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INCOME TAX

DOMESTIC TAXATION

GENERAL

DEPRECIATION ON NEW COMMERCIAL VEHICLES

The Central Board of Direct Taxes (CBDT) has issued a circular stating that the benefit of enhanced depreciation on commercial vehicles has been extended up to 30th September 2009. The eligibility for claiming depreciation @ 50 per cent on New Commercial Vehicles has been extended. Hence, the new commercial vehicles acquired upto 30th September, 2009 and put to use before the 1st October 2009 are eligible for claiming higher depreciation @ 50 per cent.

INVESTMENT OF RS. 50,000 IN NSC OR RS. 1 LAKH IN ULIP MAY NEED PAN

Investors may soon need to mention their Permanent Account Number (PAN) to invest more than Rs 50,000 in National Savings Certificates (NSC), or to buy a unit-linked insurance policy where premium payment exceeds Rs 1 lakh. The government is likely to propose an amendment to the present rules where by it would be mandatory to produce the taxpayer identification number for making investments several small savings schemes.

The move will help income-tax authorities to check tax evasion. PAN allows the authorities to establish an audit trail, as information can be matched with income and investment details disclosed in the tax return.

Presently, quoting of PAN is mandatory for credit card application, investment in mutual funds, time deposits of more than Rs 50,000 with any banking company or opening of savings account and deposit of more than Rs 50,000 with post office.

PAN is not required for investment in NSC, Kisan Vikas Patra and monthly income schemes from post office. Transactions such as purchase or sale of property, sale or purchase of a motor vehicle requiring registration other than two-wheelers, and payment to hotels and restaurants against bills exceeding Rs 25,000 also require PAN.

NEW INCOME TAX RETURN FORMS NOTIFIED FOR ASSESSMENT YEAR 2009-10

The Central Board of Direct Taxes (CBDT) has notified new income tax return forms for financial year 2008-09 (assessment year 2009-10). The new forms have been prepared having regard to the changes brought about by the Finance Act 2008.

E-PAYMENT OF TAXES MANDATORY

The Central Board of Direct Taxes (CBDT) has made e-payment of taxes mandatory for all deductors effective April 1. Accordingly, all categories of non-corporate taxpayers with turnover less than Rs 40 lakh or gross receipts less than Rs 10 lakh will have to make electronic payment to the exchequer of the income-tax that they deduct at source.

Presently, E-payment of taxes is mandatory for corporates and assesses that are subject to tax audit.

AMENDMENT IN FORM NO. 3CD

Vide notification no 36/2009; CBDT has amended Form no 3CD. In Form No. 3CD, after item 17, a new item 17A has been inserted. The item 17A requires to state the amount of interest inadmissible under Section 23 of the Micro, Small and Medium Enterprises Development Act, 2006.

CASE LAWS

1. CIT vs. Singapore Airlines (Delhi High Court)

TDS required even on commission retained by agent

The assessee-airline supplied blank tickets to the travel agent, on terms that the same be sold at a minimum price and the difference between the minimum price and the price at which the tickets were sold to the passenger was retained by the travel agent. The question arose whether the amount so retained by the agent was “commission” and whether the assessee was required to deduct tax thereon under section 194 H of the Income Tax Act.

The relationship between the airline and the travel agent was that of a principal and agent as all the requirements of section 182 of the Contract Act were fulfilled by them.

The issues before the Delhi High Courts were:

- Whether supplementary commission received by travel agents of assessee-airlines is a "commission" within the meaning of Section 194H of the Income Tax Act, 1961. If that be so, the failure on the part of the assessee-airlines would render them liable for consequences under Section 201(1) and 201(1A) of the Act.
- Whether tickets issued by assessee-airlines to its travel agents at a concessional price would result in bringing the transaction within the ambit of Section 194H of the Act. If that be so, would the assessee-airlines be liable for the ensuing consequences under Sections 201(1) and 201(1A) of the Act.

Decision of Delhi High Court:

The Delhi High Court held as under:

- By the acts of the travel agent, a legal relationship was created between the airline and the passenger. The monies retained by the travel agent in the form of supplementary commission is not a "discount" because the travel agent never obtains proprietary rights to the tickets and has never paid a "price" for the same. Instead, the same is "commission". Because it is received for services rendered on behalf of the assessee-airline, the airline thus obliged to have deducted tax under section 194H at the rate prescribed during the relevant period. The assessee-airline having not deducted the tax at source, they are liable to be held, within the terms of Section 201(1), as assessee(s)-in-default and also liable for payment of interest in terms of section 201(1A) of the Act.

- The argument that the assessee-airline is unable to deduct tax at source since it is unaware of the commission retained by the agent till a billing analysis is done is not acceptable because once an obligation is cast, it is for the assessee-airline to retrieve the necessary information from the travel agent and put itself in a position to deduct tax. The assessee cannot take up the stand that the machinery for deduction of tax has failed.

- However, in respect of the issue of "concessional" tickets to the agents, the difference between the full value and the concessional price was not "commission" because though it was a reward for services, title to the

ticket passes to the agent and the relationship was that of a principal to principal. The difference was a "discount".

2. CIT vs. Woodward Governor (Supreme Court)

Foreign Exchange fluctuation losses are allowable on accrual basis

The assessee was following on the mercantile system of accounting. The assessee claimed that the additional liability arising on account of fluctuation in the rate of exchange in respect of loans taken for revenue purposes was allowable as deduction under section 37(1) in the year of fluctuation in the rate of exchange and not in the year of repayment of such loans. The AO held that the liability as on the last date of the previous year under consideration was a contingent liability, it was not an ascertained liability and consequently it had to be added back to the total income of the assessee. Accordingly, he added back Rs. 29,49,088 being the unrealized loss due to foreign exchange fluctuation. In other words, the debit to the P&L account was disallowed. This order of the AO was upheld by the CIT (A). The Tribunal and the High Court held that the claim of the assessee for deduction of unrealized loss due to foreign exchange fluctuation as on the last date of the previous year had to be allowed. Aggrieved by the orders, the Revenue filed an appeal before Supreme Court.

The assessee further claimed that the actual cost of imported assets acquired in foreign currency is entitled to be adjusted under section 43A (prior to the amendment by the Finance Act 2002) on account of fluctuation in the rate of exchange at each balance sheet date, pending actual payment of the varied liability.

Decision of Supreme Court:

The Supreme Court passed the order dismissing the appeal of Department and held that:

- The term "expenditure" in section 37 covers an amount which is a "loss" even though the said amount has not gone out from the pocket of the assessee. The "loss" suffered by the assessee on account of the exchange difference as on the date of the balance sheet is an item of expenditure under section 37(1).
- Profits and gains are required to be computed in accordance with commercial principles and accounting standards especially AS 11 – "The effects for changes in Foreign Exchange Rates" (AS 11). Accounts and the accounting method followed by an assessee continuously for a

given period of time needs to be presumed to be correct till the AO comes to the conclusion for reasons to be given that the system does not reflect true and correct profits.

- The fact that the department taxed the gains on fluctuation on the basis of accrual while disallowing the loss is important and indicates the double standards adopted by the Department.

- Under section 43A (pre-amendment), the change in the rate of exchange subsequent to the acquisition of asset triggers the adjustment in the actual cost of the assets. Actual payment of the liability as a consequence of the exchange variation is not required. The amendment of section 43A by the Finance Act 2002 w.e.f. 1.4.2003 is not clarificatory.

International Taxation

General

NEW PROCEDURE FOR MAKING FOREIGN REMITTANCES W. E. F 1 JULY 2009

Section 195(1) of the ITA requires that any person who is responsible for paying any interest or any other sum chargeable under the provisions of the ITA (except dividend and salary income) to a non-resident or to a foreign company, must deduct tax at the applicable rates at the time of payment of the amount or at the time of credit of the amount to the payee's account, whichever is earlier.

Presently, CBDT Circular No 10/2002 dated 9 October 2002 read with Circular No 767/1998 dated 22 May 1998 and Circular No 759 dated 18 November 2007 requires the banker of the Indian resident who is making such payments to forward form A-2 (prescribed by the RBI) to the Assessing Officer. This form is to be submitted with the undertaking and the Chartered Accountant Certificate furnished by such Indian resident in the prescribed format.

Insertion of Section 195(6) and Rule 37BB

The Finance Act 2008 has now inserted a new sub-section (6) to section 195 of the ITA under which a remitter is required to furnish information relating to payment of any sum to a non resident in the form and manner as may be prescribed by the CBDT. Rule 37BB has been inserted in the IT Rules vide Notification No 30/2009 dated 25 March 2009. This Rule requires such persons to furnish the information referred to in section 195(6) in the following manner:

- Obtain a certificate from a Chartered Accountant in Form No 15CB. (R.37BB (1) and (2));
- Furnish the information as required under section 195(6) in Form No 15CA (R. 37 BB); and
- Form 15CA is required to be electronically filed (e-filing) on the website designated by the Income-Tax Department and a signed printout of the same has to be submitted prior to remitting the payment.

Incidentally, Para 34.2 of the Circular No 1/2009 dated 27 March 2009 released by the CBDT explains that such e-filing has been introduced to efficiently monitor and track transactions in a timely manner.

Effective Date

The new Rule becomes effective from 1 July 2009.

CASE LAWS

1. CIT vs. Eli Lilly and Co. (India) Pvt. Ltd. (Supreme Court)

TDS on foreign salary is required even though assessee is not the payer

Few expatriate employees employed with a Foreign Company were deputed to the assessee employer. The said employees, who were deputed to the assessee employer, continued to be employees of a Foreign Company. The said employees received salary and allowances in the home country in foreign currency. The question arose with regard to obligation of the foreign employer to deduct tax at source on such payments under section 192 of the Income Tax Act. When the matter had come up before the High Court, it was held that the assessee was not under obligation to deduct tax at source under section 192 on the ground that the said payments were made by a Foreign Company and not by the assessee.

Decision of Supreme Court:

The Supreme Court held that:

i. Though the payment of salary to the expatriate was made by the foreign company outside India, the TDS provisions did apply as the Income Tax Act had extra-territorial operation as there was a nexus between the said salary and the rendering of services in India;
ii. Under section 9 (1) (ii), salary received abroad is deemed to arise in India if it is for services rendered in India. This charging provision has to be read with the machinery provision of section 192 and both are part of an integrated code;
iii. Section 192 requires the employer to deduct tax after "estimating" the salary payable to the employee. The act of "estimation" is akin to computation of income. In making the estimate, section 9 (1) (ii) has to be taken into account;
iv. It was found that the salary paid by the foreign company was for services in India and hence the same was deemed to accrue in India under section

9 (1) (ii) and the assessee ought to have deducted tax under section 192 though it was not the payer;

v. Levy of interest under section 201 (1A) is mandatory and has to be calculated from the date of default to the date of payment either by the assessee or the payee-employee;

vi. However, levy of penalty under section 271C is not mandatory or compensatory or automatic. Penalty can be levied only if there was no good and sufficient reason for the failure to deduct tax at source. On facts, as the issues were controversial and the assessees acted bona fide, penalty could not be imposed.

2. E*Trade Mauritius Limited (Bombay High Court)

Income of a Mauritius Company from sale of shares of an Indian Company has been subjected to capital gains tax in India

Facts

E*Trade Mauritius Limited (E*Trade Mauritius) is a limited company incorporated at Mauritius and formed under the laws of Mauritius. E*Trade Mauritius is a subsidiary of E*Trade Financial Corporation (E*Trade US). E*Trade Mauritius sold shares of IL&FS Investmart Limited (IL&FS), India to HSBC Violet Investments (Mauritius) Limited (HSBC Mauritius). The Income Tax Department had issued a withholding tax certificate inter alia holding that the capital gains arising from the sale shall give rise to taxability in India. E*Trade Mauritius filed a writ petition before the Bombay High Court challenging the Certificate of Income Tax Department.

Bombay High Court's Order

The Bombay High Court had directed the matter back to the Tax Department for revision proceedings. The High Court directed HSBC Mauritius to deposit an amount of Rupees 245 million, being the tax amount, with the High Court until the matter was disposed off by the Tax Department. The Income Tax Department had concluded that E*Trade Mauritius was a shell company which acquired funds from E*Trade US for purchase of shares of IL&FS. The ownership of shares of IL&FS rested with E*Trade US and accordingly, the actual gains had accrued to E*Trade US.

The High Court held that the tax amount set aside under its earlier order, to the extent of Rupees 243 million approximately be released to the Tax Department and the balance, of INR 2 million approx, be released to E*Trade Mauritius. The Bombay High Court has directed HSBC Mauritius to issue a Tax Deducted

at Source (TDS) Certificate to E*Trade Mauritius to the extent of tax amount paid to the Tax Department.

3. Ansaldo Energia SpA v. CIT (Madras High Court)

Separate contracts for offshore and onshore activities with foreign contractor and its Indian subsidiary is taxable as single composite contract

Facts of the case

The assessee, Ansaldo Energia SpA (Ansaldo), an Italian company, was engaged in the business of selling and setting of power plants. The assessee entered into a turnkey contract with Neyveli Lignite Corporation, India (NLC) to set up a thermal power plant in India. Ansaldo had bid for the contract as a single bidder. The scope of work under the contract involved offshore and onshore supplies and services. Pursuant to the award of the contract on single bidder basis, Ansaldo requested NLC to split the single consolidated contract into four separate contracts. The contracts for offshore supplies and supervisory activities were entered into with Ansaldo, while contracts for onshore supplies and services were executed with Ansaldo Services Private Ltd (Ansaldo India), Ansaldo's Indian subsidiary. Ansaldo claimed exemption for income attributable to offshore supplies since the transfer of title in such supplies had taken place outside India.

Assessment and appellant proceedings

The Tax Authorities, relying on the bid document and specific clauses of the contracts signed by the foreign and the Indian contractor with NLC, held that though Ansaldo had executed four separate contracts for convenience but essentially it was a composite contract for construction of power plant, which was split for tax purposes. The Tax Authorities treated the receipts as FTS and levied tax accordingly.

The Commissioner (Appeals) upheld the order of the Tax Authorities and held that in substance it was one contract entered into by Ansaldo and it had a PE in India. He estimated the profits on the entire project taking into consideration the losses from onshore supply and services contracts and also profits attributable to the PE.

On second appeal, the Tribunal held that the contracts in question were one composite contract and Ansaldo had a common site in the premises of Ansaldo India. It had absolute control and management for all the contracts and that

there was a PE in India and would be taxable in respect of the profits attributable to the activities performed in India.

Decision of Madras High Court

On appeal to the High Court, the issue was whether all the contracts entered by Ansaldo were in the nature of one composite contract and whether income from contracts undertaken outside India for which consideration was also paid outside India was taxable in India?

The High Court held that:

- Ansaldo bid for the tender of NLC as a single bidder and no separate tenders were requisitioned by NLC. The contract with NLC was a single contract and split subsequently only for taxation purposes;

- The High Court distinguished the ruling of the Supreme Court of India in the case of Ishikawajima-Harima Heavy Industries Ltd v. DIT [288 ITR 408] stating that though a single contract was entered into in that case, the scope of activities to be performed had been clearly demarcated. In the present case, a single contract was initially entered into, which was split at a later stage. The activities proposed to be performed under the contracts, post division, were essentially under one contract;

- The responsibility of completing the project was with Ansaldo. Ansaldo India was not empowered to undertake certain parts of the contract independently and therefore there was an intimate, real and continuous relationship between Ansaldo and Ansaldo India; and

- Ansaldo utilised the office of Ansaldo India for carrying out its activities and also supervised its working. On account of interlacing of onshore and offshore scope of work, Ansaldo formed a PE in India in respect of execution of the entire contract. Mere passing of title outside India in respect of offshore portion of the composite contract would not exempt the offshore supply from tax in India. A part of the income arising from offshore supplies would be taxable in India.

Accordingly, the High Court held that the contract between the parties was a single composite contract and was demarcated only to avoid tax in India and payment made to the foreign contractor was taxable in India. The Court also held that the fact that the title passed outside India for offshore supply will not decide the taxability in India.

4. Lucent Technologies International Inc v. DCIT (Delhi Tribunal)

Income from transfer of right to use software loaded on hardware is not Royalty under Article 12 of the India-USA Tax Treaty

Facts of the case

The assessee, Lucent Technologies International Inc (Lucent USA), a US company, was engaged in the business of supply of hardware and software used for GSM cellular radio telephone system. Lucent USA supplied telecommunications hardware and software to its customers in India by way of entering into a contract with the Indian customers. The software provided by Lucent USA was loaded by the Indian operators onto the handsets of the customers, who would use the software to access the GSM facilities. The Indian customers entered into separate contracts with Lucent Technologies India Ltd (Lucent India), Lucent USA's Indian subsidiary, for erection and installation of the equipment purchased from Lucent USA.

The Tax Authorities held that the software and documentation provided by Lucent USA was taxable in India as Royalty under Article 12 of India-USA Tax Treaty. They held that the usage of software by the Indian customers amounted to transfer of the rights associated with the copyright of the software. They also held that Lucent USA had a fixed place of business in India in the form of Lucent India. Lucent USA sent its employees to conduct network survey, undertake negotiations and carry out market activities in India. The visits of the employees were not casual, and these employees were utilizing the office furniture and were given telephone facilities etc. Hence, it was held that Lucent India was a dependent agent and consequently, the PE of Lucent USA in India with respect to the software supplied. The Tax Authorities thus held that the profit on the supply of hardware was taxable as per Article 7 read with Article 5 of the India-USA Tax Treaty.

The Commissioner (Appeals) held that the assessee did not have a PE in India. However, he held that there was a transfer of copyright by Lucent USA in relation to the software and the amount received on account of such transfer was Royalty as per Article 12 of the India-USA Tax Treaty.

On appeal, the issues before the Tribunal were:

- Whether payment received by Lucent USA under the license agreement allowing the use of computer software by the Indian operators was in the nature of Royalty?
- Whether Lucent USA had a PE in India?

Decision of Delhi Tribunal

The Tribunal ruled that the amount received by the non resident company under a license agreement for supply of hardware and software to operate a GSM cellular system for allowing use of software was not Royalty either under the ITA or India-USA Tax Treaty.

The Tribunal held that:

- The transaction was merely a transfer of a copy of the software. The Indian operators did not license the software to the Indian customers and therefore, the transaction was an outright sale of the software product. The licensee was prohibited from making copies of the software for commercial purposes and merely because the licensee was permitted to make copies for back up purposes, it could not be said that he had acquired copyright in the software. Therefore, the payments made would amount to business profits and not Royalty income;
- A consortium or partnership was created between Lucent USA and Lucent India as both were responsible for the turnkey completion of the GSM project, individually and severally; and
- Apart from the personnel of Lucent USA, Lucent India exercised control over other persons like the employees of the affiliates of Lucent USA who had been employed through Lucent India for installation, commissioning, testing and bringing up to operation of the hardware and the software sold by Lucent USA to the GSM operators. These employees would fall within the term of other personnel and since the employees were in India for more than 90 days within one year period, Lucent India was a service PE of Lucent USA under Article 5(2)(l) of the India-USA Tax Treaty.

Accordingly, the Tribunal held that payments made to Lucent USA under the license agreement were not taxable in India as Royalty and that Lucent India was a service PE of Lucent USA in India.

FOREIGN INVESTMENTS

Foreign investors in real estate locked for 3 years

The Foreign Investment Promotion Board (FIPB), the body that clears foreign investment in real estate proposals, has said that foreign investors in Indian real estate cannot sell their stakes to another foreign investor before three years,

With this, FIPB has overruled a provision in FDI policy that exempts foreign players from the rule in cases where fund transfer is from one non-resident to another. Till now, this three-year lock-in was applicable only on foreign investment in real estate and not on investors.

The FIPB view is contrary to the stand taken by the department of industrial policy and promotion (Dipp), the nodal agency that formulates FDI rules in the country. Dipp's view is that a foreign investor can repatriate funds if it offloads its stake to another foreign investor as the actual investment in a project would remain intact and only its ownership would change.

SEBI permits Foreign Institutional Investors (FIIs) to invest its funds in IDRs

Market regulator Securities Exchange Board of India (SEBI) has permitted foreign institutional investors and mutual funds to invest in Indian Depository Receipts (IDRs).

ADRs or IDRs are derivative instruments, that is, they derive their value from the shares deposited with the custodian.

The move to widen the investor base will increase liquidity for IDRs that will be issued in India. Initially when IDRs were introduced, the government allowed only Indian citizens to invest.

Further, the board of SEBI also decided to permit the issue of depository receipts by custodians on behalf of issuers, and demat holding of IDRs.

Just like American Depository Receipts (ADRs), where Indian companies raise resources from overseas market, IDRs would enable foreign firms to do the same from Indian markets.

Basically, the foreign company will deposit shares with a custodian, who in turn will issue depository receipts based on these shares. The receipts are issued based on the ratio of how many shares equal a single depository receipt.

IDRs have not picked up because the overseas firms faced regulatory hurdles since India does not have full capital account convertibility. Taking money raised from India would have required multiple approvals from authorities like (Foreign Exchange Management Act) FEMA.

However, by allowing the foreign portfolio investors to invest in IDRs now, the government is trying to attract foreign capital and also make IDRs more attractive for overseas firms.

ACCOUNTS & AUDIT

Revised Standards on Auditing (SA) 550 (Revised) "Related Parties"

Recently the Institute of Chartered Accountants of India (ICAI) has come out with revised Standards on Auditing (SA) 550 (Revised) "Related Parties".

This Standard on Auditing (SA) deals with the auditor's responsibilities regarding related party relationships and transactions when performing an audit of financial statements. Specifically, it expands on how SA 315,[2] SA 330[3] and SA 240[4] are to be applied in relation to risks of material misstatement associated with related party relationships and transactions.

Many related party transactions are in the normal course of business. In such circumstances, they may carry no higher risk of material misstatement of the financial statements than similar transactions with unrelated parties. However, the nature of related party relationships and transactions may, in some circumstances, give rise to higher risks of material misstatement of the financial statements than transactions with unrelated parties. For example:

- Related parties may operate through an extensive and complex range of relationships and structures, with a corresponding increase in the complexity of related party transactions.
- Information systems may be ineffective at identifying or summarizing transactions and outstanding balances between an entity and its related parties.
- Related party transactions may not be conducted under normal market terms and conditions; for example, some related party transactions may be conducted with no exchange of consideration.

Responsibilities of the Auditor

Because related parties are not independent of each other, many financial reporting frameworks establish specific accounting and disclosure requirements for related party relationships, transactions and balances to enable users of the financial statements to understand their nature and actual or potential effects on the financial statements. Where the applicable financial reporting framework establishes such requirements, the auditor has a responsibility to perform audit procedures to identify, assess and respond to the risks of material misstatement

arising from the entity's failure to appropriately account for or disclose related party relationships, transactions or balances in accordance with the requirements of the framework.

Effective Date

This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

Standards on Internal Audit (SIA) 15 "Knowledge of the Entity and its Environment"

Recently the Institute of Chartered Accountants of India (ICAI) has come out with Standards on Internal Audit (SIA) 15, "Knowledge of the Entity and its Environment"

The purpose of this Standard on Internal Audit is to establish standards and provide guidance on what constitutes the knowledge of an entity's business, its importance to the various phases of an internal audit engagement and the techniques to be adopted by the internal auditor in acquiring such knowledge about the client entity and its environment, prior to commencing an internal audit engagement and subsequently thereafter, at all stages of the internal audit process. This Standard also sets out the guidelines regarding the application, usage and documentation of such knowledge by the internal auditor.

In performing an internal audit engagement, the internal auditor should obtain knowledge of the economy, the entity's business and its operating environment, including its regulatory environment and the industry in which it operates, sufficient to enable him to review the key risks and entity-wide processes, systems, procedures and controls. The internal auditor should identify sufficient, appropriate, reliable and useful information to achieve the objectives of the engagement. Such knowledge is used by the internal auditor in reviewing the key operational, strategic and control risks and in determining the nature, timing and extent of internal audit procedures.

This Standard shall become mandatory from such date as may be notified by the Council in this regard.

Announcement Relating to AS-11

Accounting Standard-11 relating to "The Effects of Changes in Foreign Exchange Rates" earlier prescribed under the Companies (Accounting Standards) Rules 2006 has been now amended by the Central Government, in terms of the powers conferred on them under the Companies Act, 1956, vide Notification dated 31st March, 2009. The said Notification contains an amendment to be inserted in the AS-11 earlier prescribed as aforementioned.

It may be noted that the amendment as contained in the said Notification shall be applicable to corporates registered under the Companies Act, 1956.

As for entities other than those registered under the Companies Act, 1956, the Accounting Standard-11 as issued by the Institute shall continue to apply.

The Financial Accounting Standards Board (FASB) issues final answer on Fair Value.

The Financial Accounting Standards Board has published the "final" versions of its three controversial FASB Staff Positions to improve guidance and disclosures on fair value measurements.

FSP FAS 157-4, "Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly," provides guidelines for making fair value measurements more consistent with the principles presented in FASB Statement No. 157, "Fair Value Measurements."

FSP FAS 107-1 and APB 28-1, "Interim Disclosures about Fair Value of Financial Instruments," enhances consistency in financial reporting by increasing the frequency of fair value disclosures. FSP FAS 115-2 and FAS 124-2, "Recognition and Presentation of Other-Than-Temporary Impairments," provides additional guidance designed to create greater clarity and consistency in accounting for and presenting impairment losses on securities.

FSP FAS 107-1 and APB 28-1 relates to fair value disclosures for any financial instruments that are not currently reflected on the balance sheet of companies at fair value. Prior to issuing this FSP, fair values for these assets and liabilities were only disclosed once a year. The FSP now requires these disclosures on a quarterly basis, providing qualitative and quantitative information about fair value estimates for all those financial instruments not measured on the balance sheet at fair value.

FSP FAS 115-2 and FAS 124-2 on other-than-temporary impairments is intended to bring greater consistency to the timing of impairment recognition, and provide greater clarity to investors about the credit and noncredit components of impaired debt securities that are not expected to be sold. The measure of impairment in comprehensive income remains fair value. The FSP also requires increased and more timely disclosures sought by investors regarding expected cash flows, credit losses, and aging of securities with unrealized losses.

The FSPs are effective for interim and annual periods ending after June 15, 2009, but entities may adopt them early for the interim and annual periods ending after March 15, 2009. Beyond these near-term actions, the FASB also has a joint project with the International Accounting Standards Board aimed at more broadly revamping and converging their respective standards on accounting for financial instruments.

The Financial Accounting Standards Board (FASB) issues guidance on mark-to-market accounting

The Financial Accounting Standards Board, which sets U.S. accounting rules, issued formal guidance that will allow companies more flexibility in their use of mark-to-market accounting.

The move is expected to improve earnings and capital levels at banks. Lawmakers, banks and other supporters of the changes had argued that the earlier version of the rules forced companies to price assets at fire-sale prices, creating a downward spiral and billions of dollars in write-downs.

In the board's formal guidance, FASB said the changes would be effective for the second quarter period for most U.S. companies, but early adoption would be permitted for the first quarter.

FASB said that its new guidance explains how companies should use mark-to-market when a market is not active, and says there is a need to use judgment in ascertaining when a formerly active market has become inactive.

The board, as expected, will also require more disclosures by companies about expected cash flows, credit losses and aging of securities with unrealized losses, in deciding how to take write-downs on assets that have fallen sharply in value.

It is a myth IFRS requires all assets and liabilities to be measured at fair value.

The use of fair value measurement in International Financial Reporting Standards (IFRS) is much higher than compared to that in Indian GAAP. However, it is a myth IFRS requires all assets and liabilities to be measured at fair value. For example, IFRS provides an option to an entity to use either the cost model or the revaluation model to measure fixed assets (property, plant and equipment (PPE) and intangible assets) subsequent to initial recognition.

An entity that selects the revaluation model measures items of fixed asset at fair value. Therefore, it is not mandatory for an entity to carry fixed assets at fair value. An entity may use cost model for one class of fixed assets (e.g. plant and equipment) and revaluation model for another class of fixed assets (e.g. land). Under IFRS the principle for valuation of inventories is the same as that in Indian GAAP. Inventories are valued at lower of cost or net realizable value (NRV).

IFRS uses fair value model for initial measurement of financial assets and financial liabilities. Subsequently, equity instruments and derivatives are measured at fair value. Loan and advances and debt instruments which the entity intends to hold till maturity are measured at amortized cost and not at fair value. Fair value is also used to record assets (including fixed assets) and liabilities acquired in a business combination. Fair value of those assets is considered the acquisition cost.

Fair value is an important and difficult concept in accounting. Determination of fair value involves judgment. IFRS defines fair value as "The amount for which an asset could be exchanged, or liability settled, or an equity instrument granted, could be exchanged, between knowledgeable, willing parties on an arm's length transaction". SFAS 157 (US GAAP) defines fair value as "Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date." Although languages are different, in spirit both definitions are same. SFAS 157 provides detailed guidance on the measurement of fair value.

The transaction to sell the asset or transfer the liability is a hypothetical transaction at the measurement date, considered from the perspective of a market participant that holds the asset or owes the liability. Thus fair value accounting is not the same as 'mark-to-market' accounting. In certain situations, for example, in the case of securities issued by a closely-held company, market value may not be available but fair value can be estimated. In certain circumstances, market value does not represent the fair value.

Fair value accounting should be viewed 'mark-to-model' accounting rather than 'mark-to-market' accounting. In estimating fair value entity uses 'observable' inputs, that is, assumptions based on market data from sources independent of the reporting entity. It also uses 'unobservable' inputs. Unobservable inputs are inputs that reflect the reporting entity's own assumptions about the assumptions market participants would use in pricing the asset or liability developed based on the best information available in the circumstances.

SFAS 157 provides a hierarchy of inputs being used to determine the fair value. The fair value hierarchy gives the highest priority to quoted prices (unadjusted) in active markets for identical assets or liabilities (Level 1) and the lowest priority to unobservable inputs (Level 3). Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. Examples of Level 2 inputs are quoted prices for similar assets or liabilities in active markets and quoted prices for identical or similar assets or liabilities in markets that are not active.

An active market for the asset or liability is a market in which transactions for the asset or liability occur with sufficient frequency and volume to provide pricing information on an ongoing basis. Examples of active market are the capital market and the commodity exchange. A quoted price in an active market provides the most reliable evidence of fair value and should be used to measure fair value whenever available. A fair value measurement assumes the transaction to sell the asset or transfer the liability occurs in the principal market for the asset or liability or, in the absence of a principal market, in the most advantageous market for the asset or liability.

Price quoted in an active market does not represent fair value if the volume and level of activity have decrease significantly and there is no orderly transaction for the asset or liability. Therefore, if the volume and level of transaction for the shares of B have decreased significantly and the transaction is not an orderly transaction the share price of Rs 80 does not represent fair value.

Recently FASB has issued a Staff Position (FSP FAS 157-4) which provides additional guidance on how to determine whether there has been a significant decrease in volume and level of transactions for a particular asset or liability. The Staff Position stipulates that if the reporting entity concludes that there has been significant decrease in the volume and level of activity, significant adjustments to the quoted price might be required to determine the fair value.

Market price may deviate from the fair value due to speculation even if the volume and activity level have not been decreased. The FASB Staff Position

does not cover this case, perhaps rightly so because it is difficult to objectively identify such deviations without the benefit of hind sight.

No AS-11 breather for non-corporate entities

The Institute of Chartered Accountants of India (ICAI) has said AS-11 would continue to apply to all non-corporate entities.

Therefore, even as corporate India is cheering after the government cleared the proposal to defer AS-11 implementation for companies to 2011, non-corporate bodies like proprietary firms, partnerships firms or Association of Persons (AoP) firms would continue to abide by AS-11 and deduct the losses incurred due to foreign exchange movement against their profits.

The government has postponed the compliance for the corporates with retrospective effect from December 7, 2006 till 2011. Now they will have the option to show the forex loss or gain according to AS-11 or Schedule VI of the Companies Act, which allows adjustment of profit or loss against the asset.

In 2011, when India will converge with the International Financial Reporting Standards (IFRS), companies will have to compulsorily report mark-to-market losses and gains.

Only peer reviewed firms to audit listed companies: ICAI

From accounting periods commencing on or after April 1, 2009, all listed companies would be audited by only those firms that have been issued peer review certificate by the Peer Review Board of the Institute of Chartered Accountants of India (ICAI), a release by the apex body said.

Apex accounting body Institute of Chartered Accountants of India (ICAI) said all listed companies would be audited by only peer review certified companies for periods starting April 1 this year and over 1,200 firms have been selected for this review.

It also said the financial statements of companies coming out with IPOs need to be certified by firms which have been issued a certificate from the Peer Review Board.

Peer review is the evaluation of work or performance by other people in the same field in order to maintain or enhance the quality of the work or performance.

The financial statements of companies coming out with Initial Public Offerings (IPO) should also be certified by the audit firms who have been issued a certificate from the Peer Review Board, the release said.

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