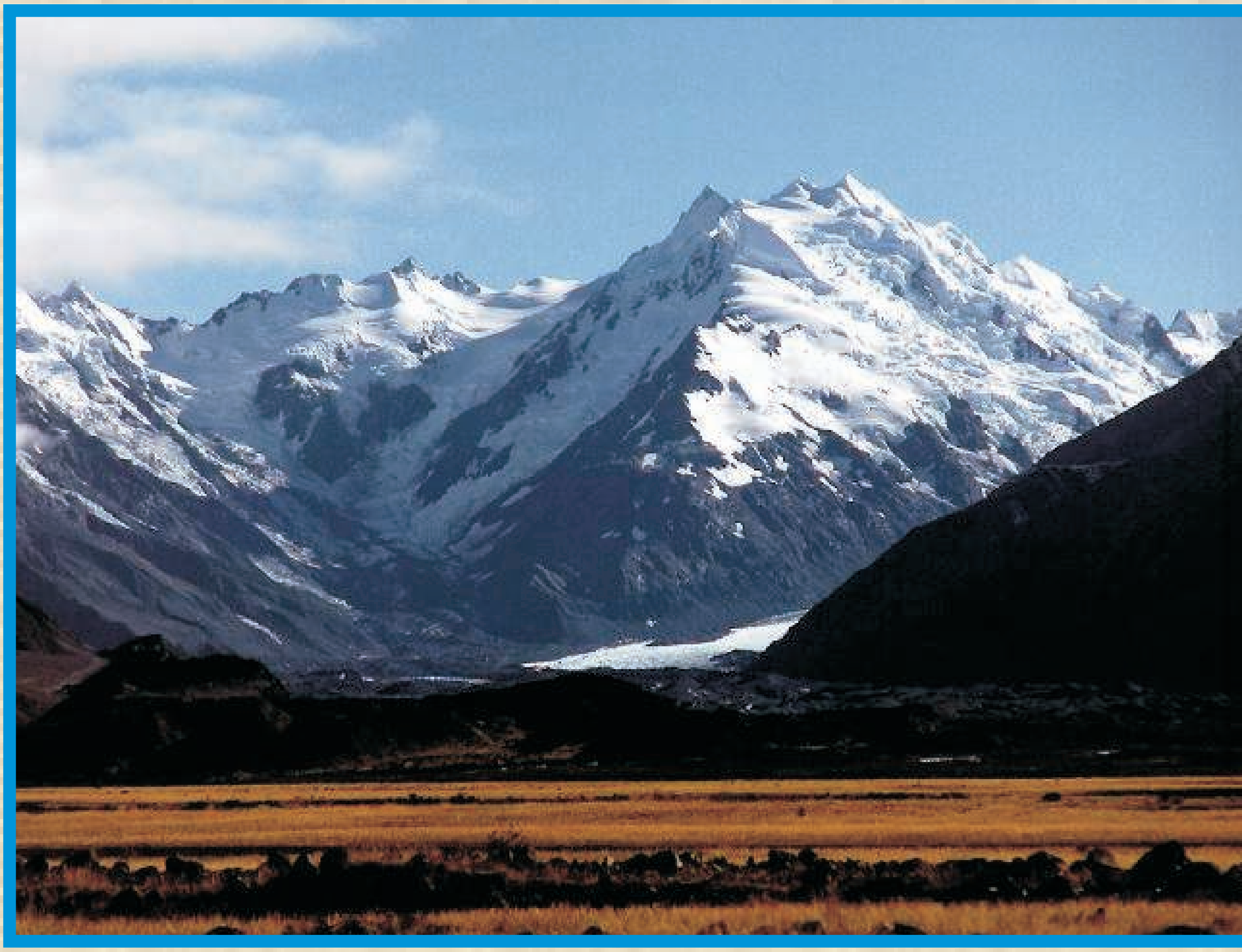
NEWSLETTER

NOVEMBER 2011

M. V. DAMANIA & Co.



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INTERNATIONAL TAX

ING Vysya Bank vs. DDIT – Banglore Tribunal

Facts: The assessee is engaged in the business of banking in India. ING Computer Lease, Belgium (ICLB) entered into License agreement with Oracle Netherland whereby the Oracle Netherland Company sold license to use Oracle Database Software (ODS) and provide technical support to whole ING group for one-time payment by ICLB.

ICLB then entered into a sub-license agreement with other ING associate Companies to provide use of such license along with the technical support for one-time charge. All the softwares are directly downloaded from the site.

The remittance was made by the Indian Company to ICLB against purchase of such software license without deduction of tax at source. The Assessing Officer held that he payment made was in the nature of Royalty and therefore the Company was required to deduct tax at source and accordingly treated the Company as 'assessee in default'.

The CIT(A) relying on the decision of Samsung Electronics, upheld the order of the AO.

The Company's contentions:

- It purchased license to use software which was used by many others and a mere sale of license was not sale of right.
- It purchased 'shrink wrapped software' which is available in the market and it was nothing but sale of software and hence no tax was required to be deducted.
- In Velankani Mauritius Ltd., Banglore Tribunal held that sale of off the shelf 'shrink wrapped software' was only sale of copy righted article and not a right in the copy right of the article and accordingly income there from was not 'Royalty' under the Act or under Treaty.
- The Samsung Electronics was set aside by the Supreme Court in GE India Technology and hence on that basis the Company cannot be treated as eassessee in default.

The Tribunal held that:

- The assessee purchased license from Oracle Database Software to use its software and this license is for its own use only. The software is not 'tailor made' for the assessee. The assessee had limited right to use the software and not to alter, modify or sell the software or sell the license to any other person.
- When the right to use of software is limited one i.e. only to use and operate, it could not be said that there was any

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transfer of intellectual property.

- Though the licensed software was developed by the Oracle for the use of intellectual property, the product was permitted only to use and operate by the assessee. The assessee had no right to alter, modify or transfer the license. Thus there was no transfer of intellectual property.

- The defination under the Act and Treaty encompasses the payment for the use of and the right to use of any intellectual property. Accordingly the license granted by the Oracle for use of its software constituted 'Royalty'.

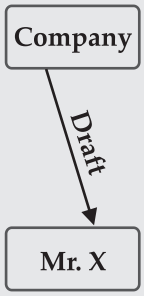
- The assessee was required to deduct tax at source for such remittance.

- The Samsung Electronics case was set aside by the Supreme Court and remitted back to the Karnataka High Court to decide on the taxability of the remittance. Hence that decision is no longer applicable.

Compiled by: Mr. Malay Damania

ESOP

Employees Stock Option Scheme - ESOP



Point of Taxation:
Difference between FMV and payment made will be taxed as Perquisite when the shares are allotted.

FMV:
Listed Companies:
Average of opening and closing price on the sate the option is excercised.

Unlisted Companies:
Value as determined by Cat I Merchant banker.

Capital Gains:
Capital Gain Tax will be charged for the difference between sale price and FMV taken for the purpose of computing perquisite.

Grant of ESOP option:
The Company "grants" option to buy shares at a Fixed Price to its Employees subject to certain conditions:

Conditions (Vesting Conditions) may be:
To continue in employment for certain time/period.
Achieve minimum performance level.

Mr. X has option to buy shares upon fulfillment of above vesting conditions.

Upon Fulfillment of Vesting Conditions:
Mr. X excercises the option of buying the shares of the Company by making payment of the "Grant Price." Thus now the shares are allotted and Mr. X becomes owner of the shares.

Sale:
The shares may be subsequently sold by Mr. X depending upon the availability of exit options to him.

Employees Stock Purchase Scheme – ESPS
Employees are offered and they can purchase shares upfront at the time of "grant" itself. Generally these come with lock-in-period. The employees are required to remain with the Company during the lock-in-period. The employees are exposed to risk of price fluctuation during the lock-in-period.

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Stock Appreciation Rights:

- Similar to that of ESOP. The variation includes establishing valuation formula for determining exit price. This method is useful when no external valuation/quoted price is available. The difference between exit price and grant price is the cash outflow for the Company.
- Not so popular since it involves cash outflow for the Company.
- Valuation is usually linked to book profit. It is less attractive as generally lower profit multiples are used due to cash outflow.

Other Key Points:

- No Rules laid down for method of arriving at FMV of shares by the Merchant banker.
- The AO cannot make reference to the valuation officer under section 55A, even if he is of the opinion that the Merchant banker has undervalued the shares.
- Period of holding of shares – from the date of allotment of shares.
- Stock options to Consultants/Vendors - Section 28(1)(iv) rws 2(24)(vd) seeks to cover such benefits as income of the consultant/vendor.
- Microsoft AAR Ruling - ESOP granted by the parent Company to the employees of the subsidiary were considered to be granted on behalf of the subsidiary and hence taxable as Salary (perquisite) to employees. Accordingly the parent Company was obliged to deduct tax at source.
- ESOP scheme needs to provide for suitable adjustment in the events like mergers, demergers etc.
- ESOP scheme also need to factor the changes in capital structure like bonus issues, rights issue, split of face value of shares etc.
- ESOP scheme should specify about the termination of employment may be due to voluntary or company termination, disablement, death etc. during vesting period and exercise period.

Compiled by: Mr. Malay Damania

ASSURANCE & AUDIT

Revised Audit Report Format- SA 700 (Revised) and SA 705 on related aspects

Standard on Auditing (SA) 700 (Revised): an Opinion & Reporting on Financial Statements:

1 Scope:
This Standard on Auditing (SA) deals with the auditor's responsibility to form an opinion on the financial statements. It also deals with the form and content of the auditor's report issued as a result of an audit of financial statements.

2 Effective Date:
This SA is effective for audits of financial statements for periods beginning on or after April 1, 2011.

3 Objectives:
The objectives of the auditor are to:
(a) Form an opinion on the financial statements based on an evaluation of the conclusions drawn from the audit evidence obtained; and
(b) Express clearly that opinion through a written report that also describes the basis for the opinion.

4 Meaning of financial statement:
Financial statement in this standard means "a complete set of general purpose financial statements, including the related notes". For example in case of a company companies act requires:
- A Balance Sheet
- A Profit and Loss account
- A Cash Flow Statement (if required)
- Notes to the accounts and significant accounting policies as referred in accounting standards under CASR (Company Accounting Standard Rules) 2006.

5 Auditor's duty:
The auditor shall form an opinion on whether the financial statements are prepared, in all material respects, in

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accordance with the applicable financial reporting framework. For this, the auditor shall conclude as to whether the auditor has obtained reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error.

6 Opinion on Financial Statements:
The auditor shall express an unmodified opinion (generally an unqualified opinion) when the auditor concludes that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

In different situations, the auditor's conclusions will be different for example:

Situation -1 Concludes that, based on the audit evidence obtained, financial statements as a whole are not free from material misstatement; or is to obtain sufficient appropriate audit evidence conclude that the statements as a whole are free from material misstatement, the auditor shall modify the opinion in the auditor's report in accordance with 705.

Situation-2:- financial statements in accordance with the requirements of a fair presentation framework not achieve fair presentation, auditor shall discuss the matter with management and, depending on the requirements of the applicable financial reporting framework and how the matter is resolved, shall determine whether it is necessary to modify the opinion in the auditor's report in accordance with SA 705.
For example: Financial statements are not in agreement with schedule VI in such situation the matter shall be discussed with management.

Situation -3:- When the **financial statements are prepared in accordance with a compliance framework, the auditor is not required to evaluate whether the financial statements achieve fair presentation.**, if in extremely rare circumstances, the auditor concludes that such financial statements are misleading; the auditor shall discuss the matter with management and, depending on how it is resolved, shall determine whether, and how, to communicate it in the auditor's report. For example IF company is following schedule VI, auditor need not to evaluate the fair presentation.

7 Basic elements of the Auditor's Report:
The auditor's report shall be in writing. With following basic elements:

- Title
  The auditor’s report shall have a title that clearly indicates that it is the report of an independent auditor.

- Addressee
  The auditor’s report shall be addressed as required by the circumstances of the engagement.

- Introductory Paragraph:
  The introductory paragraph in the auditor's report shall:
  (a) Identify the entity whose financial statements have been audited;
  (b) State that the financial statements have been audited;
  (c) Identify the title of each statement that comprises the financial statements;
  (d) Refer to the summary of significant accounting policies and other explanatory information; and

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(e) Specify the date or period covered by each financial statement comprising the financial statements.

- **Management's Responsibility for the Financial Statements**
  This section of the auditor's report describes the responsibilities of those in the organisation that are responsible for the preparation of the financial statements.

- **Auditor's Responsibility**
  The auditor's report shall state that the responsibility of the auditor is to express an opinion on the financial statements based on the audit.

- **Auditor's Opinion**
  When expressing an unmodified opinion on financial statements prepared in accordance with a fair presentation framework, the auditor's opinion shall, unless otherwise required by law or regulation, use one of the following phrases, which are regarded as being equivalent:

  (a) The financial statements present **fairly, in all material respects,**in accordance with [the applicable financial reporting framework]; or

  (b) The financial statements give **a true and fair view**of in accordance with [the applicable financial reporting framework].

  Special Note:- If the auditor addresses other reporting responsibilities in the auditor's report on the financial statements that are in addition to the auditor's responsibility under the SAs to report on the financial statements, say, like in company 227(1A),(2) (3) (4)(4A CARO), these other reporting responsibilities shall be addressed in a separate section in the auditor's report that shall be sub-**titled** ***"Report on Other Legal and Regulatory Requirements,"***

- **Signature of the Auditor**
  The auditor's report shall be signed.

- **Date of the Auditor's Report**
  The auditor's report shall be dated no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the auditor's opinion on the financial statements.

- **Place of Signature**
  The auditor's report shall name specific location, which is ordinarily the city where the audit report is signed.

cont.

Appendix
Illustrative Formats of Auditors' Reports on Financial Statements

Illustration:
Circumstances include the following:

- Audit of a complete set of separate general purpose financial statements of a company prepared under the Companies Act, 1956 financial reporting framework, which is a fair presentation framework.
-
- The terms of the audit engagement reflect description of management's responsibility for the financial statements in SA 210 (Revised).
-
- The report is unmodified and does not include either an Emphasis of Matter paragraph or an Other Matter(s) paragraph.
-
- In addition to the audit of financial statements, the auditor has other reporting responsibilities required under the Companies Act, 1956 and/or other regulatory requirements.

INDEPENDENT AUDITOR'S REPORT
To the Members of ABC Company Limited

Report on the Financial Statements

We have audited the **accompanying financial statements** of ABC Company Limited ("the Company"), which comprise the Balance Sheet as at March 31, 20XX, and the Statement of Profit and Loss and Cash Flow Statement for the year then ended, and **a summary of significant accounting policies and other explanatory information**.

Management's Responsibility for the Financial Statements:
Management is responsible for the preparation of these financial statements that give a true and fair view of the **financial position, financial performance and cash flows** of the Company in accordance with the Accounting Standards referred to in sub-section (3C) of section 211 of the Companies Act, 1956 ("the Act"). This responsibility includes the **design, implementation and maintenance of internal control** relevant to the preparation and presentation of the financial statements that give a true and fair view and are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility
Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with the Standards on Auditing issued by the Institute of Chartered Accountants of India. Those Standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves **performing procedures** to obtain **audit evidence** about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the **assessment of the risks of material misstatement** of the financial statements, whether due to fraud or error. In making those **risk**

cont.

assessments, the auditor considers **internal control** relevant to the Company's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances. An audit also includes evaluating the **appropriateness of accounting policies** used and the **reasonableness of the accounting estimates** made by management, as well as evaluating the **overall presentation of the financial statements**. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion and to the best of our information and according to the explanations given to us, the financial statements give the information required by the Act in the manner so required and give a true and fair view in conformity with the accounting principles generally accepted in India:

(a) in the case of the Balance Sheet, of the state of affairs of the Company as at March 31, 20XX;

(b) in the case of the Profit and Loss Account, of the profit/ loss for the year ended on that date; and

(c) in the case of the Cash Flow Statement, of the cash flows for the year ended on that date.

Report on Other Legal and Regulatory Requirements

1 As required by the Companies (Auditor's Report) Order, 2003 ("the Order") issued by the Central Government of India in terms of sub-section (4A) of section 227 of the Act, we give in the Annexure a statement on the matters specified in paragraphs 4 and 5 of the Order.

2 As required by section 227(3) of the Act, we report that:

(a) we have obtained all the information and explanations which to the best of our knowledge and belief were necessary for the purpose of our audit;

(b) in our opinion proper books of account as required by law have been kept by the Company so far as appears from our examination of those books [and proper returns adequate for the purposes of our audit have been received from branches not visited by us;

(c) the Balance Sheet, Statement of Profit and Loss, and Cash Flow Statement dealt with by this Report are in agreement with the books of account [and with the returns received from branches not visited by us;

(d) in our opinion, the Balance Sheet, Statement of Profit and Loss, and Cash Flow Statement comply with the Accounting Standards referred to in subsection (3C) of section 211 of the Companies Act, 1956;

(e) on the basis of written representations received from the directors as on March 31, 20XX, and taken on record by the Board of Directors, none of the directors is disqualified as on March 31, 20XX, from being appointed as a director in terms of clause (g) of sub-section (1) of section 274 of the Companies Act, 1956.

cont.

(f) Since the Central Government has not issued any notification as to the rate at which the cess is to be paid under section 441A of the Companies Act, 1956 nor has it issued any Rules under the said section, prescribing the manner in which such cess is to be paid, no cess is due and payable by the Company.

For XYZ and Co.
Chartered Accountants
Firm's Registration Number

Signature
(Name of the Member Signing the Audit Report)
(Designation)
Membership Number

Place of Signature
Date

cont.

Standard on Auditing (SA) 705 -Modifications to the Opinion in the Independent Auditor's Report

1 **Scope:**
This Standard on Auditing (SA) deals with the auditor's responsibility to issue an appropriate report in circumstances when, in **forming an opinion** in accordance with SA 700 (Revised)3, the auditor concludes that **a modification to the auditor's opinion** on the financial statements **is necessary**.

2 **Effective Date:**
This SA is effective for audits of financial statements for periods beginning **on or after April 1, 2011.**

3 **Meaning of Modification to the opinion:**
When the auditor is not giving Unmodified opinion it said he is modifying his opinion. Modified opinion refers to **a qualified opinion, an adverse opinion or a disclaimer of opinion**.

4 **When Auditor can decide to modify his opinion:**
According to SA 705(R) The auditor shall modify the opinion in the auditor's report when:

(a) The auditor concludes that, based on the audit evidence obtained, the **financial statements as a whole are not free from material misstatement**; or

(b) The auditor is **unable to obtain sufficient appropriate audit evidence** to conclude that the financial statements as a whole are free from material misstatement.

5 **Consequence of a modified audit report:**
This SA establishes three types of modified opinions, namely, a qualified opinion, an adverse opinion, and a disclaimer of opinion. The decision regarding which type of modified opinion is appropriate depends upon:

(a) The nature of the matter giving rise to the modification, that is, whether the financial statements are materially misstated; and

(b) The auditor's judgment about the pervasiveness of the effects or possible effects of the matter on the financial statements.

6 **When an auditor shall express a Qualified Opinion?**
The auditor shall express a qualified opinion when:
(a) The auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, **are material, but not pervasive**, to the financial statements; or

(b) The auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, but the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, **could be material but not pervasive.**

cont.

7 **When an auditor shall express an Adverse Opinion?**
The auditor shall express an adverse opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, **are both material and pervasive to the financial statements.**

8 **When an auditor shall express a Disclaimer of Opinion?**
The auditor shall disclaim an opinion when the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive.

The auditor shall disclaim an opinion when, **in extremely rare circumstances involving multiple uncertainties**, the auditor concludes that, notwithstanding having obtained sufficient appropriate audit evidence regarding each of the individual uncertainties, it is not possible to form an opinion on the financial statements due to the potential interaction of the uncertainties and their possible cumulative effect on the financial statements.

Illustrative Format of QUALIFIED OPINON
Case-1
Inventories are misstated. The misstatement is deemed to be material but not pervasive to the financial statements. The audit opinion is qualified for the misstatement.

Basis for Qualified opinion:
The Company's inventories are carried in the Balance Sheet at Rs. XXX. Management has not stated the inventories at the lower of cost and net realisable value but has stated them solely at cost, which constitutes a departure from the Accounting Standards referred to in sub-section (3C) of section 211 of the Act. The Company's records indicate that had management stated the inventories at the lower of cost and net realisable value, an amount of Rs. XXX would have been required to write the inventories down to their net realisable value. Accordingly, cost of sales would have been increased by Rs. XXX, and income tax, net profit and shareholders' funds would have been reduced by Rs. XXX, Rs. XXX and Rs. XXX , respectively.

Opinion
In our opinion and to the best of our information and according to the explanations given to us, except for the effects of the matter described in the Basis for Qualified Opinion paragraph, the financial statements give the information required by the Act in the manner so required and give a true and fair view in conformity with the accounting principles generally accepted in India:

(a) in the case of the Balance Sheet, of the state of affairs of the Company as at March 31, 20XX;
(b) in the case of the Profit and Loss Account, of the profit/ loss for the year ended on that date; and
(c) in the case of the Cash Flow Statement, of the cash flows for the year ended on that date.

Illustrative Format of ADVERSE OPINON
Audit of a complete set of consolidated general purpose financial statements of a parent company prepared under accounting principles generally accepted in India (as required for compliance with SEBI's regulatory requirement).

cont.

The financial statements are materially misstated due to the non-consolidation of a subsidiary. The material misstatement is deemed to be pervasive to the financial statements. The effects of the misstatement on the financial statements have not been determined because it was not practicable to do so. An adverse audit opinion is given under the circumstances.

Basis for Adverse Opinion

As explained in Note X, the Company has not consolidated the financial statements of subsidiary XYZ Company it acquired during 20XX because it has not yet been able to ascertain the fair values of certain of the subsidiary's material assets and liabilities at the acquisition date. This acquisition is therefore accounted for as an investment. Under the accounting principles generally accepted in India, the subsidiary should have been consolidated because it is controlled by the Company. Had XYZ been consolidated, many elements in the accompanying financial statements would have been materially affected. The effects on the financial statements of the failure to consolidate have not been determined.

Adverse Opinion

In our opinion, **because of the significance of the matter discussed in the Basis for Adverse Opinion paragraph**, the consolidated financial statements do not give a true and fair view in conformity with the accounting principles generally accepted in India:

(a) in the case of the consolidated Balance Sheet, of the state of affairs of the Company as at March 31, 20XX;
(b) in the case of the consolidated Profit and Loss Account, of the profit/ loss for the year ended on that date; and
(c) in the case of the consolidated Cash Flow Statement, of the cash flows for the year ended on that date.

Case-3

The auditor was unable to obtain sufficient appropriate audit evidence about multiple elements of the financial statements. That is, the auditor was unable to obtain audit evidence about the entity's inventories and accounts receivable. The possible effects of this inability to obtain sufficient appropriate audit evidence are deemed to be both material and pervasive to the financial statements. A disclaimer of audit opinion is given in the circumstances.

Basis for Disclaimer of Opinion

We were appointed as auditors of the Company after March 31, 20XX and thus could not observe the counting of physical inventories at the beginning and end of the year. Accordingly, we were unable to satisfy ourselves by alternative means concerning the inventory quantities held at December 31, 20X0 and March 31, 20X1 which are stated in the Balance Sheet at Rs. XXX and Rs. XXX, respectively. In addition, the introduction of a new computerised accounts receivable system in September 20X1 resulted in numerous errors in accounts receivable. As of the date of our audit report, management was still in the process of rectifying the system deficiencies and correcting the errors. We were unable to confirm or verify by alternative means accounts receivable included in the Balance Sheet at a total amount of Rs. XXX as at March 31, 20X1. As a result of these matters, we were unable to determine whether any adjustments might have been found necessary in respect of recorded or unrecorded inventories and accounts receivable, and the elements making up the Statement of Profit and Loss and Cash Flow Statement.

cont.

Disclaimer of Opinion

***Because of the significance of the matters described in the Basis for Disclaimer of Opinion paragraph**, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion. Accordingly, we do not express an opinion on the financial statements.*

Compiled by: Mr. Bharat Jain

Exemption from ITR-1 Filing: A Mirage

We really don't need to file ITR-1 (Sahaj) this year?
"And how we arrive at this conclusion that we don't need to file a return?"

"The notification came on June 24th, 2011 that all those having income below Rs. 5 Lakhs need not file their Income Tax Return." This exemption also requires a few more conditions to be fulfilled as mentioned below:

1. Total Income after allowable deductions is below Rs. 5 Lakhs.
2. Income is ONLY from salary and savings bank interest.
3. Salary is from ONE employer.
4. Savings bank interest is below Rs. 10,000.
5. Tax due on savings bank interest has been paid and included in Form 16.

This exemption can be avail, ONLY when ALL of the above conditions fulfilled, and not most of them or any one. Most generally, people with an income range of Rs. 2-5 Lakhs would have various other sources of income like FD's, Bonds and Mutual Funds etc. If there is income from any of these, they have to file ITR-1.
This is a problem with most of the people who "thought" they need not file a return. So this exemption appears to more like a mirage. As we approach closer to it, we will find that it doesn't really exist.

Well, we will have to view filing of ITR-1 not only as compliance but it is in our benefit to file it. There are several benefits of filing an ITR-1 such as:

1. Availing any kind of loan like home, personal or education;
2. Visa and immigration processing;
3. Income proof / net worth certification;
4. Refund claims (in case of excess taxes paid); and
5. Applying for a higher insurance cover.

So do not view it as compliance and do not feel sad that you are not getting an exemption from filing an ITR-1. File it happily as it is going to benefit us in the long run.

Compiled by: Mr. Brajeswar Pandey