Brooke Bond India Ltd Vs CIT (1997) 225 ITR 798
(SC)**

Share issue expenses are capital in nature -
disallowed

**Punjab State Industrial Development
Corporation Ltd Vs CIT (1997) 225 ITR 792
(SC)**

ROC fees for enhancement of share capital -
Disallowed

Share Capital

Share Premium Money received

Revenue?

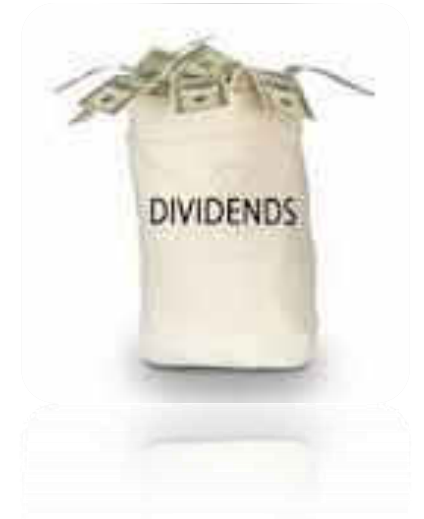


Green Infra Ltd vs ITO (ITA No 7726/ Mum/ 2012)

Share premium realised from the issue of shares is capital in nature – forms part of share capital and is not taxable u/s 56 since it is not ‘income’ – both expenditure and receipts directly relating to share capital are capital in nature

Capital?

Reserves and Surplus



Analyze Movement in Reserves vis-à-vis Share Capital Issued and Retained Profits

Look for Revenue Profits treated as Capital Profits

Dividend declared – Dividend Distribution Tax (DDT)

DDT not an allowable expenditure

Borrowings

Balance Sheet as at 31st March, 2011					
Particulars	Note No	Figures as at the end of current reporting period	Figures as at the end of previous reporting period		
(3) Non-Current					
		As at (CY)		As at (PY)	
Particulars		Non-current	Current	Non-current	Current
(a) Long-term borrowings		xxx	xxx	xxx	xxx
(b) Deferred tax liabilities		xxx	xxx	xxx	xxx
(c) Other Long term liabilities					
(d) Long term provisions					
Secured		xxx	xxx	xxx	xxx
Unsecured		xxx	xxx	xxx	xxx
TOTAL		xxx	xxx	xxx	xxx

Borrowings

Purpose/ Timing

- Capital or Revenue?
- If prior to being put to use– Interest capitalised
- Post Commencement of commercial production/after being put to use – Interest charged to P/L a/c – S. 36(iii)
- Interest on borrowings for acquisition of an asset for **extension of existing business** – disallowed – capitalised from date of borrowing to date it was put to use

Borrowings from related Parties

- Is the interest paid excessive or unreasonable having regard to FMV?
Disallowed u/s 40A(2)

MSMED Act

- Interest paid/payable by buyer under MSMED Act disallowed (to discourage delayed payment)

Borrowings – Diversion of Funds



AO Disallowed Interest Exp.

Interest paid allowed as a deduction?

S. A. Builders Ltd vs CIT (1979) 118 ITR 200 (SC)
If loan was given to sister concern and on the grounds of commercial expediency, interest cannot be disallowed.

Madhav Prasad Jatia (1979) 118 ITR 200 (SC)

- Amount is diverted not on the grounds of commercial expediency
- Used to invest in securities
- not used for business purpose – Interest disallowed

Shri. R. S. Venkatesh & Co. Ltd (2011) 331 ITR 502 (Del)
Borrowed funds and advances used for business considerations and the interest on non-interest bearing funds at the time of disallowance.

Borrowings

Relevance of Mode of Borrowing

Aggregate amount of loan borrowed as on date of borrowing, including any previous borrowings remaining unpaid

Rs. 20,000 or more – S. 269SS

Loan can be accepted only by account payee cheque or account payee bank draft

Penalty u/s 271D = Amount of loan so taken

If violated

Exceptions: Loan taken by:

Government

Banking Co, PO savings Bank, Co-Operative Bank

Corporation established under Central, State or Provincial Act

Any Govt Company and Such other institutions as notified

Where the borrower and lender have agricultural income and neither of them have income chargeable to tax

Repayment of Borrowings

Relevance of Mode of Repayment of Borrowings

Where aggregate of loan/deposit together with interest being repaid, including deposits held by such person with the same lender on the date of repayment

Rs. 20,000 or more – S. 269T

Loan can be repaid only by account payee cheque or account payee bank draft

Penalty u/s 271E = Amount of loan so repaid

If violated

Exceptions: Loan taken/accepted from:

Government

Banking Co, PO savings Bank, Co-Operative Bank

Corporation established under Central, State or Provincial Act

Any Govt Company and Such other institutions as notified

On repayment of credit facilities into cash credit account, bill account etc

Borrowings

Parameters to analyse Borrowings u/s 68

CIT vs. Precision Finance Pvt. Ltd. (1994) 208 ITR 465 (Cal) Onus on assessee to prove:

1. The identity of creditor
2. Creditworthiness of the creditor
3. Genuineness of the transaction

Do S.68 and 271D/E operate in conjunction?

Mutually exclusive - Penalty u/s 271D can be invoked only if person accepts loans in contravention of S.269SS. If revenue checked the genuineness of loan and treated it as undisclosed income, penalty u/s 271D does NOT arise.

If credits are genuine, S. 68 does not apply and if they are fictitious, S.271D/E does not apply.

Smt. Suman Gupta vs. Income-tax Officer [2012] 25 taxmann.com 220 (Agra ITAT)

AO found that lenders had no creditworthiness - very low bank balances low earnings. Held - it was money of assessee routed through bank accounts of lenders for purpose of giving credits to assessee and entries were only accommodation entries and could not be considered as genuine transactions

Provisions

Particulars	31.03.20XX	31.03.20XX
i. Provision for Employee Benefits		
Provision for Bonus & Leave Encashment	10	8
Provision for Gratuity	20	18
ii. Others		
Provision for Warranty and contractual obligation	30	20
Provision for Bad debts	40	30
Proposed dividend	10	8
Provision for		
Tax on Proposed dividend	1	1
Wealth tax	6	5
Income taxes (net)	50	40
Total	167	130

Provisions

What are the Provisions allowed as expenses?

Thumb Rule: NO provisions are allowed as Expenses under the IT Act

EXCEPTIONS

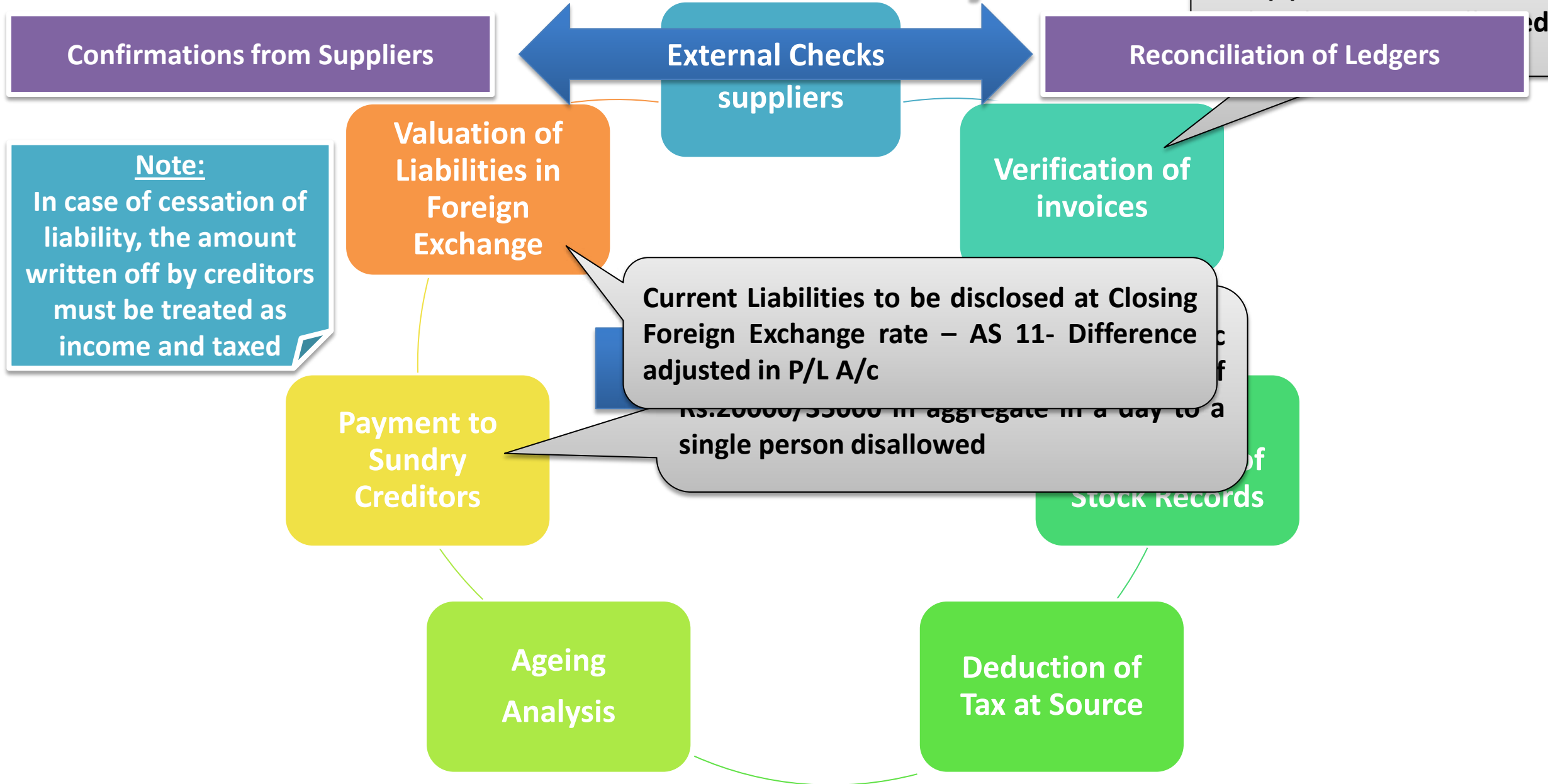
Case Study

On the last date of the FY, a case is pending before the SC which the assessee is likely to lose. Therefore, a provision is created for the same in the books.

Claims of contingent nature: Allowed as deduction in the current accounting year as the liability has become certain and reasonably quantifiable - *Bharat Earth Movers vs. CIT (2000)245 ITR 428(SC)*

Current Liabilities – Sundry Creditors

40A(2): In excess of FMV to be disclosed



Current Liabilities and S.43B

Expenses specified u/s 43B allowed as a deduction only if paid before due date of filing ROI - or else, on cash basis in the year of payment

Provisions for :
 Bonus/ commission to employees, any taxes, duties, cess under any law, interest on loans from scheduled banks etc – will be allowed as expenses in the year of payment

Case Study

“Notwithstanding anything contained in any other provision of this Act, a deduction otherwise allowable under this Act in respect of-

Exclusive Method

On the date of
 Debtors A/c
 To Sales A/c
 To VAT/Sales Tax Payable A/c

**NO Disallowance
 u/s 43B**

On due date of remittance of taxes :
 VAT/Sales Tax Payable Dr
 To Cash/Bank A/c

Inclusive Method

On the date of
 Debtors A/c
 To Sales A/c
 (Above amounts include VAT/Sales tax payable)

**Disallowance
 u/s 43B**

At the end of the year
 Profit & Loss A/c Dr
 To VAT/Sales tax A/c

Fixed Assets

PARTICULARS	GROSS BLOCK				DEPRECIATION / AMORTISATION				NET BLOCK	
	As at			As at	Up to	for the	Deletions	Up to	As at	
	31.03.20XX	Addition	Deletion	31.03.20XX	31.03.20XX	year		31.03.20XX	31.03.20XX	31.03.20XX
Tangible										
Land	25	15	5	35	-	-	-	-	25	35
Buildings	50	10	20	40	10	6	2	14	40	26
Plant	30	10	5	35	5	6	2	9	25	26
Vehicles	20	10	5	25	5	4.5	0.5	9	15	16
	125	45	35	135	20	16.5	4.5	32	105	103
Intangible										
Technical Know-How	12	4	-	16	3	1	-	4	9	12
Softwares	16	8	-	24	4	2	-	6	12	18
	28	12	-	40	7	3	-	10	21	30
TOTAL – 31.03.20XX	153	57	35	175	27	19.5	4.5	42	126	137
31.03.20XX	140	20	7	153	17	13	3	27	137	153

Fixed Assets

Cost to be Capitalized

Cost of Purchase/Construction	XX
<u>Less:</u> Amount of subsidy /grant from any authority/person	(XX)
<u>Add:</u>	
1. Interest on loan borrowed for construction (Upto to date till the asset is put to use)	XX
2. Expenses incurred for acquiring the asset – Freight, insurance etc.	XX
3. Expenses incurred in connection with installation of asset	<u>XX</u>
Actual Cost u/s 43(1)	XX

Check if Expenditure that is disallowed under the ITA is being capitalised –
Eg. Income Tax, Wealth Tax, FBT

Cost of improvements to Fixed Assets – Capital or Revenue Expenditure?

Professional's Heart Surgery

Heart cannot be considered a plant as it did not exist in the Balance sheet and COA is not determinable
Deduction u/s 37 cannot be granted - no immediate nexus between surgery expenses and efficiency in professional field - Surgery expenses cannot be treated as repairs – No deduction u/s 31
Shanti Bhushan vs CIT (2011) 336 ITR 26 (Del)

Abandoned Expansion Plans - *Indo Roma Synthetics India Ltd v CIT (2009) 32 DTR 322*

Assessee incurred expenditure on engaging services of consultants for improving operational efficiencies inextricably linked to the existing business. The project was abandoned with no new asset to be created. Expenditure – Revenue in nature

Fixed Assets

Conditions to Claim Depreciation

Ownership

- Wholly /Partly owned – depreciation allowed



Usage

- Must be used for Business/Profession
- Active use not necessary – Even for Passive use , depreciation is allowed
- CIT v/s Pepsu Road Transport Corporation (2002) 253 ITR 303 (P&H)

Eligible Class

- Asset should fall within eligible class of assets:
 - Tangible – Buildings, Machinery, Plant, Furniture
 - Intangible – Know-how, patents, copyrights, trademarks etc.

Fixed Assets

Exceptions to the Rule of Ownership to claim depreciation

Expl. 1 to Sec. 32

Any capital expenditure incurred by tenant occupying the building for Business/Profession, towards renovation, extension, improvement to building – Deprecation can be claimed by Tenant

Beneficial Owner

Mysore Minerals Ltd vs CIT (1999) 239 ITR 775 (SC): Not mandatory to have legal ownership – Beneficial ownership in terms of possession, usage, control sufficient – Merely because title deed is not registered, depn can't be denied

Hire Purchase

Classification

Have the assets been classified under the Correct head?

Cross check depreciation rates applicable

E.g. Hotel buildings, hospital buildings are classified as Buildings - not plants.

U/s 43(3), Plant does not include buildings.

Fixed Assets

Miscellaneous

No. of days:

Consider date of Put to use and not date on the invoice

Wealth Tax:

Determined on the basis of Fixed Assets and Investments

For Intangibles:

Depreciation can be claimed at 25%

Depreciation on Goodwill

CIT V/s. Smiff Securities Ltd

"Explanation 3 to sec. 32(1)-

For the purposes of this sub-section, the expressions 'assets' and 'block of assets' shall mean—

[a] tangible assets, being buildings, machinery, plant or furniture;

[b] intangible assets, being know-how, patents, copyrights, trademarks, licences, franchises or **any other business or commercial rights of similar nature.**"

Fixed Assets

Additional depreciation



Enhanced Depreciation at 20% of Actual Cost allowed w.r.t NEW Plant and Machinery (other than ships and aircrafts) acquired and installed – In additional to normal depreciation

Additional depreciation not allowed with respect to:

Any Machinery/Plant used by any other person within/outside India

Any Machinery/Plant installed in Office/Residence including Guest House

Any office appliances, Road transport vehicles

Any Machinery/Plant the whole of the actual cost of which is allowed as Depreciation in any PY

Fixed Assets

Implications on Sale

Is the Fixed asset being sold the only asset in the Block?

YES

NO

Block Ceases to Exist – No depreciation can be claimed –
Capital gains arise:

Sale Consideration	XX
Less: WDV at the beginning of the year/ Cost of Acquisition	<u>(XX)</u>
Capital Gains	XX

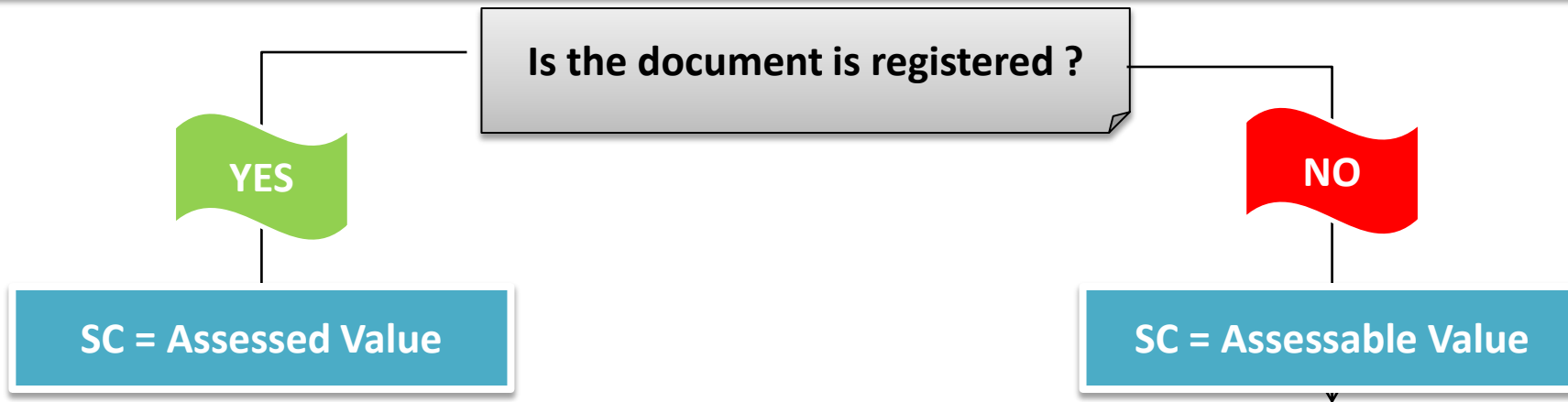
Block Continues to Exist – Depreciation can be claimed and No capital gains arise:
Calculation of Closing WDV:

Opening WDV	XX
Add: Purchases during the year	XX
Less: Asset sold during the year	<u>(XX)</u>
Closing WDV (on the which depreciation is calculated)	XX

Valuation of Sale Consideration – S. 50C

Applicable ONLY for computation of Capital Gains u/s 48 and where the transaction involves transfer of land or building or both

Applicable irrespective of registration of sale deed/ transfer through agreement to sell/ power of attorney



Reference to Valuation Officer (VO)

If assessee claims :

Stamp Duty Value > FMV,

AO can refer to Valuation Officer.

ONLY if value has not been disputed in any appeal/revision before any authority/Court

Valuation by VO

Value as per VO Report > Stamp Duty Value,
Stamp Duty Value = SC

Value as per VO Report > Actual SC but <
Stamp Value,

Value as per VO Report = SC

Conversion of Capital Asset to Stock in Trade

Case Study

Land originally held as Fixed Asset – Converted to Stock in Trade – Sold after 5 years.



Tax implication in the year of sale

Particulars	Rs
Sale Consideration	xx
Less: FMV on Date of Conversion	<u>(xx)</u>
Business Profits	xx

Particulars	Rs
FMV on date of Conversion	xx
Less: Cost of Fixed Asset	<u>(xx)</u>
Capital Gains	xx

NO tax implication on date of conversion

Investments

General Points to be Noted

Ownership

- Verify Title Deeds
- Is the Investment made in the Name of the Assessee?

Sale of Investment

- On sale of investment, capital gains would arise
- If House property held as investment is sold – Capital gains not Income from House Property

Share trading

- Screen-based trading and derivative transactions – Even though held as investments, No capital gains – Treated as PGBP
- Intra-day trading – Assessee buys and sells shares on the same day – Held in the capacity of investment – PGBP not Capital gains

Investments

Section 56 (2) (vii)(c)

Where any movable property, the aggregate FMV of which is more than Rs. 50,000, is received by an Individual/ HUF without consideration/
for consideration < Aggregate FMV by more than Rs. 50,000:

In Shares

Section 56 (2) (viia)

Where a firm/ private company receives shares of a private company, the aggregate FMV of which is more than Rs. 50,000, without consideration/
for consideration < Aggregate FMV by more than Rs. 50,000:

The aggregate FMV of the entire amount of difference exceeding Rs. 50,000 respectively taxable as IFOS

FMV determined as per Rule 11UA

Investments

Expenditure incurred where income is exempt

S. 14A

(1) For the purposes of computing the total income under this Chapter, no deduction shall be allowed in respect of **expenditure incurred by the assessee** in relation to income which does not form part of the total income under this Act.

(2) The Assessing Officer shall determine the amount of expenditure incurred in relation to such income which does not form part of the total income under this Act in accordance with such method as may be prescribed, if the Assessing Officer, having regard to the accounts of the assessee, **is not satisfied with the correctness of the claim of the assessee in respect of such expenditure** in relation to income which does not form part of the total income under this Act.

Benchmarks/ Indicators to invoke 14A r/w Rule 8D

- Is there significant movement in stock holding?
- Is Assessee trading on his own or he has engaged an Asset Management Company?
- Are there borrowed funds utilized for investment on which interest is being paid & claimed as an expenditure?
- Quantum & relevance of expenditure such as Telephone, Electricity, etc.

Investments

Issues w.r.t. Expenses incurred to Earn exempt Income

RULE 8D	
Amount of expenditure directly relating to exempt income	A
Amount of interest expenditure incurred by assessee, which is not directly attributable to any particular income	B
Amount equal to 0.5% of the average value of investment, income in respect of which is exempt	C
Total Amount disallowable u/s 14A	A+B+C

Amount disallowable w.r.t interest expenditure:
 $(X * Z)/Y$

X = Total interest except covered under A

Y = Average of Total assets in the B/S as on the first day and last day of PY

Z = Average value of Investment in the B/S, income from which does not form part of Total Income, as on the First Day and Last day of PY

Can S.14A be invoked when no exempt income is earned during the year?

CBDT Cir No 5/2014

“CBDT in exercise of its powers under S.119 of the Act hereby clarifies that Rule 8D read with Section 14A of the Act provides for disallowance of the expenditure even where taxpayer in a particular year has not earned exempt income”

CIT vs Lakhani Marketing (P&H High Court)

CIT vs Cortech Energy Pvt Ltd (Guj HC)

CIT vs Shivam Motors P Ltd (All), CIT vs M/s Delite Enterprises (Bom)

S. 14A disallowance cannot be made if the assessee has no tax-free income in the year. Four conditions prescribed to determine if 14A disallowance is applicable.

Current Assets

Points to be considered w.r.t Inventory

Used to manipulate profits

Method of Valuation of Inventory - Consistently applied?
Refer Significant Accounting Policies in Notes to Accounts

Significant increase / decrease in Closing Stock – Does it correspond with Costs of purchase/sales/
Production/Manufacturing?

- Apply ratios – Input / Output
- Verification of quantitative records with Sales, Purchase Register, Excise Records
- Comparison with Industry Standards

Inclusive vs Exclusive Method of Accounting

S. 145A: Inventory to be valued as per :

1. Method consistently applied and,
2. To be adjusted for any tax, duty, cess or fee actually paid or incurred by the assessee to bring goods to place of its location and condition as on the date of valuation.

Current Assets

Loans and Advances

Used to Siphon off funds from the Organisation

- Whom has the loan been advanced to?
- For how long is it outstanding?
- Is any interest being charged?

In case of a Private Company, verify if:

Loan/advance to any concern in which Shareholder is a member/partner holding substantial interest (20% or more during PY)

Loan/advance to shareholder holding beneficial interest or voting power

Any payment on behalf of/for

Treated as Deemed Dividend in the hands of the receiver – S. 2(22)(e) r/w S. 56

Deemed Dividend to the extent of accumulated profits

Revenue Recognition – Accrual Basis

Gross inflow of consideration arising in the course of ordinary activities, such as:

- Sale of goods.
- Rendering the services.
- Use of the enterprises resources by others giving interest, dividend and royalties.

When the delivery is delayed at buyer's request (Bill & hold sales), Revenue should be recognised.

Sale of Goods

- **Ownership or all significant risks & rewards have been transferred and no effective control is retained.**

Rendering of Services

- **Proportionate completion method (AS 9); or**
- **Completed service contract method.**

- ✓ When certainty exists regarding amount of consideration
- ✓ When certainty exists regarding collection of consideration

Proportionate Completion Method

Estimated Sales = Rs.2,00,000.

Costs:

Yr 1= Rs. 20,000,

Yr 2= Rs. 40,000

Yr 3= Rs. 40,000

What is the amount to be recognised by X Ltd?

Recognise over a period of 3 years in the ratio of the cost incurred in providing the services i.e. in the ratio of 2:4:4.

Revenue Recognition – Accrual Basis

Revenue from Interest

- Time proportion basis

Revenue from Royalties

- On accrual basis in accordance with the terms of the relevant agreement

Revenue from Dividends

- When right to receive is established

Right to Receive Dividend

Interim Dividend - Only when it is paid (*not when it is declared*)

Final Dividend - As and when it is declared (*though paid later*)

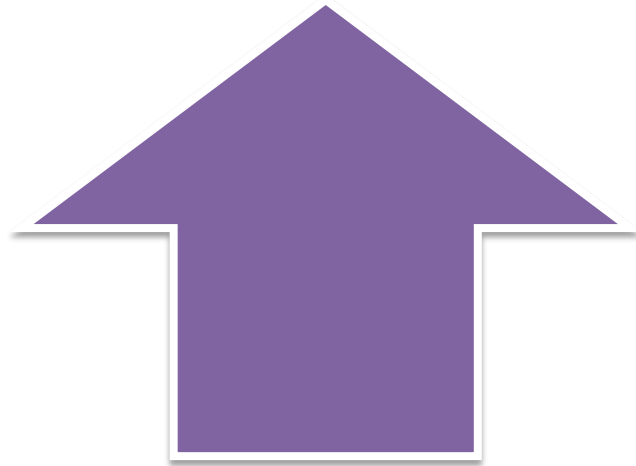
E – Commerce Transactions?

Google
Facebook

Profit & Loss Account

Particulars	Remarks
<u>Income</u>	
Direct Income	
Sale of Goods	Income Recognition; Suppression of rate & quantity
Sale of Services	
Other Income	
Rent	Head of income under which it is offered
Dividend	Exemption u/s. 10(35) & 10(34) Eligibility of exemption Section 14A
Profit on sale of assets	
Machinery	Reduction in Fixed Asset schedule
Shares	Eligibility for exemption u/s. 10(38) Eligibility for special rate of Tax u/s. 111A Price at which it is sold? - no impact on tax but impact on infusion of capital
Government Grant	Taxable if not reduced from the Cost of Fixed Assets

Thumb Rule for Expenditure



Revenue Expenditure –
Allowed unless specifically disallowed



Capital Expenditure –
Disallowed unless specifically allowed

Profit & Loss Account

Description	Section No.	For the Year ended	
		31.03.20XX	31.03.20XX
Cost of Materials	28	130	120
Cost of Manufacturing	28	140	135
Employee Cost	192, 43B	80	65
Administration, Selling & General Expenses	37(1)	35	25
Finance Cost	36(iii), 43B	25	20
Mobile Phones, Ipad	32	3	2
Depreciation, amortization & Impairment	32	14	10
Foreign Exchange Loss	43A	15	----
Other expenses subject to tax deduction	194..., 195	50	40
Legal & Professional Charges	194J	40	12
Provision for Gratuity and other retirement benefits	40A (7)	25	20
Provision for bad and doubtful debts	36 (1)	15	10
Bad Debts	36 (2)	7	6
Warranty and contractual obligation	37(1)	30	25
Repairs to building/plant and machinery	30, 31	40	35
Donations	37(1)/80G	45	40
Membership & Subscription	37(1)	4	4
Fines & Penalties	37(1)	8	9
Research & Development expense	35	100	93
Diminution in value of investments		50	40

Section 37

Foreign Education – President's son

- The fact that trainee happens to be the son of the president does not make the expenditure personal – Son was appointed by resolution as a trainee– agreement entered into that trainee after completion of education abroad will be obliged to work for the company for atleast 10 years – Expenditure on foreign education allowed
- **Gournitye Tea & Industries Ltd vs CIT (2011) Tax LR 315 (Cal)**

Foreign Travel Expenses of Spouse

- In **Glaxo Laboratories (India) Ltd vs ITO 18 ITR 226 (Bom) (SB)**, travelling expenses of Spouse were held to be **admissible** as the business visit involved social aspects and the spouse accompanied husband on grounds of commercial expediency
- CIT vs Hajee Moosa & Co (1985) 153 ITR 422 (Mad), spouse accompanied husband only to take care of his health - **Disallowed**

Smuggling Business Loss

- Professional smuggler- so his income could only be decided on net basis on considering both illegal receipts and illegal expenses or loss. The law at present is that loss from an illegal activity cannot be allowed against a legal business. But if the business or profession itself is illegal, such loss can be allowed against such illegal income.
- **CIT v. Piara Singh [1980] 124 ITR 40 (SC)**

Section 37

Heroin – Expenditure against Public Policy

- Assessee a doctor, was found in possession of heroin – contraband item – Disallowed
- Profession of being a doctor (legal) has nothing to do with Heroin production (illegal) – Therefore, loss of illegal business cannot be set off against income from legal business
- ***CIT vs T.A. Qureshi (2005) 275 ITR 352 (MP)***

Ransom Money

- While kidnapping is an offence, paying ransom is not
- Payment made by assessee to secure the release of a kidnapped director not prohibited
- ***CIT vs Khemchand Motilal Jain Tobacco Products P Ltd (2011) 340 ITR 99 (MP)***

Protection Money paid to Goons and Police

- Payment of sums to local goons and the police for maintenance of law & order is expenditure prohibited by law – No deduction
- ***CIT vs Swaminathan (M.N) (2010) 236 CTR 59***

Litigation Expenses – Criminal Proceedings

- Actor incurred expenditure in defending himself against criminal proceedings which arose out of a shooting incident
- Criminal proceedings filed against the individual – had nothing to do with profession – disallowed
- ***DCIT vs Salman Khan (2011) 8 ITR 50 (Mum Trib)***

List of sections for disallowances

36(1)

- Provision for Bad & Doubtful debts

37(1)

- Not in connection to business

40(a)

- Business disallowance – Interest, taxes, non-deduction of tax, non-remittance.

40(b)

- Interest, salary etc., paid to Partners by firm

40A(2)

- Payment to related parties at market value

40A(3)

- Cash payments exceeding Rs. 20,000

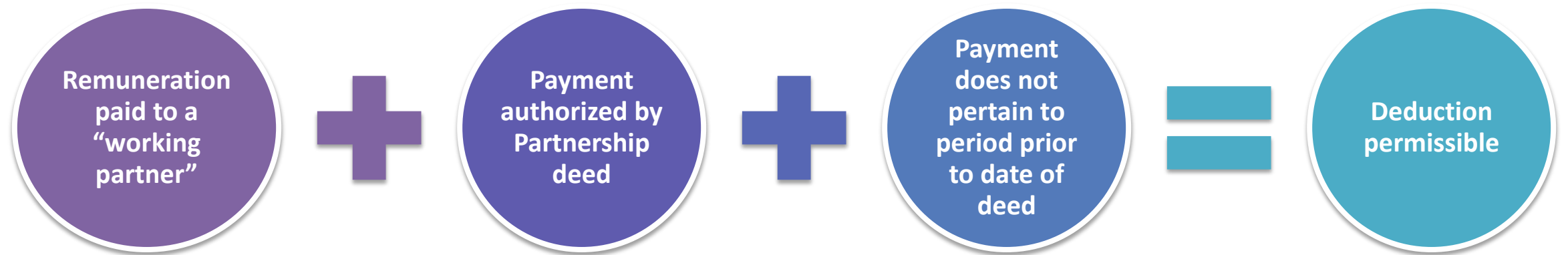
40A(7)

- Business disallowance - Gratuity

43B

- Deduction based on actual payment

Remuneration to Partners



Partner's remuneration exceeding the sum of (1) &(2) below is disallowed:

1	on the first Rs. 3,00,000 of the book-profit or in case of a loss	Rs. 1,50,000 or at the rate of 90 per cent of the book-profit, whichever is more
2	on the balance of the book-profit	at the rate of 60 per cent

Note:

Determine inadmissible amount after deducting interest to partners u/s 40(b) – to the extent of 12% SI p.a. allowed

In times of trouble, the fort provides a haven to the people and the king himself.

—Kautilya, *The Arthashastra* (4th century BCE)

Thank you. . . .

Bad Debts

Must be a debt or part thereof

Written off as irrecoverable

Business should exist in the PY

Additional conditions u/s. 36(2):

1. It has been offered to tax in the PY/s
2. Should be lent in ordinary course of business of banking/money lending

Bad debts of predecessor is allowed as deduction in the hands of successor. – *CIT vs. T Veerabhadra 155 ITR 152*

Provision for bad and doubtful debts is never allowed except under section 36(1)(viiia)

It is not necessary for assessee to prove it. It is enough if shown as irrecoverable in the books of account.

- *T R F Ltd vs CIT (2010) 190 TAXMAN 391*

Section 41(4):

Taxability of Recovered Amount (RA):

Taxable = RA - (AD – BD allowed)

Eg.

Bad debt claimed = Rs.15000

Bad debt allowed = Rs.10000

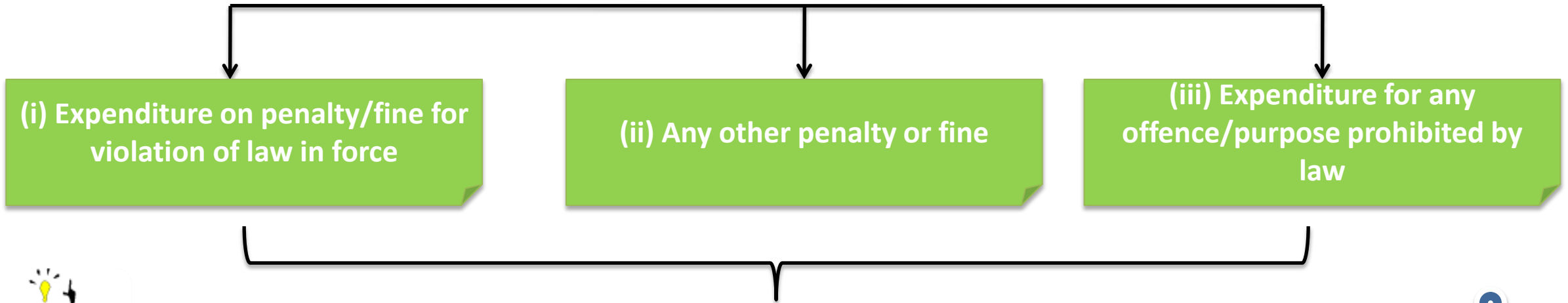
Bad debt recovery = Rs.7500

Taxable Amount = Rs.2500

If the assessee who claimed the deduction for bad debts does not exist due to succession and there is bad debt recovery, the amount of BDR shall remain untaxed in the hands of successor.

- *CIT vs. P K Kaimal 4 Taxman 319 (Mad.)*

Penalty, fine etc



Not deductible:

CIT v. Maddi Venkataratnam & Co. (P) Ltd [1998] 96 Taxman 643 : Violation of law not normal incidence of business. Business can be carried on without flouting the law

When statutory impost is paid

Don't go by nomenclature. Check nature:

Penal

• Not deductible

Compensatory

• Deductible - *Swadeshi Cotton Mills (1998) 233 ITR 199.*

Composite

• Proportionate deduction for compensatory amount - *Malwa Vanaspati & Chemical Co. v. CIT [1997] 225 ITR*

[Back](#)



Capital Expenditure disallowed

What is Capital expenditure?

Not defined in the Act.

Tests to determine if expenditure is capital in nature (not exhaustive) :

Brings asset/advantage of enduring benefit?

Is it referable to fixed capital/assets in contrast to circulating capital/asset? –

Relates to the basic framework of business?

Incurred to acquire intangible asset?

Other points to consider:

Consider payer independently of receiver – Nature of receipt in the hands of recipient is NOT a determining factor*

AO to consider :

1. Nature of expense
2. Amount incurred
3. Provision under which capital expense is deductible

Fixed Assets

Adjustments made w.r.t the following factors to be verified:

Tax Credit on Capital Goods

- **Verify** credit claimed/allowed , **exclude** from Capital Cost and **disclose** w.r.t : CENVAT, VAT, Service Tax, Customs Tariff Act (refundable)
- Verify Tax Cr = Amount subtracted from AC

Exchange rate fluctuation

- Verify that adjustments are in accordance with S. 43A and report
- Reconciliation Statement (for Auditors records) : If Auditor wants to follow different treatment or treatment as per AS and assessee do not match

Subsidy/Grant/Reimbursement

- Verify that adjustments are made as per Explanation 10 to S.43(1)

Trust

Particulars	20XX-XX	20XX-XX
Total Income as per I&E A/c.	149	756
Less: 15%	22	113
Balance	126	643
Less: Amount set aside for specific purpose as per Form 10	9	300
Amount to be applied for charitable purpose (A)	117	343
Total Payments as per R&P A/c.	142	973
Add: Donations in Kind	8	-
Add: Depreciation	-	20
Less: Closing balance	6	507
Less: Fixed Deposits	27	135
Less: Loan	-	
	117	350
Corpus Utilised	-	7
Amount Applied for Charitable Purpose (B)	117	343
Surplus Spending (B)-(A)	0	0

The income of the Trust is required to be computed under section 11 on commercial principles after providing for allowance for normal depreciation and deduction thereof from gross income of the Trust.

*- CIT vs. Institute of Banking Personnel Selection [2003]
264 ITR 110*

