

OFFENCES AND PENALTIES UNDER THE ELECTRICITY ACT, 2003



Section 135: Theft of electricity.

(1) Whoever, dishonestly,—

- (a) taps, makes or causes to be made any connection with overhead, underground or underwater lines or cables, or service wires, or service facilities of a licensee or supplier, as the case may be; or
- (b) tampers a meter, installs or uses a tampered meter, current reversing transformer, loop connection or any other device or method which interferes with accurate or proper registration, calibration or metering of electric current or otherwise results in a manner whereby electricity is stolen or wasted; or
- (c) damages or destroys an electric meter, apparatus, equipment, or wire or causes or allows any of them to be so damaged or destroyed as to interfere with the proper or accurate metering of electricity; or
- (d) uses of electricity through a tampered meter; or
- (e) uses electricity for the purpose other therefore which the usage of electricity was authorised,

so as to abstract or consume or use electricity shall be punishable with imprisonment for a term which may extend to three years or with fine or with both:

Provided that in a case where the load abstracted, consumed, or used or attempted abstraction or attempted consumption or attempted use—

- (i) does not exceed 10 kilowatt, the fine imposed on first conviction shall not be less than three times the financial gain on account of such theft of electricity and in the event of second or subsequent conviction the fine imposed shall not be less than six times the financial gain on account of such theft of electricity;
- (ii) exceeds 10 kilowatt, the fine imposed on first conviction shall not be less than three times the financial gain on account of such theft of electricity and in the event of second or subsequent conviction, the sentence shall be imprisonment for a term not less than six months, but which may extend to five years and with fine not less than six times the financial gain on account of such theft of electricity:



Provided further that in the event of second and subsequent conviction of a person where the load abstracted, consumed, or used or attempted abstraction or attempted consumption or attempted use exceeds 10 kilowatt, such person shall also be debarred from getting any supply of electricity for a period which shall not be less than three months but may extend to two years and shall also be debarred from getting supply of electricity for the period from any other source or generating station:

Provided also that if it is proved that any artificial means or means not authorised by the Board or licensee or supplier, as the case may be, exist for the abstraction, consumption or use of electricity by the consumer, it shall be presumed, until the contrary is proved, that any abstraction, consumption or use of electricity has been dishonestly caused by such consumer.

(1A) Without prejudice to the provisions of this Act, the licensee or supplier, as the case may be, may, upon detection of such theft of electricity, immediately disconnect the supply of electricity:

Provided that only such officer of the licensee or supplier, as authorised for the purpose by the Appropriate Commission or any other officer of the licensee or supplier, as the case may be, of the rank higher than the rank so authorised shall disconnect the supply line of electricity:

Provided further that such officer of the licensee or supplier, as the case may be, shall lodge a complaint in writing relating to the commission of such offence in police station having jurisdiction within twenty-four hours from the time of such disconnection:

Provided also that the licensee or supplier, as the case may be, on deposit or payment of the assessed amount or electricity charges in accordance with the provisions of this Act, shall, without prejudice to the obligation to lodge the complaint referred to in the second proviso to this clause, restore the supply line of electricity within forty-eight hours of such deposit or payment.]

(2) Any officer of the licensee or supplier, as the case may be, authorized in this behalf by the State Government may—

- (a) enter, inspect, break open and search any place or premises in which he has reason to believe that electricity 3[has been or is being], used unauthorisedly;
- (b) search, seize and remove all such devices, instruments, wires and any other facilitator or article which 3[has been or is being], used for unauthorised use of electricity;
- (c) examine or seize any books of account or documents which in his opinion shall be useful for or relevant to, any proceedings in respect of the offence under sub-section (1) and allow the person from whose custody such books of account or documents are seized to make copies thereof or take extracts therefore in his presence.

(3) The occupant of the place of search or any person on his behalf shall remain present during the search and a list of all things seized in the course of such search shall be prepared and delivered to such occupant or person who shall sign the list:

Provided that no inspection, search and seizure of any domestic places or domestic premises shall be carried out between sunset and sunrise except in the presence of an adult male member occupying such premises.



(4) The provisions of the Code of Criminal Procedure, 1973 (2 of 1974), relating to search and seizure shall apply, as far as may be, to searches and seizure under this Act.

(1) Whoever, dishonestly,—

- (a) taps, makes or causes to be made any connection with overhead, under- ground or underwater lines or cables, or service wires, or service facilities of a licensee; or
- (b) tampers a meter, installs or uses a tampered meter, current reversing transformer, loop connection or any other device or method which interferes with accurate or proper registration, calibration or metering of electric current or otherwise results in a manner whereby electricity is stolen or wasted; or
- (c) damages or destroys an electric meter, apparatus, equipment, or wire or causes or allows any of them to be so damaged or destroyed as to interfere with the proper or accurate metering of electricity so as to abstract or consume or use electricity shall be punishable with imprisonment for a term which may extend to three years or with fine or with both:

Provided that in a case where the load abstracted, consumed, or used or attempted abstraction or attempted consumption or attempted use—

- (i) does not exceed 10 kilowatt, the fine imposed on first conviction shall not be less than three times the financial gain on account of such theft of electricity and in the event of second or subsequent conviction the fine imposed shall not be less than six times the financial gain on account of such theft of electricity;
- (ii) exceeds 10 kilowatt, the fine imposed on first conviction shall not be less than three times the financial gain on account of such theft of electricity and in the event of second or subsequent conviction, the sentence shall be imprisonment for a term not less than six months but which may extend to five years and with fine not less than six times the financial gain on account of such theft of electricity:

Provided further that if it is proved that any artificial means or means not authorised by the Board or licensee exist for the abstraction, consumption or use of electricity by the consumer, it shall be presumed, until the contrary is proved, that any abstraction, consumption or use of electricity has been dishonestly caused by such consumer."

Section 136: Theft of electric lines and materials

(1) Whoever, dishonestly—

- (a) cuts or removes or takes away or transfers any electric line, material or meter from a tower, pole, any other installation or place of installation or any other place, or site where it may be rightfully or lawfully stored, deposited, kept, stocked, situated or located, including during transportation, without the consent of the licensee or the owner, as the case may be, whether or not the act is done for profit or gain; or
- (b) stores, possesses or otherwise keeps in his premises, custody or control, any electric line, material or meter without the consent of the owner, whether or not the act is committed for profit or gain; or
- (c) loads, carries, or moves from one place to another any electric line, material or meter without the consent of its owner, whether or not the act is done for profit or gain;



is said to have committed an offence of theft of electric lines and materials, and shall be punishable with imprisonment for a term which may extend to three years or with fine or with both.

- (2) If a person, having been convicted of an offence punishable under subsection (1) is again guilty of an offence punishable under that sub-section, he shall be punishable for the second or subsequent offence for a term of imprisonment which shall not be less than six months but which may extend to five years and shall also be liable to fine which shall not be less than ten thousand rupees.

Section 137: Punishment for receiving stolen property

Whoever, dishonestly receives any stolen electric line or material knowing or having reasons to believe the same to be stolen property, shall be punishable with imprisonment of either description for a term which may extend to three years or with fine or with both.

Section 138: Interference with meters or works of licensee

(1) Whoever,—

- (a) unauthorisedly connects any meter, indicator or apparatus with any electric line through which electricity is supplied by a licensee or disconnects the same from any such electric line; or
- (b) unauthorisedly reconnects any meter, indicator or apparatus with any electric line or other works being the property of a licensee when the said electric line or other works has or have been cut or disconnected; or
- (c) lays or causes to be laid, or connects up any works for the purpose of communicating with any other works belonging to a licensee; or
- (d) maliciously injures any meter, indicator, or apparatus belonging to a licensee or wilfully or fraudulently alters the index of any such meter, indicator or apparatus or prevents any such meter, indicator or apparatus from duly registering.

shall be punishable with imprisonment for a term which may extend to three years, or with fine which may extend to ten thousand rupees, or with both, and, in the case of a continuing offence,- with a daily fine which may extend to five hundred rupees; and if it is proved that any means exist for making such connection as is referred to in clause (a) or such reconnection as is referred to in clause (b), or such communication as is referred to in clause (c), for causing such alteration or prevention as is referred to in clause (d), and that the meter, indicator or apparatus is under the custody or control of the consumer, whether it is his property or not, it shall be presumed, until the contrary is proved, that such connection, reconnection, communication, alteration, prevention or improper use, as the case may be, has been knowingly and wilfully caused by such consumer.

Section 139: Negligently breaking or damaging works

Whoever, negligently breaks, injures, throws down or damages any material connected with the supply of electricity, shall be punishable with fine which may extend to ten thousand rupees.



Section 140: Penalty for intentionally injuring works

Whoever, with intent to cut off the supply of electricity, cuts or injures, or attempts to cut or injure, any electric supply line or works, shall be punishable with fine which may extend to ten thousand rupees.

Section 141: Extinguishing public lamps

Whoever, maliciously extinguishes any public lamp shall be punishable with fine which may extend to two thousand rupees.

Section 142: Punishment for non-compliance of directions by Appropriate Commission

In case any complaint is filed before the Appropriate Commission by any person or if that Commission is satisfied that any person has contravened any of the provisions of this Act or the rules or regulations made there under, or any direction issued by the Commission, the Appropriate Commission may after giving such person an opportunity of being heard in the matter, by order in writing, direct that, without prejudice to any other penalty to which he may be liable under this Act, such person shall pay, by way of penalty, which shall not exceed one lakh rupees for each contravention and in case of a continuing failure with an additional penalty which may extend to six thousand rupees for every day during which the failure continues after contravention of the first such direction.

Section 143: Power to adjudicate.—

- (1) For the purpose of adjudging under this Act, the Appropriate Commission shall appoint any of its Members to be an adjudicating officer for holding an inquiry in such manner as may be prescribed by the Appropriate Government, after giving any person concerned a reasonable opportunity of being heard for the purpose of imposing any penalty.
- (2) While holding an inquiry, the adjudicating officer shall have power to summon and enforce the attendance of any person acquainted with the facts and circumstances of the case to give evidence or produce any document which in the opinion of the adjudicating officer, may be useful for or relevant to the subject-matter of the inquiry, and if, on such inquiry, he is satisfied that the person has failed to comply with the provisions of section 29 or section 33 or section 43, he may impose such penalty as he thinks fit in accordance with the provisions of any of those sections.

Section 144: Factors to be taken into account by adjudicating officer

While adjudicating the quantum of penalty under section 29 or section 33 or section 43, the adjudicating officer shall have due regard to the following factors, namely:—

- (a) the amount of disproportionate gain or unfair advantage, wherever quantifiable, made as a result of the default;
- (b) the repetitive nature of the default.



Section 145: Civil court not to have jurisdiction

No civil court shall have jurisdiction to entertain any suit or proceeding in respect of any matter which an assessing officer referred to in section 126 or an appellate authority referred to in section 127 or the adjudicating officer appointed under this Act is empowered by or under this Act to determine and no injunction shall be granted by any court or other authority in respect of any action taken or to be taken in pursuance of any power conferred by or under this Act.

Section 146: Punishment for non-compliance of orders or directions

Who ever, fails to comply with any order or direction given under this Act, within such time as may be specified in the said order or direction or contravenes or attempts or abets the contravention of any of the provisions of this Act or any rules or regulations made there under, shall be punishable with imprisonment for a term which may extend to three months or with fine which may extend to one lakh rupees, or with both in respect of each offence and in the case of a continuing failure, with an additional fine which may extend to five thousand rupees for every day during which the failure continues after conviction of the first such offence.

Section 147: Penalties not to affect other liabilities

The penalties imposed under this Act shall be in addition to, and not in derogation of, any liability in respect of payment of compensation or, in the case of a licensee, the revocation of his licence which the offender may have incurred.

Section 148: Penalty where works belong to Government

The provisions of this Act shall, so far as they are applicable, be deemed to apply also when the acts made punishable there under are committed in the case of electricity supplied by or of works belonging to the Appropriate Government.

Section 149: Offences by companies.—

- (1) Where an offence under this Act has been committed by a company, every person who at the time the offence was committed was in charge of and was responsible to the company for the conduct of the business of the company, as well as the company shall be deemed to be guilty of having committed the offence and shall be liable to be proceeded against and punished accordingly:

Provided that nothing contained in this sub-section shall render any such person liable to any punishment if he proves that the offence was committed without his knowledge or that he had exercised all due diligence to prevent the commission of such offence.

- (2) Notwithstanding anything contained in sub-section (1), where an offence under this Act has been committed by a company and it is proved that the offence has been committed with the consent or connivance of or is attributable to any neglect on the part of any director, manager, secretary or other officer of the company, such director, manager, secretary or other officer shall also be deemed to be guilty of having committed such offence and shall be liable to be proceeded against and punished accordingly.



Explanation.—For the purposes of this section,—

- (a) "company" means a body corporate and includes a firm or other association of individuals; and
- (b) "director", in relation to a firm, means a partner in the firm.

Section 150: Abetment

- (1) Whoever abets an offence punishable under this Act, shall, notwithstanding anything contained in the Indian Penal Code (45 of 1860), be punished with the punishment provided for the offence.
- (2) Without prejudice to any penalty or fine which may be imposed or prosecution proceeding which may be initiated under this Act or any other law for the time being in force, if any officer or other employee of the Board or the licensee enters into or acquiesces in any agreement to do, abstains from doing, permits, conceals or connives at any act or thing whereby any theft of electricity is committed, he shall be punishable with imprisonment for a term which may extend to three years, or with fine, or with both.
- (3) Notwithstanding anything contained in sub-section (1) of section 135, sub-section (1) of section 136, section 137 and section 138, the licence or certificate of competency or permit or such other authorization issued under the rules made or deemed to have been made under this Act to any person who acting as an electrical contractor, supervisor or worker abets the commission of an offence punishable under sub-section (1) of section 135, sub-section (1) of section 136, section 137, or section 138, on his conviction for such abetment, may also be cancelled by the licensing authority:

Provided that no order of such cancellation shall be made without giving such person an opportunity of being heard.

Explanation.—For the purposes of this sub-section, "licensing authority" means the officer who for the time being in force is issuing or renewing such licence or certificate of competency or permit or such other authorization.]

Section 151: Cognizance of offences

No court shall take cognizance of an offence punishable under this Act except upon a complaint in writing made by Appropriate Government or Appropriate Commission or any of their officer authorised by them or a Chief Electrical Inspector or an Electrical Inspector or licensee or the generating company, as the case may be, for this purpose.

Provided that the court may also take cognizance of an offence punishable under this Act upon a report of a police officer filed under section 173 of the Code of Criminal Procedure, 1973 (2 of 1974):

Provided further that a special court constituted under section 153 shall be competent to take cognizance of an offence without the accused being committed to it for trial.]



Section 151A: Power of Police to investigate

For the purposes of investigation of an offence punishable under this Act, the police officer shall have all the powers as provided in Chapter XII of the Code of Criminal Procedure, 1973 (2 of 1974).

Section 151B: Certain offences to be cognizable and non-bailable

Notwithstanding anything contained in the Code of Criminal Procedure, 1973 (2 of 1974), an offence punishable under sections 135 to 140 or section 150 shall be cognizable and non-bailable.]

Section 152: Compounding of offences

- (1) Notwithstanding anything contained in the Code of Criminal Procedure, 1973 (2 of 1974), the Appropriate Government or any officer authorised by it in this behalf may accept from any consumer or person who committed or who is reasonably suspected of having committed an offence of theft of electricity punishable under this Act, a sum of money by way of compounding of the offence as specified in the Table below:

TABLE

Nature of service	Rate at which the sum of money for compounding to be collected per Kilowatt (KW)/Horse Power (HP) or part thereof for Low Tension (LT) supply and per Kilo Volt Ampere (KVA) of contracted demand for High Tension (HT)
(1)	(2)
1. Industrial Service	twenty thousand rupees;
2. Commercial Service	ten thousand rupees;
3. Agricultural Service	two thousand rupees;
4. Other Services	four thousand rupees;

Provided that the Appropriate Government may, by notification in the Official Gazette, amend the rates specified in the Table above.

- (2) On payment of the sum of money in accordance with sub-section (1), any person in custody in connection with that offence shall be set at liberty and no proceedings shall be instituted or continued against such consumer or person in any criminal court.
- (3) The acceptance of the sum of money for compounding an offence in accordance with sub-section (1) by the Appropriate Government or an officer empowered in this behalf shall be deemed to amount to an acquittal within the meaning of section 300 of the Code of Criminal Procedure, 1973 (2 of 1974).
- (4) The compounding of an offence under sub-section (1) shall be allowed only once for any person or consumer.

DECISION TREE



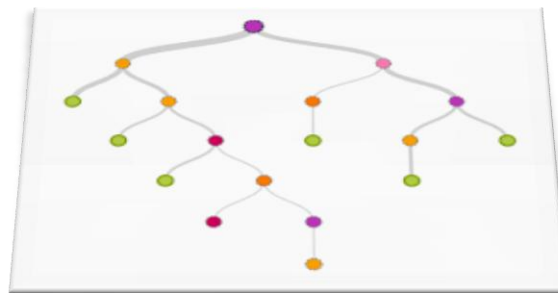
Decision making may be defined as a 'process which results in the selection from a set of alternative courses of action, that course of action which is considered to meet the objectives of the decision problem more satisfactorily than others as judged by the decision maker.

Decision tree is a graphic display of the relationship between a present decision and future events, future decision and their consequences.

A diagram that illustrates the chronological ordering of actions and events in a decision analysis problem.

This approach assumes that there are only two types of situation that a finance manager has to face. The first situation is where the manager has control or power to determine what happens next. This is known as "Decision", as he can do what he desires to do. The second situation is where finance manager has no control over what happens next. This is known as "Event". Since the outcome of the events is not known, a probability distribution needs to be assigned to the various outcomes or consequences.

When a finance manager faced with a decision situation, he is assumed to act rationally.





Steps involved in Decision Tree Analysis



Step 1- Defining Investment: Decision tree analysis can be applied to a variety of business decision-makings. Usually it includes following types of decisions.

- Whether or not to launch a new product, whether this launch should be local, national, or international.
- Whether extra production requirement should be met by extending the factory or by outsourcing it to an external supplier.
- Whether to dig for oil or not if so, upto what height and continue to dig even after finding no oil upto a certain depth.

Step 2- Identification of Decision Alternatives: It is essential to clearly identify decision alternatives. For example if a company is planning to introduce a new product, it may be local launch, national launch or international launch.

Step 3- Drawing a Decision Tree: After identifying decision alternatives, at the relevant data such as the projected cash flows, probability distribution expected present value etc. should be put in diagrammatic form called decision tree.

While drawing a decision tree, it should be noted that NPVs etc. should be placed on the branches of decision tree, coming out of the decisions identified.

While drawing a decision tree, it should be noted that the:-

- The decision point (traditionally represented by square), is the option available for manager to take or not to take - in other words action at these points.
- The event or chance or outcome (traditionally represented by circle) which are dependent on chance process, along with the probabilities thereof, and monetary value associated with them.
- This diagram is drawn from left to right.

Step 4- Evaluating the Alternatives: After drawing the decision the next step is the evaluation of alternatives. The various alternatives can be evaluated as follows:

- This procedure is carried out from the last decision in the sequence (extreme right) and goes on working back to the first (left) for each of the possible decision.
- At each final stage decision point, select the alternative which has the highest NPV and truncate the other alternatives. Each decision point is assigned a value equal to the NPV of the alternative selected at the decision point.
- Proceed backward in the same manner calculating the NPV at chance or event or outcome points (O) selecting the decisions alternative which has highest NPV at various decision points [□] rejecting the inferior decision option, assigning NPV to the decision point, till the first decision point is reached.

By drawing a decision tree the alternatives are highlighted through a diagram, giving the range of possible outcomes.



Problem & Solution

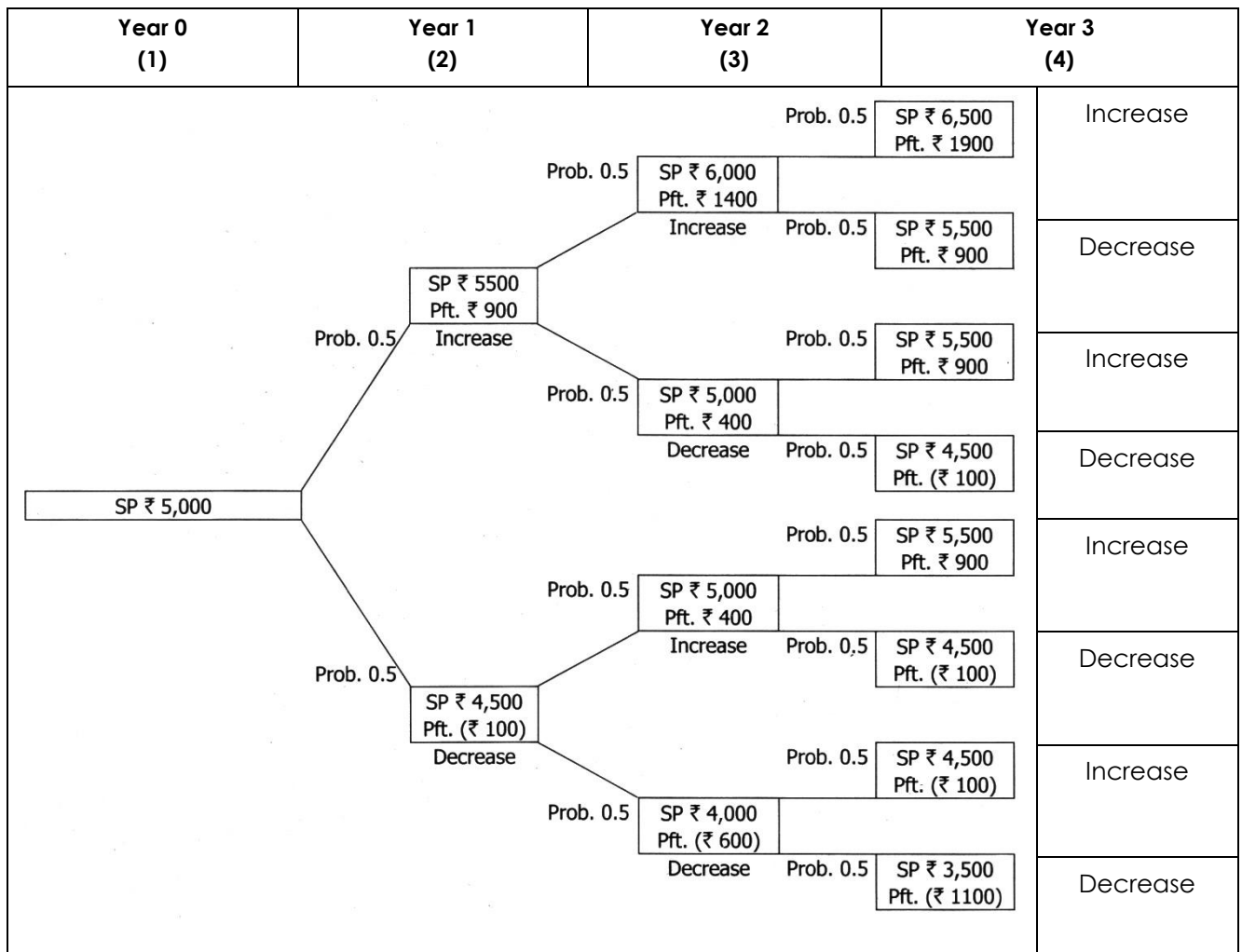
Problem 1:

Y owns an unused Gold mine that will cost ₹10,00,000 to re-open. If Y open the mine, Y expects to extract 1,000 Ounces of Gold a year for each of three years. After that the deposit will be exhausted. The gold price is currently ₹5,000 an Ounce, and each year the price is equally likely to rise or fall by ₹500 from its level at the start of year. The extraction cost is ₹4,600 an ounce and the discount rate is 10%.

Required: Should Y open the mine now or delay one year in the hope of a rise in the Gold price?

Solution:

1. Computation of Mean NPV (Open Mine Now)





Average Profit per Ounce	800/2	1600/4	3200/8
Profit per Ounce	₹ 400	₹ 400	₹ 400
Profit for 1000 Ounces	₹ 4,00,000	₹ 4,00,000	₹ 4,00,000
PV Factor @ 10%	0.909	0.826	0.751
PV of Cash Inflow	₹ 3,63,600	₹ 3,30,400	₹ 3,00,400

Net Present Value = PV of Cash Inflows Less Initial Investment
 = (₹3,63,600 + ₹3,30,400 + ₹3,00,400) - ₹10,00,000 = ₹9,94,400 - ₹10,00,000 = (₹5,600)

Conclusion: Since the project has a Mean negative NPV, the Company should not start extracting gold now.

Problem 2:

A Firm has an investment proposal, requiring an outlay of ₹ 80,000. The investment proposal is expected to have two years economic life with no salvage value. In year 1, there is a 0.4 probability that Cash Inflow after Tax will be ₹50,000 and 0.6 probability that Cash Inflow after Tax will be ₹60,000. The probability assigned to Cash Inflow after Tax for the Year 2 are as follows –

Cash Inflow Year 1	₹ 50,000		₹ 60,000	
Cash Inflow Year 2	Probability		Probability	
	₹ 24,000	0.2	₹ 40,000	0.4
	₹ 32,000	0.3	₹ 50,000	0.5
	₹ 44,000	0.5	₹ 60,000	0.1

The Firm uses a 10% discount rate for this type of investment. Required:



- (a) Construct a Decision Tree for the proposed investment project, and calculate the expected Net Present Value (NPV).
- (b) What Net Present value will the project yield, if worst outcome is released? What is the probability of occurrence of this NPV?
- (c) Will the project be accepted?

Solution:





CMA Students Newsletter (For Final Students)

Vol.3C: February 15, 2016

Year 0 (0)	Year 1 (1)	Year 2 (2)	Joint. Probl. (4)	NPV (5) = (3) + (2) - (1)	Prob. of NPV (6) = (4) × (5)
<div style="border: 1px solid black; padding: 5px; width: fit-content; margin: 0 auto;">Cash Outlay ₹ 80,000</div>	<div style="border: 1px solid black; padding: 5px; width: fit-content; margin: 0 auto;">CF 50,000 DCF 45,450</div>	<div style="border: 1px solid black; padding: 5px; width: fit-content; margin: 0 auto;">CF 24,000 DCF 19,824</div>	0.08 0.4 × 0.2	(14,726) [45,450 + 19,824 - 80,000]	(1,178) [0.08 × (14726)]
		<div style="border: 1px solid black; padding: 5px; width: fit-content; margin: 0 auto;">CF 32,000 DCF 26,432</div>	0.12 0.4 × 0.3	(8,118) [45,450 + 26,432 - 80,000]	(974) [0.12 × (8,118)]
		<div style="border: 1px solid black; padding: 5px; width: fit-content; margin: 0 auto;">CF 44,000 DCF 36,344</div>	0.20 0.4 × 0.5	1,794 [45,450 + 36,344 - 80,000]	359 [0.20 × 1794]
		<div style="border: 1px solid black; padding: 5px; width: fit-content; margin: 0 auto;">CF 40,000 DCF 33,040</div>	0.24 0.6 × 0.4	7,580 [54,540 + 33,040 - 80,000]	1,819 [0.24 × 7580]
		<div style="border: 1px solid black; padding: 5px; width: fit-content; margin: 0 auto;">CF 50,000 DCF 41,300</div>	0.30 0.6 × 0.5	15,840 [54,540 + 41,300 - 80,000]	4,752 [0.30 × 15840]
		<div style="border: 1px solid black; padding: 5px; width: fit-content; margin: 0 auto;">CF 60,000 DCF 49,560</div>	0.06 0.6 × 0.1	24,100 [54,540 + 49,560 - 80,000]	1,446 [0.06 × 24100]
Time 0 PVF 1.000	Time 1 PVF 0.909	Time 2 PVF 0.826	Mean NPV		6,224

Conclusions:

- (a) Expected Net Present Value ₹ 6,224
- (b) Worst Case NPV (₹ 14,726). Probability 0.08 or 8%
- (c) Action on Project: Accept the Project, since as the Mean NPV or the Expected NPV is positive.





INCOME COMPUTATION AND DISCLOSURE STANDARDS

Central Government vide **Notification No. 32/2015, dated 31-3-2015** has notified the "Income Computation and Disclosure Standards" as specified below to be followed by all assessees, following the mercantile system of accounting, for the purposes of computation of income chargeable to income-tax under the head "**Profit and Gains of Business or Profession**" or "**Income from Other Sources**". This notification shall come into force with effect from 1st day of April, 2015, and shall accordingly apply to the assessment year 2016-17 and subsequent assessment years.

List of Standards are as follows:

- (1) Income Computation and Disclosure Standard I relating to accounting policies Preamble
- (2) Income Computation and Disclosure Standard II relating to valuation of inventories
- (3) Income Computation and Disclosure Standard III relating to construction contracts
- (4) Income Computation and Disclosure Standard IV relating to revenue recognition Preamble
- (5) Income Computation and Disclosure Standard V relating to tangible fixed assets Preamble
- (6) Income Computation and Disclosure Standard VI relating to the effects of changes in foreign exchange rates
- (7) Income Computation and Disclosure Standard VII relating to government grants Preamble
- (8) Income Computation and Disclosure Standard VIII relating to securities Preamble
- (9) Income Computation and Disclosure Standard IX relating to borrowing costs Preamble
- (10) Income Computation and Disclosure Standard X relating to provisions, contingent liabilities and contingent assets

(1) Income Computation and Disclosure Standard I relating to accounting policies Preamble

This Income Computation and Disclosure Standard is applicable for computation of income chargeable under the head "Profits and gains of business or profession" or "Income from other sources" and not for the purpose of maintenance of books of accounts.

In the case of conflict between the provisions of the Income-tax Act, 1961 ('the Act') and this Income Computation and Disclosure Standard, the provisions of the Act shall prevail to that extent.

1. **Scope**

This Income Computation and Disclosure Standard deals with significant accounting policies.

2. **Fundamental Accounting Assumptions**

The following are fundamental accounting assumptions, namely:—

(a) **Going Concern**

"Going concern" refers to the assumption that the person has neither the intention nor the necessity of liquidation or of curtailing materially the scale of the business, profession or vocation and intends to continue his business, profession or vocation for the foreseeable future.

(b) **Consistency**



"Consistency" refers to the assumption that accounting policies are consistent from one period to another.

(c) Accrual

"Accrual" refers to the assumption that revenues and costs are accrued, that is, recognised as they are earned or incurred (and not as money is received or paid) and recorded in the previous year to which they relate.

3. Accounting Policies

The accounting policies refer to the specific accounting principles and the methods of applying those principles adopted by a person.

4. Considerations in the Selection and Change of Accounting Policies

Accounting policies adopted by a person shall be such so as to represent a true and fair view of the state of affairs and income of the business, profession or vocation. For this purpose,—

- (i) the treatment and presentation of transactions and events shall be governed by their substance and not merely by the legal form; and
- (ii) marked to market loss or an expected loss shall not be recognised unless the recognition of such loss is in accordance with the provisions of any other Income

5. Computation and Disclosure Standard

An accounting policy shall not be changed without reasonable cause.

6. Disclosure of Accounting Policies

All significant accounting policies adopted by a person shall be disclosed.

7. Any change in an accounting policy which has a material effect shall be disclosed. The amount by which any item is affected by such change shall also be disclosed to the extent ascertainable. Where such amount is not ascertainable, wholly or in part, the fact shall be indicated. If a change is made in the accounting policies which has no material effect for the current previous year but which is reasonably expected to have a material effect in later previous years, the fact of such change shall be appropriately disclosed in the previous year in which the change is adopted and also in the previous year in which such change has material effect for the first time.

8. Disclosure of accounting policies or of changes therein cannot remedy a wrong or inappropriate treatment of the item.

9. If the fundamental accounting assumptions of Going Concern, Consistency and Accrual are followed, specific disclosure is not required. If a fundamental accounting assumption is not followed, the fact shall be disclosed.

10. Transitional Provisions

All contract or transaction existing on the 1st day of April, 2015 or entered into on or after the 1st day of April, 2015 shall be dealt with in accordance with the provisions of this standard after taking into account the income, expense or loss, if any, recognised in respect of the said contract or transaction for the previous year ending on or before the 31st March, 2015.



(2) Income Computation and Disclosure Standard II relating to valuation of inventories

Preamble

This Income Computation and Disclosure Standard is applicable for computation of income chargeable under the head "Profits and gains of Business or profession" or "Income from other sources" and not for the purpose of maintenance of books of accounts.

In the case of conflict between the provisions of Income Tax Act, 1961 ('the Act') and this Income Computation and Disclosure Standard, the provisions of the Act shall prevail to that extent.

1. Scope

This Income Computation and Disclosure Standard shall be applied for valuation of inventories, except:

- (a) Work-in-progress arising under 'construction contract' including directly related service contract which is dealt with by the Income Computation and Disclosure Standard on construction contracts;
- (b) Work-in-progress which is dealt with by other Income Computation and Disclosure Standard;
- (c) Shares, debentures and other financial instruments held as stock-in-trade which are dealt with by the Income Computation and Disclosure Standard on securities;
- (d) Producers' inventories of livestock, agriculture and forest products, mineral oils, ores and gases to the extent that they are measured at net realizable value;
- (e) Machinery spares, which can be used only in connection with a tangible fixed asset and their use is expected to be irregular, shall be dealt with in accordance with the Income Computation and Disclosure Standard on tangible fixed assets.

2. Definitions

- (1) The following terms are used in this Income Computation and Disclosure Standard with the meanings specified:
 - (a) "Inventories" are assets:
 - (i) held for sale in the ordinary course of business;
 - (ii) in the process of production for such sale;
 - (iii) in the form of materials or supplies to be consumed in the production process or in the rendering of services.
 - (b) "Net realisable value" is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale.
- (2) Words and expressions used and not defined in this Income Computation and Disclosure Standard but defined in the Act shall have the meanings assigned to them in that Act.

3. Measurement

Inventories shall be valued at cost, or net realisable value, whichever is lower.

4. Cost of Inventories

Cost of inventories shall comprise of all costs of purchase, costs of services, costs of conversion and other costs incurred in bringing the inventories to their present location and condition.



5. Costs of Purchase

The costs of purchase shall consist of purchase price including duties and taxes, freight inwards and other expenditure directly attributable to the acquisition. Trade discounts, rebates and other similar items shall be deducted in determining the costs of purchase.

6. Costs of Services

The costs of services in the case of a service provider shall consist of labour and other costs of personnel directly engaged in providing the service including supervisory personnel and attributable overheads.

7. Costs of Conversion

The costs of conversion of inventories shall include costs directly related to the units of production and a systematic allocation of fixed and variable production overheads that are incurred in converting materials into finished goods. Fixed production overheads shall be those indirect costs of production that remain relatively constant regardless of the volume of production. Variable production overheads shall be those indirect costs of production that vary directly or nearly directly, with the volume of production.

8. The allocation of fixed production overheads for the purpose of their inclusion in the costs of conversion shall be based on the normal capacity of the production facilities.

Normal capacity shall be the production expected to be achieved on an average over a number of periods or seasons under normal circumstances, taking into account the loss of capacity resulting from planned maintenance. The actual level of production shall be used when it approximates to normal capacity. The amount of fixed production overheads allocated to each unit of production shall not be increased as a consequence of low production or idle plant. Unallocated overheads shall be recognised as an expense in the period in which they are incurred. In periods of abnormally high production, the amount of fixed production overheads allocated to each unit of production is decreased so that inventories are not measured above the cost. Variable production overheads shall be assigned to each unit of production on the basis of the actual use of the production facilities.

9. Where a production process results in more than one product being produced simultaneously and the costs of conversion of each product are not separately identifiable, the costs shall be allocated between the products on a rational and consistent basis. Where by-products, scrap or waste material are immaterial, they shall be measured at net realisable value and this value shall be deducted from the cost of the main product.

10. Other Costs

Other costs shall be included in the cost of inventories only to the extent that they are incurred in bringing the inventories to their present location and condition.

11. Interest and other borrowing costs shall not be included in the costs of inventories, unless they meet the criteria for recognition of interest as a component of the cost as specified in the Income Computation and Disclosure Standard on borrowing costs.

12. Exclusions from the Cost of Inventories

In determining the cost of inventories in accordance with paragraphs 4 to paragraphs 11, the following costs shall be excluded and recognised as expenses of the period in which they are incurred, namely:—



- (a) Abnormal amounts of wasted materials, labour, or other production costs;
- (b) Storage costs, unless those costs are necessary in the production process prior to a further production stage;
- (c) Administrative overheads that do not contribute to bringing the inventories to their present location and condition;
- (d) Selling costs.

13. Cost Formulae

The Cost of inventories of items—

- (i) that are not ordinarily interchangeable; and
- (ii) goods or services produced and segregated for specific projects shall be assigned by specific identification of their individual costs.

14. 'Specific identification of cost' means specific costs are attributed to identified items of inventory.

15. Where there are a large numbers of items of inventory which are ordinarily interchangeable, specific identification of costs shall not be made.

16. First-in First-out and Weighted Average Cost Formula

Cost of inventories, other than the inventory dealt with in paragraph 13, shall be assigned by using the First-in First-out (FIFO), or weighted average cost formula. The formula used shall reflect the fairest possible approximation to the cost incurred in bringing the items of inventory to their present location and condition.

17. The FIFO formula assumes that the items of inventory which were purchased or produced first are consumed or sold first, and consequently the items remaining in inventory at the end of the period are those most recently purchased or produced. Under the weighted average cost formula, the cost of each item is determined from the weighted average of the cost of similar items at the beginning of a period and the cost of similar items purchased or produced during the period. The average shall be calculated on a periodic basis, or as each additional shipment is received, depending upon the circumstances.

18. Retail Method

Where it is impracticable to use the costing methods referred to in paragraph 16, the retail method can be used in the retail trade for measuring inventories of large number of rapidly changing items that have similar margins. The cost of the inventory is determined by reducing from the sales value of the inventory, the appropriate percentage gross margin. The percentage used takes into consideration inventory, which has been marked down to below its original selling price.

19. Net Realisable Value

Inventories shall be written down to net realisable value on an item-by-item basis. Where 'items of inventory' relating to the same product line having similar purposes or end uses and are produced and marketed in the same geographical area and cannot be practicably evaluated separately from other items in that product line, such inventories shall be grouped together and written down to net realisable value on an aggregate basis.



20. Net realisable value shall be based on the most reliable evidence available at the time of valuation. The estimates of net realisable value shall also take into consideration the purpose for which the inventory is held. The estimates shall take into consideration fluctuations of price or cost directly relating to events occurring after the end of previous year to the extent that such events confirm the conditions existing on the last day of the previous year.
21. Materials and other supplies held for use in the production of inventories shall not be written down below the cost, where the finished products in which they shall be incorporated are expected to be sold at or above the cost. Where there has been a decline in the price of materials and it is estimated that the cost of finished products will exceed the net realisable value, the value of materials shall be written down to net realisable value which shall be the replacement cost of such materials.
- 22. Value of Opening Inventory**
- The value of the inventory as on the beginning of the previous year shall be—
- the cost of inventory available, if any, on the day of the commencement of the business when the business has commenced during the previous year; and
 - the value of the inventory as on the close of the immediately preceding previous year, in any other case.
- 23. Change of Method of Valuation of Inventory**
- The method of valuation of inventories once adopted by a person in any previous year shall not be changed without reasonable cause.
- 24. Valuation of Inventory in Case of Certain Dissolutions**
- In case of dissolution of a partnership firm or association of person or body of individuals, notwithstanding whether business is discontinued or not, the inventory on the date of dissolution shall be valued at the net realisable value.
- 25. Transitional Provisions**
- Interest and other borrowing costs, which do not meet the criteria for recognition of interest as a component of the cost as per para 11, but included in the cost of the opening inventory as on the 1st day of April, 2015, shall be taken into account for determining cost of such inventory for valuation as on the close of the previous year beginning on or after 1st day of April, 2015 if such inventory continue to remain part of inventory as on the close of the previous year beginning on or after 1st day of April, 2015.
- 26. Disclosure**
- The following aspects shall be disclosed, namely:—
- the accounting policies adopted in measuring inventories including the cost formulae used; and
 - the total carrying amount of inventories and its classification appropriate to a person.



(3) Income Computation and Disclosure Standard III relating to construction contracts

Preamble

This Income Computation and Disclosure Standard is applicable for computation of income chargeable under the head "Profits and gains of business or profession" or "Income from other sources" and not for the purpose of maintenance of books of accounts.

In the case of conflict between the provisions of the Income-tax Act, 1961 ('the Act') and this Income Computation and Disclosure Standard, the provisions of the Act shall prevail to that extent.

1. Scope

This Income Computation and Disclosure Standard should be applied in determination of income for a construction contract of a contractor.

2. Definitions

(1) The following terms are used in this Income Computation and Disclosure Standard with the meanings specified:

- (a) "Construction contract" is a contract specifically negotiated for the construction of an asset or a combination of assets that are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use and includes:
 - (i) contract for the rendering of services which are directly related to the construction of the asset, for example, those for the services of project managers and architects;
 - (ii) contract for destruction or restoration of assets, and the restoration of the environment following the demolition of assets.
- (b) "Fixed price contract" is a construction contract in which the contractor agrees to a fixed contract price, or a fixed rate per unit of output, which may be subject to cost escalation clauses.
- (c) "Cost plus contract" is a construction contract in which the contractor is reimbursed for allowable or otherwise defined costs, plus a mark up on these costs or a fixed fee.
- (d) "Retentions" are amounts of progress billings which are not paid until the satisfaction of conditions specified in the contract for the payment of such amounts or until defects have been rectified.
- (e) "Progress billings" are amounts billed for work performed on a contract whether or not they have been paid by the customer.
- (f) "Advances" are amounts received by the contractor before the related work is performed.

(2) Words and expressions used and not defined in this Income Computation and Disclosure Standard but defined in the Act shall have the meaning respectively assigned to them in the Act.

3. A construction contract may be negotiated for the construction of a single asset. A construction contract may also deal with the construction of a number of assets which are closely interrelated or



interdependent in terms of their design, technology and function or their ultimate purpose or use.

4. Construction contracts are formulated in a number of ways which, for the purposes of this Income Computation and Disclosure Standard, are classified as fixed price contracts and cost plus contracts. Some construction contracts may contain characteristics of both a fixed price contract and a cost plus contract, for example, in the case of a cost plus contract with an agreed maximum price.

5. Combining and Segmenting Construction Contracts

The requirements of this Income Computation and Disclosure Standard shall be applied separately to each construction contract except as provided for in paragraphs 6, 7 and 8 herein. For reflecting the substance of a contract or a group of contracts, where it is necessary, the Income Computation and Disclosure Standard should be applied to the separately identifiable components of a single contract or to a group of contracts together.

6. Where a contract covers a number of assets, the construction of each asset should be treated as a separate construction contract when:
 - (a) separate proposals have been submitted for each asset;
 - (b) each asset has been subject to separate negotiation and the contractor and customer have been able to accept or reject that part of the contract relating to each asset; and
 - (c) the costs and revenues of each asset can be identified.
7. A group of contracts, whether with a single customer or with several customers, should be treated as a single construction contract when:
 - (a) the group of contracts is negotiated as a single package;
 - (b) the contracts are so closely interrelated that they are, in effect, part of a single project with an overall profit margin; and
 - (c) the contracts are performed concurrently or in a continuous sequence.
8. Where a contract provides for the construction of an additional asset at the option of the customer or is amended to include the construction of an additional asset, the construction of the additional asset should be treated as a separate construction contract when:
 - (a) the asset differs significantly in design, technology or function from the asset or assets covered by the original contract; or
 - (b) the price of the asset is negotiated without having regard to the original contract price.

9. Contract Revenue

Contract revenue shall be recognised when there is reasonable certainty of its ultimate collection.

10. Contract revenue shall comprise of:
 - (a) the initial amount of revenue agreed in the contract, including retentions; and
 - (b) variations in contract work, claims and incentive payments:
 - (i) to the extent that it is probable that they will result in revenue; and



- (ii) they are capable of being reliably measured.
11. Where contract revenue already recognised as income is subsequently written off in the books of accounts as uncollectible, the same shall be recognised as an expense and not as an adjustment of the amount of contract revenue.
- 12. Contract Costs**
- Contract costs shall comprise of:
- (a) costs that relate directly to the specific contract;
 - (b) costs that are attributable to contract activity in general and can be allocated to the contract;
 - (c) such other costs as are specifically chargeable to the customer under the terms of the contract; and
 - (d) allocated borrowing costs in accordance with the Income Computation and Disclosure Standard on Borrowing Costs. These costs shall be reduced by any incidental income, not being in the nature of interest, dividends or capital gains, that is not included in contract revenue.
13. Costs that cannot be attributed to any contract activity or cannot be allocated to a contract shall be excluded from the costs of a construction contract.
14. Contract costs include the costs attributable to a contract for the period from the date of securing the contract to the final completion of the contract. Costs that are incurred in securing the contract are also included as part of the contract costs, provided
- (a) they can be separately identified; and
 - (b) it is probable that the contract shall be obtained.
- When costs incurred in securing a contract are recognised as an expense in the period in which they are incurred, they are not included in contract costs when the contract is obtained in a subsequent period.
15. Contract costs that relate to future activity on the contract are recognised as an asset. Such costs represent an amount due from the customer and are classified as contract work in progress.
- 16. Recognition of Contract Revenue and Expenses**
- Contract revenue and contract costs associated with the construction contract should be recognised as revenue and expenses respectively by reference to the stage of completion of the contract activity at the reporting date.
17. The recognition of revenue and expenses by reference to the stage of completion of a contract is referred to as the percentage of completion method. Under this method, contract revenue is matched with the contract costs incurred in reaching the stage of completion, resulting in the reporting of revenue, expenses and profit which can be attributed to the proportion of work completed.
18. The stage of completion of a contract shall be determined with reference to:
- (a) the proportion that contract costs incurred for work performed upto the reporting date bear to the estimated total contract costs; or
 - (b) surveys of work performed; or



(c) completion of a physical proportion of the contract work.

Progress payments and advances received from customers are not determinative of the stage of completion of a contract.

19. When the stage of completion is determined by reference to the contract costs incurred upto the reporting date, only those contract costs that reflect work performed are included in costs incurred upto the reporting date. Contract costs which are excluded are:

- (a) contract costs that relate to future activity on the contract; and
- (b) payments made to subcontractors in advance of work performed under the subcontract.

20. During the early stages of a contract, where the outcome of the contract cannot be estimated reliably contract revenue is recognised only to the extent of costs incurred. The early stage of a contract shall not extend beyond 25 % of the stage of completion.

21. Changes in Estimates

The percentage of completion method is applied on a cumulative basis in each previous year to the current estimates of contract revenue and contract costs.

Where there is change in estimates, the changed estimates shall be used in determination of the amount of revenue and expenses in the period in which the change is made and in subsequent periods.

22. Transitional Provisions

Contract revenue and contract costs associated with the construction contract, which commenced on or before the 31st day of March, 2015 but not completed by the said date, shall be recognised as revenue and costs respectively in accordance with the provisions of this standard. The amount of contract revenue, contract costs or expected loss, if any, recognised for the said contract for any previous year commencing on or before the 1st day of April, 2014 shall be taken into account for recognising revenue and costs of the said contract for the previous year commencing on the 1st day of April, 2015 and subsequent previous years.

23. Disclosure

A person shall disclose:

- (a) the amount of contract revenue recognised as revenue in the period; and
- (b) the methods used to determine the stage of completion of contracts in progress.

24. A person shall disclose the following for contracts in progress at the reporting date, namely:—

- (a) amount of costs incurred and recognised profits (less recognised losses) upto the reporting date;
- (b) the amount of advances received; and
- (c) the amount of retentions.



SMALL SERVICE PROVIDER EXEMPTION IN SERVICE TAX

Small service provider: Small service provider means a service provider, the "aggregate value" of taxable services rendered by whom, from one or more premises, does not exceed ₹ 10 lakhs in the preceding financial year.

[Aggregate Value means -

- ◆ the sum total of value of taxable services
- ◆ charged in the first consecutive invoices
- ◆ issued during a financial year

but does not include value charged in invoices issued towards such services which are exempt from whole of service tax leviable thereon u/s 66B of Finance Act, 1994]

Quantum of exemption: Exemption for aggregate value upto ₹ 10 lakhs [Notification No. 33/2012-ST, dated 20-6-2012]. Small service provider is entitled 100% exemption from service tax of aggregate value of taxable services upto ₹ 10 lakhs provided during the financial year. If the "aggregate value" in any financial year exceeds ₹ 10 lakhs, then such excess over ₹ 10 lakhs shall be chargeable to service tax.

Exemption is optional: The provider of taxable service has the option not to avail the exemption contained in this notification and pay service tax on the taxable services provided by him and such option, once exercised in a financial year, shall not be withdrawn during the remaining part of such financial year.

Exemption to apply service-provider wise, not for each taxable service or each premise: Where a taxable service provider provides one or more taxable services from one or more premises, this exemption shall apply to the "aggregate value" of all such taxable services and from all such premises and not separately for each premises or each services.

Small scale exemption and multiple service providers using same premises - Value of services not clubbable: One of the conditions for availing small scale service provider exemption under Notification No. 33/2012-ST, dated 20-6-2012, is that the exemption is applicable to a service provider rendering one or more services from one or more premises. Therefore, such exemption is person-specific and will be admissible even when more than one service provider uses the same premises.

Branded services - Exemption shall not apply: Taxable services provided by a person under a brand name or trade name, whether registered or not, of another person, this exemption shall not apply.

Person liable to pay service tax as recipient under Reverse Charge - Not eligible to claim this exemption: Nothing contained in this notification shall apply to such value of taxable services in respect of which service tax shall be paid by such person and in such manner as specified u/s 68(2) read with Service Tax Rules, 1994.

No CENVAT credit on input services and capital goods: The provider of taxable service shall not avail the CENVAT credit of service tax paid on any input services, under the CENVAT Credit Rules, 2004, used for providing the said taxable service, for which exemption from payment of service tax is availed of.



The provider of taxable service shall not avail the CENVAT credit under rule 3 of the said rules, on capital goods received, during the period in which the service provider avails exemption from payment of service tax under this notification.

Payment of CENVAT credit on inputs in stock on date of opting for exemption and lapsing of balance credit:

The provider of taxable service who starts availing this exemption shall, -

- (i) be required to pay an amount equivalent to the CENVAT credit taken by him, if any, in respect of such inputs lying in stock or in process on the date on which the provider of taxable service starts availing this exemption; and
- (ii) the balance of CENVAT credit lying unutilised in the account of the taxable service provider after deducting the amount referred to in (i) above, if any, shall not be utilised and shall lapse on the day such service provider starts availing this exemption.

Computation of ₹10 lakh for goods transport agency (GTA) - Sums where person liable to pay service tax is person other than GTA not to be included: For purposes of determining aggregate value not exceeding ₹ 10 lakh, to avail exemption, in relation to taxable service provided by a goods transport agency, the payment received towards the gross amount charged by such GTA for which the person liable for paying service tax is as specified u/s 68(2) of the Finance Act, 1994 shall not be taken into account.

Illustration 1: A GTA service provider provided services valuing ₹ 20 lakh in 2014-15 and services valuing ₹ 30 lakhs in 2015-16. Out of the said sums, 60% relates to cases where the person liable to pay service tax was other than GTA. Whether GTA is eligible for this exemption in 2015-16.

Solution: Yes. Value of services provided in 2014-15 = ₹ 20 lakhs - 60% towards sum received where person liable to pay service tax was other than GTA = ₹ 8 lakh.

Hence, GTA is eligible for exemption in year 2015-16.

Aggregate value of services in 2015-16 = ₹ 30 lakhs - 60% = ₹ 12 lakhs. Out of this ₹ 10 lakhs will be exempt and balance ₹ 2 lakhs will be liable to service tax in hands of GTA. This benefit is not available to other service providers.

Points to be considered in determining the aggregate value:

- (a) **Aggregate value of taxable service not to include value of goods or value of material supplied by recipient of service:** If goods are sold along with services, value of such goods is not includible while computing the aggregate value of ₹ 10 lakhs. Similarly, value of materials supplied by recipient of service is not required to be included while calculating the exemption limit.
- (b) **Activities not amounting to service - Value not includible:** The aggregate value is computed for the 'taxable services'. Thus, any sum received for an activity carried out, which doesn't amount to service, cannot form part of the aggregate value, as the same is not for any service.
- (c) **Only service portion includible in case of declared services:** In case of service providers providing declared services, only portion of service declared under section 66E will be considered.

For example, in case of service portion in execution of works contract, only the value of service portion as determined under Rule 2A of Valuation Rules, 2006 will be included in determining the value of taxable services.



- (d) **Services specified in negative list - Value not to be included in aggregate value:** In case of service providers providing services specified in the negative list, the value of such services shall not form part of aggregate value of taxable services under Notification No. 33/2012-ST, as the said services are not 'taxable services'.
- (e) **Services wholly exempt from tax - Value not to be included in aggregate value:** The definition of aggregate value itself excludes the value of services wholly exempted under any other notification. Hence, value of wholly exempt service cannot form part of 'aggregate value' under this notification.
- (f) **Abatements - Whole of the amount includible:** If any service is eligible for abatement, then, whole of the amount of value of service would be considered for computing aggregate value without excluding the abatement. For example, renting of hotel is eligible for abatement of 40% under Notification No. 26/2012-ST. In this case, even if rent charged is ₹ 100 and value after abatement is ₹ 60, the aggregate value under Notification No. 33/2012-ST will be computed by including ₹ 100.
- (g) **Service provided outside Taxable territory - Not includible:** Services provided outside India are not chargeable to service tax under section 66B and are, therefore, not taxable service. Such services will not form part of aggregate value under this Notification.

Illustration 2: Mr. Thakur has provided the following services during the year 2014-15. Determine whether he is eligible for threshold exemption during the year 2015-16:

- (1) Services provided outside India : ₹ 3 lakh ;
- (2) Services falling under negative list: ₹ 1 lakh ;
- (3) Services fully exempt under other notifications : ₹ 5 lakh ;
- (4) Declared Services (Sum charged ₹ 3 lakh, but, value determined as per the valuation rules is 60% i.e., ₹ 1,80,000);
- (5) Services where amount charged is ₹ 1,20,000, but, after abatement, value is ₹ 40,000;
- (6) Other services provided: ₹ 7 lakh (including ₹ 1 lakh towards services where whole of the service tax was payable by the service recipient)

Solution:

Mr. Thakur would be eligible for threshold exemption under Notification No. 33/2012-ST, if the "aggregate value" of taxable services provided during the year 2014-15 is upto ₹ 10 lakhs. The relevant computations are shown below —

Case	Particulars	₹
(1) Services provided outside India	Not taxable service, as not liable to service tax u/s 66B of the Finance Act, 1994 - Not includible	NIL
(2) Services (falling under negative list)	Not taxable service, as not liable to service tax u/s 66B of the Finance Act, 1994 - Not includible	NIL
(3) Services fully exempt under other notifications	Specifically excluded in determination of aggregate value	NIL
(4) Declared Services	Value as determined as per section 67 of the Finance Act, 1994 and Valuation Rules is to be taken	1,80,000
(5) Services eligible for	Abatement is a form of partial exemption. Value as per section	1,20,000



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abatement	67 of the Finance Act, 1994 viz. ₹ 60,000 shall be taken.	
(6) Other Services	Includible (Even services covered under reverse charge are includible) (It is assumed that Mr. Sharma is not a GTA service provider).	7,00,000
Aggregate Value under Notification No. 33/2012-ST for financial year 2014-15		10,00,000
Since the aggregate value is ₹ 10 lakhs (i.e., not exceeding ₹ 10 lakhs) during financial year 2014-15, Mr. Thakur is eligible for threshold exemption during the financial year 2015-16.		Eligible for exemption

Illustration 3: ABC Ltd. commenced its business on 1st July, 2015, in Jaipur. It has provided the following services upto 31st March, 2016, determine its service tax liability for Financial Year 2015-16:

- (1) Service provided under its own brand name ₹ 23,00,000 (out of which services of ₹ 7,80,000 has been wholly exempt under Notification No. 25/2012, dated 20-06-2012).
- (2) Service provided with brand name of PQR Ltd. ₹ 2,00,000, It also availed services of goods transport agency and paid freight of ₹ 2,50,000.

Solution:

Since ABC Ltd. has commenced its operations w.e.f. 1st July, 2015, it is eligible for small service providers exemption, 100% exemption from service tax is provided upto value of services of ₹ 10,00,000. Besides this, services which are wholly exempt under other notification are not included for determining eligibility limit of ₹ 10,00,000.

Such exemption shall not be applicable in the following cases:

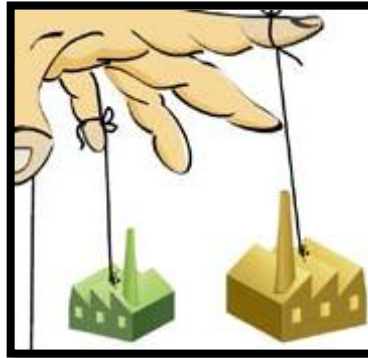
- (1) Services provided under brand name or trade name of another person.
- (2) Service received from goods transport agency.

Hence, the service tax liability shall be determined as under:

(amount in ₹)	
Service provided under own brand name	23,00,000
Less: Value of services which are exempt under other notification	7,80,000
	15,20,000
Less: Small service provider exemption	10,00,000
Taxable value of services	5,20,000
Services provided under brand name of another person	2,00,000
Total Value of Services	7,20,000
Service tax @ 14.5%	1,04,400
Service tax in respect of services received from GTA – ₹2,50,000 × 30% × 14.5%	10,875
Total Service Tax	1,15,275

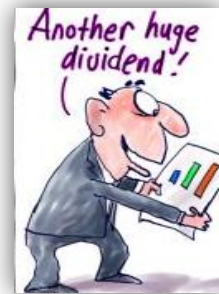
Working Note: Abatement of 70% of the amount charged by the goods transport agency is admissible. Further, entire service tax is payable by service receiver since the person liable to pay freight is a company and small service providers' exemption is not available in respect of such services.

Some Points to be noted at the time of Accounting for Holding Companies



1) Dividend paid out of pre-acquisition profits:

- ❖ The amount of dividend paid by subsidiary company out of pre-acquisition profits must be appropriated from last year's profits.
- ❖ Holding Co's share of the same must be deducted from the amount paid for acquisition of shares



- ❖ in order to ascertain Goodwill or Capital Reserve as the case may be.
- ❖ Holding Co's share of the same should also be deducted from Consolidated Profit.



2) Interim Dividend paid by Subsidiary company:

- A. The mount of interim dividend paid by subsidiary company must be added with current profits.



- B. Minority' share of the same will be deducted from Minority's interest.
- C. Holding Co's share of the same should also be deducted from Consolidated Profit.

3) Proposed Dividend already shown in the Balance Sheet of the Subsidiary Company:

- A. The amount of Proposed Dividend must be added with Current profits.
- B. Minority's share of the same should be deducted from Minority's interest which will appear again separately as a liability.

4) Proposed Dividend recommended by the Subsidiary company but not yet given effect in the Accounts:

Simply Minority's share of the proposed dividend should be deducted from Minority's interest which will appear again separately as a liability in the Consolidated Balance Sheet.

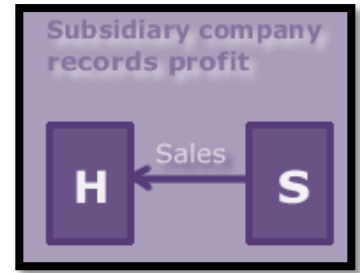


5) Bonus shares recommended by the Subsidiary company but not given effect in the A/cs:

- A. The amount of bonus shares recommended by the Subsidiary company must be appropriated from undistributed profits;
- B. Holding Company's share of the same will be adjusted against Goodwill, i.e. while calculating Cost of Control ;
- C. Minority's share of the same will added with Minority Interest.

6) Bonus shares already given effect in the Balance Sheet of the Subsidiary Co:

- A. Holding Co's share of the same will be adjusted against goodwill, i.e. to be considered while considering Cost of Control.
- B. Minority's share of the same will be added with Minority's interest.



7) **Unrealized profit on stock:**

(i) Holding company to subsidiary company: **downstream transaction:** 100% of unrealized profits shall be adjusted against the reserves of the Holding company.

(ii) Subsidiary company to Holding company: **upstream transaction :**

- ❖ Share of the holding company shall be adjusted against Holding company's reserves ;
- ❖ Share of minority shall be adjusted against Minority Interest.



8) **Elimination of Mutual Owings:**

All inter-company owings are to be eliminated.



RELATIVE VALUATION

Valuing a company relative to another company

Relative vs. Fundamental Valuation

The DCF (WACC, FTE, APV) model of valuation is a fundamental method.

- Value of firm (equity) is the PV of future cash flows.
- Ignores the current level of the stock market (industry).
- Appropriate for comparing investments across different asset classes (stocks vs. bond vs. real estate, etc).
- In the long run, fundamental is the correct way of value any asset.

Relative vs. Fundamental Valuation

Relative valuation is based on P/E ratios and a host of other "multiples".

- Extremely popular with the press, CNBCs, Stock brokers
- Used to value one stock against another.
- Can not compare value across different asset classes (stocks vs. bond vs. real estate, etc).
- Can not answer the question is the "stock market over valued?"
- Can answer the question, "I want to buy a tech stock, which one should I buy?"
- Can answer the question, "Which one of these overpriced IPO's is the best buy?"

Relative vs. Fundamental Valuation

You are investing for your retirement. You are planning to take a buy and hold strategy which involves picking some fairly priced stocks and holding them for several years. Which valuation approach should you use?

Relative or fundamental?

Relative vs. Fundamental Valuation

You are a short term investor. You trade several times a week on your E-trade account, and rarely hold a stock for more than a month. Which valuation technique should you use?

Relative or fundamental?

Relative Valuation

Prices can be standardized using a common variable such as earnings, cashflows, book value, or revenues.

- Earnings Multiples
 - Price/Earning ratio (PE) and variants
 - Value/EBIT
 - Value/EBDITA
 - Value/Cash flow
 - Enterprise value/EBDITA
- Book Multiples
 - Price/Book Value (of equity) PBV



- Revenues
 - Price/Sales per Share (PS)
 - Enterprise Value/Sales per Share (EVS)
- Industry Specific Variables (Price/kwh, Price per ton of steel, Price per click, Price per labor hour)

Multiples

Relative valuation relies on the use of multiples and a little algebra.

For example: house prices.

House	Price	Sq ft	Price per sq ft
A	\$ 110,000	1,700	\$ 64.71
B	\$ 120,000	1,725	\$ 69.57
C	\$ 96,000	1,500	\$ 64.00
D	\$ 99,000	1,550	\$ 63.87
E	\$ 105,000	1,605	\$ 65.42
		Average	\$65.51

What is the price of a 1,650 sq ft house?

Answer: $1,650 \times 65.51 = \$108,092$

Multiples can be misleading

To use a multiple inelegantly you must:

- Know what are the fundamentals that determine the multiple.
- Know how changes in these fundamentals change the multiple.
- Know what the distribution of the multiple looks like.
- Ensure that both the denominator and numerator represent claims to the same group
 - OK: P/E – Price → equity holders, EPS → equity holders
 - Not OK: P/EBIT – Price → equity holders, EBIT → All claimants
- Ensure that firms are comparable.

Price Earnings Ratios

PE – Market price per share / Earnings per share

There are a number of variants of the basic PE ratio in use. They are based on how the price and earnings are defined.

- Price
 - current price
 - or average price for the year
- Earnings
 - most recent financial year
 - trailing 12 months (Trailing PE)
 - forecasted eps (Forward PE)



PE Ratio: Understanding the Fundamentals

To understand the fundamental start with the basic equity discounted cash flow model.

- With the dividend discounted model

$$P_0 = \frac{\text{Div}_1}{r_e - g}$$

- Dividing both sides by EPS

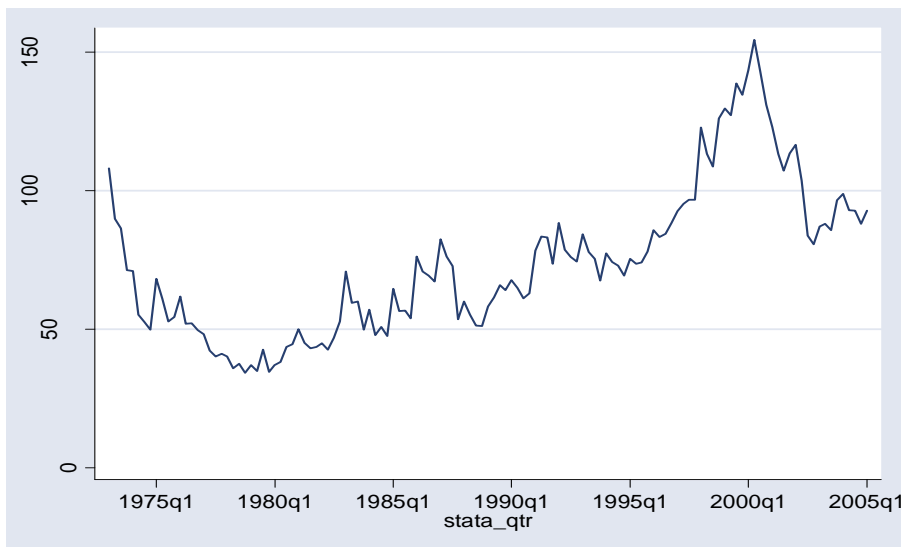
$$\frac{P_0}{\text{EPS}_0} = \frac{\text{Payout ratio} \times (1 + g)}{r_e - g}$$

Holding all else equal

- higher growth firms will have a higher PE ratio than lower growth firms.
- higher risk firms will have a lower PE ratio than low risk firms.
- Firms with lower reinvestment needs will have a higher PE ratio than firms with higher reinvestment needs.

Of course, other things are difficult to hold equal since high growth firms, tend to have high risk and high reinvestment rates.

Graph PE ratio



Is low (high) PE cheap (expensive)?

- A market strategist argues that stocks are over priced because the PE ratio today is too high relative to the average PE ratio across time. Do you agree?
- Yes



- No
- If you do not agree, what factor might explain the high PE ratio today?

Question:

You are reading an equity research report on Informix, and the analyst claims that the stock is undervalued because its PE ratio is 9.71 while the average of the sector PE ratio is 35.51. Would you agree?

- Yes
- No
- Why or why not?

Example: Valuing a firm using P/E ratios

- In an industry we identify 4 stocks which are similar to the stock we want to evaluate.

Stock A	PE=14
Stock B	PE=18
Stock C	PE=24
Stock D	PE=21

- The average PE = $(14+18+24+21)/4=19.25$
- Our firm has EPS of \$2.10
- $P/19.25 = 2.10 \rightarrow P = 19.25 * 2.10 = \40.425
- Note – do not include the stock to be valued in the average
- Also do not include firm with negative P/E ratios

Value/ Cash flow

- PE ratios are for equityholders, while cash flow measures are the whole firm.
- Cash flow is from continuing operations before capital expenditure.
- FCF is uncommitted freely available cash flow after capital expenditure to maintain operations at the same economic level.
- FCFF (cash flow from assets) is free cash flow to total firm

$$\frac{\text{Value}}{\text{FCFF}} = \frac{\text{MVequity} + \text{MVdebt}}{\text{FCFF}}$$

- In the US in 1999, the mean value was 24.

Value/FCFF

- For a firm with a constant growth rate

$$V_0 = \frac{\text{FCFF}_0 (1+g)}{\text{wacc} - g}$$

$$\frac{V_0}{\text{FCFF}_0} = \frac{(1+g)}{\text{wacc} - g}$$



- Therefore, the value/FCFF is a function of the
 - The cost of capital
 - The expected growth rate

Example: Valuing using value/FCFF

- Industry average is 20
 - Firm has FCFF of \$2,500
 - Shares outstanding of 450
 - MV of debt = \$30,000
 - Using Value/FCFF=20
 - value = FCFF × 20
 - MV equity + MV debt = FCFF*20
 - MV equity = FCFF × 20 – MV debt
 - Price = (FCFF × 20-MV debt)/Shares
- $$\text{Price} = (\$2,500 \times 20 - \$30,000)/450 = 44.44$$

Alternatives to FCFF: EBDITA and EBIT

- Most analysts find FCFF to complex or messy to use in multiples. They use modified versions.
- After tax operating income: EBIT (1-t)
- Pre tax operating income or EBIT
- EBDITA, which is earnings before interest, tax, depreciation and amortization.

$$\frac{\text{Value}}{\text{EBDITA}} = \frac{\text{MVequity} + \text{MVdebt}}{\text{EBDITA}}$$

Value/EBDITA multiple

- The no-cash version

$$\frac{\text{Value}}{\text{EBDITA}} = \frac{\text{MVequity} + \text{MVdebt} - \text{cash}}{\text{EBDITA}}$$

- When cash and marketable securities are netted out of the value, none of the income from the cash or securities should be reflected in the denominator.
- The no-cash version is often called "Enterprise Value".

Enterprise Value

- EV = market value of equity + market value of debt – cash and marketable securities
- Many companies who have just conducted an IPOs have huge amount of cash – a "war chest"
- EV excludes this cash from value of the firm
- Cash +MV of non-cash assets = MV debt + MV equity



→ MV of non-cash assets = MV debt + MV equity - Cash

For example: Nasdaq AWRE (did IPO in 1996)

Its 1996 cash was \$31.1 million, Total assets = \$40.1 million, Debt = 0 → EV= \$9 million.

For young firms it is common to use EV instead of Value.

Reasons for increased use of Value/EBDITA

1. The multiple can be computed even for firms that are reporting net losses, since EBDITA are usually positive.
2. More appropriate than the PE ratio for high growth firms.
3. Allows for comparison across firms with different financial leverage.

Price to Book Value Ratio

The measure of market value of equity to book value of equity.

$$\frac{P}{B} = \frac{MVequity}{BVequity}$$

Price Book Value Ratio: Stable Growth Firm

- Going back to dividend discount model,

$$P_0 = \frac{Div_1}{r_e - g}$$

- Defining the return on equity (ROE) = EPS_0/BV_0 and realizing that $div_1 = EPS_0 \times \text{payout ratio}$, the value of equity can be written as

$$P_0 = \frac{BV_0 \times ROE \times \text{payout ratio} \times (1+g)}{r_e - g}$$

$$\frac{P_0}{BV_0} = PVB = \frac{ROE \times \text{payout ratio} \times (1+g)}{r_e - g}$$

- If the return is based on expected earnings (next period)

$$\frac{P_0}{BV_0} = PVB = \frac{ROE \times \text{payout ratio}}{r_e - g}$$

Price Sales Ratio

- The ratio of market value of equity to the sales

$$\frac{P}{S} = \frac{MVequity}{\text{Total Revenue}}$$



- Though the third most popular ratio it has a fundamental problem.
 - the ratio is internally inconsistent.

Price Sales Ratio

- Using the dividend discount model, we have

$$P_0 = \frac{\text{Div}_1}{r_e - g}$$

- Dividing both sides by sales per share and remembering that

$$\text{Profit margin} = \frac{\text{Earnings per share}}{\text{Sales per share}}$$

- We get

$$\frac{P_0}{\text{sales}_0} = \text{PS} = \frac{\text{Profit margin} \times \text{payout ratio} \times (1 + g)}{r_e - g}$$

Price Sales Ratio and Profit Margin

- The key determinant of price-sales ratio is profit margin.
- A decline in profit margin has a twofold effect
 - First, the reduction in profit margin reduces the price-sales ratio directly
 - Second, the lower profit margin can lead to lower growth and indirectly reduce price-sales ratio.

Expected growth rate = retention rate * ROE

→ retention ratio * (Net profit/sales) * (sales/book value of equity)

→ retention ratio * (profit margin) * (sales/ BV of equity)

Inconsistency in Price/Sales Ratio

- Price is the value of equity
- While sales accrue to the entire firm.
- Enterprise to sales, however, is consistent.

$$\frac{EV_0}{\text{sales}_0} = \frac{\text{MV equity} + \text{MV debt} - \text{Cash}}{r_e - g}$$

- To value a firm using EV/S
- Compute the average EV/S for comparable firms
- EV of subject firm = average EV/S time subject's firm projected sales
- Market value = EV – market debt value + cash



Choosing between the Multiples

- There are dozen of multiples
- There are three choices
 - Use a simple average of the valuations obtained using a number of different multiples
 - Use a weighted average of the valuations obtained using a number of different multiples (one ratio may be more important than another)
 - Choose one of the multiples and base your valuation based on that multiple (usually the best way as you provide some insights why that multiple is important – remember car industry video segment)

