## REVISION TEST PAPER
## CAP-II:
## ADVANCED ACCOUNTING

## QUESTIONS

### Accounting for Departments

1. BBC Ltd. has three departments M,N,O. The following information is provided for the year ended 31.3.2073:

| | M | N | O |
|---|---|---|---|
| | Rs. | Rs. | Rs. |
| Opening stock | 5,000 | 8,000 | 19,000 |
| Opening reserve for unrealized profit | — | 2,000 | 3,000 |
| Materials consumed | 16,000 | 20,000 | — |
| Direct labour | 9,000 | 10,000 | — |
| Closing stock | 5,000 | 20,000 | 5,000 |
| Sales | — | — | 80,000 |
| Area occupied (sq. mtr.) | 2,500 | 1,500 | 1,000 |
| No. of employees | 30 | 20 | 10 |

Stocks of each department are valued at costs to the department concerned. Stocks of M are transferred to N at cost plus 20% and stocks of N are transferred to O at a gross profit of 20% on sales. Other common expenses are salaries and staff welfare Rs. 18,000, rent Rs. 6,000.

Prepare Departmental Trading, Profit and Loss Account for the year ending 31.3.2073.

### Insurance Claim

2. On 2.6.2072 the stock of *Mr. Narendra* was damaged by flood. However, following particulars were furnished from the records saved:

| | |
|---|---|
| Stock at cost on 1.4.2071 | 135,000 |
| Stock at 90% of cost on 31.3.2072 | 162,000 |
| Purchases for the year ended 31.3.2072 | 645,000 |
| Sales for the year ended 31.3.2072 | 900,000 |
| Purchases from 1.4.2072 to 2.6.2072 | 225,000 |
| Sales from 1.4.2072 to 2.6.2072 | 480,000 |

Sales upto 2.6.2072 includes Rs. 75,000 being the goods not dispatched to the customers. The sales invoice price is Rs. 75,000. Purchases upto 2.6.2072 includes machinery acquired for Rs. 15,000.

Purchases upto 2.6.2072 does not include goods worth Rs. 30,000 received from suppliers, as invoice not received upto the date of fire. These goods have remained in the godown at the time of incident. The insurance policy is for Rs. 120,000 and it is subject to average clause. Ascertain the amount of claim for loss of stock.

### Investment Accounts

3. On 1.4.2070, *Mrs. Sabina Thapa* purchased 1,000 equity shares of Rs. 100 each in SBB Ltd. @ Rs. 120 each from a Broker, who charged 1% brokerage. She incurred 50 paisa per Rs. 100 as cost of shares transfer stamps. On 31.1.2071, 50% Bonus share was declared. Before and after the record date of bonus shares, the shares were quoted at Rs. 155 per share and Rs. 90 per share

respectively. On 28.2.2071 Mrs. Thapa sold bonus shares through a Broker, who charged 1% brokerage.

She held the shares as Current assets. Show the Investment Account in the books of Mrs. Thapa on 31.3.2071 when the market value per share was Rs. 79.

**Accounting for Branches**

4. A company has three branches at Thimi, Kapan and Gwarko. The Head Office at Newroad purchases goods and sends them to branches, to be sold at a uniform percentage of profit on cost. The following particular are made available to you to enable you to prepare a combined Trading Account for the year ended 31st Ashadh, 2073.

| | Newroad Rs. | Thimi Rs. | Kapan Rs. | Gwarko Rs. |
|---|---|---|---|---|
| Stock on 1st Shrawan, 2072 | 54,000 | 16,000 | 12,500 | 10,000 |
| Purchases in the year | 274,000 | - | - | - |
| Sales | - | 180,000 | 120,000 | 100,000 |
| Stock on 31st Ashadh, 2073 | 28,000 | 6,000 | 5,000 | 2,500 |
| Branch Accounts on 1st Shrawan, 2072: | | | | |
| Thimi | 15,000 | | | |
| Kapan | 32,000 | | | |
| Gwarko | 4,000 | | | |
| Remittances from Branch | 320,000 | 150,000 | 100,000 | 70,000 |

Head Office invoices goods to the branches at fixed sales prices but maintains branch accounts in its ledgers at cost price.

**Hire Purchase Transactions**

5. *Tushal Enterprises, Palpa* purchased a machine on Hire Purchase System. The total cost price of the machine was Rs. 1,500,000 payable 20% down and four annual installments of Rs. 420,000, Rs. 390,000, Rs. 360,000 and Rs. 330,000 at the end of the 1st year 2nd year, 3rd year and 4th year respectively. Calculate the interest included in each year's installment assuming that the sales were made at the beginning of the year.

**Issue of Shares and Debentures**

6. Elite Limited recently made a public issue in respect of which the following information is available:
   **a)** No. of partly convertible debentures issued 200,000; face value and issue price NRs.100 per debenture.

   **b)** Convertible portion per debenture 60%, date of conversion on expiry of 6 months from the date of closing of issue.

   **c)** Date of closure of subscription lists 1.5.2015, date of allotment 1.6.2015, rate of interest on debenture 15% payable from the date of allotment, value of equity share for the purpose of conversion NRs. 60 (Face Value NRs. 10).

   **d)** Underwriting Commission 2%.

   **e)** No. of debentures applied for 150,000.

   **f)** Interest payable on debentures half-yearly on 30th September and 31st March.

Write relevant journal entries for all transactions arising out of the above during the year ended 31st March, 2016 (including cash and bank entries).

7. Everest Co. Ltd. issued 200,000 shares of Rs. 100 each at a premium of Rs. 20 per share payable as follows:

| | |
|---|---|
| on application | Rs. 20 |
| on allotment | Rs. 50 (including premium) |
| on First/ call | Rs. 30 |
| on second and final call | Rs. 20 |

Applications were received for 300,000 shares and pro-rata allotment was made to applicants of 240,000 shares. Amount excess received on application was employed on account of sum due on allotment as part of share capital. Mr. Subash, to whom, 4,000 shares were allotted, failed to pay the allotment money and on his subsequent failure to pay the first call, his shares were forfeited and Mr. Dhiraj, the holder of 6,000 shares failed to pay to calls and his shares were forfeited after the second call. Of the forfeited shares, 8,000 shares were reissued to Mr. Gopal at a discount of 10%, the whole of Dhiraj's forfeited shares being reissued. Pass necessary journal entries in the books of Everest Co. Ltd.

**Underwriting of Shares and Debentures**

8. Kathmandu Ltd. came out with an issue of 450,000 equity shares of Rs. 100 each at a premium of Rs. 20 per share. The promoters took 20% of the issue and the balance was offered to the public. The issue was equally underwritten by A & Co; B & Co. and C & Co.
Each underwriter took firm underwriting of 10,000 shares each. Subscriptions for 310,000 equity shares were received with marked forms for the underwriters as given below:

| | |
|---|---|
| A & Co. | 72,500 shares |
| B & Co. | 84,000 shares |
| C & Co. | 131,000 shares |
| Total | 287,500 shares |

The underwriters are eligible for a commission of 5% on face value of shares. The entire amount towards shares subscription has to be paid along with application. You are required to:
(a) Prepare the statement showing the underwriters' liability (number of shares)
(b) Compute the amounts payable or due to underwriters; and
(c) Pass necessary journal entries in the books of Kathmandu Ltd. relating to underwriting.

**Incomplete Records**

9. The following is the Balance Sheet of Pathibhara Enterprises on 31st Ashadh, 2070 :

| | Rs. | | Rs. |
|---|---|---|---|
| Capital | 1,000,000 | Fixed Assets | 400,000 |
| Creditors (Trade) | 140,000 | Stock | 300,000 |
| Profit & Loss A/c | 60,000 | Debtors | 150,000 |
| | | Cash & Bank | 350,000 |
| | 1,200,000 | | 1,200,000 |

The management estimates the purchases and sales for the year ended 31st Ashadh, 2071 as under:

| | upto 31.2.2071<br>Rs. | Ashadh 2071<br>Rs. |
|---|---|---|
| Purchases | 1,410,000 | 110,000 |
| Sales | 1,920,000 | 200,000 |

It was decided to invest Rs. 100,000 in purchases of fixed assets, which are depreciated @ 10% on cost.

The time lag for payment to Trade Creditors for purchase and receipt from sales is one month. The business earns a gross profit of 30% on turnover. The expenses against gross profit amount to 10% of the turnover. The amount of depreciation is not included in these expenses.

Draft a Balance Sheet as at 31st Ashadh, 2071 assuming that creditors are all Trade Creditors for purchases and debtors for sales and there is no other item of current assets and liabilities apart from stock and cash and bank balances.

**Ratio Analysis**

10. *Nyatapola Enterprises* asked you to prepare their Balance Sheet from the particulars furnished hereunder:

    Gross Profit Margin: 10%

    Stock Velocity: 12

    Capital turnover ratio: 2

    Fixed assets turnover ratio: 5

    Debt collection period: 1 month

    Creditor's payment period: 73 days

    Gross Profit: Rs. 100,000

    Excess of closing stock over opening stock: Rs. 30,000

    Make suitable assumptions wherever necessary.

**Business Combination**

11. The following is the Balance Sheet of Blue Star Ltd. as at 31st Ashadh, 2072:

| Liabilities | Rs. | Assets | Rs. |
|---|---|---|---|
| 8,000 equity shares of Rs.100 each | 800,000 | Building | 340,000 |
| 10% debentures | 400,000 | Machinery | 640,000 |
| Loan from A | 160,000 | Stock | 220,000 |
| Creditors | 320,000 | Debtors | 260,000 |
| General Reserve | 80,000 | Bank | 136,000 |
| | | Goodwill | 130,000 |
| | | Deferred Revenue Exp. | 34,000 |
| | 1,760,000 | | 1,760,000 |

Big Star Ltd. agreed to absorb Blue Star Ltd. on the following terms and conditions:

(1) Big Star Ltd. would take over all Assets, except bank balance at their book values less 10%. Goodwill is to be valued at 4 year's purchase of super profits, assuming that the normal rate of return be 8% on the combined amount of share capital and general reserve.

(2) Big Star Ltd. is to take over creditors at book value.

(3) The purchase consideration is to be paid in cash to the extent of Rs. 600,000 and the balance in fully paid equity shares of Rs.100 each at Rs.125 per share.

The average profit is Rs. 124,400. The liquidation expenses amounted to Rs. 16,000 to be borne by Big Star Ltd. Blue Star Ltd. had purchased prior to 31st Ashadh, 2072 goods costing Rs. 120,000 from Big Star Ltd. for Rs. 160,000. Rs. 100,000 worth of goods is still in stock of Blue Star Ltd. on 31st Ashadh, 2072. Creditors of Blue Star Ltd. include Rs.40,000 still due to Big Star Ltd.

Show the necessary Ledger Accounts to close the books of Blue Star Ltd. and prepare the Balance Sheet (extract) of Big Star Ltd. as at 1st Shrawan, 2072 after the takeover.

**Internal Reconstruction**

12. The following is the Balance Sheet of Pokhara Light Ltd. as on 31.3.2072:

| Liabilities | Rs. | Assets | Rs. |
|---|---|---|---|
| Equity shares of Rs.100 each | 10,000,000 | Fixed assets | 12,500,000 |
| 12% cumulative preference shares of Rs.100 each | 5,000,000 | Investments (Market value Rs.950,000) | 1,000,000 |
| 10% debentures of Rs.100 each | 4,000,000 | Current assets | 10,000,000 |
| Sundry creditors | 5,000,000 | P & L A/c | 400,000 |
| Provision for taxation | 100,000 | Preliminary expenses | 200,000 |
| | 24,100,000 | | 24,100,000 |

The following scheme of reorganization is sanctioned by the AGM and Court:

(i) All the existing equity shares are reduced to Rs.40 each.

(ii) All preference shares are reduced to Rs.60 each.

(iii) The rate of interest on debentures is increased to 12%. The debenture holders surrender their existing debentures of Rs.100 each and exchange the same for fresh debentures of Rs. 70 each for every debenture held by them.

(iv) One of the creditors of the company to whom the company owes Rs. 2,000,000 decides to forgo 40% of his claim. He is allotted 30,000 equity shares of Rs.40 each in full satisfaction of his claim.

(v) Fixed assets are to be written down by 30%.

(vi) Current assets are to be revalued at Rs. 4,500,000.

(vii) The taxation liability of the company is settled at Rs.150,000.

(viiii) Investments to be brought to their market value.

(ix) It is decided to write off the fictitious assets.

Pass Journal entries and show the Balance sheet of the company after giving effect to the above.

**Profit or Loss Pre and Post Incorporation**

13. The partnership of Bara Enterprises decided to convert the partnership into private limited company named Churimai Company Pvt. Ltd. with effect from 1st Baisakh 2071. The consideration was agreed at Rs. 234,00,000 based on firm's Balance Sheet as on 31st Chaitra 2070. However, due to some procedural difficulties, the company could be incorporated only on 1st Shrawan 2071. Meanwhile, the business was continued on behalf of the company and the consideration was settled on that day with interest at 12% p.a. The same books of accounts were continued by the company, which closed its accounts for the first time on 31st Ashadh, 2072 and prepared the following summarized profit and loss account:

| Particulars | Rs. | Particulars | Rs. |
|---|---|---|---|
| To Cost of goods sold | 327,60,000 | By sales | 468,00,000 |
| To Salaries | 2340,000 | | |
| To Depreciation | 360,000 | | |
| To Advertisement | 1404,000 | | |
| To Discount | 2340,000 | | |
| To Managing Director's Salary | 180,000 | | |
| To Miscellaneous Office Expenses | 240,000 | | |
| To Office/Showroom Rent | 1440,000 | | |
| To Interest paid | 1902,000 | | |
| To Net Profit | 3834,000 | | |
| **Total** | **468,00,000** | **Total** | **468,00,000** |

The company's only borrowing was a loan of Rs. 100,00,000 at 12% p.a. to pay the purchase consideration due to the firm and for working capital requirements. The company was able to double the monthly average sales of the company from 1st Shrawan 2071 but the salaries treble from that date. It had to occupy additional space from 1st Kartik 2071 for which rent was Rs. 60,000 per month.

Prepare a statement showing apportionment of costs and revenue between pre-incorporation and post-incorporation periods.

**Liquidator's Final Statement**

14. The following is the Balance Sheet of Himchuli Co. Limited as at 31st Ashadh, 2072:

| Liabilities | Rs. | Assets | Rs. |
|---|---|---|---|
| Share Capital: | | Fixed Assets: | |
| 2,000 Equity Shares of Rs. 100 | | Land & Buildings | 400,000 |
| each Rs. 75 per share paid up | 150,000 | Plant and Machineries | 380,000 |
| 6,000 equity shares of Rs. 100 | | Current Assets: | |
| each Rs. 60 per share paid up | 360,000 | Stock at Cost | 110,000 |
| 2,000 10% Preference Share of | | Cash at Bank | 60,000 |
| Rs. 100 each fully paid up | 200,000 | Profit and Loss A/c | 240,000 |
| 10% Debentures (having a floating | | Sundry Debtors | 220,000 |
| charge on all assets) | 200,000 | | |
| Interest accrued on Debentures | | | |
| (also secured as above) | 10,000 | | |
| Sundry Creditors | 490,000 | | |
| | 1,410,000 | | 1,410,000 |

On that date, the company went into Voluntary Liquidation. The dividends on preference shares were in arrear for the last two years. Sundry Creditors include a loan of Rs. 90,000 on mortgage of Land and Buildings. The assets realized were as under:-

| | Rs. |
|---|---|
| Land and Buildings | 340,000 |
| Plant & Machineries | 360,000 |
| Stock | 120,000 |
| Sundry Debtors | 160,000 |

Interest accrued on loan on mortgage of buildings upto the date of payment amounted to Rs. 10,000. The expenses of Liquidation amounted to Rs. 4,600. The Liquidator is entitled to a remuneration of 3% on all the assets realized (except cash at bank) and 2% on the amounts distributed among equity shareholders. Sundry creditor included preferential creditors Rs. 30,000. All payments were made on 31st Ashwin 2072. Prepare the liquidator's final statement.

**Accounting for Partnership**

15. A, B and C were partners of a firm sharing profits and losses in the ratio of 3 : 4 : 3. The Balance Sheet of the firm, as at 31st Ashadh, 2070 was as under:

| Liabilities | | Rs. | Assets | Rs. |
|---|---|---|---|---|
| Capital Accounts: | | | Fixed Assets | 100,000 |
| A | 48,000 | | Current Assets: | |
| B | 64,000 | | Stock | 30,000 |
| C | 48,000 | 160,000 | Debtors | 60,000 |
| Reserve | | 20,000 | Cash and Bank | |
| | 30,000 | | | |
| Creditors | | 40,000 | | |
| | | 220,000 | | 220,000 |

The firm had taken a Joint Life Policy for Rs. 100,000; the premium periodically paid was charged to Income Statement. Partner C died on 30th Poush, 2070. It was agreed between the remaining partners and the legal representatives of C that:

(i) Goodwill of the firm will be taken at Rs. 60,000.

(ii) Fixed Assets will be written down by Rs. 20,000.

(iii) In lieu of profits, C should be paid at the rate of 25% per annum on his capital as on 31st Ashadh, 2070.

Policy money was received and the legal representatives were paid off. The profits for the year ended 31st Ashadh, 2071, after charging depreciation of Rs. 10,000 (depreciation upto 30th Poush was agreed to be Rs. 6,000) were Rs. 48,000. Legal representative claimed proportionate profit for remaining period after death.

Partners' Drawings Accounts showed balances as under:

A Rs. 18,000 (drawn evenly over the year)

B Rs. 24,000 (drawn evenly over the year)

C (up-to-date of death) Rs. 20,000

On the basis of the above figures, please indicate the entitlement of the legal representatives of C, assuming that they had not been paid anything other than the share in the Joint Life Policy.

**Accounting for Non-profit making organisation**

16. *Jhapa School* maintains separate building fund. As on 31.3.2071, balance of building fund was Rs. 1,000,000 and it was represented by fixed deposit (8% per annum) of Rs. 600,000 and current account balance of Rs. 400,000. During the year 2071/72, the school collected as donations towards the building fund Rs. 560,000 and transferred 40% of developmental fee collected Rs. 2,256,500 to building fund. Capital work progress as on 31st Ashadh 2071 was Rs. 825,000 for which contractor's bill upto 75% was paid on 14.4.2071. The extension of building was finished on 31.12.2071 costing Rs. 725,000 for which contractors' bill was fully met. It was decided to transfer the cost of completed building (Rs. 1,550,000) to the corresponding asset account.

You are required to pass journal entries to incorporate the above transactions in the books of *Jhapa School* for the year 2071/72 and show the trial balance of building fund ledger.

**Accounting for Banks**

17. *SSS Bank Limited* provides you the following information regarding Loan Loss provisioning as on 31st Ashadh 2073:

| Category | Amount Rs. |
|---|---|
| 1. Pass | 5,000,000 |
| 2. Rescheduled /Restructured | 210,000 |
| 3. Substandard | 500,000 |
| 4. Doubtful | 300,000 |
| 5. Bad | 500,000 |

During financial year 2072-73 additional loans amounting to Rs. 3,000,000 were disbursed. The Bad loans amounting to Rs. 200,000 was written off during the year. Loans amounting to Rs. 150,000 were shifted from Doubtful category to Bad category. Similarly, Loans amounting to Rs. 500,000 shifted from Good category to substandard category and Substandard Loans amounting to Rs. 200,000 were rescheduled during the year.

From the above information, you are required to calculate the loan loss provision and pass necessary journal entries in the books of *SSS Bank Limited* as per the directive issued by Nepal Rastra Bank and find the percentage of total Non-Performing Assets.

18. From the following information calculate Core capital ratio and total capital adequacy ratio of *DDD Bank Ltd.* and suggest management about the compliance of the same:

| | In lakh |
|---|---|
| Paid up Capital | 20,000 |
| General Reserve Fund | 377 |
| Retained Earnings | 308 |
| Profit for current year | 1,945 |
| General Loan Loss Provision | 1,215 |
| Investment Adjustment Reserve | 22 |
| Loan Given to Relatives of Staffs | 37 |
| Risk weighted Exposure for Credit Risk | 213,546 |
| Risk weighted Exposure for Operational Risk | 4,235 |
| Risk Weighted Exposure for Market Risk | 1,618 |

**Cash Flow Statement**

19. The following are the changes in the account balances taken from the balance sheet of *Nepal Ltd.* as the beginning and end of the year.

| Particular | Debit | Credit |
|---|---|---|
| 8% Debentures | | 150,000 |
| Debenture Discount | 3,000 | |
| Plant and Machinery at cost | 180,000 | |
| Depreciation on Plant and Machinery | | 43,200 |
| Trade Receivables | 150,000 | |
| Inventory including work in progress | 115,500 | |
| Trade payables | | 35,400 |
| Net profit for the year | | 229,500 |
| Dividend paid in respect of earlier years | 90,000 | |
| Provision for Doubtful Debts | | 9,900 |
| Trade Investments at cost | 141,000 | |
| Bank | | 211,500 |
| Total | 679,500 | 679,500 |

You are informed that:

- During the year plant costing Rs. 54,000 against which depreciation provision of Rs. 40,500 was lying was sold for Rs. 21,000.
- During the middle of the year, Rs. 150,000 debentures were issued for cash at a discount of Rs. 3,000.
- The net profit for the year was after crediting the profit on sale of plant and charging debenture interest.

Prepare a cash flow statement which will explain why bank borrowing has increased by Rs. 211,500 during the year end, ignore taxation.

**Nepal Accounting Standards**

20. a. Curex Pvt. Ltd., a pharmaceutical company, while valuing its finished stock at the yearend wants to include interest on bank overdraft as an element of cost, for the reason that overdraft has been taken specifically for the purpose of financing current assets like inventory and for meeting day to day working expenses. State your comments on this treatment.

b. When the construction of a qualifying asset is performed by a third party, are borrowing costs capitalised on the prepayments made to the third party for the acquisition of the asset? State on the basis of relevant NAS.

c. A company is in a dispute involving allegation of infringement of patents by a competitor company who is seeking damages of a huge sum of Rs. 20 million. The directors are of the opinion that the claim can be successfully resisted by the company. How would you deal with the same in the annual accounts of the company?

d. An earthquake destroyed a major warehouse of ABC Ltd. on 30.4.2072. The accounting year of the company ended on 31.3.2072. The accounts were approved on 30.6.2072. The loss from earthquake is estimated at Rs. 25 lakhs. State with reasons, whether the loss due to earthquake is an adjusting or non-adjusting event and how the fact of loss is to be disclosed by the company.

e. Discuss on *'Other comprehensive income'* as outlined in Nepal Accounting Standard.

f. A company capitalizes interest cost of holding investments and adds to cost of investment every year, thereby understating interest cost in profit and loss account. Comment on the accounting treatment done by the company in context of the relevant NAS.

**Write Short Notes**

21. (a). Watch list in Loan loss provisioning

(b). Super profits in partnership firms

(c). Components of Financial Statements

(d). Government Accounting System in Nepal

(e). Prediction of insolvency on the basis of ratios

(f). Advantages of Customized Accounting Packages

## SUGGESTED ANSWERS

### Accounting for Departments

**1. Answer:**

**BBC Ltd.**
**Departmental Trading and Profit and Loss Account**
**for the year ended 31.3.2073**

| | M Rs. | N Rs. | O Rs. | Total Rs. | | M Rs. | N Rs. | O Rs. | Total Rs. |
|---|---|---|---|---|---|---|---|---|---|
| To Opening stock | 5,000 | 8,000 | 19,000 | 32,000 | By Sales | | | 80,000 | 80,000 |
| To Material consumed | 16,000 | 20,000 | | 36,000 | By Inter-departmental transfer | 30,000 | 60,000 | | 90,000 |
| To Direct labour | 9,000 | 10,000 | | 19,000 | By Closing stock | 5,000 | 20,000 | 5,000 | 30,000 |
| To Inter-departmental transfer | | 30,000 | 60,000 | 90,000 | | | | | |
| To Gross profit | 5,000 | 12,000 | 6,000 | 23,000 | | | | | |
| | 35,000 | 80,000 | 85,000 | 2,00,000 | | 35,000 | 80,000 | 85,000 | 2,00,000 |
| To Salaries and staff welfare | 9,000 | 6,000 | 3,000 | 18,000 | By Gross profit b/d | 5,000 | 12,000 | 6,000 | 23,000 |
| To Rent | 3,000 | 1,800 | 1,200 | 6,000 | By Net loss | 7,000 | | | 7,000 |
| To Net profit | | 4,200 | 1,800 | 6,000 | | | | | |
| | 12,000 | 12,000 | 6,000 | 30,000 | | 12,000 | 12,000 | 6,000 | 30,000 |
| To Net loss (M) | | | | 7,000 | By Stock reserve b/d (N + O) | | | | 5,000 |
| To Stock reserve (N+O) (Refer W.N.) | | | | 3,000 | By Net profit (N + O) | | | | 6,000 |
| To Balance transferred to Profit and loss account | | | | 1,000 | | | | | |
| | | | | 11,000 | | | | | 11,000 |

**Working Note:**

**Calculation of unrealized profit on closing stock**

| | Rs. |
|---|---|
| Stock reserve of N department | |
| Cost | 30,000 |
| Transfer from M department | 30,000 |
| | 60,000 |
| Stock of N department | 20,000 |

Proportion of stock of M department = $\text{Rs. }20{,}000 \times \frac{\text{Rs.}30{,}000}{\text{Rs.}60{,}000}$ = Rs.10,000

Stock reserve =Rs.10,000 $\times \frac{20}{120}$ = Rs.1667 (approx.)

| *Stock reserve of O department* | *Rs.* |
|---|---|
| Stock transferred from N department | 5,000 |
| *Less:* Profit (stock reserve) 5,000 × 20% | 1,000 |
| Cost to N department | 4,000 |

Proportion of stock of M department =Rs. $4{,}000 \times \frac{\text{Rs.}30{,}000}{\text{Rs.}60{,}000} = \text{Rs.}2{,}000$

$\text{Stock reserve} = \text{Rs.}2{,}000 \times \frac{20}{120} = \text{Rs.}333$ (approx.)

Total stock reserve = Rs. 1,000 + Rs.333 = Rs. 1,333

**Insurance Claim**

**2. Answer:**

In the books of Narendra
Trading Account for the year ended 31.3.2072

| | | | |
|---|---|---|---|
| To Opening stock<br>To Purchases<br>To Gross Profit | 135,000<br>645,000<br>300,000 | By Sales<br>By Closing Stock<br>(162,000X90/100) | 900,000<br>180,000 |
| Total | 1,080,000 | | 1,080,000 |

Memorandum Trading Account
for the period form 1.4.2072 to 2.6.2072

| | | | | | |
|---|---|---|---|---|---|
| To Opening stock | | 180,000 | By Sales | 480,000 | |
| To Purchases | 225,000 | | Less: goods not dispatched | (75,000) | 405,000 |
| Add: goods received but invoice not | 30,000 | | | | |
| Less: machinery purchased | (15,000) | 240,000 | By Closing Stock (balancing figure) | | 150,000 |
| To Gross Profit (working note) | | 135,000 | | | |
| Total | | 555,000 | Total | | 555,000 |

**Calculation of insurance claim**

Claim subject to average clause: 120,000X150,000/150,0000 = 120,000

Working note:

Gross profit ratio = (300,000/900,000)X 100% = 1/3$^{rd}$ on sales

Amount of gross profit = 405,000 x 1/3 = 135,000

**Investment Accounts**

**3. Answer:**

**In the books of Mrs. Sabina Thapa**
**Investment Account (Share)**
**for the year ended 31.3.2071**

Dr. Cr.

| Date | | Particulars | Nominal Value | Cost | Date | | | Nominal Value | Cost |
|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | | | |

| | | | (Rs.) | (Rs.) | | | | (Rs.) | (Rs.) |
|---|---|---|---|---|---|---|---|---|---|
| 1.4.70 | To | Bank A/c | 1,00,000 | 1,21,800 | 28.2.71 | By | Bank A/c | 50,000 | 44,550 |
| 31.1.71 | To | Bonus shares | 50,000 | – | 31.3.71 | By | P & L A/c | - | 2,200 |
| 28.2.71 | To | P & L A/c | – | 3,950 | 31.3.71 | By | Balance c/d | 1,00,000 | 79,000 |
| | | | 1,50,000 | 1,25,750 | | | | 1,50,000 | 1,25,750 |

**Working Notes:**

(i) Cost of shares purchased on 1.4.2070 = 1,000 × Rs. 120 + 1% of Rs. 1,20,000 + ½% of Rs. 1,20,000 = Rs. 1,21,800

(ii) Sale proceeds of shares sold on 28.2.2071 = 500 × Rs. 90 – 1% of Rs. 45,000 = Rs. 44,550.

(iii) Profit on sale of bonus shares on 28.2.2071

= Sales proceeds – Average cost

Sales proceeds = Rs. 44,550

Average cost = Rs. (1,21,800 × 50,000)/1,50,000

= Rs. 40,600

Profit = Rs. 44,550 – Rs. 40,600 = Rs. 3,950.

(iv) Valuation of shares on 31.3.2071

Cost = (Rs. 1,21,800 × 1,00,000)/1,50,000 = Rs. 81,200

Market Value = 1,000 shares × Rs. 79 = Rs. 79,000

Closing balance has been valued at Rs. 79,000 being the market value is lower than cost price.

**Accounting for Branches**

**4. Answer:**

Combined Trading Account

For the year ended 31st Ashadh 2073

| Particular | Newroad | Thimi | Kapan | Gwarko | Total |
|---|---|---|---|---|---|
| To Opening stock at cost (Working note iv) | 54,000 | 12,800 | 10,000 | 8,000 | 84,800 |
| To Purchases | 274,000 | - | | - | - |
| To Goods received from HO at cost (balancing figure) | - | 136,000 | 90,000 | 74,000 | 300,000 |
| To Gross profit @ 20% on Sales | | 36,000 | 24,000 | 20,000 | 80,000 |
| Total | 328,000 | 184,800 | 124,000 | 102,000 | 738,800 |
| By Sales | - | 180,000 | 120,000 | 100,000 | 400,000 |
| By Goods sent to branch at cost | 300,000 | - | - | - | 300,000 |
| By Closing Stock at cost (working note iv) | 28,000 | 4,800 | 4,000 | 2,000 | 38,800 |
| Total | 328,000 | 184,800 | 124,000 | 102,000 | 738,800 |

Working Notes:

i). Calculation of cost of Stock sent to all branches

| | |
|---|---|
| Opening stock at HO | 54,000 |
| Add: Total Purchases at HO | 274,000 |
| Less: Closing stock at HO | (28,000) |
| Goods sent to branches at cost | 300,000 |

ii). Calculation of invoice of goods received from HO by all branches

| | | |
|---|---|---|
| Closing stock at branch level (total) | | 13,500 |
| Add: Total sales | 400,000 | |
| Less: Opening stock at branch level (total) | | (38,500) |
| Goods received from HO (total) | 375,000 | |

iii) Calculation of profit margin on goods sent to the branches

| | | |
|---|---|---|
| Goods sent to branches at Invoice Price | 375,000 | |
| Less: Goods sent to branches at cost price | | (300,000) |
| Profit | 75,000 | |

Rate of profit margin is 20% of Invoice price or 25% of cost price

iv). Valuation of stock at cost price

| | Opening Stock | Closing stock |
|---|---|---|
| Thimi | 16,000x80%= 12,800 | 6,000x80%=4,800 |
| Kapan | 12,500x80%=10,000 | 5,000x80%=4,000 |
| Gwarko | 10,000x80%=8,000 | 2,500x80%=2,000 |

**Hire Purchase Transactions**

**5. Answer:**

(a) Calculation of Interest for each year:

Interest for 1st year = Rs. 300,000 x 150/360 = Rs. 125,000

Interest for 2nd year = Rs. 300,000 x 108/360 = Rs. 90,000

Interest for 3rd year = Rs. 300,000 x 69/360 = Rs. 57,500

Interest for 4th year = Rs. 300,000 x 33/360 = Rs. 27,500

Total Rs. 300,000

Working Notes:

1. Hire Purchase Price = Down Payment + Instalments
   = 300,000 + (420,000 + 390,000 + 360,000 + 330,000) = 18,00,000
2. Total Interest = H.P. Price – Cash Price
   = 1,800,000 – 1,500,000 = 300,000
3. Calculation of ratio of hire purchase price outstanding in the beginning of each year

| A<br>Year | B<br>Outstanding Hire Purchase Price in the Beginning of each Year | C<br>Instalment Paid | D = B - C<br>Outstanding Hire Purchase Price at the End of each Year |
|---|---|---|---|
| I | 1,500,000 | 420,000 | 1,080,000 |
| II | 1,080,000 | 390,000 | 690,000 |
| III | 690,000 | 360,000 | 330,000 |
| IV | 330,000 | 330,000 | 0 |

Ratio of Outstanding Hire Purchase Price at the beginning of year = 150:108:69:33.

**Issue of Shares and Debentures**

**6. Answer:**

Journal Entries
In the books of Elite Ltd.

| Date | Particulars | | NRs. Dr. | NRs. Cr. |
|---|---|---|---|---|
| 1.5.2015 | Bank A/c | Dr. | 15,000,000 | |
| | To Debenture Application A/c | | | 15,000,000 |
| | (Application money received on 150,000 debentures @ NRs. 100 each) | | | |
| 1.6.2015 | Debenture Application A/c | Dr. | 15,000,000 | |
| | Underwriters A/c | Dr. | 5,000,000 | |
| | To 15% Debentures A/c | | | 20,000,000 |
| | (Allotment of 150,000 debentures to applicants and 50,000 debentures to underwriters) | | | |
| 1.6.2015 | Underwriting Commission A/c | Dr. | 400,000 | |
| | To Underwriters A/c | | | 400,000 |
| | (Commission payable to underwriters @ 2% on NRs. 20,000,000) | | | |
| 1.6.2015 | Bank A/c | Dr. | 4,600,000 | |
| | To Underwriters A/c | | | 4,600,000 |
| | (Amount received from underwriters in settlement of account) | | | |
| 30.9.2015 | Debenture Interest A/c | Dr. | 1,000,000 | |
| | To Bank A/c | | | 1,000,000 |
| | (Interest paid on debentures for 4 months @ 15% on NRs. 20,000,000) | | | |
| 30.10.2015 | 15% Debentures A/c | Dr. | 12,000,000 | |
| | To Equity Share Capital A/c | | | 2,000,000 |
| | To Securities Premium A/c | | | 10,000,0000 |
| | (Conversion of 60% of debentures into shares of NRs. 60 each with a face value of NRs. 10) | | | |
| 31.3.2016 | Debenture Interest A/c | Dr. | 750,000 | |
| | To Bank A/c | | | 750,000 |
| | (Interest paid on debentures for the half year) | | | |

Working Note:

Calculation of Debenture Interest for the half year ended 31st March, 2016

On NRs. 8,000,000 for 6 months @ 15% = NRs. 600,000

On NRs. 12,000,000 for 1 months @ 15% = NRs. 150,000

NRs. 750,000

**7. Answer:**

Journal Entries
In the books of Everest Co. Ltd.

| | | |
|---|---|---|
| Bank A/c Dr.<br>To Share Application A/c<br>(Being application amount received) | 6,000,000 | 6,000,000 |
| Share Application A/c Dr.<br>To Share Capital A/c | 6,000,000 | 4,000,000 |

| | | |
|---|---|---|
| To Bank A/c<br>To Share Allotment A/c<br>(Being application money transferred to share capital, refunded and excess transferred to allotment ) | | 1,200,000<br>800,000 |
| Share Allotment a/c Dr.<br>To Share Capital A/c<br>To Share Premium A/c<br>(Being allotment amount due) | 10,000,000 | <br>6,000,000<br>4,000,000 |
| Bank A/c Dr.<br>Calls in Arrear A/c Dr.<br>To Share Allotment A/c<br>(Being allotment money received except from Mr. Subash) | 9,016,000<br>184,000 | <br><br>9,200,000 |
| Share First Call A/c Dr.<br>To Share Capital A/c<br>(Being first call amount due) | 6,000,000 | <br>6,000,000 |
| Bank A/c Dr.<br>Calls in Arrear A/c Dr.<br>To Share First Call A/c<br>(Being first call money received except from Mr. Subash and Mr. Dhiraj) | 5,700,000<br>300,000 | <br><br>6,000,000 |
| Share Capital A/c Dr.<br>Share Premium a/c Dr.<br>To Calls in Arrear A/c<br>To Share Forfeiture A/c<br>(Being forfeiture of shares of Mr. Subash) | 320,000<br>80,000 | <br><br>304,000<br>96,000 |
| Share Final Call A/c Dr.<br>To Share Capital A/c<br>(Being final call amount due) | 3,920,000 | <br>3,920,000 |
| Bank A/c Dr.<br>Calls in Arrear A/c Dr.<br>To Share Final Call A/c<br>(Being final call money received except from Mr. Dhiraj) | 3,800,000<br>120,000 | <br><br>3,920,000 |
| Share Capital A/c Dr.<br>To Calls in Arrear A/c<br>To Share Forfeiture A/c<br>(Being forfeiture of shares of Mr. Dhiraj) | 600,000 | <br>300,000<br>300,000 |
| Bank A/c Dr.<br>Share Forfeiture A/c Dr.<br>To Share Capital A/c<br>(Being re-issue of shares @ 90 to Mr. Gopal as fully paid up) | 720,000<br>80,000 | <br><br>800,000 |
| Share Forfeiture a/c Dr.<br>To Capital Reserve A/c<br>(Being forfeiture amount transferred to capital Reserve A/c) | 268,000 | <br>268,000 |

**Working Note:**

1. No. of Shares applied by Mr. Subash = (240,000/200,000) x 4,000 = 4,800
2. Amount paid my Mr. Subash at the time of application = 4,800 x 20 = 96,000
3. Forfeiture amount available for use = full of Mr. Dhiraj (300,000) + half of Mr. Subash (96,000/2)

=348,000

4. Amount Transferred to capital reserve = 348,000 – 80,000 = 266,000

## Underwriting of Shares and Debentures

**8. Answer:**

**(a) Statement showing the underwriters' liability (No. of shares)**

| | A & Co. | B & Co. | C & Co. |
|---|---|---|---|
| Gross Liability | 120,000 | 120,000 | 120,000 |
| Less: Firm underwriting | 10,000 | 10,000 | 10,000 |
| | 110,000 | 110,000 | 110,000 |
| Less: Marked applications | 72,500 | 84,000 | 131,000 |
| | 37,500 | 26,000 | (21,000) |
| Less: Unmarked applications distributed to A & Co. and B & Co. in equal ratio | (11,250) | (11,250) | Nil |
| | 26,250 | 14,750 | (21,000) |
| Less: Surplus of C & Co. distributed to A & Co. and B & Co. in equal ratio | (10,500) | (10,500) | 21,000 |
| Net liability (excluding firm underwriting) | 15,750 | 4,250 | Nil |
| Add: Firm underwriting | 10,000 | 10,000 | 10,000 |
| Total liability (No. of shares) | 25,750 | 14,250 | 10,000 |

**(b) Computation of amounts payable by underwriters**

| | | | |
|---|---|---|---|
| Liability towards shares to be subscribed @ 120 per share | 3,090,000 | 1,710,000 | 1,200,000 |
| Less: Commission (5% on 1.2 lakhs shares @ 100 each) | 600,000 | 600,000 | 600,000 |
| Net amount to be paid by the underwriters | 2,490,000 | 1,110,000 | 600,000 |

**(c) In the Books of Kathmandu Ltd.**

**Journal Entries**

| *Particulars* | *Dr.* *Rs.* | *Cr.* *Rs.* |
|---|---|---|
| Underwriting commission A/c Dr. | 1,800,000 | |
| To A & Co. A/c | | 600,000 |
| To B & Co. A/c | | 600,000 |
| To C & Co. A/c | | 600,000 |
| (Being underwriting commission on the shares underwritten) | | |
| A & Co. A/c Dr. | 3,090,000 | |
| B & Co. A/c Dr. | 1,710,000 | |
| C & Co. A/c Dr. | 1,200,000 | |
| To Equity share capital A/c | | 5,000,000 |
| To Share premium A/c | | 1,000,000 |
| (Being shares including firm underwritten shares allotted to underwriters) | | |
| Bank A/c Dr. | 4,200,000 | |
| To A & Co. A/c | | 2,490,000 |
| To B & Co. A/c | | 1,110,000 |
| To C & Co. A/c | | 600,000 |

(Being the amount received towards shares allotted to underwriters less underwriting commission due to them)

**Incomplete Records**

**9. Answer:**

**Projected Balance Sheet as on 31st Ashadh, 2071**

| Liabilities | | Rs. | Assets | | Rs. |
|---|---|---|---|---|---|
| Capital | | 1,000,000 | Fixed Assets | 400,000 | |
| Profit & Loss Account as on | | | Additions | 100,000 | |
| 1st Shrawan, 2070 | 60,000 | | | 500,000 | |
| Add: Profit for the year | 374,000 | 434,000 | Less: Depreciation | (50,000) | 450,000 |
| Creditors (Trade) | | 110,000 | Stock in trade | | 336,000 |
| | | | Sundry Debtors | | 200,000 |
| | | | Cash & Bank Balances | | 558,000 |
| | | 1,544,000 | | | 1,544,000 |

**Working Notes:**

**Projected Trading and Profit and Loss Account for the year ended 31st Ashadh, 2071**

| | Rs. | | Rs. |
|---|---|---|---|
| To Opening Stock | 300,000 | By Sales | 2,120,000 |
| To Purchases | 1,520,000 | By Closing Stock (balancing figure) | 336,000 |
| To Gross Profit (30% on sales) | 636,000 | | |
| | 2,456,000 | | 2,456,000 |
| To Sundry Expenses (10% on sales) | 212,000 | By Gross Profit b/d | 636,000 |
| To Depreciation | 50,000 | | |
| To Net Profit | 374,000 | | |
| | 636,000 | | 636,000 |

**Cash and Bank Account for the period 1st Shrawan, 2070 to 31st Ashadh, 2071**

| | Rs. | | Rs. |
|---|---|---|---|
| To Balance b/d | 350,000 | By Sundry Creditors | 1,550,000 |
| To Sundry Debtors | 2,070,000 | (Rs. 140,000 + Rs. 1,410,000) | |
| (Rs. 150,000 + Rs. 1,920,000) | | By Expenses | 212,000 |
| | | By Fixed Assets | 100,000 |
| | | By Balance c/d | 558,000 |
| | 2,420,000 | | 2,420,000 |

***Note:*** It is assumed that the entire sales and purchases are on credit basis.

**Ratio Analysis**

**10. Answer:**

**Balance Sheet of Nyatapola Enterprises**

| Liabilities | Rs. | Assets | Rs. |
|---|---|---|---|
| Capital | 500,000 | Fixed Assets | 200,000 |

| | | | |
|---|---|---|---|
| Creditors | 186,000 | Stock | 90,000 |
| | | Debtors | 83,333 |
| | | Bank Balance (balancing figure) | 312,667 |
| | 686,000 | | 686,000 |

**Working Note**

(i) Gross profit= Rs. 100,000

Gross profit margin= 10%

Hence, Sales= Rs. 100,000 x 100/10= Rs. 1,000,000

Cost of goods sold = Sales – Gross profit

= Rs.( 1000,000-100,000)

= Rs. 900,000

Purchase = Cost of goods sold + Increase in stock

= Rs. ( 900,000+30,000) = Rs. 930,000

Average stock= Cost of goods sold/stock velocity

= Rs. 900,000/12=75000

(ii) Capital:

Capital turnover ratio = 2

Sales/Capital=2

Hence, Capital= Rs. 1,000,000/2 = Rs. 500,000

(iii)Creditors:

Creditors payment period = 73 days

Hence, Creditors= Purchases x 73/365 =Rs. 930,000 x 1/5 = Rs. 186,000

(iv)Fixed assets:

Fixed assets turnover ratio = 5

Hence, Fixed Assets = Sales/5= Rs. 1,000,000/5= Rs. 200,000

(v) Closing stock:

Closing stock is Rs. 30,000 more than opening stock; it is Rs. 15000 more than average stock.

Hence, closing stock= Average stock + Rs. 15000

= Rs. 75,000+Rs.15,000= Rs. 90,000

(vi)Debtors:

Debt collection period = 1 month

Hence, debtors= Sales x 1/12 = Rs. 1,000,000 x 1/12 = Rs. 83,333.33

It is assumed that there is no change in capital during the period.

**Business Combination**

**11. Answer:**

**Books of Blue Star Limited**

### Realization Account

| | | Rs. | | | Rs. |
|---|---|---|---|---|---|
| To | Building | 3,40,000 | By | Creditors | 3,20,000 |
| To | Machinery | 6,40,000 | By | B Ltd. | 12,10,000 |
| To | Stock | 2,20,000 | By | Equity Shareholders A/c (Loss) | 60,000 |
| To | Debtors | 2,60,000 | | | |
| To | Goodwill | 1,30,000 | | | |
| | | 1,590,000 | | | 1,590,000 |

Bank Account

| | | | | | |
|---|---|---|---|---|---|
| To | Balance b/d | 136,000 | By | 10% debentures | 400,000 |
| To | Big Star Ltd. | 600,000 | By | Loan from A | 160,000 |
| | | | By | Equity shareholders A/c | 176,000 |
| | | 736,000 | | | 736,000 |

Big Star Ltd. Account

| | | | | | |
|---|---|---|---|---|---|
| To | Realisation A/c | 1,210,000 | By | Bank A/c | 600,000 |
| | | | By | Equity Share holders A/c (4,880 shares at Rs.125 each in Big Star Ltd.) | 610,000 |
| | | 1,210,000 | | | 1,210,000 |

Equity Share Holders Account

| | | | | | |
|---|---|---|---|---|---|
| To | Realisation A/c | 60,000 | By | Equity Share Capital | 800,000 |
| To | Deferred Revenue Exp. | 34,000 | By | General Reserve | 80,000 |
| To | Equity shares in Big Star Ltd. | 610,000 | | | |
| To | Bank A/c | 176,000 | | | |
| | | 880,000 | | | 880,000 |

**Big Star Ltd.**
**Balance Sheet as on 1st Shrawan, 2072 (An extract)**

| *Liabilities* | *Rs.* | *Assets* | *Rs.* |
|---|---|---|---|
| 4880 Equity shares of Rs.100 each | 488,000 | Goodwill | 232,000 |
| (Shares have been issued for consideration other than cash) | | Building | 306,000 |
| Securities Premium | 122,000 | Machine | 576,000 |
| Profit and Loss A/c …. Less: unrealized profit 15,000 | ….. | | |
| Creditors (320,000 - 40,000) | 280,000 | Stock (198,000 -15,000) | 183,000 |
| Bank Overdraft | 616,000 | Debtors (260,000 – 40,000) 220,000 | |
| | | Less: Provision for bad debts 26,000 | 194,000 |

**Working Notes:**

**1. Valuation of Goodwill**

| | *Rs.* |
|---|---|
| Average profit | 124,400 |
| Less: 8% of Rs. 880,000 | 70,400 |

| | |
|---|---|
| Super profit | 54,000 |
| Value of Goodwill = 54,000 x 4 | 216,000 |

**2. Net Assets for purchase consideration**

| | | |
|---|---|---|
| Goodwill as valued in W.N.1 | | 216,000 |
| Building | | 306,000 |
| Machinery | | 576,000 |
| Stock | | 198,000 |
| Debtors | | 260,000 |
| Total Assets | | 1,556,000 |
| Less: Creditors | 320,000 | |
| Provision for bad debts | 26,000 | 346,000 |
| Net Assets | | 1,210,000 |

Out of this Rs. 600,000 is to be paid in cash and remaining i.e., (1,210,000–600,000) Rs. 610,000 in shares of Rs. 125/-. Thus, the number of shares to be allotted 610,000/125 = 4,880 shares.

| **3. Unrealized Profit on Stock** | Rs. |
|---|---|
| The stock of Blue Star Ltd. includes goods worth Rs. 100,000 which was sold by Big Star Ltd. on profit. Unrealized profit on this stock will be $\frac{40,000}{1,60,000} \times 1,00,000$ | 25,000 |
| As Big Star Ltd. purchased assets of Blue Star Ltd. at a price 10% less than the book value, 10% need to be adjusted from the stock i.e., 10% of Rs.100,000. | (10,000) |
| Amount of unrealized profit | 15,000 |

4. Liquidation expenses borne by the Big Star Ltd. so that should be debited to Goodwill Account.

**Internal Reconstruction**

**12. Answer:**

**Journal Entries**
**in the books of Pokhara Light Ltd.**

| | | | *Rs.* | *Rs.* |
|---|---|---|---|---|
| (i) | Equity Share Capital (Rs.100) A/c | Dr. | 1,00,00,000 | |
| | To Equity Share Capital (Rs.40) A/c | | | 40,00,000 |
| | To Reconstruction A/c | | | 60,00,000 |
| | (Being conversion of equity share capital of Rs.100 each into Rs.40 each as per reconstruction scheme) | | | |
| (ii) | 12% Cumulative Preference Share capital (Rs.100) A/c | Dr. | 50,00,000 | |
| | To 12% Cumulative Preference Share Capital (Rs.60) A/c | | | 30,00,000 |
| | To Reconstruction A/c | | | 20,00,000 |
| | (Being conversion of 12% cumulative preference share capital of Rs.100 each into Rs.60 each as per reconstruction scheme) | | | |
| (iii) | 10% Debentures A/c | Dr. | 40,00,000 | |

| | Particulars | | Dr. Rs. | Cr. Rs. |
|---|---|---|---|---|
| | To 12% Debentures A/c | | | 28,00,000 |
| | To Reconstruction A/c | | | 12,00,000 |
| | (Being 12% debentures issued to 10% debenture-holders for 70% of their claims. The balance transferred to capital reduction account as per reconstruction scheme) | | | |
| (iv) | Sundry Creditors A/c | Dr. | 20,00,000 | |
| | To Equity Share Capital A/c | | | 12,00,000 |
| | To Reconstruction A/c | | | 8,00,000 |
| | (Being a creditor of Rs.20,00,000 agreed to surrender his claim by 40% and was allotted 30,000 equity shares of Rs.40 each in full settlement of his dues as per reconstruction scheme) | | | |
| (v) | Provision for Taxation A/c | Dr. | 1,00,000 | |
| | Reconstruction A/c | Dr. | 50,000 | |
| | To Current Assets (Bank A/c) | | | 1,50,000 |
| | (Being conversion of the provision for taxation into liability for taxation for settlement of the amount due) | | | |
| (vi) | Reconstruction A/c | Dr. | 99,50,000 | |
| | To P & L A/c | | | 4,00,000 |
| | To Preliminary Expenses A/c | | | 2,00,000 |
| | To Fixed Assets A/c | | | 37,50,000 |
| | To Current Assets A/c | | | 55,00,000 |
| | To Investments A/c | | | 50,000 |
| | To Capital Reserve A/c | | | 50,000 |
| | (Being amount of Reconstruction utilized in writing off P & L A/c (Dr.) Balance, Preliminary Expenses, Fixed Assets, Current Assets, Investments and the Balance transferred to Capital Reserve) | | | |

**Balance Sheet of Pokhara Light Ltd. (and reduced)**

**as on 31.3.2071**

| *Liabilities* | *Rs.* | *Assets* | *Rs.* |
|---|---|---|---|
| Issued, subscribed and paid up capital: 1,30,000 equity shares of Rs.40 each | 52,00,000 | Fixed Assets (1,25,00,000 – 37,50,000) | 87,50,000 |
| 12% Cumulative Preference Shares of Rs. 60 each | 30,00,000 | Investments (10,00,000 – 50,000) | 9,50,000 |
| Reserves & Surplus: Capital Reserve | 50,000 | Current Assets (45,00,000 – 1,50,000) | 43,50,000 |
| Secured Loan: 12% Debentures | 28,00,000 | | |
| Current Liabilities and Provisions: Sundry Creditors: (50,00,000 – 20,00,000) | 30,00,000 | | |
| | 1,40,50,000 | | 1,40,50,000 |

**Working Note:**

**Reconstruction Account**

*Rs.* *Rs.*

| | | | |
|---|---|---|---|
| To Liability for taxation A/c | 50,000 | By Equity share capital | 60,00,000 |
| To P & L A/c | 4,00,000 | By 12% Cum. preference share | 20,00,000 |
| To Preliminary expenses | 2,00,000 | By 10% Debentures | 12,00,000 |
| To Fixed assets | 37,50,000 | By Sundry creditors | 8,00,000 |
| To Current assets | 55,00,000 | | |
| To Investment | 50,000 | | |
| To Capital Reserve (balancing figure) | 50,000 | | |
| | 1,00,00,000 | | 1,00,00,000 |

**Profit or Loss Pre and Post Incorporation**

**13. Answer:**

**Statement showing calculation of profits for pre and post incorporation periods**
**For the year ended 31.3.2072 (15 months)**

| Gross profit | Total | Ratio | Pre | Post |
|---|---|---|---|---|
| Gross Profit | 140,40,000 | 1:8 | 1560,000 | 124,80,000 |
| Less: Salaries | 2340,000 | 1:12 | 180,000 | 2160,000 |
| Depreciation | 360,000 | 1:4 | 72,000 | 288,000 |
| Advertisement | 1404,000 | 1:8 | 156,000 | 1248,000 |
| Discount | 2340,000 | 1:8 | 260,000 | 2080,000 |
| Managing Director's Salary | 180,000 | Post | - | 180,000 |
| Office/showroom rent | 1440,000 | Actual | 180,000 | 1260,000 |
| Miscellaneous office expenses | 240,000 | 1:4 | 48,000 | 192,000 |
| Interest paid | 1902,000 | Actual | 702,000 | 1200,000 |
| **Goodwill (loss)** | | | **38,000** | **-** |
| **Net Profit** | | | **-** | **3,872,000** |

Working note:

| | Pre | post |
|---|---|---|
| 1. calculation of time ratio = 1:4 | 1st Baisakh to 31.3.2071<br>3 months | 1.4.2071 to 31.3.2072<br>12 months |
| 2. Calculation of sales ratio = 1:8 | 3x1 = 3 | 12 x 2 = 24 |
| 3. Calculation of staff salary ratio = 1:12 | 3x1 = 3 | 12 x 3 = 36 |
| 4. calculation of interest | 234,00,000 x 12% for 3 months<br>Rs. 702,000 | 100,00,000 x 12% for 1 year<br>Rs. 1200,000 |
| 5. Calculation of Rent<br>(i) additional rent<br>(ii) regular rent = (1440,000-540000) = 900,000 | 900,0000X3/15 = 180,000 | 60,000x9 = 540,000<br>900,0000X12/15 = 720,000 |

6. Calculation of gross profit = sales – cost of goods sold = 468,00,000-327,60,000 = 140,40,000

**Liquidator's Final Statement**

**14. Answer:**

**Liquidator's Final Statement**

| Receipts | Rs. | Rs. | Payments | Rs. | Rs. |
|---|---|---|---|---|---|

| | | | | | |
|---|---|---|---|---|---|
| Cash at Bank | | 60,000 | Liquidation expenses | | 4,600 |
| Assets realised: | | | | | |
| Sundry Debtors | 160,000 | | Liquidator's remuneration (W.N. 1) | | 30,400 |
| Stock | 120,000 | | Debenture holders: | | |
| Plant & Machinery | 360,000 | 640,000 | 10% debentures | 200,000 | |
| Surplus from Land & | | | Interest accrued (W.N.2) | 15,000 | 215,000 |
| Buildings: | | | Preferential creditors | | 30.000 |
| Amount realised | 340,000 | | Unsecured creditors | | 370,000 |
| Less: Secured | | | Preference shareholders: | | |
| Creditors | 100,000 | 240,000 | 10% Preference Share | | |
| | | | Capital | 200,000 | |
| | | | Arrear dividend | 40,000 | 240,000 |
| | | | Equity Shareholders (W.N. 3) : | | |
| | | | Rs. 17.50 per share on 2,000 shares | 35,000 | |
| | | | Rs. 2.50 per share on 6,000 shares | 15,000 | 50,000 |
| | | 940,000 | | | 940,000 |

**Working Notes:**

(1) **Liquidator's remuneration:**

| | *Rs.* |
|---|---|
| 3% on Assets realised (3% of Rs. 980,000) | 29,400 |
| 2% of the amounts distributed among Equity Shareholders (2/102 × Rs. 51,000) | 1,000 |
| | 30,400 |

(2) **Interest accrued on 10% debentures**

| | |
|---|---|
| Interest accrued as on 31.3.2071 | 10,000 |
| Interest accrued upto the date of payment (upto 31st Ashwin, 2071) | 5,000 |
| | 15,000 |

(3) **Amount payable to Equity Shareholders**

| | |
|---|---|
| Equity Share Capital | 510,000 |
| *Less:* Surplus available for Equity Shareholders | 50,000 |
| Loss to be borne by them | 460,000 |
| Loss per Equity share (Rs. 460,000/8,000) | 57.50 |
| Amount payable to Equity shareholders: | |
| Each Equity share of Rs. 75 paid up | 17.50 |
| Each Equity share of Rs. 60 paid up | 2.50 |

**Accounting for Partnership**

**15. Answer:**

Computation of entitlement of legal representatives of C

(1) Profits for the half year ended 31st Ashadh, 2071

| | Rs. |
|---|---|
| Profits for the year ended 31st Ashadh, 2071 (after depreciation) | 48,000 |
| Add: Depreciation | 10,000 |

| | |
|---|---|
| Profits before depreciation | 58,000 |
| Profits for the first half (assumed: evenly spread) | 29,000 |
| Less: Depreciation for the first half | 6,000 |
| Profits for the first half year (after depreciation) | 23,000 |

| | |
|---|---|
| Profits for the second half (i.e., 1st Magh, 2070 to 31st Ashadh, 2071) | 29,000 |
| Less: Depreciation for the second half | 4,000 |
| Profits for the second half year (after depreciation) | 25,000 |

(2) Capital Accounts of Partners as on 30th Poush, 2070

| Dr. | A Rs. | B Rs. | C Rs. | | A Rs. | B Rs. | C Rs. Cr. |
|---|---|---|---|---|---|---|---|
| To Fixed Assets (loss on revaluation) | 6,000 | 8,000 | 6,000 | By Balance b/d | 48,000 | 64,000 | 48,000 |
| | | | | By Reserve | 6,000 | 8,000 | 6,000 |
| | | | | By Goodwill | 18,000 | 24,000 | 18,000 |
| To Drawings | 9,000 | 12,000 | 20,000 | By Interest (Rs. 48,000 @ 25% for 6 months) | — | — | 6,000 |
| To C Executor's A/c | | | 52,000 | | | | |
| To Balance c/d | 57,000 | 76,000 | – | | | | |
| | 72,000 | 96,000 | 78,000 | | 72,000 | 96,000 | 78,000 |

(3) Calculation of Proportionate profit to Legal Representative of C

Profit for the second half = 25,000

Proportionate profit to C's legal representative = 25,000 x 52,000/(57,000+76,000+52,000)
= 7,027

| (4) Amount due to legal representative of C | | Rs. |
|---|---|---|
| Balance in C's Executor's account | 52,000 | |
| Amount of profit earned out of unsettled capital [calculated in (3)] | 7,027 | |
| Total Amount due | | 59,027 |

**Accounting for Non-profit making organization**

**16. Answer:**
**Solution**

| | | Dr. | Cr. |
|---|---|---|---|
| a. | Bank A/c Dr. | 560,000 | |
| | To Building Fund A/c | | 560,000 |
| | (on collection of donations) | | |
| b. | Bank A/c Dr. | 902,600 | |
| | To Building Fund A/c | | 902,000 |
| | (40% of the development fees directly) | | |
| c. | Fixed Deposit a/c Dr. | 48,000 | |
| | To Interest A/c | | 48,000 |
| | (on accrual of interest) | | |
| d. | Interest A/c Dr. | 48,000 | |
| | To Building Fund A/c | | 48,000 |
| | (Interest accrued on fixed deposit transferred) | | |

e. Capital work in progress a/c Dr. 725,000
To Contractor's a/c 725,000
(Work completed and certified during the year)

f. Contractors' a/c Dr. 1,343,750
To Bank A/c 1,343,750
(Payments made during the year)

g. Building a/c Dr. 1,550,000
To Capital Work in progress A/c 1,550,000
(transfer to completed building to asset a/c)

h. Building Fund a/c 1,550,000
To General Fund A/c 1,550,000
(corresponding building fund transferred)

Trial Balance of Building Fund as on 31st Ashadh 2072

| | Dr. | Cr. |
|---|---|---|
| Building Fund | | 1,002,600 |
| Contractor's A/c | | 206,250 |
| Fixed Deposit A/c | 648,000 | |
| Current a/c | 560,850 | |
| Total | 1,208,850 | 1,208,850 |

**Accounting for Banks**

**17. Answer:**

**Calculation of Loan Loss Provisioning**

| **Category** | **Loan Amount 31st Ashad 2072** | **Provision as on 31st Ashad 2072** | **Additional Loans** | **Shifting** | **Amount 31st Ashad 2073** | **Rate of Provision** | **Total Provision** |
|---|---|---|---|---|---|---|---|
| 1. Pass | 5,000,000 | 50,000 | 3,000,000 | (500,000) | 7,500,000 | 1% | 75,000 |
| 2. Rescheduled /Restructured | 210,000 | 26,250 | | 200,000 | 410,000 | 12.5% | 51,250 |
| 3. Substandard | 500,000 | 125,000 | | 300,000 | 800,000 | 25% | 200,000 |
| 4. Doubtful | 300,000 | 150,000 | | (150,000) | 150,000 | 50% | 75,000 |
| 5. Bad | 500,000 | 500,000 | | (50,000) | 450,000 | 100% | 450,000 |
| **Total** | **6,510,000** | **851,250** | | | **9,310,000** | | **851,250** |
| **Total NPA** | | | | | 1,400,000 | | |
| **NPA %** | | | | | 15.04% | | |

**Journal Entries**

**In the books of SSS Bank Limited**

| | | |
|---|---|---|
| Loans and Advances Dr.<br>To Cash A/c<br>(Being Loans given during the year. Assumed that all the loans | 30,00,000 | 30,00,000 |

| | | |
|---|---|---|
| are taken in cash) | | |
| Profit and Loss A/c<br>Dr.<br>Restructured Loans<br>Dr.<br>Substandard Loans Dr.<br>To Pass Loans<br>To Doubtful Loans<br>To Bad Loans<br>(Being changes of in various categories of loans and advances during the year.) | <br>2,00,000<br>2,00,000<br>3,00,000 | <br><br><br><br>5,00,000<br>1,50,000<br>50,000 |
| Profit and Loss A/c Dr.<br>To LLP Pass Loans<br>To LLP Restructured Loans<br>To LLP Substandard<br>(Being changes of in various categories of loans loss provisioning during the year.) | <br>1,25,000 | <br><br>25,000<br>25,000<br>75,000 |
| LLP Doubtful Loans Dr.<br>LLP Bad Loans Dr.<br>To Profit and Loss A/c<br>(Being changes of in various categories of loans and advances during the year.) | <br>75,000<br>50,000 | <br><br><br>1,25,000 |

**Note:**

Though no additional entry is required for the amount of LLP as the amount of LLP last year and this year is same but individual category wise LLP has changed thus requiring the above journal entries.

**18. Answer:**

a. Calculation of Total Risk Weighted Assets = 213,546 + 4,235 + 1,618 = 219,399

b. Calculation of Core Capital

| Particular | Amount |
|---|---|
| Paid up Capital | 20,000 |
| General Reserve Fund | 377 |
| Retained Earnings | 308 |
| Profit for current year | 1,945 |
| Less: Loan Given to Relatives of Staffs | (37) |
| Total core capital | 22,593 |

c. Supplementary Capital

| Particular | Amount |
|---|---|
| General Loan Loss Provision | 1,215 |
| Investment Adjustment Reserve | 22 |
| Total Supplementary Capital | 1,237 |

d. Core Capital Ratio = 22,593 X 100/ 219,399 = 10.29%

e. Total Capital Adequacy Ratio = (22,593 + 1,237) X 100/ 219,399 = 10.86%

f. Compliance with NRB Directives

| Particular | NRB Requirement | Actual |
|---|---|---|
| Core Capital Ratio | 6% | 10.29% |
| Total Capital Adequacy Ratio | 10% | 10.86% |

**Cash Flow Statement**

**19. Answer:**

Cash Flow Statement

| Particular | Amount | Amount |
|---|---|---|
| Cash Flow from Operating Activities | | |
| Net Profit before Taxation (given) | | 229,500 |
| Adjustment for Depreciation (WN 2) | 83,700 | |
| Debenture Interest (150,000x8%x6/12) | 6,000 | |
| Provision for Doubtful Debts | 9,900 | |
| Profit/gain on sale of plant (WN 1) | (7,500) | 92,100 |
| Operating profit before working capital changes | | 321,600 |
| Increase in Inventory | (115,500) | |
| Increase in Trade Receivables | (150,000) | |
| Increase in Trade Payables | 35,400 | (230,100) |
| Net cash flow from Operating Activities (A) | | 91,500 |
| Cash Flow from Investing Activities | | |
| Purchase of Plant & Machinery (WN 3) | (234,000) | |
| Purchase of Trade Investments | (141,000) | |
| Sale of machinery | 21,000 | |
| Net cash flow from Investing Activities (B) | | (354,000) |
| Cash Flow from Financing Activities | | |
| Proceeds from issue of 8% Debentures (net) | 147,000 | |
| Interest paid on 8% Debentures | (6,000) | |
| Dividends paid in respect of earlier years | (90,000) | |
| Net Cash flow from Financing Activities (C) | | 51,000 |
| Net Increase/(Decrease) in Cash and Cash Equivalents (A+B+C) | | (211,500) |

Working Notes:

1. Profit on sale of Plant = WDV at disposal – sale value
   = (54,000-40,500) – 21,000
   = 7,500

2. Depreciation for current year = 43,200 + 40,500 = 83,700

3. Cash flow towards assets purchase = Increase in Plant & machinery at cost + cost of plant sold
   = 180,000 + 54,000 = 234,000

**Nepal Accounting Standards**

**20. Answers:**

(a) As per Nepal Accounting Standard (NAS) – 2 'Inventories', cost of inventories comprises all costs of purchase, cost of conversion and other costs incurred in bringing the inventories to their present location and condition. However, it makes clear that interest and other borrowing costs are usually not included in the cost of inventories because generally such costs are not related in bringing the inventories to their present location and condition. Therefore, the proposal of Curex Pvt. Ltd. to include interest on bank overdraft as an element of cost is not acceptable because it does not form part of cost of production.

(b). The borrowing costs incurred by an entity to finance prepayments on a qualifying asset are capitalised on the same basis as the borrowing costs incurred on assets constructed by the entity.

The capitalisation starts when all three conditions are met: expenditures are incurred, borrowing costs are incurred, and the activities necessary to prepare the asset for its intended use or sale are in progress.

Expenditures on the asset are incurred when the prepayments are made (payments of the instalments). Borrowing costs are incurred when borrowing is obtained. The last condition – the activities necessary to prepare the asset for its intended use or sale are in progress – can vary depending on facts and circumstances. When the construction process by the third party does not start at the prepayment date, management assesses whether it is appropriate to start capitalisation from this date or whether it should be deferred to a later date.

(c). As per NAS 37 'Provisions, contingent liabilities and contingent assets' a provision should be recognised when;

(a) an enterprise has a present obligation as a result of a past event.

(b) it is probable that an outfolow of resources embodying economic benefits will be required to settle the obligation; and

(c) a reliable estimate can be made of the amount of the obligation. If these conditions are not met, no provision should be recognised.

In the given situation the directors of the company are of the opinion that the claim can be successfully resisted by the company, therefore there will be no out flow of the resources. The company will disclose the same as contingent liability by way of the following notes:

'Ligation is in process against the company relating to a dispute with a competitor who alleges that the company has infringed patents and is seeking damages of Rs. 20 millions. However, the directors are of the opinion that the claim can be successfully resisted by the company.'

(d). Nepal Accounting Standard (NAS) 10 'Events after the reporting period', states that adjustments to assets and liabilities are not appropriate for events occurring after the balance sheet date, if such events do not relate to conditions existing at the balance sheet date. The destruction of warehouse due to earthquake did not exist on the balance sheet date i.e. 31.3.2072. Therefore, loss occurred due to earthquake is not to be recognized in the financial year 2071-72.

However, unusual changes affecting the existence or substratum of the enterprise after the balance sheet date may indicate a need to consider the use of fundamental accounting assumption of going concern in the preparation of the financial statements. As per the information given in the question, the earthquake has caused major destruction; therefore fundamental accounting assumption of going concern is called upon.

Hence, the fact of earthquake together with an estimated loss of Rs. 25 lakhs should be disclosed in the report of the directors for the financial year 2071-72.

(e). '*Other Comprehensive Income'*s per NAS

Other comprehensive income comprises items of income and expenses (including reclassification adjustments) that are not recognized in profit and loss as required or permitted by other NFRSs.

The components of other comprehensive income include;

1. changes in revaluation surplus
2. re-measurements of defined benefit plans
3. gains and losses arising from translating the financial statements of a foreign operation

4. gains and losses from investments in equity instruments measured at fair value through other comprehensive income in accordance NFRS related with financial instruments
5. the effective portion of gains and losses on hedging instruments in a cash flow hedge
6. for particular liabilities designed as at fair value through profit or loss, the amount of the change in the fair value that is attributable to changes in the liability's credit risk.

f. The investments other than investment in properties are not qualifying assets as per NAS-23 Borrowing Costs. Therefore, interest cost of holding such investments cannot be capitalized. Further, even interest in respect of investment properties can only be capitalized if such properties meet the definition of qualifying asset, namely, that it necessarily takes a substantial period of time to get ready for its intended use or sale. Also, where the investment properties meet the definition of 'qualifying asset', for the capitalization of borrowing costs, the other requirements of the standard such as that borrowing costs should be directly attributable to the acquisition or construction of the investment property and suspension of capitalization as per NAS-23 have to be complied with.



**Write Short Notes**

**21. Answers:**

**(a). Watch list in Loan loss provisioning**

Nepal Rastra Bank has formulated a new category of loan for provisioning purposes. As per the Central Bank's Rule, all loans are required to be classified into 5 different categories including Watch List whereby 5% of the total loan is required to be kept as provisioning though the provision can be reversed when the loan becomes performing later. Provision made for watch list loans is a general loan loss provision. As per the circular issued by Central Bank, the loans having the following characteristics are to be classified as Watch List loans:

1. If interest and principal repayments are outstanding for more than a month.
2. Short term/Working Capital Loans that are not renewed on time and are renewed on temporary basis.
3. Loans and advances to customers/ group of customers who have been categorized as non performing by other banks and financial institutions.
4. Firms/Companies/Organizations having negative net worth or net loss though interest and principal are served on regular basis.

**(b). Super profits in partnership firms**

Among various basis of determining the sharing and paying for joining or sacrificing the profits of a firm one basis is super profit method. Under this method, it is assumed that any partner can get normal profits by joining any average firm in the market. However, focus should be given on super profits of the firm. Such super profit implies that the profit can be earned by a firm over and above all ordinary firms in the industry/market. This is the excess amount of profit earned by a firm over the past years and expected to continue the same in the future.

If and only if the average profit of the firm is more than the normal profit in the market there comes into existence the super profit or goodwill.

**(c). Components of Financial Statements**

A complete set of financial statement includes the following components:

1. A statement showing financial position as at the end of the period;
2. A statement of profit or loss and other comprehensive income for the period;
3. A statement of changes in equity for the period;
4. A statement of cash flows for the period;
5. Notes comprising a summary of significant accounting policies and other explanatory information; and
6. A statement of financial position as at the beginning of the earliest comparative period when an entity applies an accounting policy retrospectively or makes a retrospective restatement of items in its financial statements, or when it reclassifies items in its financial statements.

**(d). Government Accounting System in Nepal**

Government Accounting System in Nepal is generally on Cash Basis. It has set chart of accounts under which revenue and expenditure are accounted for. It follows double entry system; however, do not follow the mercantile system of accounting. Government accounting system broadly classifies expenditure into administrative and development expenses. Accounting system followed by the government differentiates Capital expenditures and revenue expenditure in its subsidiary records. Office of the Financial Comptroller General specifies the chart of accounts under which all the government revenue and expenditure are to be accounted for.

**(e). Prediction of insolvency on the basis of ratios**

The relevance of the ratios in predicting insolvency can be elaborated with the help of the following illustrative ratios as below:
Working capital to total assets indicates the liquidity position of the firm. If the ratio is too low it indicates inability of the firm to carry on its day to day activities. If it is negative, the firm will not have fund for its day to operations. If such situation continues, the firm may be forced to suspend its operations and it may result insolvency in the long run.
Similarly, ratio of sales to total assets indicates the utilization of its assets to generate sales which ultimately generates surplus for the firm. If it is too low, it indicates that the firm is keeping idle assets which in long run may result to insolvency.
Another example can be given of retained earnings to total assets. Retained earnings are cushion for firm's health. So if it is too thin it may indicate that firm has very low leverage and is posed to insolvency earlier.

**(f). Advantages of customized Accounting packages**

Following are the advantages of the customized accounting packages:

- The input screens can be tailor made to match the input documents for ease of data entry.
- The reports can be prepared as per the specification of the organization. Many additional MIS reports can be included in the list of reports.
- Bar-code scanners can be used as input devices suitable for the specific needs of and individual organization.
- The system can suitably match with the organizational structure of the company.

# AUDIT AND ASSRANCE

## QUESTIONS

1. ***Knowledge on regulatory compliance, Nepal Standards on Auditing and Ethical aspects***

a. ***Which of the following best describes the reason why an independent auditor reports on financial statements?***

A A management fraud may exist and is more likely to be detected by auditors.

B Different interests may exist between the company preparing the statements and the persons using the statements.

C A misstatement of account balances may exist and is generally corrected as the result of the auditor's work.

D Poorly designed internal control may exist.

**Answer B is correct.** A, C and D are incorrect because they can also be dealt with by internal auditors

b. ***Independent auditing can best be described as :***

A A branch of accounting.

B A discipline that attests to the results of accounting and other functional operations and data.

C A professional activity that measures and communicates financial and business data.

D A regulatory function that prevents the issuance of improper financial information.

**Answer C is correct.** Information used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Audit evidence includes both information contained in the accounting records underlying the financial statements and other information.

c. ***Which of the following is correct in relation to materiality?***

A A matter is material only if it changes the audit report

B A matter is material if the auditor and the directors both decide that further work needs to be done in the area under question

C A matter is material only if it affects directors' emoluments

D A matter is material if its omission or misstatement would reasonably influence the decisions of an addressee of the auditors' report

**Answer D is correct.**

***d. A walk-through test is designed to do what?***

A To check that materiality levels are acceptable

B As a checklist to see if all substantive tests have been performed

C To provide assurance within a letter of representation

D To confirm that the auditor understands of the internal control system is correct

**Answer D is correct.**

***e. Which of the following is true about written representations?***

A They are the best source of audit evidence

B They should be used only when there is a lack of other substantive audit evidence

C They should be used only when there is other substantive audit evidence to complement it

D Shareholders receive a copy of all material written representations

**Answer B is correct.**

***f. KP is Chartered Accountant Member of the Institute of Chartered Accountants of Nepal. He could not pay off the loan taken from one of the Commercial Bank. The Bank blacklisted and published the name in national daily newspaper. The Bank wrote a letter to ICAN for action.***

***Ans:*** As per section 22 of Nepal Chartered Accountants Act, 1997 on provision of removal of names and re-instatement, the Council may issue an order to remove the name of any member from the Membership Register on any of the following circumstances:

- If he is convicted by a court in a criminal offense involving moral turpitude and punished there for,
- If he fails to pay any fees required to be paid to the Institute,
- If he fails to abide by the professional conduct referred to in this Act and the Rules framed under this Act,
- If he becomes unsound-minded, or
- If he is dead.

Based on the above provision, mere on the ground of loan defaulter, ICAN cannot initiate action.

g. ***Total trade receivable of a company is Rs. 20 crores. It includes receivables from Maheswary Limited amounting to Rs 2 Crores. Maheswary Limited was declared bankrupt on 15th Asoj 2071; i.e. after the reporting period of Ashad end 2071 and before the date when financial statements were authorized for issue; i.e. Asoj Masant 2071. The company management claims that the carrying amount of trade receivable does not need to be adjusted because the information about bankruptcy was known after the reporting period.***

Ans: Events after the reporting period are those events, favorable and unfavorable, that occur between the end of the reporting period and the date when the financial statements are authorized for issue. Two types of events can be identified:

i) those that provide evidence of conditions that existed at the end of the reporting period (adjusting events after the reporting period); and

ii) those that are indicative of conditions that arose after the reporting period (non-adjusting events after the reporting period)

So, the event in the given case (knowing information about bankruptcy of the debtor after balance sheet date) seems to be an adjusting event because the debtor was bankrupt on the balance sheet date which was declared by the court later on. Hence the carrying amount of the trade receivable should be presented at Rs. 18 crores instead of Rs. 20 crores in the balance sheet.

h. ***Mr. Shyam, a practicing Chartered Accountant, prepared a feasibility report for one of his client to obtain a long term loan of Rs. 5 crore from a commercial bank and decided to charge fees @ 5% of the loan approved. Subsequently, the bank approved the loan. Consequent to the approval of loan by the bank, Mr. Shyam raised an invoice for his services @ 5% of the loan approved as decided.***

Ans: As per section 34 (10) of chapter VIII of Nepal Chartered Accountant Act 1997 and section 240 of Part B of code of Ethics for professional Accountant in practice, a Chartered Accountant in practice is deemed to be guilty of professional misconduct if he charges or offers to charge or accepts or offers to accept in respect of any professional employment fees which are based on a percentage of profit or on any other uncertain events.

In the given case, Mr. Shyam has prepared a feasibility report for one of his client, to obtain a long term loan. However he decided to raise an invoice for his services @ 5% of the loan to be sanctioned in the future, which is basically contingent upon the findings. Therefore, Mr. Shyam will be held for professional misconduct under the above mentioned clause.

***i. X Ltd. sold the apartment to M Ltd. for Rs. 60 lakhs on 30.09.2014 and gave possession of the property to M Ltd. However, Malpot documentation and legal formalities are pending. Due to this, the company has not recorded the sale and has shown the amount received as an advance. The book value of the building is Rs. 25 lakhs as on March 31, 2014.***

Ans: Principles of prudence, substance over form and materiality should be looked into, to ensure true and fair consideration in a transaction. In the given case, the economic reality and substance of the transaction is that the rights and beneficial interest in the property has been transferred although legal title has not been transferred. Hence, X Ltd. should record the sale and recognize the profit of Rs. 35 lakhs in its financial statements for the year ended 31st March, 2015; value of building should be removed from the balance sheet.

Therefore the treatment given by the company is not correct.

***j. An INGO invites bid from interested CA firms for audit service for the calendar year 2014. Upon request by Lakhe & Co, Chartered Accountants, the INGO does not provide information about the audit fees for the year 2013. Please advise whether Lakhe & Co should submit his bid for the audit or not.***

Ans: As per council decision/code of ethics in relation to minimum audit fee, an audit firm shall take into account the audit fees of the previous year while quoting audit fees such that the current year's fee should not be less than the previous year. If information about the previous year's fee cannot be obtained, the auditor shall specify in his proposal that his fee shall be higher of the proposed audit fee and previous year's audit fee.

So, in the given case, Lakhe & Co can submit his proposal by clearly mentioning that the audit fee shall be the higher of the proposed audit fee or previous year's audit fee.

***k. Organo Pvt. Ltd., manufacturing noodles, has valued at the year end its closing stock of packed finished goods for which firm sales contracts have been received, at realizable value inclusive of profit and cash incentive. As at the year end, the ownership of the goods has not been transferred to the buyers***

Ans: Valuation of Inventories: NAS 2 requires that inventories should be valued as lower of cost and Net realizable value(NRV). A departure from the general principle can be made if the NAS is not applicable or having regard to the nature of industry. NAS 2 also states that (a) work in progress arising under construction contracts, including directly related service contracts (b) work in progress arising in the ordinary course of business of service providers;(c) shares, debentures and other financial instruments held as stock-in-trade; and (d) producers' inventories of livestock, agricultural and forest products are measured as NRV based on established practices. In the given case the sale is assumed under a forward contract but the goods are not of a nature covered by the above exceptions taking into account the facts the closing stock of finished goods should have been valued at cost, as it is lower than the realizable value (as it includes profit). Further, sale cash incentives should not be included for valuation purposes.

The policy adopted by the Organo Pvt. Ltd. for valuing its closing stock of inventory of finished goods on selling price plus sale incentives is not correct. The statutory auditor should give a qualified report.

***2. <u>Distinguish between</u>***

*a. <u>Qualified Report and Adverse Report:</u>*

- A qualified opinion should be expressed when the auditor concludes that an unqualified opinion cannot be expressed but that the effect of any disagreement with management is not so material and pervasive as to require an adverse opinion, or limitation on scope is not so material and pervasive as to require a disclaimer of opinion. An adverse opinion should be expressed when an effect of a disagreement is so material and pervasive to the financial statements that the auditor concludes that the qualification of the report is not adequate, to disclose the misleading or incomplete nature of the financial statement.
- In qualified report, auditor`s reservation generally written as "subject to or except for, we report that the financial statements shows the true & fair view". Whereas in case of adverse report, the auditor states that "the financial statements do not present a true and fair view of the state of affairs and working results".
- In qualified report, auditor gives an opinion subject to certain reservations whereas in the case of adverse report the auditor concludes that on the basis of his examination he is not satisfied with the affirmation made in the financial statements

*b.* ***Hot review & Cold Review in audit***

Hot file review or hot review is conducted usually conducted during the audit and/or audit work is completed but before the auditor's report is issued. This in nature is a detailed review that is conducted with an aim to find out if there's any weakness in application of audit procedures or if the results have been misinterpreted. Hot reviews are usually carried out usually by the senior the audit team or someone with the same authority who is not connected with the engagement. Such reviews mostly include meetings with audit team personnel and their individual work so that both work and the skills of members are improved by pointing out discrepancies and providing recommendations.

The purpose of a hot review is to identify any key areas that need to be addressed prior to signing the report. The categories for review which may be undertaken can be described as follows:

i. Comfort reviews
ii. High risk reviews
iii. Training reviews
iv. Independence reviews
v. NSQC reviews

To summarize**,** hot review is conducted during the audit work is conducted but before the auditor's report is issued with a prime objective to ensure compliance with relevant auditing standards and achieving engagement's objectives

Cold file review or cold review is an objective evaluation on the date of auditor's report and is performed by the auditor i.e. partner himself when all the audit work has been concluded and the required sufficient appropriate audit evidence has been obtained and conclusions drawn and reported. This review usually takes place when the auditor's report is signed off. The purpose of this review is to ensure compliance with relevant auditing standards and to analyze weaknesses in the way whole audit work is conducted and how it can be improved for next similar assignments by updating firm's quality control standards, training the staff etc. Normally the cold file review would aim to:

- Identify whether the disclosure requirements had been properly met - incorrect disclosures are the largest subject of complaints to the Institute.
- Identify whether the Auditing Standards and Regulations have been properly complied with - each audit would be "scored" using a comprehensive file review checklist.
- Assess the effectiveness of any independent manager review and the partner review, looking for any points that should have been picked up by a manager but had not been, and likewise with the partner.

To summarize, cold review is conducted with a view to check for the weaknesses in the firm's quality control procedures and system, proficiency of audit team members and how they can be improved to make later audit assignment more effective and efficient.

*c.* *Points of difference between Reserves & Provisions:*

1. Reserve is an appropriation of profit whereas provision is a charge against Profit.
2. Reserves are not intended to meet any liability, contingency or diminution in the value of assets. Provisions are made to provide for depreciation, renewal or a known liability or a disputed claim.
3. Reserves cannot be created unless there is a profit except revaluation reserve and capital subsidy. Provisions must be created whether or not there is profit.
4. Reserves are generally optional except in certain situations – Capital Redemption reserve, Debenture Redemption Reserve, Declaration of dividend higher than 10% etc. Provisions are not optional and have to be made as per generally accepted accounting principles.
5. Reserves are shown on the liability side. Provisions for depreciation and provision for doubtful debts are shown as deduction from respective assets. Provision for liability is shown on the liability side.

*d.* *Audit Through the Computer and Audit Around the Computer*

Auditing around the computer involves arriving at an audit opinion through examining the internal control system for a computer installation and the input and output only for application systems. On the basis of the quality of the input and output of the application system, the auditor infers the quality of the processing carried out. Application system processing is not examined directly. The auditor views the computer as a black box. The auditor generally audit around the computer when either of the following situations applies to application systems existing in the installation: i. the system is simple and batch oriented, and ii. The system uses generalized software that is well tested and used widely by many installations.

On the other hand, an auditor can use the computer to test i. the logic and controls existing within the system and ii. The records produced by the system. Depending upon the complexity of the application system being audited, the approach may be fairly simple or require extensive technical competence on the part of the auditor. There are several circumstances where auditing through the computer must be used:

- The application system processes large volumes of input and produces large volumes of output that make extensive direct examination of the validity of input and output difficult.
- Significant parts of the internal control system are embodied in the computer system.

- The logic of the system is complex and there are large portions that facilitate use of the system or efficient processing.
- Because of cost-benefit considerations, there are substantial gaps in the visible audit trail.

e. *Distinction between Audit Reports and Certificates:*

The term 'certificate', is a written confirmation of the accuracy of the facts stated therein and does not involve any estimate or opinion. When an auditor certifies a financial statement, it implies that the contents of that statement can be measured and that the auditor has vouchsafed the exactness of the data. The term certificate is, therefore, used where the auditor verifies certain exact facts. An auditor may thus, certify the circulation figures of a newspaper or the value of imports or exports of a company. An auditor's certificate represents that he has verified certain precise figures and is in a position to vouch safe their accuracy as per the examination of documents and books of account. An auditor's report, on the other hand, is an expression of opinion. When we say that an auditor is reporting, we imply that he is expressing an opinion on the financial statements.

The term report implies that the auditor has examined relevant records in accordance with generally accepted auditing standards and that he is expressing an opinion whether or not the financial statements represent a true and fair view of the state of affairs and of the working results of an enterprise. Since an auditor cannot guarantee that the figures in the balance sheet and profit and loss account are absolutely precise, he cannot certify them. This is primarily because the accounts itself are product of observance of several accounting policies, the selection of which may vary from one professional to another and, thus, he can only have an overall view of the accounts through normal audit procedures. Therefore, the term certificate cannot be used in connection with these, statements.

Thus, when a reporting auditor issues a certificate, he is responsible for the factual accuracy of what is stated therein. On the other hand, when a reporting auditor gives a report, he is responsible for ensuring that the report is based factual data, that his opinion is in due accordance with facts, and that it is arrived at by the application of due care and skill.

f. *Evidence and validity of transaction*

Entries in the books are usually made on the basis of some kind of documentary evidence. It generally exists in a variety of forms e.g. payees receipts, suppliers invoices, statements of account of parties, minutes of Board of Directors or shareholders, contract documents etc. These all form documentary evidence for transactions. On the other hand, it is also the function of audit to establish that payments have been made validly to the person who is shown to be recipients e.g. salary is paid to partners according to provision contained in the partnership deed, director's fee is paid according to the minute of shareholders meeting, suppliers are paid according to their invoices etc. It is termed as the validation of the transactions.

3. ***How will you vouch/verify***

*a. Substantive procedures for bank reconciliation*

- Obtain bank account reconciliation and cast to check the additions to ensure arithmetical accuracy.
- Agree the balance per the bank reconciliation to an original year-end bank statement and to the bank confirmation letter.
- Agree the reconciliation's balance per the cash book to the year-end cash book.
- Trace all the outstanding lodgements to the pre year-end cash book, post year-end bank statement and also to paying-in-book pre year end.
- Trace all unpresented cheques through to a pre year-end cash book and post year-end statement. For any unusual amounts or significant delays, obtain explanations from management.
- Examine any old unpresented cheques to assess if they need to be written back into the purchase ledger as they are no longer valid to be presented.

*b. Substantive procedures for work in progress (WIP)*

- Prior to attending the inventory count, discuss with management how the percentage completions are attributed to the WIP
- During the count, observe the procedures carried out in assessing the level of WIP and consider the reasonableness of the assumptions used.
- Agree for a sample that the percentage completions assessed during the count are in accordance with the policies communicated prior to the count.
- Discuss with management the basis of the standard costs applied to the percentage completion of WIP, and how often these are reviewed and updated.
- Review the level of variances between standard and actual costs and discuss with management how these are treated.
- Obtain a breakdown of the standard costs and agree a sample of these costs to actual invoices or payroll records to assess their reasonableness.
- Cast the schedule of total WIP and agree to the trial balance and financial statements.
- Agree sample of WIP assessed during the count to the WIP schedule, agree percentage completion is correct and recalculate the inventory valuation

*c. Receipt of Special backward area subsidy from Nepal Government*

- The claim for backward area subsidy submitted to the authorities should be studied.
- It should be ascertained whether the grant is of a capital nature for funding assets or of a revenue nature. Mere computation formula of quantum of grant with reference to the cost of project of itself will not make the grant a capital nature ipso facto.
- The accounting of the grant should be in accordance with NAS 10 "Accounting for Government Grants" of ICAN. The revenue grant can be taken to income statement with appropriate disclosure.
- The capital grant may be adjusted against cost of assets or may be kept in the capital reserve to be transferred to profit or loss account each year in proportion to the depreciation of that asset charged in profit and loss account.
- The receipt of the grant should be checked with bank statement, remittance challan etc.

*d. After sales service*

- Nature of after sales services rendered by the enterprise.
- Maintenance of adequate records such as customer cards of after sales services provided to each customer indicating the period and other details.
- Manner of distinction should be made between the customers being serviced under warranty period and those under the annual maintenance contract.
- Type of a form describing date wise the services rendered or parts replaced on each visit by service engineers.
- Manner of collecting service charges on annual basis or on periodic visits from customers who are not covered by annual maintenance contract by service engineers and issue provisional receipts to customers in the case of changeable parts.
- Existence of any system of reconciliation of stores and spare parts issued with the cash received.

*e. Borrowing from Banks:*

Borrowing from banks may be either in the form of overdraft limits or term loans. In each case, the borrowings should be verified as follows:

- Primarily, the authority under which a loan has been raised should be verified. An unauthorized loan cannot be treated as a liability of the concern. In the case of a company, only the Board of Directors is authorized to raise a loan or borrow from a bank.
- The copy of the loan agreement should be referred to find out the rate of interest, the terms of repayment and the conditions as to security agreed to by the client.

- Reconcile the balances in the overdraft or loan account with that shown in the pass book(s) and confirm the last mentioned balance by obtaining a certificate from the bank showing the balance in the accounts as at the end of the year.
- Obtain a certificate from the bank showing particulars of securities deposited with the bank as security for the loans or of the charge created on an asset or assets of the concern and confirm that the same has been correctly disclosed and duly registered with Registrar of Companies and recorded in the Register of charges.
- Ascertain the purpose for which loan has been raised and the manner in which it has been utilised and that this has not prejudicially affected the entity.
- If any guarantee has been provided for the repayment of the loan the particulars thereof should be ascertained for the purpose of disclosure in the balance sheet.

*f. Building*

- Examine the title deeds of buildings to see whether the client holds the title on the balance sheet date. If the property has been mortgaged, the title deeds will be in the possession of the mortgagee, from whom a certificate should be obtained to that effect.
- Verify the original cost of buildings by reference to the deed of conveyance. If the building is constructed by the client, verify the original cost by reference to the cost as recorded in the books of account of the year in which the construction was completed.
- Verify that appropriate depreciation has been provided against the buildings. In case no depreciation is provided on the buildings, a note to this effect should be given in the profit and loss account.
- See the appropriate lease deed, if the building is leasehold, to ascertain the cost, amortization, etc. Also ensure that all contents in the lease deed have been fulfilled by the client.
- See that the buildings have been valued at cost less depreciation. If any revaluation has taken place, see the basis of revaluation and ensure that the disclosure of the same has been made.
- See that the relevant particulars of buildings have been entered in the fixed assets record maintained by the client.

***4. <u>Write short note on following</u>***

*a. Sources for obtaining Knowledge of the client business:*

The various sources from which the auditor can obtain knowledge of the client business are:

- General economic factors and industry conditions affecting the client's business.

- Important characteristics of the client, its business, its financial performance and its reporting requirements including changes since the date of the prior audit.
- The general level of competence of the management.
- The clients annual report to shareholders.
- Minutes of meetings of shareholders, board of directors and important committees.
- Internal financial management reports for current and previous periods, including budgets.
- The previous year audit working papers and other relevant files.
- Firm personnel responsible for non-audit services to the client who may be able to provide information on matters that may affect audit.
- Discussions with the client.
- The client's policy and procedures manual.
- Relevant publications of ICAN and other professional bodies, industry publications, trade journals, magazines, newspapers etc.
- Consideration of state of economy and its effect on the client's business and
- Visits to the client's premises and plant facilities.

*b. Financial indicators of going concern issue*

- Net liability or net current liability position.
- Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment; or excessive reliance on short-term borrowings to finance long-term assets.
- Indications of withdrawal of financial support by debtors and other creditors.
- Negative operating cash flows indicated by historical or prospective financial statements.
- Adverse key financial ratios.
- Substantial operating losses or significant deterioration in the value of assets used to generate cash flows.
- Arrears or discontinuance of dividends.
- Inability to pay creditors on due dates.
- Inability to comply with the terms of loan agreements.
- Change from credit to cash-on-delivery transactions with suppliers.
- Inability to obtain financing for essential new product development or other essential investments.

*c. Draft an internal control questionnaire on purchases*

- Is the store department's purchase requisition in parity with receiving reports?
- Were the competitive bidding procedures followed?

- Are the receiving reports initialed and signed properly?
- Are the copies of requisition, purchase order, invoice and receiving report in order and complete?
- Whether the principles of buying i.e. right price, quantity, quality etc. are adhered to or not?
- Whether the terms in the purchase requisition tally with the materials specifications, quality required and delivery schedule?
- Whether a master list of suppliers is maintained, if any?
- Whether proper coordination exists between initiating department and purchase department?
- Whether quotations are received and evaluated or not?
- Whether follow up for delivery is done?
- Whether the operations are in sync are with those in purchase manual?
- Whether management directives are adhered to?
- How purchase records are maintained?
- How the stock ledgers and records maintained?
- Whether the transactions are in parity with purchase budget and cost control budget?
- Whether any procurement committee report exists?
- Whether statutory laws and rules are complied with?

d. *Different types of threats observed by the ICAN Code of Ethics*

Ans: The circumstances in which professional accountants operate may create specific threats to compliance with the fundamental principles. Threats may be created by a broad range of relationships and circumstances. Threats fall into one or more of the following categories:

- Self-interest threat – the threat that a financial or other interest will inappropriately influence the professional accountant’s judgment or behavior;
- Self-review threat – the threat that a professional accountant will not appropriately evaluate the results of a previous judgment made or service performed by the professional accountant, or by another individual within the professional accountant’s firm or employing organization, on which the accountant will rely when forming a judgment as part of providing a current service;
- Advocacy threat – the threat that a professional accountant will promote a client’s or employer’s position to the point that the professional accountant’s objectivity is compromised;
- Familiarity threat - the threat that due to a long or close relationship with a client or employer, a professional accountant will be too sympathetic to their interests or too accepting of their work; and
- Intimidation threat – the threat that a professional accountant will be deterred from acting objectively because of actual or perceived pressures, including attempts to exercise undue influence over the professional accountant

*e. Surprise Check*

Surprise checks are mainly intended to ascertain whether the system of internal control is operating effectively and whether the accounting and other records are prepared concurrently and kept up-to-date. It has often been found that manipulations and frauds are facilitated under a system of book-keeping which does not give proper emphasis to the need to keep the books up-to-date. Errors in book-keeping are often indicative of weaknesses in internal control which may be taken advantage of in order to perpetrate frauds or manipulations.

The element of surprise in an audit can be both with regard to the time of the audit, that is the selection of the date at which the auditor visits the clients' office to carry out the audit and the selection of the items which are subjected to audit.

Surprise checks are a useful method of determining whether or not such errors exist and where they exist, of bringing the matter promptly to the attention of the management so that corrective action is taken immediately. Consequently, surprise visits by the auditor can exercise a good moral check on the client's staff.

*f. Audit trail in a computerized accounting environment*

Audit trail or audit log is a chronological sequence of audit records, each of which contains evidence directly pertaining to and resulting from the execution of a business process or system function. In simple accounting words, it refers to documentation of detailed transactions supporting summary ledger entries. This documentation may be on paper or electronic records.

An audit trail refers to a situation where it is possible to relate 'one-to-one' basis, the original input along with the final output. The work of an auditor would be hardly affected if "Audit Trail" is maintained i.e. if it were still possible to relate, on a 'one-to-one' basis, the original input with the final output. A simplified representation of the documentation in a manually created audit trail. The particular credit notes may be located by the auditor at any time he may wish to examine them, even months after the balance sheet date. He also has the means, should he so wish, of directly verifying the accuracy of the totals and sub-totals that feature in the control listing, by reference to individual credit notes. He can, of course, check all detailed calculations, casts and postings in the accounting records, at any time.

In first and early second-generation computer systems, such a complete and trail was generally available, no doubt, to management's own healthy skepticism of what the new machine could be relied upon to achieve – an attitude obviously shared by the auditor. In such a system

- The output itself is as complete and as detailed as in any manual system.
- The trail, from beginning to end, is complete, so that all documents may be identified by located for purposes of vouching, totaling and cross-referencing.

Any form of audit checking is possible, including depth testing in either direction. In case audit trail is missing, the auditor employs Computer Assisted Techniques (CAATs) to ensure the validity of accounting data.

5. ***Planning an audit engagement***

a. ***What is COSO? Explain in brief the components of the COSO framework.***

Ans: The Committee of Sponsoring Organizations (COSO) was established in the mid-1980s, initially to sponsor research into the causes of fraudulent financial reporting. Its current mission is to: 'provide thought leadership through the development of comprehensive frameworks and guidance on enterprise risk management, internal control and fraud deterrence designed to improve organizational performance and governance and to reduce the extent of fraud in organizations.'

Although COSO's guidance is non-mandatory, it has been influential because it provides frameworks against which risk management and internal control systems can be assessed and improved. Corporate scandals, arising in companies where risk management and internal control were deficient and attempts to regulate corporate behavior as a result of these scandals have resulted in an environment where guidance on best practice in risk management and internal control has been particularly welcome.

The COSO model defines internal control as a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance of the achievement of objectives in the following categories:

- Effectiveness and efficiency of operations
- Reliability of financial reporting
- Compliance with applicable laws and regulations

In an "effective" internal control system, the following five components work to support the achievement of an entity's mission, strategies and related business objectives.

**Control Environment**

The control environment sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure. Control environment factors include the integrity, ethical values and competence of the entity's people; management's philosophy and operating style; the way management assigns authority and responsibility, and organizes and develops its people; and the attention and direction provided by the board of directors.

**Risk Assessment**

Every entity faces a variety of risks from external and internal sources that must be assessed. A precondition to risk assessment is establishment of objectives, linked at different levels and internally consistent. Risk assessment is the identification and analysis of relevant risks to achievement of the objectives, forming a basis for determining how the risks should be managed. Because economic, industry, regulatory and operating conditions will continue to change, mechanisms are needed to identify and deal with the special risks associated with change.

**Control Activities**

Control activities are the policies and procedures that help ensure management directives are carried out. They help ensure that necessary actions are taken to address risks to achievement of the entity's objectives. Control activities occur throughout the organization, at all levels and in all functions. They include a range of activities as diverse as approvals, authorizations, verifications, reconciliations, reviews of operating performance, security of assets and segregation of duties.

**Information and Communication**

Pertinent information must be identified, captured and communicated in a form and timeframe that enable people to carry out their responsibilities. Information systems produce reports, containing operational, financial and compliance-related information, that make it possible to run and control the business. They deal not only with internally generated data, but also information about external events, activities and conditions necessary to informed business decision-making and external reporting. Effective communication also must occur in a broader sense, flowing down, across and up the organization. All personnel must receive a clear message from top management that control responsibilities must be taken seriously. They must understand their own role in the internal control system, as well as how individual activities relate to the work of others. They must have a means of communicating significant information upstream. There also needs to be effective communication with external parties, such as customers, suppliers, regulators and shareholders.

**Monitoring**

Internal control systems need to be monitored--a process that assesses the quality of the system's performance over time. This is accomplished through ongoing monitoring activities, separate evaluations or a combination of the two. Ongoing monitoring occurs in the course of operations. It includes regular management and supervisory activities, and other actions personnel take in performing their duties. The scope and frequency of separate evaluations will depend primarily on an assessment of risks and the effectiveness of ongoing monitoring procedures. Internal control deficiencies should be reported upstream, with serious matters reported to top management and the board.

There is synergy and linkage among these components, forming an integrated system that reacts dynamically to changing conditions. The internal control system is intertwined with the entity's operating activities and exists for fundamental business reasons. Internal control is most effective when controls are built into the entity's infrastructure and are a part of the essence of the enterprise. "Built in" controls support quality and empowerment initiatives, avoid unnecessary costs and enable quick response to changing conditions. There is a direct relationship between the three categories of objectives, which are what an entity strives to achieve, and components, which represent what is needed to achieve the objectives. All components are relevant to each objectives category. When looking at any one category--the effectiveness and efficiency of operations, for instance--all five components must be present and functioning effectively to conclude that internal control over operations is effective.

The internal control definition--with its underlying fundamental concepts of a process, effected by people, providing reasonable assurance--together with the categorization of objectives and the components and criteria for effectiveness, and the associated discussions, constitute this internal control framework.



b. ***There are a number of key procedures which auditors should perform if they wish to rely on internal controls and reduce the level of substantive testing they perform. These include:***

- ***(i) Documentation of accounting systems and internal control;***
- ***(ii) Walk-through tests;***
- ***(iii) Audit sampling;***
- ***(iv) Testing internal controls;***
- ***(v) Dealing with deviations from the application of control activities.***

***Required: Briefly explain each of the procedures listed above.***

nswer:

(i) Documentation of accounting systems and internal control Auditors are required to obtain an understanding of the business they are to audit. As part of that process they record the accounting and internal control systems to enable them to plan the audit and develop an effective audit approach. This allows the auditor to determine the adequacy of the system for producing the financial statements and to perform an initial risk assessment. There are a number of different techniques which may be used to record the system. These include narrative notes, flowcharts and questionnaires. The extent of the work will depend on the nature of the organisation and the practical circumstances. For example in a smaller company where a substantive rather than controls based approach is to be taken, a detailed record of internal control would not be necessary. For a new client with a large and complex system a much more detailed review would be required.

(ii) Walk-through tests Walk through tests are performed by the auditors to confirm that their recording and understanding of the system is correct. They are often performed as the recording of the system takes place or in conjunction with the tests of controls. The process involves the tracing of a sample of transactions from the start of the operating cycle to the end and vice versa. For example a sales transaction could be traced from the initial order through to the entry in the nominal ledger accounts.

(iii) Audit sampling Audit sampling involves the application of audit procedures to a selection of transactions within a population (ie rather than applying the procedures to 100%). The auditor then obtains and evaluates the evidence in order to form a conclusion about the population as a whole. Sampling is normally adopted for practical reasons as in most cases it would be too time consuming to audit the whole population. A number of different techniques can be used in order to select the sample including random, systematic or haphazard selection. When designing the size and the structure of the audit sample the auditor will need to consider sampling risk – the risk that the sample is not representative of the population as a whole, meaning that results cannot be extrapolated.

(iv) Testing internal controls Tests of controls are used to confirm the auditor's assessment of the operation of the control system. They are tests to obtain audit evidence which confirm that controls have been carried out correctly and consistently. For example a control activity over the payment of supplier invoices could be that all invoices are authorized by the purchases manager's signature. The auditor would test this control by looking for evidence of this on a sample of paid purchase invoices. As this is a test of controls rather than a substantive procedure the size of the balance on the invoice is irrelevant and any exceptions potentially show a failure in the system. The results of this work will then determine the extent to which further substantive procedures are required. If controls have proved to be effective less additional work is required. If controls are not in place or are not effective more additional evidence will be required.

(v) Deviations If deviations from the application of control activities are found the auditor will need to determine whether this is an isolated incident or evidence of a more comprehensive breakdown in procedures. This will normally be confirmed by extending the sample size and testing more transactions. If the problem is an anomalous error arising from an isolated incident, no further formal action is required (although the auditor may wish to mention it to management informally). If the breakdown is more comprehensive the auditor needs to consider the impact this will have on this particular aspect of the audit and the audit approach as a whole. An unexpectedly high deviation rate, which is in excess of the tolerable rate of deviation set by the auditor, will mean the auditor will need to re-assess audit risk. If a compensating control cannot be identified and tested satisfactorily, a substantive approach will need to be adopted.

c. ***What do you understand by audit risk? Describe and present a comparison between them?***

Ans: Audit Risk is the risk that an auditor expresses an inappropriate opinion on the financial statements. Audit risk is the risk that an auditor issues an incorrect opinion on the financial statements. Examples of inappropriate audit opinions include the following:

- Issuing an unqualified audit report where a qualification is reasonably justified;
- Issuing a qualified audit opinion where no qualification is necessary;
- Failing to emphasize a significant matter in the audit report;
- Providing an opinion on financial statements where no such opinion may be reasonably given due to a significant limitation of scope in the performance of the audit

**Inherent Risk** is the risk of a material misstatement in the financial statements arising due to error or omission as a result of factors other than the failure of controls (factors that may cause a misstatement due to absence or lapse of controls are considered separately in the assessment of control risk). Inherent risk is generally considered to be higher where a high degree of judgment and estimation is involved or where transactions of the entity are highly complex.

**Control Risk** is the risk of a material misstatement in the financial statements arising due to absence or failure in the operation of relevant controls of the entity. Organizations must have adequate internal controls in place to prevent and detect instances of fraud and error. Control risk is considered to be high where the audit entity does not have adequate internal controls to prevent and detect instances of fraud and error in the financial statements.

**Detection Risk** is the risk that the auditors fail to detect a material misstatement in the financial statements. An auditor must apply audit procedures to detect material misstatements in the financial statements whether due to fraud or error. Misapplication or omission of critical audit procedures may result in a material misstatement remaining undetected by the auditor. Some detection risk is always present due to the inherent limitations of the audit such as the use of sampling for the selection of transactions. Detection risk can be reduced by auditors by increasing the number of sampled transactions for detailed testing

*Audit Risk = Inherent Risk x Control Risk x Detection Risk*

Audit risk may be considered as the product of the various risks which may be encountered in the performance of the audit. In order to keep the overall audit risk of engagements below acceptable limit, the auditor must assess the level of risk pertaining to each component of audit risk

**A Comparison Chart**

| Inherent Risk | Control Risk | Detection Risk |
|---|---|---|
| Risk that material misstatement may occur | Risk that internal control fail to prevent, detect the misstatement | Risk that auditor's substantive procedure will not detect a material misstatement |
| Arises at level of management | Arises at level of management | Arises at auditors level |
| Auditor can only assess this risk | Auditor can only assess this risk | Auditor can frame this risk |
| Risk of system of management | Risk of internal control system | Risk of auditor procedure adopted by auditor |



***d. What is audit sampling and sampling risk? What are the methods of selecting samples?***

Ans: Audit sampling is the application of audit procedures to less than 100% of items within a population of audit relevance such that all sampling units have a chance of selection. This will enable the auditor to obtain and evaluate audit evidence about some characteristic of the items selected in order to provide the auditor with a reasonable basis on which to draw conclusions about the entire population. Audit sampling can be applied using either statistical or non-statistical approaches.

The population is the entire set of data from which a sample is selected and about which the auditor wishes to draw conclusions.

Auditors are unlikely to test 100% of items when carrying out tests of controls, but 100% testing may be appropriate for certain substantive procedures. For example, if the population is made up of a small number of high value items, there is a high risk of material misstatement and other means do not provide sufficient appropriate audit evidence, then 100% examination may be appropriate.

Audit sampling can be done using either statistical sampling or non-statistical sampling methods.

Statistical sampling is an approach to sampling that involves random selection of the sample items, and the use of probability theory to evaluate sample results, including measurement of sampling risk. Non-statistical sampling is a sampling approach that does not have these characteristics.

The auditor may alternatively select certain items from a population because of specific characteristics they possess. The results of items selected in this way cannot be projected onto the whole population but may be used in conjunction with other audit evidence concerning the rest of the population.

- High value or key items. The auditor may select high value items or items that are suspicious, unusual or prone to error.
- All items over a certain amount. Selecting items this way may mean a large proportion of the population can be verified by testing a few items.
- Items to obtain information about the client's business, the nature of transactions, or the client's accounting and control systems.
- Items to test procedures, to see whether particular procedures are being performed.

Sampling risk arises from the possibility that the auditor's conclusion, based on a sample of a certain size, may be different from the conclusion that would be reached if the entire population were subjected to the same audit procedure.

Non-sampling risk arises from factors that cause the auditor to reach an erroneous conclusion for any reason not related to the size of the sample. For example, the use of inappropriate audits procedures, or misinterpretation of audit evidence and failure to recognize a misstatement or deviation.

Sampling unit is the individual items constituting a population. It may be a physical item (e.g. credit entries on bank statements, sales invoices, receivables' balances) or a monetary unit. Stratification is the process of dividing a population into sub-populations, each of which is a group of sampling units which have similar characteristics, often monetary value.

The auditor must consider the purpose of the audit procedure when designing an audit sample. The auditor must also consider the characteristics of the population. When considering the characteristics of the population, the auditor might determine that stratification or value-weighted selection is appropriate. The auditor must design a sample size sufficient to reduce sampling risk to an acceptably low level.

Sampling risk can lead to two types of erroneous conclusions: for tests of controls, that they are more effective that they actually are or for tests of details, that a material misstatement does not exist when it actually does; and for tests of controls, that controls are less effective than they actually are or for tests of details, that a material misstatement exists when it actually does not. The lower the risk the auditor is willing to accept, the greater the sample size will need to be. Sample size can be determined using a statistically-based formula or through the use of judgement.

The standard also requires the auditor to select items for the sample in such a way that each sampling unit in the population has a chance of selection. When statistical sampling is used, each sampling unit has a known probability of being selected. When non-statistical sampling is used, judgement is applied. However, it is important that the auditor selects a representative sample, free from bias, by choosing sample items that have characteristics typical of the population. The main methods of selecting samples are random selection, systematic selection and haphazard selection. We discuss these and other methods below.

- Random selection ensures that all items in the population have an equal chance of selection, e.g. by use of random number tables or random number generators.
- Systematic selection involves selecting items using a constant interval between selections, the first interval having a random start. While using a systematic selection, auditors must ensure that the population is not structured in such a manner that the sampling interval corresponds with a particular pattern in the population.
- Haphazard selection may be an alternative to random selection provided auditors are satisfied that the sample is representative of the entire population. This method requires care to guard against making a selection which is biased, for example towards items which are easily located, as they may not be representative. It should not be used if auditors are carrying out statistical sampling.
- Block selection may be used to check whether certain items have particular characteristics. For example an auditor may use a sample of 50 consecutive cheques to test whether cheques are signed by authorized signatories rather than picking 50 single cheques throughout the year. Block sampling may however produce samples that are not representative of the population as a whole, particularly if errors only occurred during a certain part of the period, and hence the errors found cannot be projected onto the rest of the population.
- Monetary unit sampling is a type of value-weighted selection in which sample size, selection and evaluation results in a conclusion in monetary amounts.

## 6. ***<u>Internal audit and corporate governance</u>***

**a. *Explain the circumstances when work of the internal audit function cannot be used by External Auditor.***

Ans: The external auditor's evaluation of whether the internal audit function of organizational status and relevant policies and procedures adequately support the objectivity of the internal auditors, the level of competence of the internal audit function, and whether it applies a systematic and disciplined approach may indicate that the risks to the quality of the work of the function are too significant and therefore it is not appropriate to use any of the work of the function as audit evidence.

Consideration of the factors of NSA 610 individually and in aggregate is important because an individual factor is often not sufficient to conclude that the work of the internal audit function cannot be used for purposes of the audit. For example, the internal audit function's organizational status is particularly important in evaluating threats to the objectivity of the internal auditors.

If the internal audit function reports to management, this would be considered a significant threat to the function's objectivity.

This is because of the possibility that the engagement team will use the results of the internal audit service without properly evaluating those results or without exercising the same level of professional skepticism as would be exercised when the internal audit work is performed by individuals who are not members of the firm.

**b.** ***Discuss the advantages and disadvantages of outsourcing an internal audit department.***

nswer: Outsourcing the internal audit department:

Advantages

Staffs do not need to be recruited externally as the service provider should be able to provide good quality audit staff. The service provider has different specialist skills and can assess what management's requirements are, and the company will have access to a broad range of skills. Outsourcing can provide an immediate internal audit department. Associated costs such as recruitment and training can be eliminated if the function is outsourced. The contract can be for a specific time period, depending on the needs of the company. Outsourcing can be used on a short-term basis.

Disadvantages

There will be independence and objectivity issues if the firm providing the internal audit function is also the same as that providing the external audit service. The cost of outsourcing the internal audit function may be high enough to force the directors to choose not to have such a function in place at all. Outsourced internal audit staff may change frequently resulting in a poor service being provided due to lack of understanding of the client's systems and operations.

**c.** ***NSA 610 Using the work of internal auditors provides guidance to external auditors on the use of internal audit work. Required List and briefly explain the various criteria that should be considered by***

***external auditors when assessing whether to take reliance from work performed by internal audit.***

***(b) List four examples of audit evidence that might be obtained from the use of an auditor's expert.***

***(c) NSA 620 Using the work of an auditor's expert provides guidance to auditors on relying on work carried out by an expert.***

***Required List the factors that should be considered by the auditor when evaluating the work carried out by the expert and briefly explain what actions the auditor should take if he concludes that the results of the expert's work do not provide sufficient, appropriate audit evidence or if the results are inconsistent with other audit evidence.***

nswer:

(a) Criteria to be considered when assessing whether to place reliance on internal audit work include the following: Objectivity of function The external auditor should consider whom the internal auditors report to and whether they are subject to any conflicting responsibilities, constraints or restrictions. This will affect the capability of the internal auditors to communicate significant matters openly. Scope of function The external auditors should consider the extent and nature of assignments performed by the internal auditors and the action taken by management as a result of internal audit reports. Technical competence The external auditors should consider whether the internal auditors have adequate technical training and proficiency. Due professional care The external auditors should consider whether the work of internal audit is properly planned, supervised, reviewed and documented.

(b) Audit evidence that could be obtained from an expert – Valuations of assets such as land and buildings, plant and machinery, works of art, precious stones – Determination of quantities or physical condition of assets – Determination of amounts using specialized techniques or methods, such as an actuarial valuation – Measurement of work completed and to be completed on contracts in progress – Legal opinions concerning interpretations of agreements, statutes and regulations

(c) Factors to consider when evaluating the work carried out by an auditor's expert: – Relevance and reasonableness of the work and consistency with other audit evidence – Relevance and reasonableness of any assumptions and methods used – Relevance, completeness and accuracy of any source data used If the results of the expert's work do not provide sufficient, appropriate audit evidence or are inconsistent with other audit evidence, the auditor needs to resolve the matter. This could be done through discussions with the entity and the expert, applying additional audit procedures, including engaging another expert, or modifying the auditor's opinion in the auditor's report (this is a last resort if the issues are still unresolved after all the other avenues have been explored).

d. ***What actions should the auditor take when the two-way communication between the auditor and those charged with governance is not adequate and the situation cannot be resolved?***

nswer: Paragraph A44, NSA 260 states 'If the two-way communication between the auditor and those charged with governance is not adequate and the situation cannot be resolved, the auditor may take such actions as:

- Modifying the auditor's opinion on the basis of a scope limitation.
- Obtaining legal advice about the consequences of different courses of action.
- Communicating with third parties (for example, a regulator), or a higher authority in the governance structure that is outside the entity, such as the owners of a business (for example, shareholders in a general meeting), or the responsible government minister or parliament in the public sector.
- Withdrawing from the engagement, where withdrawal is possible under applicable law or regulation'.

e. ***Write down the functions, duties and powers of audit committee Company Act, 2063.***

Ans: Section 165 of the company act 2063 has prescribed the functions, duties and powers of audit committee: The functions, duties and powers of the audit committee formed pursuant to subsection (1) of Section 164 shall be as follows:

a. To review the accounts and financial statements of the company and ascertain the truth of the facts mentioned in such statements;
b. To review the internal financial control system and the risk management system of the company;
c. To supervise and review the internal auditing activity or the company;
d. To recommend the names of potential auditors for the appointment of the auditor of the company, fix the remuneration and terms and conditions of appointment of the auditor and present the same in the general meeting for the ratification thereof;
e. To review and supervise as to whether the auditor of the company has observed such conduct, standards and directives determined by the competent body pursuant to the prevailing law as required to be observed in the course of doing auditing work;
f. Based on the conduct, standard and directives determined by the competent body pursuant to the prevailing law, to formulate the polices required to be observed by the company in respect of the appointment and selection of the auditor;
g. To prepare the accounts related policy of the company and enforce, or cause to be enforced, the same;

h. Where any regulatory body has provided for the long term audit report to be set out in the audit report of the company, to comply with the terms required preparing such report;

i. To perform such other terms as prescribed by the board of directors in respect of the accounts, financial management and audit of the company.

7. ***Audit conclusions and reporting***

a. ***'After the statutory audit has been completed a fraud has been detected at the office of the auditee.' What is your defense as an auditor that you performed the duty properly?***

Ans: The responsibility for the prevention and detection of fraud and error rests with management through the implementation and continued operation of an adequate system of internal control. Such a system reduces but does not eliminate the possibility of fraud and error.

In forming his opinion, the auditor carries out procedures designed to obtain evidence that will provide reasonable assurance that the financial information is properly stated in all material respects. Consequently, the auditor seeks reasonable assurance that fraud or error which may be material to the financial information has not occurred or that; if it has occurred, the effect of fraud is properly reflected in the financial information or the error is corrected. The auditor, therefore, plans his audit so that he has a reasonable expectation of detecting material misstatements in the financial information resulting from fraud or error. The degree of assurance of detecting errors would normally be higher than that of detecting fraud, since fraud is usually accompanied by acts specifically designed to conceal its existence.

Due to the inherent limitations of an audit there is a possibility that material misstatements of the financial information resulting from fraud and, to a lesser extent, error may not be detected. The subsequent discovery of material misstatement of the financial information resulting from fraud or error existing during the period covered by the auditor's report does not, in itself, indicate that whether the auditor has adhered to the basic principles governing an audit. The question of whether the auditor has adhered to the basic principles governing an audit (such as performance of the audit work with requisite skills and competence, documentation of important matters, details of the audit plan and reliance placed on internal controls, nature and extent of compliance and substantive tests carried out, etc.) is determined by the adequacy of the procedures undertaken in the circumstances and the suitability of the auditor's report based on the results of these procedures. The liability of the auditor for failure to detect fraud exists only when such failure is clearly due to not exercising reasonable care and skill.

Thus in the instant case after the completion of the statutory audit, if a fraud has been detected, the same by itself cannot mean that the auditor did not perform his duty properly. If the auditor can prove with the help of his papers (documentation) that he has followed adequate procedures necessary for the proper conduct of an audit, he cannot be held responsible for the same. If however, the same cannot be proved, he would be held responsible.

**b.** ***According to NSA 240 The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements: 'When identifying and assessing the risks of material misstatement due to fraud, the auditor shall, based on a presumption that there are risks of fraud in revenue recognition, evaluate which types of revenue, revenue transactions or assertions give rise to such risks.'***

Ans: There are a number of reasons why there should be a presumption that there are risks of fraud in revenue recognition. One reason is that managers of companies are often under pressure, particularly in listed companies, to achieve certain performance targets. The achievement of those targets often impacts their job security and their compensation. These performance targets often include measures of revenue growth, providing an incentive for management to use earnings management techniques. In other companies there may be incentives to understate revenues, for example, to reduce reported profits and, therefore, company taxation charges. This may be more relevant to private limited companies where management may not be under such pressure to achieve revenue based targets. There is also usually a high volume of revenue transactions during a financial period. As the volume of transactions increases, the risk of failing to detect fraud and error using traditional, sample based auditing techniques also increases. This means that it is potentially easier for management to successfully manipulate these balances than other balances which are subject to a lower volume of transactions. Material misstatement through the manipulation of revenue recognition can be readily achieved by recording revenue in an earlier or later accounting period than is proper or by creating fictitious revenues.

Revenue recognition can also be a judgemental area. Examples include the recognition of revenues on long-term contracts, such as the construction of buildings, and from the provision of services. These require the estimation of the percentage of completion at the period end, increasing the scope for management to manipulate reported results. As well as requiring judgement, revenue recognition can also be a complex issue. For example, some sales have multiple elements, such as the sale of goods and the separate sale of related maintenance contracts and warranties. This added complexity increases the risk of manipulation. In some companies, for example, those in the retail industry, a high proportion of revenue may be earned through cash sales. This increases the risk of the theft of cash and the consequent manipulation of recorded revenues to conceal this crime. Methods of revenue manipulation have also featured prominently in cases of accounting fraud, such as Enron and Worldcom. The prevalence of these methods in modern accounting frauds and the failure of auditors to detect this in these cases suggests that it is one of the more common methods of earnings management and one which auditors should rightly consider as high risk. While revenue recognition in general may be considered a high risk area, it is not always the case; companies with simple revenue streams or a low volume of transactions may be considered at low risk of fraud through revenue manipulations. Accordingly NSA 240 The Auditor's Responsibility Relating to Fraud in an Audit of Financial Statements permits the rebuttable of the fraud risk presumption for revenue recognition. One example of simple revenue streams would be where a company leases properties for fixed annual amounts over a fixed period of time. If this is the case, the reasons for not treating revenue as a high fraud risk area must be fully documented by the auditor.

**c.** ***It is not necessary to sign audit engagement letter every year in case of recurring/ongoing audits. Please explain the statement as per provisions of NSA 210.***

Ans: As per NSA 210, on recurring audits, the auditor shall assess whether circumstances require the terms of the audit engagement to be revised and whether there is a need to remind the entity of the existing terms of the audit engagement. The auditor may decide not to send a new audit engagement letter or other written agreement each period.

However, the following factors may make it appropriate to revise the terms of the audit engagement or to remind the entity of existing terms.

- Any indication that the entity misunderstands the objective and scope of the audit.
- Any revised or special terms of the audit engagement.
- A recent change of senior management.
- A significant change in ownership.
- A significant change in nature or size of the entity's business.
- A change in legal or regulatory requirements.
- A change in the financial reporting framework adopted in the preparation of the financial statements.
- A change in other reporting requirements.

## *8. Government audit*

**a.** ***Explain propriety audit in the context of Audit Act, 2048.***

**Ans:** As per section 5 of the Audit Act, 2048 requires that the Auditor General shall audit following matters considering the propriety thereof:

I) On the propriety of any expenditure and its authorization, if in the opinion of the Auditor General such expenditure is a reckless one or is an abuse of national property, whether movable or immovable, despite that the expenditure confirms to the authorization, and

ii) On the propriety of all authorizations issued in respect of any grant of national property whether movable or immovable, fixed or current, or underwriting of any revenue, or any contract, license or permits relating to mining, forest, water resources, etc. and any other act of abandoning movable or immovable, assets of the nation.

The Auditor General may not include in the report minor items of discrepancy and other items deemed as insignificant in view of their property which were observed during the audit of income and expenditure.

b. ***You are appointed as an auditor of the Village Development Committee. Explain the audit provisions that you will consider in preparing the Audit Programme. During the second year of your audit it was declared as a Municipality therefore, in this context do you think you need to revise your Audit Programme? If yes, what are the additional provisions that you need to consider for performing the audit?***

Ans: The audit provisions are explained under Section 69 of the Act. It provides that:

1. The internal audit of the incomes and expenditures of the VDC shall be carried out by the DDC within 4 months from the date of completion of a fiscal year.
2. The final audit of the VDC shall have to be carried out by an auditor approved by the DDC on the recommendation of the accounts committee constituted by the Village Council.
3. The Chairman shall have to take necessary actions on the issues referred to in the audit report and submit such report along with the details of actions taken to the accounts committee.
4. The accounts committee shall have to study the report submitted by the Chairman and furnish it to the Village Council along with the opinion and suggestions.
5. The Village Council shall discuss on the report received with the suggestions and opinion of the account committee and if the irregularities shown and determined by the audit cannot be regularized, it shall give directions to the VDC for the clearance and settlement of such irregularities.

Further, with regards to the audit of the Municipality following points under Section 135 of the Act shall be considered.

1. The Municipality shall itself do the internal audit of the income and expenditure.
2. The final audit of income and expenditure of the Municipality shall have to be carried out by the registered auditor appointed by the Municipal Council on the recommendation of the accounts committee.

3. The Mayor shall have to submit to the accounts committee the final reports submitted by the Mayor and furnish it to Municipal Council along with its opinion and suggestions.

4. The Municipality Council may regularize any irregular amount shown in the audit report received along with the suggestions and opinion of the accounts committee. The Municipal Council shall forward to the Municipality to take necessary action, pursuant to the prevailing law, for the purpose of settlement and realization in respect of those irregular amounts which cannot be regularized by it. Upon receipt of such writing, the Municipality shall have to realize and recover as government dues.

***9. Audit of specific organizations***

***a. Explain the important points which you will consider in preparing the Audit Programme of a NGO.***

Ans: The audit programme should include in a sequential order all assets, liabilities, receipts and expenditures ensuring that no material item is omitted.

- Corpus Fund: The contributions / grants received towards corpus are vouched with special reference to the letters from the donor(s). The interest income is checked with Investment Register and Physical Investments in hand.
- Reserves: Vouch transfers from projects / programmes with donor's letters and board resolutions of NGO. Also check transfer of gross value of asset sold from capital reserve to general reserve and adjustments during the year.
- Ear-marked Funds: Check requirements of donor's institutions, board resolution of NGO, rules and regulations of the schemes of the ear-marked funds.
- Project / Agency Balances: Vouch disbursements and expenditure as per agreements with donors for each of the balances.
- Loans: Vouch loans with loan agreements, receipt counter-foil issued.
- Fixed Assets: Vouch all acquisitions / sale or disposal of assets including depreciation and the authorizations for the same. Also check donor's letters/agreements for the grant. In the case of immovable property check title, etc.
- Investments: Check Investment Register and the investments physically ensuring that investments are in the name of the NGO. Verify further investments and disinvestments for approval by the appropriate authority and reference in the bank accounts for the principal amount and interest.
- Cash in Hand: Physically verify the cash in hand and impress balances, at the close of the year and whether it tallies with the books of account.
- Bank Balance: Check the bank reconciliation statements and ascertain details for old outstanding and unadjusted amounts.

- Stock in Hand: Verify stock in hand and obtain certificate from the management for the quantities and valuation of the same.
- Programme and Project Expenses: Verify agreement with donor/contributor(s) supporting the particular programme or project to ascertain the conditions with respect to undertaking the programme / project and accordingly, in the case of programmes/projects involving contracts, ensure that income tax is deducted, deposited and returns filed and verify the terms of the contract.
- Establishment Expenses: Verify that provident fund, life insurance premium, employee's insurance and their administrative charges are deducted, contributed and deposited within the prescribed time. Also check other office and administrative expenses such as postage, stationery, travelling, etc.

***b. Draft an audit programme to audit the receipts of a cinema theatre.***

- Verify that entrance to the cinema hall is only through printed tickets; tickets are serially numbered and bound into books; that the number of tickets issued for each show and class are different and that for advance booking a separate series of tickets is issued
- Stock of tickets is kept in proper custody.
- If tickets are issued through computer- audit the system to ensure its reliability and authenticity of data generated by it.
- System should provide that at the end of each show a proper statement should be prepared and cash collected be tallied.
- Cash collected is deposited in banks partly on the same day and rest on the next day – depending upon the banking facility available.
- Verify that proper record is kept for free passes issued and the same are issued under proper authority.
- Cross check the entertainment tax deposited.
- Verify the income from advertisements and slides showed before the show.
- Vouch the expenditure incurred on publicity of picture, maintenance of hall, electricity expenses etc.
- Confirm that depreciation on machinery and furniture has been charged at an appropriate rate which is higher, as compared to those admissible in the case of other businesses, in respect of similar assets.
- Vouch payments on account of film hire with bills of distribution and in the process, the agreements concerned should be referred to.
- Examine unadjusted balance out of advance paid to the distributors against films hire contracts to see that they are good and recoverable. If any film in respect of which an advance was paid has already run, it should be enquired as to why the advance has not been adjusted. The management should be asked to make a provision in respect of advances that are considered irrecoverable.
- The arrangement for collection of the share in the restaurant income should be enquired into either a fixed sum or a fixed percentage of the taking may be receivable annually. In case the restaurant is run by

the Cinema, its accounts should be checked. The audit should cover sale of various items of foodstuffs, purchase of foodstuffs, cold drink, cigarettes etc.

# Corporate and Other Laws
## Question and Answer

### Nepal Chartered Accountants Act, 2053 and Nepal Chartered Accountants Rules, 2061

1. Mr. X, council member who is convicted by the Supreme Court of Nepal in a criminal offense involving moral turpitude. The council member has only 9 months tenure left. What will be the consequence of the issue? Discuss fully referring Nepal Chartered Accountants Act, 2053.

**Answer:**

**Nepal Chartered Accountants Act, 2053**

Sec 18. Disqualification for Membership : Following persons shall not be deemed to be eligible to be a member of the Institute:-

- (a) One who has not acquired qualifications as referred to in sub-sections (2) and (3) of Section 16,
- (b) One who has not attained the age of twenty-one years,
- (c) ………………………..
- (d) One who is insolvent and is unable to settle up the debts,
- (e) One who is convicted by the court in a criminal offense involving moral turpitude,
- (f) One who is insane.

**Sec 9. Vacancy and Fulfillment:**

(1) The Council shall, if any seat of any Council member elected pursuant to clause (a) or (b) of sub-section (3) of Section 7 turns vacant due to death or resignation or disqualification to continue as a member of the Institute pursuant to the other provisions of this Act, designate any member as Council member for the remaining term of office, provided the remaining period of such vacated office is of less than a year; and if such term is of more than a year, the vacancy shall be filled through election.

(2) A seat, falling vacant owing to death or resignation of any Council member, nominated pursuant to clause (c) of sub-section (3) of Section 7, shall be fulfilled, for the remaining term of office, as per the procedure set forth in the same section.

On the basis of above provision, Mr. X is disqualified to remain the member of ICAN, consequently he cannot be a member of council. The council shall designate any member as

Council member for the remaining term of office as the remaining period of such vacated office is of less than a year.

2. Discuss the legal provision on facility of subject exemption under Nepal Chartered Accountants rules, 2061.

**Answer:**

Nepal Chartered Accountants Rules, 2061

Rule 16. Facility of subject exemption: If examinee appeared in Chartered Accountancy Education Intermediate or Final Level Examinations obtains at least 30% in a subject of any group and 60% or more in any other subject, he/she shall get facility of exemption in that subject obtaining 60 % marks and he/she shall not have to appear in that subject in three examinations just afterwards.

Provided that except the subject exempted under this rule, an examinee who has not appeared in all the subject of a group shall not get this facility.

16A. Facility of Subject Exemption to Registered Auditors

The council may grant subject exemption as follows to the registered auditor gained following education.

a) If passed the intermediate level from recognized foreign Chartered Accounts Institute, exemption from the examination of Chartered Accountancy Education Intermediate Level of the Institute of Chartered Accountant of Nepal.
b) If passed any group of the intermediate level from recognized foreign Chartered Account Institute and the subjects are in the intermediate level of the Institute of Chartered Accountant of Nepal, s/he may get exemption of the subject.
c) If he/she has completed bachelor degree or master degree in commerce or business administration with major subject account, audit cost accounting, financial management or tax and if the subject securing 50(Fifty) percent in the level resembles the subject of Chartered Accountancy Education Intermediate Level, s/he may get exemption of the subject.
d) Nothwithstanding anything contained in part(c), If he/she has completed bachelor degree or master degree in commerce or business administration from university situated in Nepal with specialization in accountancy securing at least 50(Fifty) percent marks, s/he may get exemption of all the subjects of chartered accountancy education intermidate level.

16B Facility of Subject Exemption to Accounting Technician

If the person eligible to be registered in the intermediate level of Chartered Accountancy Education and completed accounting technician education conducted by this institute desires to gain chartered accountancy education and if the subject passed in the accounting technician resembles the subject of Chartered Accountancy Education Intermediate Level, the council may provide exemption of the subject of intermediate level.

## The Companies Act 2063

3. XYZ Ltd. purchases 20 percent share of ABC Private Ltd. Further DEF Ltd. also purchases 10% share of ABC Private Ltd. What will be the legal status of the ABC Private Ltd.? Is there any formality to be completed under Companies Act, 2063 in this regard?

**Answer:**

**The Companies Act 2063**

**Under Sec 13 of the Act**:

**Conversion of private company into public company**: (1) In the following circumstances, a private company shall be converted into a public company under this section:

(a) If the general meeting of the private company, by adopting a special resolution, decides to convert that company into a public company, Provided, however, that no private company shall be capable of being converted into a public company unless and until it fulfills the requirements to be fulfilled under this Act for being a public company

(b) If twenty five percent or more of the shares of a private company are subscribed by one or more than one public company, Provided, however, that in computing the percentage as referred to in this Clause, the share passed by any banking or financial company as a trustee shall not be calculated.

(c) If a private company subscribes twenty five percent or more of the shares of a public company.

(2) In the circumstances as refer to in Clause (a) of Sub-section (1), the concerned private company, shall for being converted into a public company, make an application as prescribed, accompanied by a copy of the resolution mentioned in that Clause and by the fees as prescribed , to the office within thirty days after the date of such resolution.

(3) On receipt of an application pursuant to Sub-station (2), the office shall, if the concerned private company has fulfilled the necessary requirements for carrying on transactions as a public company, mention in the company register the contents of conversion of such company into a public company and give a company conversion certificates as prescribed within sixty days.

(4) If any private company has to be converted into a public company owing into the circumstances referred to in Clause (b) or (c) of Sub-section (1), the concerned private company shall make an application, as prescribed, setting out all details, accompanied by the fees as prescribed, to the Office for being converted into a public company within seven days after the date of occurrence of such circumstances.

(5) On receipt of an application pursuant to Sub-section(4), the Office shall, if such company has fulfilled the requirements to be fulfilled by a public company under this Act to carry on transactions, mention in the company register the contents of conversion of company into a public company and give a company conversion certificate as prescribed.

(6) If private company is converted into a public company pursuant to this Section, any subsidiary company of that company, as well, shall, *ipso facto* be deemed to have been converted into a public company in the same date.

(7) In the event of conversion into a public company pursuant to Sub-section (6), it shall be the obligation of the concerned company to make an application, accompanied by the required documents, to the Office to get recorded in the company register the contents of conversion of such subsidiary company into a public company and obtain the certificate.

(8) In the event of conversion of any private company into a public company pursuant to this Section, the provisions applicable to the public company under this Act shall be deemed to be, *ipso facto*, applicable to that company after the date of such conversion.

(9) In the event of conversion of any private company into a public company pursuant to this Section, all the assets and liabilities of the private company so converted shall devolve on the successor company.

On the basis of above provision, If twenty five percent or more of the shares of a private company are subscribed by one or more than one public company, the private company shall be converted into a public company. XYZ Ltd. and DEF Ltd. has purchased 30% share of ABC Private Ltd, hence the private limited shall be converted in to public company by completing above formalities.

4. What are the liabilities for matters contained in prospectus? Discuss with the defense available in case of misstatement of prospectus under Companies Act, 2063.

Answer:

Companies Act, 2063

**Section 24. Liability for matters contained in prospectus**: (1) It shall be the duty and obligation of the concerned company to abide by the matters contained in the prospectus published under Section (23).

(2) The directors who have signed the prospectus as referred to in Sub-section (1) shall be liable for the matters mentioned in that prospectus .

(3) If any published prospectus contains false statements made maliciously or deliberately and any person sustains any loss or damage by reason of his/her subscription of securities on the faith of that prospectus, the directors who have signed that prospectus shall be personally liable to pay compensation for the actual loss or damage so sustained .

Provided, however, that a promoter who resigns before the decision made by the company to publish the prospectus or whom on becoming aware of any false statement in the prospectus, publishes a notice of that matter to the information of the general public prior to the sale or allotment of securities or who proves that he/she did not know that the prospectus contained any false statement shall not be liable to bear such compensation.

5. When can an Extra Ordinary General Meeting be convened as per Companies Act, 2063.

Answer:

**Companies Act,**

**Section 82. Extra-ordinary general meeting**: (1) The board of directors of a company may convene an extra-ordinary general meeting if it deems necessary.

(2) If ,in the course of examining the account of a company, it is deemed necessary to call an extra ordinary general meeting for any reason, the auditor may request the board of directors to call such meeting; and if the board of directors fails to call the meeting accordingly, the auditor may make an application, setting out the matter , too the Office; and if an application is so made, the Office may call the extra-ordinary general meeting of the company.

(3) If the shareholders holding at least ten percent shares of the paid–up capital of a company or at least twenty five per cent shareholders of the total number of shareholders make an application, setting out the reasons therefore, to the registered office of the company for calling an extra-ordinary general meeting of the company.

(4) If the board of directors does not call the extra-ordinary general meeting within thirty days from the date on which an application is made pursuant to Sub-section (3), the concerned shareholders may make a petition to the Office setting out the matter; and if a such petition's made, the Office may cause to call such meeting.

(5) If the Office deems necessary to call an extra-ordinary general meeting in view of the findings of any inspection or investigation or for any others reason, it any itself call or cause there board of directors to call such meeting.

6. Discuss the legal provision on removal of auditor under Companies Act, 2063.

Answer:

**Under Section 119 of Companies Act, 2063,**

**Provision relating to removal of appointed auditor**:

(1) No auditor appointed pursuant to this Chapter shall be removed pending the completion of audit of accounts of any financial year for which he/she was appointed as the auditor.

(2) Notwithstanding anything contained in Sub-section (1) , if any auditor breaches the code of conduct of auditors or does any act against the interest of the company which has appointed him as the auditor or commits any act contrary to the prevailing law, such auditor may be removed through the same process whereby he/she was appointed as auditor, by giving prior information to the Nepal Chartered Accountants Institute, and with the approval of the regulatory authority, if any authorized by the prevailing law for the regulation of business of the company concerned , and failing such authority, with the approval of the Office.

(3) While removing an auditor pursuant to Sub-section (2), the auditor shall be provided with a reasonable opportunity to defend him/herself.

**Securities Act 2063**

7. What are the Qualification of Chairperson and member of SEBON.

Answer

Securities Act, 2063

**10. Qualification of Chairperson and member:** In order to be appointed as a Chairperson or a member, as the case may be, a person shall have to possess the qualification as follows:-

(a) One who is a citizen of Nepal,

(b) One who has maintained high moral character,

(c) One who has gained at least seven years of professional experience in the field of stock exchange management, capital market development, economics, finance, commerce, management or law, and

(d) One who is not disqualified under Section 11.

Under section 11 Any of the following persons shall not be eligible to be appointed to the office of Chairperson or member, as the case may be:-

(a) One who is an officer-bearer of a political party,

(b) A person involved in securities business,

(c) One who is adjudicated as an insolvent,

(d) One who is insane,

(e) One who has been convicted by the court of an offense involving moral turpitude.

8. Discuss the conditions where Securities Board of Nepal may refuse to issue license to a body corporate to carry on stock exchange under Securities Act, 2063.

Answer:

**Securities Act**

**Section 40. Power to refuse to issue license to carry on stock exchange:**

(1) Notwithstanding anything contained in Section 38, the Board may, on any of the following conditions, refuse to issue a license to a body corporate to carry on a stock exchange:

(a) Where it is not necessary to carry on the stock exchange based on the development of industry and business and feasibility of the existing transactions in securities,

(b) Where it does not appear just and appropriate to allow the operation of stock exchange for the protection of interests of investors.

(2) Where the Board is to refuse the issue of a license to any body corporate to carry on the stock exchange on any condition referred to in sub-section (1), the Board shall give a notice assigning the reason for such refusal to the concerned body corporate.

9. Write Short Notes on types of securities business

Answer:

Securities Act, 2063

**Section 63. Types of securities business:** (1) the securities business shall be divided into the following types:-

(a) Securities brokerage,

(b) Securities trade,

(c) Issue and sales management,

(d) Investment management,

(e) Investment consultancy service,

(f) Collective investment fund management,

(g) Securities registration or securities central deposit service or custodial service,

(h) Service relating to the settlement of the account of securities transactions,

(i) Market maker,

(j) Such other business as may be specified by the Board to be a securities business.

(2) The scope and other provisions of the securities business referred to in Sub-section (1) shall be as prescribed.

**Banks and Financial Institutions Act, 2063**

10. Discuss the circumstances where Nepal Rastra Bank may refuse to issue a license to any bank or financial institution to carry on the financial transactions under BAFIA.

Answer:

Banks and Financial Institutions Act, 2063

**Section 32. Power to refuse to issue license to carry on financial transactions:** (1)Notwithstanding anything contained in Section 30, the Rastra Bank may, in any of the following circumstances, refuse to issue a license to any bank or financial institution to carry on the financial transactions:

(a) If, in view of the existing condition and potentiality of the banking or financial sector, it does not appear appropriate to grant a license to additional bank or financial institution to carry on the financial transactions;

(b) If, in the light of the situation mentioned in Clause (a), for the protection of the interests of depositors, it does not appear just and appropriate to issue a license to carry on the financial transactions;
(c) If it does not appear that the details or requirements referred to in Sections 29 and 30 have been completed.
(2) If there exists a situation where the license to carry on the financial transactions cannot be issued to any bank or financial institution pursuant to Sub-section (1), the Rastra Bank shall give a notice thereof, accompanied by the reason for the same, to the concerned bank or financial institution within one hundred twenty days from the date of application. If the Rastra Bank has requested for any additional details within that period, such notice shall be given within ninety days from the date of receipt of such details.

Under Section -37 of Banks and Financial Institutions Act, 2063, Conversion of licensed institution of higher class into licensed institution of lower class: (1) If any licensed institution fails to meet any of the following conditions, the Rastra Bank may make a decision to convert it into a Class "B" licensed institution if it is a Class "A" licensed institution, and into a Class "C" licensed institution if it is a Class "B" licensed institution:
(a) If it has failed to raise the capital as prescribed within the period prescribed by the Rastra Bank;
(b) If it has been incurring loss since five consecutive years;
(c) If it has been subjected to action for frequent violations of the directives issued by the Rastra Bank;
(d) If it has failed to maintain a risk-bearing fund as prescribed by the Rastra Bank.
(2) The Rastra Bank shall, prior to taking action against any bank or financial institution pursuant to Sub-section (1), give a reasonable opportunity to the concerned bank or financial institution to furnish its explanations against such action.
(3) If any licensed bank or financial institution of a higher class intends to be converted into a licensed bank or financial institution of a lower class and makes an application to the Rastra Bank for approval, and if the Rastra Bank gives its approval after making necessary inquiries, such bank or financial institution shall be converted into a licensed bank or financial institution of a lower class.

11. Mr. Toran is a Director of Triveni Bank Ltd. Mrs Rima, (adopted son's daughter of Mr. Toran) is a qualified chartered accountant having obtained COP from ICAN. The General Meeting of the Bank appointed Mrs. Rima an auditor of the bank. After completion of all the audit but before signing the report, Mrs Rima asks your suggestion about any legal complication on issuing the report. Advice her with other related provision of BAFIA whether she is qualified or not.

Answer:
BAFIA
**Section 61. Disqualification for appointment as auditor:** Any of the following persons or any firm or company in which such person is a promoter or partner shall not be eligible to be appointed as an auditor

of a licensed institution and shall cease to hold the office of auditor even though such person is already appointed:

(a) A director of the licensed institution or his or her family member;

(b) An employee of the licensed institution;

(c) A person working as a partner of any director or employee of the licensed institution;

(d) A debtor of the licensed institution;

(e) A person who has been punished in an offense relating to audit, and a period of five years has not lapsed after he or she has served the punishment;

(f) A person who is insolvent;

(g) A person, firm, company or institution having subscribed one percent or more of the shares in the licensed institution;

(h) A person who has been punished by the court for a criminal offense involving moral turpitude, and a period of five years has not lapsed after he or she has served the punishment;

(i) A person who has been punished by a court for an offense relating to corruption or cheating;

(j) A person who is not included in the list of auditors approved by the Rastra Bank.

2(pp) “family” means the concerned person's husband or wife, son, daughter, adopted son, adopted daughter, father, mother, stepmother and elder brother, younger brother, elder sister and younger sister to be maintained by him or her;

On the basis of above provision adopted son's daughter of director of the bank is not in the family member's list, hence she is qualified to be appointed as an auditor of the Bank.

**Nepal Rastra Bank Act, 2058**

12. What are the functions, duties and powers of the Governor under Nepal Rastra Bank Act, 2058?

Answer

**Section 30. Functions, Duties and Powers of the Governor:** (1) The functions, duties and powers of the Governor shall be as follows:-

(a) To implement the decisions made by the Board;

(b) To operate and manage the Bank;

(c) To systematize the functions to be carried out by the Bank;

(d) To represent and cause to represent on behalf of the Bank in international organizations and associations;

(e) To implement and cause to implement the policies relating to monetary and foreign exchange matters;

(f) To formulate necessary policy on rates of interest for deposits and loan with commercial banks and financial institutions;

(g) To formulate necessary policies with regard to the rates of interest to be paid by commercial banks and financial institution on deposit and loan or the rate of interest to be charged by them on deposits and loan;

(h) To formulate necessary policies relating to liquidity to be maintained by commercial banks and financial institutions;

(i) To make necessary arrangement with regard to the basis, amount, methods, conditions and duration of compulsory deposit to be maintained by commercial banks and financial institutions, and its use;

(j) To fix the terms and conditions relating to adequacy of the capital fund of commercial banks and financial institutions;

(k) To take decision with regard to the procedures and terms and conditions to be followed while purchasing and selling gold and other precious metals;

(l) To fix the charge on the services to be provided by the Bank;

(m) To take decision for opening and closing branch offices and other offices of the Bank as may be necessary;

(n) To establish and close the agency of the Bank;

(o) To make necessary arrangement for development and operation of information system of the Bank;

(p) To make necessary arrangement for supervision of commercial banks and financial institutions;

(q) To take decision with regard to revocation of the license provided to commercial banks and financial institutions;

(r) To take decisions on any other matters subject to the powers delegated by the Board of Directors; (2) The powers to be exercised by the Governor of a Central Bank in accordance with international practice shall be vested in the Governor.

13. What are the assets which may consist in the Foreign Exchange Reserve under Nepal Rastra Bank Act, 2063.

Answer

Under section 66 of Nepal Rastra Bank Act (1) The Bank shall mobilize the foreign exchanges reserve. Such reserve shall be denominated in the respective foreign exchange and such reserve shall consist of the following assets:-

(a) Gold and other precious metals held by or for the account of the Bank;

(b) Foreign currencies held by or for the account of the Bank;

(c) Foreign currencies held in the accounts of the Bank on the books of a foreign central bank or other foreign banks;

(d) Special drawing rights (SDR) held by the Bank at the International Monetary Fund;

(e) Bill of exchange, promissory note, certificate of deposit, bonds, and other debt instrument payable in convertible foreign currencies issued by any debtor or liability holder and held by the Bank;
(f) Any forward purchase or repurchase agreements of the Bank concluded with or guaranteed by foreign central banks or public international financial institutions, and any futures and option contracts of the Bank providing for payment in freely convertible foreign currency.
(2) While selecting the assets referred to in Sub-section (1), due consideration should be given to the Bank's capital and liquidity to maximize earnings.
(3) The Bank shall maintain international reserve at a level, which shall be adequate for the execution of monitory and exchange rate policies and for the prompt settlement of the international transaction.
(4) If international reserves have declined or, in the opinion of Bank, are in danger of declining to such an extent as to jeopardize the execution of the monetary or exchange rate policies in the prompt settlement of the country's international transactions, the Bank shall submit to Government of Nepal a report on the international reserves position and the causes which have led or may lead to such a decline, together with such recommendations as it considers necessary to remedy the situation.
(5) Until such time as, the situation referred in Sub-section (4) has been rectified, the Bank shall make further such report and recommendations to Government of Nepal.
(6) The Bank shall hold the foreign exchange reserve referred to in Sub-section (1) in its balance sheet.

## Industrial Enterprises Act, 2049

14. Enumerate the constitution of Industrial Promotion Board?

Answer

**Section 12. Constitution of Industrial Promotion Board:**

(1) Government of Nepal shall constitute an Industrial Promotion Board consisting of the following members:
(a) The Minister or State Minister for Industries -Chairman
(b) The Assistant Minister for Industries -Member
(c) Member (looking after industries), National Planning commission -Member
(d) The Governor, Nepal Rastra Bank -Member
(e) The Secretary, Ministry of Industry -Member
(f) The Secretary, Ministry of Finance -Member
(g) The Secretary, Ministry of commerce -Member
(h) The Secretary, Ministry of Tourism -Member
(i) The Director General, Department of Cottage and Small Industries - Member
(j) Representative, Federation of Nepal Chamber of Commerce and Industry -Member

(k) To persons nominated by Government of Nepal, either from among the industry, commerce and tourism sector organizations or from among the persons of high distinction in the same field -Member

(l) The Director General, Depart of Industries -Member Secretary

(2) Government of Nepal may, by notification published in the

Nepal Gazette, make necessary alteration or change in the membership of the Board.

(3) The Board may, if it deems necessary, invite any national or foreign expert or consultant at any meeting of the Board to participate therein as an observer.

(4) The procedures relating to the meetings of the Board shall be as determined by the Board.

**Labor Act, 2048**

15. Discuss the circumstances in which the employee may be retrenched under Labour Act, 2048. Mr. A, B, C are engaged in similar types of works in any establishment. Mr. A was appointed in the year 2065, Mr. B was appointed in the year 2067 and Mr. C was appointed in the year 2069. The establishment wants to retrench Mr. A and C, can it do so? Discuss with reference to the relevant legal provision.

Answer

**Section 12. Retrenchment and reinstatement:** (1) If, for any special circumstances, the production or service of the Enterprise had to be curtailed or the Enterprise has to be closed party or wholly for more than three months, the Proprietor may, with the approval of Government of Nepal through the Department of Labour, retrench in the number of the workers and employees, partly or wholly, of the Enterprise.

□(1A) If the Manager makes a demand to Government of Nepal for approval in respect of the retrenchment of workers or employees pursuant to Sub-section (1), Government of Nepal shall have to make decision within two months on whether such retrenchment of employees to be made or not.

(2) While retrenching the workers or employees under Sub-section (1), engaged in similar type of works, those permanent workers or employees who \were appointed in the last shall be retrenched first.

Provided that, if it is required to retrench some of the workers or employees appointed earlier, not following the prescribed order of retrenchment such retrenchment may be made by specifying the reasons thereof.

(3) While doing retrenchment as per Sub-section (2), it shall be done as follows –

(a) By providing a notice with the reasons or retrenchment either one month in advance or paying the remuneration of one month in case of worker or employee who is permanent, and

(b) By paying a lump sum compensation to each worker or employee of the amount of remuneration calculated by multiplying the number of each year of service performed at the Enterprise by the amount of his/her present remuneration for 30 days.

**Explanation:** For the purposes of this Clause, the work performed for at least six months in any year shall be counted as one year of service.

(4) The provisions of Sub-section (3) shall not applicable to any worker or employee appointed under contract service.

(5) If anybody has to be engaged in the job of worker or employee retrenched earlier, priority shall be given to the retrenched workers or employees.

**Explanation:** For the purposes of Section 11 and 12 the "Special Circumstance" shall mean damage, break down or failure of machines or the Enterprise and thereby causing stoppage in the production or failure in the supply of fuel, electricity, coal or similar energy or due to any kind of force majeure or insufficient supply of raw materials or stock piling of the produced goods due to loss of sale or other similar situations.

On the basis of above relevant provision, while retrenching the workers or employees engaged in similar type of works, those permanent workers or employees who \were appointed in the last shall be retrenched first.

However if it is required to retrench some of the workers or employees appointed earlier, not following the prescribed order of retrenchment such retrenchment may be made by specifying the reasons. Hence the establishment may retrench Mr. A also specifying reason.

**Bonus Act, 2030**

16. Discuss the Categories of Bonus And Time-Limit for Payment of bonus under Bonus Act, 2030.

Answer:

Bonus Act

**Section 9. Categories of Bonus And Time-Limit for Payment**

1. Bonus payable under this act shall be paid in cash.
2. Bonus shall be paid within eight months after the expiry of the fiscal year.
3. In case the General Manager submits an application to the Labor Office mentioning the reasons why bonus con not be paid within the time-limit mentioned in Sub-Section (2), and in case such reasons are considered proper, the Labor Office may extend the time-

limit for a maximum period of there months, or permit the payment of two years bonus in one lump sum during the next fiscal year.

## Contract Act 2056

17. The law of contracts is not a whole law of agreements, nor is it the whole law of obligations. It is the law of those agreements which create legal obligations and those obligations which have their source in agreement. Discuss

**Answer:**

The above mentioned statement was stated by Salmond. As law of contracts excludes from its purview all such obligations, and agreements of social nature and hence is not enforceable by law. All contracts are agreements, but all agreements are not contracts. So there is material difference between agreements and contracts.

Only those agreements which are enforceable by law are contracts. Thus legally enforceable promises are termed contracts. To be a valid contract it must fulfill certain requirements or possess certain essential elements. Essentials of the valid contracts are: Offer and acceptance, Intention to create legal relations, Lawful consideration/object, Capacity of parties, Free consent, Meeting of Mind, Writing and registration, Possibility of performance.

An agreement enforceable by law is a contract. Enforceability implies a legal obligation or duty arising out of agreement. But every sort of agreement may not create legal obligation. If an agreement creates obligation which can be enforced through a court of law, the agreement is known a contract.

Where agreement does not create legal obligation, it does not fall under the definition of the contract. All legal obligations however are not contractual in nature. For instance, obligation to maintain wife and children or obligation resulting from judgment of courts, or performance of legal duty etc.

So, since all the agreements are not contract, the law of contracts is not a whole law of agreements. Law of contract does not cover the whole law of obligations. It is the law of those agreements which create legal obligations and those obligations should be created in an agreement by the parties.



## Insurance Act 2049

18. XYZ Insurance Company is dissolved due to cancellation of its registration under Insurance Act as liability of it exceeded its assets within Nepal. The company is unable to settle all of its liability. The

insured, employee of Insurer, Creditor all claimed their amount requesting for giving first priority to them. Discuss the settlement of liabilities in this situation under Insurance Act, 2049.

Answer

**Section 41B. Order of Priority in Settlement of Liabilities :** If any Insurer is dissolved due to the cancellation of its registration pursuant to Section 13, the liabilities shall be settled in the following order of priority :-

(a) The expenses incurred for the dissolution,

(b) The amount to be paid against the insurance claims to the Insured pursuant to Section 16,

(c) The remuneration and other outstanding amounts to be obtained by the employees of the Insurer,

(d) Loan amounts,

(e) The amount to be paid to the Board,

(f) The amount to be paid to the Government of Nepal .

**Negotiable Instruments Act 2034**

19. What do you mean by Holder in Due Course? A Draws a Crossed Cheque in favorable of B bearing in the words "not negotiable". C Steals the same from B and endorses to D. D takes the instrument for value before it is overdue and without any notice of defects in the title of C. Can D become a good owner of the instrument? Discuss the objective of not negotiable crossing with relevant provision of Negotiable Instrument Act 2034.

**Answer:**

Negotiable Instruments Act, 2034

2k) "Holder" means a person entitled in his own name to the posession of a Negotiable Instrument and to recieve the amount due on it.

2(o) "Holder in due Course" means a person having entitlement upon the Negotiable Instrument according to law, in the case of a Negotiable Instrument payable to a bearer, and the Payee or a person endorsed by him, in the case of a Negotiable Instrument payable to the ordered perosn.

Provided that, such entitlement must have received or endorsed before the maturity of such Negotiable Instrument without having sufficient cause to believe that any defect existed in the title of the person from whom he derived his title.

**89. Cheque Bearing "Not Negotiable":** A person taking a Cheque Crossed generally or specially bearing in either case the words "not negotiable" shall not have, and shall not be capable of giving a better title to the Cheque than that which the person from whom he took it had.

So, if the holder has a good title, he can still transfer it with a good title, but if the transferor has a defective title, his transferee is affected by such defects, and he can not claim the rights of a holder in due course.

The primary objective of not negotiable crossing is to safeguard the interest of the true owner of the cheque. It is in reality a warning to the payee or endorsee or to the holder of the cheque to accept it only if he knows the endorser and is convinced that the latter has good title thereto, because in its absence, his own title to the cheque will become defective and he himself will be liable to the true owner of the cheque even if he has acquired it for consideration.

If the transferor had defective title, the title of the holder in due course also becomes defective. Therefore, he will have to refund the amount to the true owner. Principle of "Nemo Dat Quod non hebet will be applicable to a cheque with a not negotiable crossing.

So, cheque with not negotiable crossing are negotiable so long as their title is good.Once the title of the transferor becomes defective the title of the transferee is also affected by such defect and the transferee can not claim the right of a holder in due course. So Mr. D can not claim the right of a holder in due course and he can not be a good owner.

20. When does notice of dishonor unnecessary Under Negotiable Instruments Act, 2034?

Answer

Negotiable Instruments, Act, 2034

**Section 70. When Notice of Dishonour is Unnecessary:** No notice of dishonour is necessary in the following conditions:-

(a) When it is dispensed with by the party entitled thereto,

(b) When the Drawer has countermanded payment,

(c) When the party has not suffered damage for want of notice,

(d) When the acceptor is also a Drawer,

(e) In the case of a Promissory Note which is not negotiable.

(f) When the party entitled to notice cannot after due search be found, or the party bound to give notice, is for any other reason, unable without any fault of his/her own to give it,

(g) When the party entitled to notice, knowing the facts, promises unconditionally to pay the amount due on the Negotiable Instrument.

**Social Welfare Act, 2049**

21. What are the Functions, Duties and Powers of the Social Welfare Council?

Answer

**Section 9 of Social Welfare Act, 2049**

The functions, Duties and Powers of the Council shall be as follows:

(a) To run or cause to run the social welfare activit ies smoothly and effectively, to extend help to the social organizations and institutions and to de velop co-ordinations among them and to supervise, followupand carry out evaluations of their activities.

(b) To extend or cause to extend help and support to establish social organizations and institutions, their development, strengthening and extensions.

(c) To work or cause to work as co-coordinator between Government of Nepal and social organizations and institutions.

(d) To provide consultancies to Government of Nepal in order to formulate policies and programmes directly related to social welfare activit ies and other social services.

(e) To establish and conduct or cause to establish and conduct a fund, for the social welfare activities.

(f) To work or cause to work as a center for dissemination of information and documentation to the affiliated service oriented organizations and institutions with Council.

(g) To conduct or cause to conduct trainings, studies and research programmes in the areas with social welfare.

(h) To carry out or cause to carry out the physical supervisions of the properties of those social institutions and organizations affiliated
with the Council.

(i) To carry out or cause to carry out the necessary functions to implement the objectives of this Act.

(j) To make or cause to make contract or agreement with the local, foreign or international organizations and foreign countries.

(k) To collect grant from the national and international agency and to manage the received grant.

**WTO and Nepalese Laws**

22. What are the Objectives of WTO?

Answer

Followings are the objectives of WTO;

(1) to implement the new world trade system as visualized in the Agreement;

(2) to promote World Trade in a manner that benefits every country;

(3) to ensure that developing countries secure a better balance in the sharing of the advantages resulting from the expansion of international trade corresponding to their developmental needs;

(4) to demolish all hurdles to an open world trading system and usher in international economic renaissance because the world trade is an effective instrument to foster economic growth;

(5) to enhance competitiveness among all trading partners so as to benefit consumers and help in global integration;

(6) to increase the level of production and productivity with a view to ensuring level of employment in the world;

(7) to expand and utilize world resources to the best;

(8) to improve the level of living for the global population and speed up economic development of the member nations.



23. Write Short notes/ Distinguish between the following.

**a) Reinsurance and Double insurance.**

Every insurance company has a limit to the risk it is willing to undertake in respect of an individual policy. Thus, if an insurance company finds that it has entered into an insurance contract which is an expensive proposition for it or if it wishes to minimize the chances of any possible loss, it will reinsure a portion of the risk with some other insurance company or companies. This is known as re insurance.

When the same subject matter is insured with two or more insurers and the total sum insured exceeds the actual value of the subject matter, it is known as double insurance and it amounts to over insurance. In case of loss, the assured may claim payment from the insurers in such order as he thinks fit, but he will not get more than his actual loss, as each contract of insurance is a contract of indemnity. The advantage of double insurance is that it protects him against loss in the event of one or more of the insurers becoming insolvent, he can recover up to the value of the policy from the solvent insurer. There is no double insurance in case of life insurance.

Reinsurance Vs. Double insurance.

1. Re insurance business entered into by the original insurer with other insurers. But in double insurance the insured gets the same subject matter insured with more than one insurer or under more than one policy with the same insurer.
2. In reinsurance the insured cannot claim any part of his loss from the insurer. But in double insurance the insured can claim only his actual loss from each of the insurers up to the amount insured with them.
3. In reinsurance the reinsured will claim a part of the loss proportionate to the risk reinsured by him with the reinsurers. But in double insurance each insurer is liable to contribute on prorate basis towards loss suffered by the insured.

b) Standard Form Contract.

Answer:

Where the term and condition of agreement has already been fixed in a standard form and the other party of the agreement has to accept those term and condition such types of contract is called 'Standard Form of Contract'. In the modern age some persons, institutions or establishments such as the Railway, insurance companies, Bank, Manufacturers of various goods, etc. may have to enter into a very large numbers of contracts with thousands of persons, they cannot possibly negotiate individually with the persons with whom the contracts are to be made. Contracts with pre-drafted matters are generally prepared by one party, which the other has to agree to it or leave it.

**FINANCIAL MANAGEMENT**
**QUESTIONS**

## Time value of Money

### Question 1

Mr Ramesh Thapa, Senior Computer Engineer of the ICT Technology Pvt Ltd wish to retire forty years from today. He determine that he need Rs 500,000 per year once he retire, with the first retirement funds withdrawn one year from the day he retire. He estimate that he will earn 6% per year on his retirement funds and that he will need funds up to and including his 25th birthday after retirement. He hired a financial consultant to determine his retirement plan. As a financial consultant

a. How much must he should deposit in an account today so that he have enough funds for retirement?

b. How much must he should deposit each year in an account, starting one year from today, so that he have enough funds for retirement?

## Capital structure and Leverage

### Question 2

Nepal Sugar Factory Pvt ltd is the profit making company, is planning to expand new line of production(ie Cube Sugar). In order to expand the new line of product, company requires Rs 20,00,000 for which company has following two alternatives

(i) Equity share capital of Rs.12,00,000 and 10.5% debentures of Rs.8,00,000

**Or**

(ii) Equity share capital of Rs.9,00,000, 14% preference share capital of Rs.5,00,000 and 10.5% debentures of Rs.6,00,000.

Assume the corporate tax rate is 30% and par value of equity share is Rs.100 in each case
As a financial analysis suggest the company on determination of capital sturcutre.

## Cost of capital

### Question 3

Lipton Limited has the following book value capital structure:

| | |
|---|---|
| 10 million Equity Share at Rs.100 | Rs.1,000 million |
| 2.5 million,10.5% Preference Share Capital at Rs.100 | Rs.250 million |
| 1.5 million, 9% Debentures at Rs.1000 | Rs.1,500 million |
| 8% Term Loans from Financial Institutions | Rs.500 million |

The current market price per equity share is Rs.560. The prevailing default-risk free interest rate on 10-year Treasury Bonds is 6.5%. The average market risk premium is 8.5%. The beta of the company is 1.2515.

The preferred stock of the company is redeemable after 5 years is currently selling at Rs.94.59 per preference share.

The debentures of Lipton Limited are redeemable after three years and are quoting at Rs.975.13 per debenture. The applicable income tax rate for the company is 30%.

Required:

*(i)* Calculate weighted average cost of capital of the company using market value weights.

*(ii)* Define the weighted marginal cost of capital structure for the company if it raises Rs 750 million , given the following information

- The firm plans to have a target debt to value ratio of 20%.
- The debt capital will be raised through term loans. It will carry interest rate of 9.5% for the first 100 million and 10% for the next Rs.50 million.
- The beta of new project is 1.4375

**Cost of Capital**

**Question No 4:**

JKL Ltd. has the following book-value capital structure as on Ashad 31, 2072.

| | Rs. |
|---|---|
| Equity share capital (2,00,000 shares) | 40,00,000 |
| 11.5% preference shares | 10,00,000 |
| 10% debentures | 30,00,000 |
| | 80,00,000 |

The equity share of the company sells for Rs.20. It is expected that the company will pay next year a dividend of Rs.2 per equity share, which is expected to grow at 5% p.a. forever. Assume a 35% corporate tax rate.

Required:

i. Compute weighted average cost of capital (WACC) of the company based on the existing capital structure.

ii. Compute the new WACC, if the company raises an additional Rs.20 lakhs debt by issuing 12% debentures. This would result in increasing the expected equity dividend to Rs.2.40 and leave the growth rate unchanged, but the price of equity share will fall to Rs. 16 per share.

**Analysis of Financial Statement**

**Question No 5 :**

Pooja trade Ltd is a dealer in automobile components. While preparing the financial statements for the year ended 31.03.2073, it was discovered that a substantial portion of the records were missing, however the accountant was able to gather the following data

| Liability | Rs | Rs | Assets | Rs | Rs |
|---|---|---|---|---|---|
| Authorised , subscribed and Paid up Share Capital ( 20,000 Equity Share of Rs 10 Each) | | 200,000 | Land | | 120,000 |
| Reserve and surplus | | | Plant and Machinery | | |
| Balance as on 01.04.2072 | 60,000 | | at cost | ? | |
| Add: Transfer during the year | ? | ? | Less: Depreciation | ? | ? |
| 15% Loan | | ? | Current Assets | | ? |
| Current Liabilities | | 200,000 | Cash and Bank | | ? |
| Proposed Dividend | | ? | Debtors | | ? |
| Provision for Tax | | ? | Stock | | ? |
| Creditors | | ? | | | |
| Total | | | Total | | |

Following are other information

| | | |
|---|---|---|
| 1. Current Ratio | 2 times | |
| 2. Cash and Bank | 30% of total current assets | |
| 3. Debtor turnover ratio | 12 times | |
| 4.Stock turnover ratio | 12 times | |
| 5. Creditor turnover ratio | 12 times | |
| 6.Gross profit ratio | | 25% |
| 7.Proposed Dividend | | 20% |
| 7. Tax rate | | 33.33% |
| 8. Debt service coverage ratio | 1 times | |
| 9.Interest coverage ratio | 3 times (Interest on the balance of loan outstanding on 1.4.72) | |
| 10.Selling and distribution Expense | | 180000 |
| 11. Depreciation rate | | 40% |
| 12. Cost of good sold does not include depreciation | | |

**Valuation of Securities**

**Question No 7:**

YHT Ltd is expected to pay a dividend growing at 30% for the next three years. In the fourth year, the dividends will begin to grow constantly by 1.5%. If this year's dividend was Rs 5.00 and the appropriate discount rate is 13%, what is the current price of YHT stock?

**Valuation of Securities**

**Question No 8:**

The par value of the share of Sanima Bank is Rs 100 and the bank will pay a dividend of 36% next year. The required rate of return of investor is 12% and expect the dividend to grow forever (at a constant rate). If investor are now willing to pay Rs 730.00 to purchase stock of Sanima Bank. What must the implied growth rate?

**Capital Investment Decision**

**Question No 9 :**

The Gorakh-Kali Rubber Udyog manufactures small rubber components for the local market. It is presently using 8 machines which were acquired 3 years ago at a cost of Rs 18 lakh each having a useful life of 8 years with no salvage value. The policy of the company is to depreciate all machines in 5 years. Their production capacity is 37 lakh units while the annual demand is 30 lakh units. The Gorakh-Kali Rubber Udyog has received an order from a leading automobile company of Sipradi Trading for the supply of 20 lakh rubber bushes at Rs 15 per unit. The existing machines can be sold @Rs 12 lakh per machine. It is estimated that the removal cost of each machine would be Rs 60,000. In order to meet the increased demand, the Gorakh-Kali Rubber Udyog can acquire 3 new machines at an estimated cost of Rs 100 lakh each which will have a combined production capacity of 52 lakh units.

The operating parameters of the existing machines are as follows:

i. Labour requirements (Unskilled-18; Skilled-18; Supervisor-3; and Maintenance-2) and their per month salaries are Rs 3,500; Rs 5,500; Rs 6,500 and Rs 5,000 each respectively with an increase of 10 percent to adjust inflation.
ii. Raw materials cost, inclusive of wastage is 60 per cent of revenues.
iii. Maintenance cost – years 1-5 (Rs 22.5 lakh), and years 6-8 (Rs 67.5 lakh).
iv. Operating expenses – Rs 52.10 lakh expected to increase annually by 5 percent.
v. Insurance cost/premium – year 1,2 per cent of the original cost of the machine, afterwards discounted by 10 per cent.
vi. Selling Price – Rs15 per unit.

The projected operating parameters with the replacement by the new machines are as follows:

i. Additional working capital – Rs 50 lakh.
ii. Savings in cost of utilities – Rs 2.5 lakh.
iii. Maintenance cost – years 1-2 (Rs 7.5 lakh); years 3.5 (Rs 37.5 lakh).
iv. Raw materials cost – 55 per cent of sales.
v. Employee requirement (6 skilled at monthly salary of Rs 7,000 each and one for maintenance at monthly salary of Rs 6,500).
vi. Laying off cost of 34 workers – (Unskilled-18; Skilled-12; Supervisors-3; and maintenance-1) Rs 9,21,000, that is equivalent to six months salary.

vii. Insurance cost/premium-2 per cent of the Purchase cost of machine in the first year and discounted by 10 percent in subsequent years.

viii. Life of machines – 5 years and salvage value – Rs. 10 lakh per machine.

The company follows straight line method of depreciation and the same is accepted for tax purposes. Corporate tax rate is 35 per cent and the cost of capital is 20 percent.

As the Finance Manager of Gorakh-Kali Rubber Udyog prepare a report for submission to the top management with your recommendations about the financial viability of the replacement of the existing machine.

**Capital Investment Decision**

**Question No 10:**

Nepal Timber Ltd. has just installed Machine-R at a cost of Rs. 2,00,000. The machine has a five year life with no residual value. The annual volume of production is estimated at 1,50,000 units, which can be sold at Rs. 6 per unit. Annual operating costs are estimated at Rs. 2,00,000 (excluding depreciation) at this output level. Fixed costs are estimated at Rs. 3 per unit for the same level of production.

Nepal Timber Ltd. has just come across another model called Machine-S capable of giving the same output at an annual operating cost of Rs. 1,80,000 (exclusive of depreciation).There will be no change in fixed costs. Capital cost of this machine is Rs. 2,50,000 and the estimated life is for five years with nil residual value.

The company has an offer for sale of Machine-R at Rs. 1,00,000. But the cost of dismantling and removal will amount to Rs. 30,000. As the company has not yet commenced operations, it wants to sell Machine –R and purchase Machine-S.

Nepal Timber Ltd. will be a zero-tax company for seven years in view of several incentives and allowances available. Company plans to follow dividend discount model to estimate the cost of equity capital. The Company plans to pay a dividend of Rs 4 per share in the next year. The current market price of company 's equity share is Rs 90 per share. The dividend per share of the company is expected to grow at 10% per annum. Ignore tax on capital gain or loss. P.V. factors for five years at 14% are as follows:

| Year | P.V. Factors |
|---|---|
| 1 | 0.877 |
| 2 | 0.769 |
| 3 | 0.675 |
| 4 | 0.592 |
| 5 | 0.519 |

*(i)* Advise whether the company should opt for the replacement.

*(ii)* Will there be any change in your view if Machine-R has not been installed but the company is in the process of selecting one or the other machine?

Support your view with necessary workings.

## Capital Investment Decision

### Question No 11

Om Co-Operative Limited has decided to go in for a new model of Mercedes Car. The cost of the vehicle is Rs.40 lakhs. The company has two alternatives:

*(a)* taking the car on finance lease; or

*(b)* borrowing and purchasing the car.

LMN Limited is willing to provide the car on finance lease of Om Co-Operative Limited for five years at an annual rental of Rs.8.75 lakhs, payable at the end of the year.

The vehicle is expected to have useful life of 5 years, and it will fetch a net salvage value of Rs.10 lakhs at the end of year five. The depreciation rate for tax purpose is 40% on written-down value basis. The applicable tax rate for the company is 35%. The applicable before tax borrowing rate for the company is 13.8462%.

What is the net advantage of leasing for the Om Co-Operative Limited?

## Working Capital Management and Financial Forecasting

### Question No 12:

A proforma cost sheet of a Hulas Galvanize company provides the following particulars:

| Particulars | Amount per unit |
|---|---|
| Raw materials | 80 |
| Direct labour | 60 |
| Overhead | 62 |
| Total cost | 202 |
| Profit | 88 |
| Selling price | 290 |

The following further particulars are available:
Raw materials in stock, on average, one month;
Materials in process (completion stage, 50 per cent), on average, half a month;
Finished goods in stock, on average, one month.
Credit allowed by suppliers is one month;
Credit allowed to debtors is two months;
Average time-lag in payment of wages is 1.5 weeks and one month in overhead expenses;
one-fourth of the output is sold against cash; cash in hand and at bank is desired to be maintained at 15% of net working capital.

**Required:**

You are required to prepare a statement showing the working capital needed to finance a level of activity of 1,20,000 units of production. You may assume that production is carried on evenly throughout the year, and wages and overheads accrue similarly. For calculation purposes, 4 weeks may be taken as equivalent to a month and year has 52 weeks.

**Account Receivable Management**

**Question No 13**

As a part of the strategy to increase sales and profits, the sales manager of a Nepal Cookies Pvt Ltd proposes to sell goods to a group of new customers with 10% risk of non-payment. This group would require one and a half months credit and is likely to increase sales by Rs 1,00,000 p.a. Production and Selling expenses amount to 80% of sales and the income-tax rate is 30%. The company's minimum required rate of return (after tax) is 25%.

Should the sales manager's proposal be accepted?

Also find the degree of risk of non-payment that the company should be willing to assume if the required rate of return (after tax) were (i) 30%, (ii) 40% and (iii) 60%.

**Payment to creditor**

**Question No 14:**

Misha Limited presently gives terms of net 30 days. It has Rs 6 crores in sales, and its average collection period is 45 days. To stimulate demand, the company may give terms of net 60 days. If it does instigate these terms, sales are expected to increase by 15%. After the change, the average collection period is expected to be 75 days, with no difference in payment habits between old and new customers. Variable costs are Rs 0.80 for every Rs 1.00 of sales, and the company's required rate of return on investment in receivables is 20 per cent. Should the company extend its credit period? (Assume a 360 days year).

**Factoring**

**Question No 15:**

M/s Atlantic Company Ltd. with a turnover of Rs. 4.80 Crores is expecting growth of 25% for forthcoming year, Average credit period is 90 days. The past experience shows that bad debt losses are 1.75% on sales. The Company's administering cost for collecting receivables is Rs. 600000/-. It has decided to take factoring services of Pacific Factors on terms that factor will buy receivables by charging 2 % commission and 20 % risk with recourse. The factor will pay advance on receivables to the firm at 16 % interest rate P.a after withholding 10 % as reserve.

Calculate the effective cost of factoring to the firm ( Assume 360 days in a year).

**Valuation of mutual Fund**

**Question No 16:**

A Siddhartha Mutual Fund has the following assets under it on the close of business as on:

| Company | No. of Shares | 1st Baishak 2073 Market price per share ` | 2nd Baishak, 2073 Market price per share ` |
|---|---|---|---|
| HIDCL | 20,000 | 435 | 445 |
| Fewa Bikas Bank | 30,000 | 322 | 360 |
| Garima Bikas Bank | 20,000 | 461 | 483 |
| Malika Bikas Bank | 60,000 | 525 | 515 |

Total No. of Units 6,00,000

(i) Calculate Net Assets Value (NAV) of the Fund.

(ii) Following information is given:

Assuming one Mr. A, submits a cheque of Rs 30,00,000 to the Mutual Fund and the Fund manager of this company purchases 8,000 shares of Fewa Bikas Bank and the balance amount is held in Bank. In such a case, what would be the position of the Fund?

Find new NAV of the Fund as on 2nd Baishak, 2073

***Capital Investment Decision***
***Question No 16***

A Kathmandu Oil Pvt Ltd is considering the installation of a machine to process the waste produced by one of its existing manufacturing process to be converted into a marketable product. At present, the waste is removed by a contractor for disposal on payment by the company of Rs. 50 lacs per annum for the next four years. The contract can be terminated upon installation of the aforesaid machine on payment of a compensation of Rs. 30 lacs before the processing operation starts. This compensation is not allowed as deduction for tax purposes.

The machine required for carrying out the processing will cost Rs. 200 lacs to be financed by a loan repayable in 4 equal installments commencing from the end of year 1. The interest rate is 16% per annum. At the end of the 4th year, the machine can be sold for Rs. 20 lacs and the cost of dismantling and removal will be Rs. 15 lacs.

Sales and direct costs of the product emerging from waste processing for 4 years are estimated as under: (Rs. In lacs)

| Year | 1 |
|---|---|
| Sales | 322 |
| Material consumption | 30 |
| Wages | 75 |
| Other expenses | 40 |
| Factory overheads | 55 |

| | |
|---|---|
| Depreciation (as per income tax | 50 |

Initial stock of materials required before commencement of the processing operations is Rs. 20 lacs at the start of year 1. The stock levels of materials to be maintained at the end of year 1, 2 and 3 will be Rs. 55 lacs and the stocks at the end of year 4 will be nil. The storage of materials will utilise space which would otherwise have been rented out for Rs. 10 lacs per annum. Labour costs include wages of 40 workers, whose transfer to this process will reduce idle time payments of Rs. 15 lacs in the year 1 and Rs. 10 lacs in the year 2. Factory overheads include apportionment of general factory overheads except to the extent of insurance charges of Rs. 30 lacs per annum payable on this venture. The company's tax rate is 50%.

Advise the management on the desirability of installing the machine for processing the waste. All calculations should form part of the answer.

**Question no 17:**

Discuss the dividend-price approach, and earnings price approach to estimate cost of equity capital.

**Question no 18**

Liquidity ratios are useful in credit analysis by bank and other suppliers of short term loans" Comment

**Question no 19**

**Explain the following**

a. Basic propositions of mm approach
b. Mutual funds
c. Factoring
d. Net income approach

**Write short notes on:**

**Question 20**

a. Trading on equity
b. miller Orr model
c. Securitization
d. The Arbitrage process
e. Operating cycle
f. Pecking order theory

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## ANSWER HINT

**Time Value of Money**

**Answer No 1:**

a. Amount he must deposit in an account today is

PVretire = Rs 500,000 (PV annuity factor, N=25 and i=6%)

Amount required at the time of retirement is

= Rs 500,000 x PVIFA(6%, 25 yrs)

= Rs 500,000 x 12.783

= Rs 63, 91,500

However, Rs 63,91,500 is the amount required at the time of retirement but the amount to be deposited today is present value of required amount

Amount required in an account today =

= Rs 63,91,500 x PVIF ( 6%, 40 yrs)

= Rs 63,91,500 x 0.0972

=Rs 6,21,382

b. Amount he must deposit in an account each year is

Amount to be deposit each year is

Rs 63,91,500 = Annuity Amount x FVIFA ( 6%, 40 yrs)

Annuity Amount = Rs 63,91,500 / FVIFA(6%, 40 yrs)

=Rs 63,91,500 / 154.762

= Rs 41,298.9

**Capital structure and Leverage**

**Answer No 2 :**

Computation of level of earnings before interest and tax (EBIT)

In case alternative (i) is accepted, then the EPS of the firm would be:

$$\text{EPS(i)} = \frac{(\text{EBIT} - \text{I})(1 - \text{Tax})}{\text{No Of Equity Share}}$$

$$\text{EPS(i)} = \frac{(\text{EBIT} - 0.105 \times 8{,}00{,}000)(1 - 0.3)}{12{,}000}$$

In case the alternative (ii) is accepted, then the EPS of the firm would be

$$\text{EPS(ii)} = \frac{(\text{EBIT} - \text{I})(1 - \text{Tax}) - prev\ Dividend}{\text{No Of Equity Share}}$$

$$\text{EPS(ii)} = \frac{(\text{EBIT} - 0.105 \text{ x } 6{,}00{,}000)(1 - 0.3) - 0.14\ x\ 2{,}00{,}000}{9{,}000}$$

In order to determine the indifference level of EBIT, the EPS under the two alternative plans should be equated as follows:

$$\frac{(\text{EBIT} - 0.105 \text{ x } 8{,}00{,}000)(1 - 0.3)}{12{,}000} = \frac{(\text{EBIT} - 0.105 \text{ x } 6{,}00{,}000)(1 - 0.3) - 0.14\ x\ 2{,}00{,}000}{9{,}000}$$

$$\frac{0.7\text{EBIT} - 58{,}800}{4} = \frac{0.7\text{EBIT} - 72{,}100}{3}$$

2.1EBIT – 176400 = 2.8 EBIT – 288400

0.7EBIT = 112,000

EBIT = Rs 160,000

**Recommendation:**

**As** at the EBIT level Rs 160,000 both the capital sturcutre provides same level of EPS to the shareholder wealth. If the company expect the EBIT level would go above Rs 160,000, alternative (ii) would be more preferable.

EBIT > Rs 160,000 : alternative (ii)

If the company expect the EBIT level would be below the Rs 160,000, Alternative (i) would be more prefereable

EBIT < Rs 160,000 : Alternative (i)

**Cost of Capital**

**Answer No 3 :**

**Working Notes:**

Computation of cost of debentures (Kd) :

$$975.13 = \frac{90}{(1 + ytm)^1} + \frac{90}{(1 + ytm)^2} + \frac{90 + 1{,}000}{(1 + ytm)^3}$$

Yield to Maturity (YTM) = 10% (approximately)

After tax cost of debt ( Kd) = YTM X ( 1-t)

=10% ( 1-0.30)

=7%

Computation of cost of term loans (KT) : = i x ( 1-t)

= 8% ( 1 x 0.30)

=5.6%

Computation of cost of preference capital (KP) :

$$94.59 = \frac{10.5}{(1+ytm)^1} + \frac{10.5}{(1+ytm)^2} + \frac{10.5}{(1+ytm)^3} + \frac{10.5}{(1+ytm)^4} + \frac{100+10.5}{(1+ytm)^5}$$

Yield to Maturity (YTM) = 12% ( approximately)

Kp = 12%

Computation of cost of equity (Ke) =Risk-Free Rate + Average market risk premium x Beta

=6.5% + 8.5% x 1.2515

=17.15%

Computation of proportion of equity capital, preference share, debentures and term loans in the market value of capital structure:

Market value of capital structure

| | (Rs. in million) | Proportion |
|---|---|---|
| Equity share capital (10 million share Rs 560) | 5600 | 72 |
| 10.5% Preferential share capital (2.5 million shares Rs 94.59) | 236 | 3 |
| 9 % Debentures (1.5 million debentures Rs.975.13) | 1463 | 19 |
| 8% Term loans | 500 | 6 |
| | 7799 | 100 |

Weighted Average cost of Capital( WACC) : (Using Market Value Weight)

$$\text{WACC} = \text{kd x } \frac{\text{Debenture}}{\text{Total Value}} + \text{kt x } \frac{\text{Term Loan}}{\text{Total Value}} + \text{ kp x } \frac{\text{Preference share}}{\text{Total Value}} + \text{ ke x } \frac{\text{Equity share}}{\text{Total Value}}$$

=7% x 0.19 + 5.6% x 0.06 + 12% x 0.03 + 17.15% x 0.72

=0.0133+0.0033+0.003+0.1234

=14.37%

Marginal cost of capital (MCC) schedule :

Cost of Equity ( Ke) (New Project) = Risk-Free Rate + Average market risk premium x Beta

= 6.5% + 8.5% x 1.4375

= 18.7%

Cost of Debt (Kd) = i x ( 1-t)

First slab =9.5% x ( 1x 0.30)

=6.65%

Second Slab =10% x (1x 0.30)

=7%

Marginal cost of capital (MCC) =
= 18.7% x 0.80 + 6.65% x 100/750 + 7 % x 50/750
= 16.31% (Approximately)

**Cost of Capital**

**Answer No 4 :**

(i) Weighted Average Cost of Capital of the Company (Based on Existing Capital Structure)

| | After tax cost | Weights (WN 4) | Weighted cost |
|---|---|---|---|
| Equity share capital cost (WN 1) | 0.15 | 0.5 | 0.075 |
| Cost of preference share capital @11.5% (WN 2) | 0.115 | 0.125 | 0.014375 |
| Cost of debentures (WN 3) | 0.065 | 0.375 | 0.02437 |
| Weighted average cost of capital | | | 11.38% |

**Working Note (WN 1)**

$$\text{Cost of Equity Share (Ke)} = \frac{\text{Dividend}}{\text{Current Market Price}} + \text{growth}$$

$$= \frac{\text{Rs } 2}{\text{Rs } 20} + 5\%$$

=15% or 0.15

**Working Note (WN 2)**

$$\text{Cost of Preference Share (Kp)} = \frac{\text{Annual Preference Dividend}}{\text{Net Proceeds in the issue of Preference share}}$$

$$= \frac{\text{Rs } 1{,}15{,}000}{\text{Rs } 10{,}00{,}000}$$

= 0.115

**Working Note (WN 3)**

$$\text{Cost of Debenture (Kd)} = \frac{1}{\text{Net Proceed}} \text{ x (Interest} - \text{Tax)}$$

$$= \frac{1}{\text{Rs } 30{,}00{,}000} \text{ x ( Rs } 3{,}00{,}000, - \text{Rs } 1{,}05{,}000)$$

= 0.065

**Working Note (WN 4)**

*Weights of equity share capital, preference share capital and debentures in total investment of Rs.80,00,000:*

$$\text{Weight of Equity Share Capital} = \frac{\text{Total Equity Share Capital}}{\text{Total Investments}}$$

$$= \frac{\text{Rs } 40{,}00{,}000}{\text{Rs } 80{,}00{,}000}$$

$= 0.5$

$$\text{Weight of Preference Share Capital} = \frac{\text{Total Preference Share Capital}}{\text{Total Investments}}$$

$$= \frac{\text{Rs } 10{,}00{,}000}{\text{Rs } 80{,}00{,}000}$$

$= 0.125$

$$\text{Weight of Debenture} = \frac{\text{Total Debenture}}{\text{Total Investments}}$$

$$= \frac{\text{Rs } 30{,}00{,}000}{\text{Rs } 80{,}00{,}000}$$

$= 0.375$

*(ii) New Weighted Average Cost of Capital of the Company (Based on new capital structure)*

| | After tax cost | Weights (WN 5) | Weighted cost |
|---|---|---|---|
| Cost of equity share capital (WN 6) | 0.2 | 0.4 | 0.08 |
| Cost of preference share | 0.115 | 0.1 | 0.0115 |
| Cost of debentures @ 10% | 0.065 | 0.3 | 0.0195 |
| Cost of debentures @12% | 0.078 | 0.2 | 0.0156 |
| Weighted average cost of capital | | | 12.66% |

**Working Note (WN 5)**

*Weights of equity share capital, preference share and debentures in total investment of Rs.100,00,000*

$$\text{Weight of Equity Share Capital} = \frac{\text{Rs } 40{,}00{,}000}{\text{Rs } 1{,}00{,}00{,}000}$$

$= 0.4$

$$\text{Weight of Preference Share Capital} = \frac{\text{Rs } 10{,}00{,}000}{\text{Rs } 1{,}00{,}00{,}000}$$

$= 0.1$

$$\text{Weight of Debenture @ 10\%} = \frac{\text{Rs } 30{,}00{,}000}{\text{Rs } 1{,}00{,}00{,}000}$$

$= 0.3$

$$\text{Weight of Debenture @ 12\%} = \frac{\text{Rs } 20{,}00{,}000}{\text{Rs } 1{,}00{,}00{,}000}$$

$= 0.2$

**Working Note (WN 6)**

$$\text{Cost of Equity Share (Ke)} = \frac{\text{Dividend}}{\text{Current Market Price}} + \text{growth}$$

$$= \frac{\text{Rs } 2.40}{\text{Rs } 16} + 5\%$$

$=20\%$ or $0.20$

**Analysis of Financial Statement**

**Answer No 5:**

**Statement of Financial Position**

| Liability | Rs | Rs | Assets | Rs | Rs |
|---|---|---|---|---|---|
| Authorised , subscribed and Paid up Share Capital ( 20,000 Equity Share of Rs 10 Each) | | 200,000 | Land | | 120,000 |
| Reserve and surplus | | | Plant and Machinery | | |
| Balance as on 01.04. 2072 | 60,000 | | at cost | 300,000 | |
| Add: Transfer during the year | 40,000 | 100,000 | Less: Depreciation | 120,000 | 180,000 |
| 15% Loan | | 200,000 | Current Assets | | |
| Current Liabilities | | 200,000 | Cash and Bank | | 120,000 |
| Proposed Dividend | 120,000 | | Debtors | | 160,000 |
| Provision for Tax | 40,000 | | Stock | | 120,000 |
| Creditors | 40,000 | | | | |
| Total | | 700,000 | Total | | 700,000 |

Working note

Current ratio = 2 times

$$\text{Current ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

$$2 = \frac{\text{Current Assets}}{\text{Rs } 200{,}000}$$

Current Assets = ( Rs 200,000 X 2) = Rs 400,000

Cash and Bank = ( 30% of Rs 400,000) = Rs 120,000

Stock and Debtor = (Rs 400,000 –Rs 120,000) = Rs 280,000

$$\text{Debtor turnover ratio} = \frac{\text{Sales}}{\text{Debtors}}$$

Sales = 12 x Debtor

$$\text{Stock turnover ratio} = \frac{\text{Cost of Goods Sold}}{\text{Stock}}$$

Cost of goods sold = 12 x Stock

Sales – Gross profit = Cost of goods sold

Sales – 25 % of sales = 12 x stock

0.75 Sales = 12 x Stock

0.75( 12 x Debtor) = 12 x Stock

$$\frac{\text{Debtors}}{\text{Stock}} = \frac{4}{3}$$

$$\text{Debtor} = \frac{4}{7}\text{ X Rs 280,000} = \text{Rs 160,000}$$

$$\text{Stock} = \frac{4}{7}\text{ X Rs 280,000} = \text{Rs 120,000}$$

Total Sales ( 12 x Rs 160,000) Rs 1920,000

Gross Profit ( 25 % of Rs 1920,000) = Rs480,000

Cost of Good sold ( Rs 1920,000 – Rs 480,000) = Rs 1440,000

$$\text{Creditor turnover ratio} = \frac{\text{Cost of Goods Sold}}{\text{Creditor}}$$

$$12 = \frac{\text{Rs 1440,000}}{\text{Creditor}}$$

Creditor = Rs 120,000

Proposed Dividend ( 20% of 200,000) =Rs 40,000

Provision for tax= Current Liabilities – ( Proposed Dividend + Creditors)

= Rs 200,000 – ( Rs 40,000 + Rs 120,000)

= Rs 40,000

Tax rate = 33.33%

Profit before tax ( Rs 40,000 x 3) = Rs 120,000

Profit After tax ( Rs 120,000 – Rs 40,000) = Rs 80,000

$$\text{Interest Coverage ratio} = \frac{\text{Profit before Interest and tax}}{\text{Interest}}$$

$$3 = \frac{\text{Rs } 120{,}000 + \text{Interest}}{\text{Interest}}$$

Interest = Rs 60,000

Profit before Interest and Tax ( Rs 120,000 + Rs 60,000) =Rs 180,000

Depreciation = Gross profit – ( Selling and Distribution Expense + Interest+ Profit Before Tax)

=Rs 480,000- ( Rs180,000 + Rs 60,000 + Rs 120,000)

= Rs 120,000

Plant and Machinery (Rs 120,000 X 100 /40) = Rs 300,000

$$\text{Debt Service Coverage ratio} = \frac{\text{Profit after tax} + \text{Dep} + \text{Interest}}{\text{Interest} + \text{Installment}}$$

$$1 = \frac{\text{Rs } 80{,}000 + \text{Rs } 120{,}000 + \text{Rs } 60{,}000}{\text{Rs } 60{,}000 + \text{Installment}}$$

Installment = Rs 200,0000

Opening Loan ( Rs 60,000 x 100 /15) =Rs 400,000

Closing Loan =Rs 200,000

Profit and loss account for the year ended on 31st Ashad, 2073

| | |
|---|---|
| Sale | 1,920,000 |
| Less: Cost of good sold | 1,440,000 |
| Gross Profit | 480,000 |
| Less: Selling and distribution Expense | 180,000 |
| Depreciation | 120,000 |
| Interest | 60,000 |
| Profit Before tax | 120,000 |
| Less : Tax | 40,000 |
| Profit After tax | 80,000 |
| Less : Dividend | 40,000 |
| Retained Earnings | 40,000 |

**Valuation of Securities**

**Answer No 7 :**

Dividend at year 0 (D0) = Rs 5
Dividend at year 1 (D1) = D0(1+g)

= Rs 5 x ( 1+ 0.3)
= Rs 6.50

Dividend at year 2 (D2) = D1(1+g)

= Rs 6.50 x ( 1+ 0.3)
= Rs 8.45

Dividend at year 3 (D3) = D2(1+g)

= Rs 8.45 x ( 1+ 0.3)
= Rs 10.99

Dividend at year 4 (D4) = D3(1+g)

= Rs 10.99 x ( 1+ 0.015)
= Rs 11.15

$$\text{Value of Share} = \frac{D1}{(1+ke)} + \frac{D2}{(1+ke)^2} + \frac{D3}{(1+ke)^3} + \frac{\frac{D4}{Ke-g}}{(1+ke)^3}$$

$$\text{Value of Share} = \frac{6.50}{(1+0.13)} + \frac{8.45}{(1+0.13)^2} + \frac{10.99}{(1+0.13)^3} + \frac{\frac{11.15}{0.13-0.015}}{(1+0.13)^3}$$

Value of Share = Rs 87.18

**Valuation of Securities**

**Answer No 8:**

$$\text{Value of share} = \frac{\text{Next year dividend (D1)}}{\text{rate of Return(ke)} - \text{growth rate (g)}}$$

$$\text{Rs } 730 = \frac{\text{Rs } 36}{0.12 - \text{growth rate (g)}}$$

$$0.12 - \text{growth rate (g)} = \frac{36}{Rs\ 730}$$

0.12 – growth rate(g) = 0.05
Growth rate(g) = 0.12- 0.05
= 0.07 or 7%

**Capital Investment Decision**

**Answer No 9:**

Incremental CFAT and NPV **(Rs in lakhs)**

| **Particulars** | **1** | **2** | **3** | **4** | **5** |
|---|---|---|---|---|---|
| Sales | 300 | 300 | 300 | 300 | 300 |
| Add: Cost Savings: | | | | | |
| Maintenance (WN 2) | 15 | 15 | 30 | 30 | 30 |
| Cost of utilities | 2.5 | 2.5 | 2.5 | 2.5 | 2.5 |
| Labour Costs (WN3) | 17.16 | 18.87 | 20.76 | 22.84 | 25.12 |
| **Less: Incremental cost** | | | | | |
| Raw materials (WN 4) | 142.5 | 142.5 | 142.5 | 142.5 | 142.5 |
| Depreciation (WN 5) | 25.2 | 25.2 | 54 | 54 | 54 |
| Insurance (WN 6) | 4.12 | 3.71 | 3.34 | 3 | 2.71 |
| **Earning before Tax** | **163.04** | **165.16** | **153.42** | **155.84** | **158.76** |
| Less: Taxes (0.35) | 57.064 | 57.806 | 53.607 | 54.544 | 55.426 |
| **Earnings after taxes** | **105.98** | **107.354** | **99.723** | **101.296** | **102.93** |
| CFAT (EAT + Depreciation) | 130.98 | 132.354 | 153.723 | 155.296 | 156.93 |
| Salvage Value | | | | | 30 |
| Release of working capital | | | | | 50 |
| **Present Value factor at .20** | 0.833 | 0.694 | 0.579 | 0.482 | 0.402 |
| **PV** | 109.1 | 91.85 | 89.01 | 74.85 | 95.25 |
| **Total present value (t = 1-5)** | | | | | 460.06 |
| Less: cash Outflow | | | | | 276.55 |
| **NPV** | | | | | 183.51 |

Comments: Since the NPV is positive, replacement of the exiting machines is financially viable.

**Working Notes**

**WN No 1:**

Incremental cash outflows:

| | |
|---|---|
| Cost of 3 new machines (Rs. 100 lakh × 3) | 300,00,000 |
| Additional working capital | 50,00,000 |
| Less: Sale proceeds of existing machines | 96,00,000 |
| Add: Removal cost of existing machines | 4,80,000 |
| Tax on profit on sale of machine (working note 1(i)) | 11,76,000 |

| | |
|---|---|
| Cost of layng off 34 workers (Rs. 921000 tax advantage @ .35 i.e. to Rs. 3,22,350) | 5,98,650 |
| Incremental cash outflows | 2,76,54,650 |

i) Tax on profit on sale of existing machine:

| | |
|---|---|
| Sale proceeds of existing machine: | 96,00,000 |
| Less: Book value (8 × 12,00,000) (Rs. 18 lakh × 8 – Original Cost accumulated depreciation 28.80 × 3) | 57,60,000 |
| Gross profit | 38,40,000 |
| Less: Removal Cost (60,000 × 8) | 4,80,000 |
| Net Profit | 33,60,000 |
| Tax rate | 0.35 |
| Taxes payable on profit | 11,76,000 |

**WN No 2:**

Saving in Maintenance cost: (Rs. in lakhs)

| **Year** | **1** | **2** | **3** | **4** | **5** |
|---|---|---|---|---|---|
| Old Machine | 22.5 | 22.5 | 67.5 | 67.5 | 67.5 |
| New Machine | 7.5 | 7.5 | 37.5 | 37.5 | 37.5 |
| Saving in cost | 15 | 15 | 30 | 30 | 30 |

**WN No 3:**

Savings in Labour cost:

| | | |
|---|---|---|
| Existing labour cost | | |
| Unskilled | (18 × Rs. 3,500 × 12 months) | 7,56,000 |
| Skilled | (18 × Rs. 5,500 × 12 months) | 11,88,000 |
| Supervisor | (3 × Rs. 6,500 × 12 months) | 2,34,000 |
| Maintenance | (2 × Rs. 5,000 × 12 months) | 1,20,000 |
| | | 22,98,000 |
| Proposed labor cost | | |
| Skilled | (6 × Rs 7,000 × 12 months) | 5,04,000 |
| Maintenance | (1 × Rs 6,500 × 12 months) | 78,000 |
| Cost savings | | 17,16,000 |

Savings in subsequent years will increase by 10%

**WN No 4:**

Incremental cost of raw material:

| | |
|---|---|
| Raw material required for old machine: (3000000 × Rs 15 per unit × 0.60) | 2,70,00,000 |
| Raw material required for new machine (5000000 × Rs 15 per unit × 0.55) | 4,12,50,000 |
| Additional raw material Cost | 1,42,50,000 |

**WN No 5:**

Incremental Depreciation: (Rs in Lakhs)

| Years | 1 – 2 | 3 – 5 |
|---|---|---|
| Depreciation (with new machine) (Rs. 100 lakh × 3 – 10 × 3) / 5 years | 54 | 54 |
| Depreciation (with old machine) (Rs. 18 lakh × 8/5 years) | 28.8 | - |
| **Incremental Depreciation** | 25.2 | 54 |

**WN No 6:**

Insurance: (Rs in lakhs)

| Years | 1 | 2 | 3 | 4 | 5 |
|---|---|---|---|---|---|
| New Machine | 6 | 5.4 | 4.86 | 4.37 | 3.94 |
| Old Machine | 1.88 | 1.69 | 1.52 | 1.37 | 1.23 |
| **Incremental Insurance** | 4.12 | 3.71 | 3.34 | 3 | 2.71 |

**Capital Investment Decision**
**Answer No 10:**

(i) Replacement of Machine –R

Incremental cash out flow

(i) Cash out flow on Machine –S Rs. 2,50,000

Less: Sale Value of Machine –R

Less : Cost of dismantling and removal

(Rs. 1,00,000-Rs. 30,000) Rs. 70,000

Net outflow Rs. 1,80,000

Incremental cash flow from Machine-S

Annual cash flow from Machine –S Rs. 2,70,000

Annual cash flow from Machine –R Rs. 2,50,000

Net incremental Cash in flow Rs. 20,000

Present value of incremental cash in flows

= Rs. 20,000 x (0.877 +0.769+0.675+0.592+0.519)

= 20,000 x 3.432 = Rs. 68,640

NPV of Machine -S = Rs. 68,640 – Rs. 1,80,000

= (-) Rs. 1,11,360

Rs. 2,00,000 spent on Machine –R is a sunk cost and hence it is not relevant for deciding the replacement.

Decision: Since Net present value of Machine –S is in the negative, replacement is not advised.

If the company is in the process of selecting one of the two machines, the decision is to be made on the basis of independent evaluation of two machines by comparing their Net-present values.

*(ii) Independent evaluation of Machine –R and Machine –S:*

| | Machine –R | Machine –S |
|---|---|---|
| Units produced | 1,50,000 | 1,50,000 |
| Selling price per unit (Rs.) | 6 | 6 |
| Sale value | 9,00,000 | 9,00,000 |
| Less: Operating Cost | | |
| (exclusive of depreciation) | 2,00,000 | 1,80,000 |
| Contribution | 7,00,000 | 7,20,000 |
| Less: Fixed Cost | 4,50,000 | 4,50,000 |
| Annual cash flow | 2,50,000 | 2,70,000 |
| Present value of cash flows for five years | 8,58,000 | 9,26,640 |
| Cash Outflow | 2,00,000 | 2,50,000 |
| Net Present Value | 6,58,000 | 6,76,640 |

As the NPV of cash in flow of Machine –S is higher than that of Machine –R, the choice should fall on machine –S.

Note: As the company is a zero tax company for seven years (Machine life in both cases is only for five years), depreciation and the tax effect on the same are not relevant for consideration.

**Capital Investment Decision**
**Answer No 11:**

Cash flow of lease contract is shown below:

(Rs. in lakhs)

| | 0 | 1 | 2 | 3 | 4 |
|---|---|---|---|---|---|
| Cost of car | 40 | | | | |
| Depreciation | | 16 | 9.6 | 5.76 | 3.456 |
| Loss of depreciation tax shield (Dep tax rate) | | -5.6 | -3.36 | -2.016 | -1.21 |
| Lease payment | | -8.75 | -8.75 | -8.75 | -8.75 |

| | | | | | | |
|---|---|---|---|---|---|---|
| Tax shield on lease payment | | 3.0625 | 3.0625 | 3.0625 | 3.0625 | |
| Loss of salvage value | | | | | | |
| Cash flow of lease | 40 | -11.29 | -9.048 | -7.704 | -6.897 | |
| Present value cash flow | | □□□□□□□□□ | □□□□□□□□□ | □□□□□□□□ | □□□□□□□□ | □□□ |
| | | *(□11.2875 x 0.9174)* | *(□9.0475 x 0.8417)* | *(□7.7035 x 0.7722)* | *(□6.8971 x 0.7084)* | *(□16. 0.649* |

Present value cash flow of lease payment = Rs 39.47 Lakh

Net Advantage of Leasing (Kd = 9%) = Rs.0.53 lakhs (Rs.40 lakhs - Rs.39.47 lakhs)

**Working Capital Management and Financial Forecasting**
**Answer No 12:**

Statement showing determination of net working capital

| Particular | Rs. |
|---|---|
| (A) Current assets: | |
| (i) Stock of materials for 1 month: (1,20,000× Rs 80× 4/52) | 738,462 |
| (ii) Work-in-progress for 0.5 month: | |
| (a) Material (1,20,000 × Rs 80 × 2/52) × 0.50 | 184,615 |
| (b) Labour (1,20,000 × Rs 60 × 2/52) × 0.50 | 138,462 |
| (c) Overheads (1,20,000 × Rs 62 × 2/52) × 0.50 | 143,077 |
| (iii) Finished goods for 1 month: (1,20,000 × Rs 202 × 4/52) | 1,864,615 |
| (iv) Debtors for 2 months (90,000 × Rs 202× 8/52) | 2,796,923 |
| (v) Cash in hand and at bank | 767240 |
| Total investments in current assets | 6,633,394 |
| | |
| (B) Current liabilities: | |
| (i) Creditors, 1 month's purchase of raw materials, (i.e. 1,20,000× Rs.80× 4/52) | 738,462 |
| (ii) Average time-lag in payment of expenses | |
| (a) Labour (1,20,000× Rs 60× 1.5/52) | 207,692 |
| (b) Overheads (1,20,000× Rs 62× 4/52) | 572,308 |
| Total estimate of current liabilities | 1,518,462 |
| | |
| (C) Net working capital = Current assets – Current liabilities ( A –B) | 5,114,932 |

Working notes and assumptions

(i) 30,000 units have been sold for cash. Therefore, credit sales pertain to 90,000 units only.

(ii) All overheads are assumed to be variable. Presence of depreciation element in overheads will lower the working capital requirement.

(iii) Calculation of Cash balance

Let x be the net working capital

5,866,154 + 0.15x-1,518,462 = x

4,347,692 =0.85x

x=Rs 5,114,932
Cash Balance = 0.15 x 5,114,932
= Rs 767,240

**Account receivable Management**
**Answer no 13:**

**Extension of credit to a group of new customers:**

| Profitability of additional sales: | Rs |
|---|---|
| Increase in sales per annum | 100,000 |
| Less: Bad debt losses (10%) of sales | 10,000 |
| Net sales revenue | 90,000 |
| Less: Production and selling expenses (80% of sales) | 80,000 |
| Profit before tax | 10,000 |
| Less: Income tax (50%) | 3,000 |
| Profit after tax | 7,000 |

**Average investment in additional receivables**

Period of credit: $1\frac{1}{2}$ Months $= 1.5$ Months

Receivables turnover: $= \frac{12}{1.5} = 8$ times

Average amount of receivables: $\frac{\text{Rs } 100{,}000}{8}$ =Rs 12,500

Average investment in receivables: Rs 12,500 X 80% = Rs 10,000

The available rate of return: $\frac{\text{Rs } 7{,}000}{\text{Rs } 10{,}000}$ X 100 = 70%

Since the available rate of return is 70%, which is higher than the required rate of return of 25%, the Sales Manager's proposal should be accepted.

(i) **Acceptable degree of risk of non-payment if the required rate of return (after tax is 30%)**

Required amount of profit after tax on investment:

= Rs 10,000 x 30% = Rs 3000

Required amount of profit before tax at this level:

$= \frac{\text{Rs } 3{,}000 \text{ X } 100}{70}$

= Rs 4,285

Net sales revenue required

= Rs 80,000 + Rs 4,285

=Rs 84,285

Acceptable amount of bad debt losses:

Rs 1,00,000 – Rs 84,285

= Rs 15,715

Acceptable degree of risk of non-payment :

$= \frac{Rs\ 15{,}714}{Rs\ 100{,}000}$ X 100%

= 15.7%

(ii) **Acceptable degree of risk of non-payment if the required rate of return (after tax) is 40%:**

Required amount of profit after tax on investment:

Rs 10,000 × 40% = Rs 4,000

Required amount of profit before tax

$\frac{Rs\ 4{,}000\ X\ 100}{70}$ = Rs 5,714

Net sales revenue required:

Rs 80,000 + Rs 5,714= Rs 85,714

Acceptable amount of bad debt losses:

Rs 1,00,000 – Rs 85,714= Rs 14,286

Acceptable degree of risk of non-payment:

$= \frac{Rs\ 14286}{100{,}000}$ X 100

= 14.2%

(iii) **Acceptable degree of risk of non-payment of the required rate of return (after tax) is 60%:**

Required amount of profit after tax on investment:

Rs 10,000 × 60% = Rs 6,000

Required amount of profit before tax:

$= \frac{\text{Rs } 6{,}000 \text{ X } 100}{70}$

=Rs 8571

Net sales revenue required:

Rs 80,000 + Rs 8571= Rs 88,571

Acceptable amount of bad debt losses:

Rs 1,00,000 – Rs 88,571= 11429

Acceptable degree of risk of non-payment:

$= \frac{\text{Rs } 11429}{100{,}000}$ X 100

=11.4 %

**Payment to creditor**

**Answer No 14:**

$\text{Receivable Turnover} = \frac{360}{75}$

= 4.8

Profitability of additional sales

= Rs 90,00,000 X 0.2

= Rs 18,00,000

Additional receivables associated with the new sales

$= \frac{\text{Rs } 90{,}00{,}000}{4.8}$

= Rs 18, 75,000

Additional investment in receivables associated with the new sales

= Rs 18,75,000 X 0.8 = Rs 15,00,000

New level of receivables associated with the original sales

$= \frac{\text{Rs } 6{,}00{,}00{,}000}{4.8}$

=Rs 1,25,00,000

Old level of receivables associated with the original sales

$$= \frac{\text{Rs } 6{,}00{,}00{,}000}{8}$$

=Rs 75,00,000

Incremental receivable investment, original sales = Rs 50,00,000.

Total increase in receivable investment = Rs 15,00,000 + Rs 50,00,000 = Rs 65,00,000.

Carrying cost of additional investment = 0.20 X Rs 65,00,000 = Rs 13,00,000.

Advise : As the incremental carrying cost is less than the incremental profitability, the company should lengthen its credit period from 30 to 60 days.

**Factoring**

**Answer No 15:**

Calculation of Net amt financed (Rs in Lacs)

| | |
|---|---|
| Expected credit sales for next year = 480 x 125% | 600 |
| Debtors on the basis of 90 days = (600 x 90/360) | 150 |
| (-) Factor reserve 10% | -15 |
| (-) Commission charged upfront @ 2% of 150 | -3 |
| (-) Interest charged upfront (16% of 132 x 90/360) | -5.28 |
| | 126.72 |

Net periodic cost of Factoring for 90 days

| | |
|---|---|
| Factoring commission | 3 |
| (+) Interest | 5.28 |
| (-) Bad Debts saved (20% of 1.75% of 600 x 90/360) | -0.525 |
| (-) Administration Expense Saved (6 x 90/360) | -1.5 |
| | 6.255 |

Therefore, cost of factoring for 90 days = (6.255/126.72) x100 = 4.94%
Annualised effective cost of factoring = 4.94% x 360/90 = 19.74%
Assumptions: 1. All sales are credit sales 2. Factor will bear 20% risk of Bad debts

**Valuation of mutual Fund**

**Answer No 16:**

*NAV of the Fund*

$$= \frac{87{,}00{,}000 + 96{,}60{,}000 + 9220{,}000 + 315{,}00{,}000}{600{,}000}$$

$$= \frac{59,080,000}{600,000}$$

=Rs 98.47

*The revised position of fund shall be as follows:*

| Company | No. of Shares | 1st Baishak 2073 Market price per share | Total |
|---|---|---|---|
| HIDCL | 20,000 | 435 | 8,700,000 |
| Fewa Bikas Bank | 38,000 | 322 | 12,236,000 |
| Garima Bikas Bank | 20,000 | 461 | 9,220,000 |
| Malika Bikas Bank | 60,000 | 525 | 31,500,000 |
| Cash | | | 424,000 |
| | | | 62,080,000 |

$$\text{Number of units of Fund} = 600,000 + \frac{3,000,000}{98.47}$$

= 630,466 units

*On 2nd Baishak, 2073, the NAV of fund will be as follows:*

| Company | No. of Shares | 2nd Baishak, 2073 Market price per share | Total |
|---|---|---|---|
| HIDCL | 20,000 | 445 | 8,900,000 |
| Fewa Bikas Bank | 38,000 | 360 | 13,680,000 |
| Garima Bikas Bank | 20,000 | 483 | 9,660,000 |
| Malika Bikas Bank | 60,000 | 515 | 30,900,000 |
| Cash | | | 424,000 |
| | | | 63,564,000 |

NAV as on 2nd Baishak, 2073

$$= \frac{63,564,000}{630,466}$$

= Rs 100.82 per unit

***Capital Investment Decision***

***Answer No 16***

**Statement of Incremental Profit**

(Rs. in lacs)

| Years | 1 |
|---|---|
| Sales :(A) | 322 |
| Material consumption | 30 |
| Wages | 60 |
| Other expenses | 40 |
| Factory overheads (insurance) | 30 |
| Loss of rent | 10 |
| Interest | 32 |
| Depreciation (as per income tax | 50 |
| Total cost: (B) | 252 |
| Incremental profit (C)=(A)-(B) | 70 |
| Tax (50% of (C)) | 35 |

***Statement of Incremental Cash Flows***

(Rs. in lacs)

| **Years** | *0* | *1* | *2* | *3* | *4* |
|---|---|---|---|---|---|
| Material stocks | -20 | -35 | - | - | - |
| Compensation for contract | -30 | - | - | - | - |
| Contract payment saved | - | 50 | 50 | 50 | 50 |
| Tax on contract payment | - | -25 | -25 | -25 | -25 |
| Incremental profit | | | | | |
| Depreciation added back | | | | | |
| Tax on profits | | | | | |
| Loan repayment | | | | | |
| Profit on sale of machinery (net) | | | | | |
| Total incremental cash flows | | | | | |
| Present value factor | | .87 | .756 | .658 | .572 |
| Net present value of cash flows | 50 | 1.75 | 6.288 | 8.164 | 7.456 |
| Net present value | = Rs. 123.658 – Rs 50 = 73.658 lacs. | | | | |

Advice: Since the net present value of cash flows is Rs. 73.658 lacs which is positive the management should install the machine for processing the waste.

**Notes:**

- Material stock increases are taken in cash flows.
- Idle time wages have also been considered

- Apportioned factory overheads are not relevant only insurance charges of this project are relevant.
- Interest calculated at 16% based on 4 equal installments of loan repayment.
- Sale of machinery- Net income after deducting removal expenses taken. Tax on Capital gains ignored.
- Saving in contract payment and income tax there on considered in the cash flows.

**Answer No 17**

In dividend price approach, cost of equity capital is computed by dividing the current dividend by average market price per share. This ratio expresses the cost of equity capital in relation to what yield the company should pay to attract investors.

It is computed as:

$$\text{Cost of Equity (Ke)} = \frac{D1}{P0}$$

Where,

D1 = Dividend per share in period 1

P0 = Market price per share today

Whereas, on the other hand, the advocates of earnings price approach co-relate the earnings of the company with the market price of its share. Accordingly, the cost of ordinary share capital would be based upon the expected rate of earnings of a company. This approach is similar to dividend price approach, only it seeks to nullify the effect of changes in dividend policy.

**Answer No 18:**

Liquidity ratios are used to determine a company's ability to meet its short-term debt obligations. Investors often take a close look at liquidity ratios when performing fundamental analysis on a firm. Since a company that is consistently having trouble meeting its short-term debt is at a higher risk of bankruptcy, liquidity ratios are a good measure of whether a company will be able to comfortably continue as a going concern. In this Fundamental Focus, liquidity ratios should be investigated using time-series analysis, competitive analysis and sector and industry analysis. If the firms are classified as consumer cyclical, following the market cycle then such firms will have less cash coming in and will possibly have to borrow more in order to weather the downturn in economy. These scenarios will place an added burden on liquidity ratios.

These ratios show the number of times the short term debt obligations are covered by the cash and liquid assets. The firms with higher liquidity ratios are better able to meet their short-term obligations. Apparently, If the value is greater than 1, it means the short term obligations are fully covered.

Commercial banks and other short-term creditors are generally interested in such an analysis. These institution adopt these ratios to ascertain how efficiently they utilize the working capital in the business and assess the prospects of interest payments

**Answer No 19:**

**a. Basic propositions of MM approach**

Their three basic propositions are :

(i) The total market value of the firm and its cost of capital are independent of its capital structure. The total market value of a firm is given by capitalizing the expected stream of operating earnings at a discount rate appropriate for its risk class.

(ii) The expected yield of a share of stock, Ke is equal to the capitalisation rate of a pure equity stream, plus a premium for financial risk equal to the difference between the pure equity capitalization rate and Kg times the ratio B/S. In other words, Ke increases in a manner to exactly offset the use of cheaper debt funds.

(iii) The cut-off rate for investment purposes is completely independent of the way in which an investment is financed. This proposition along with the first implies a complete separation of the investment and financing decisions of the firm.

**b. Mutual funds**

Mutual fund is one of the funds based financial services which provides the stock market benefits to small investors. It is a concept, leading to attract the small investors to invest their pooling of savings in a trusted as well as profitable manner. Mutual funds act as a link between the investor and the stock market.

A mutual fund is an investment vehicle for investors who pool their savings for investing in diversified portfolio of securities with the aim of attractive yields and appreciation in their value. Mutual fund is a trust that attracts savings which are then invested in capital markets. So it is as a fund, established in the form of a trust to raise money through the sale of units to the public or a section of the public under one or more scheme for investing in securities, including money market instruments.

**c. Factoring**

Factoring is a service of financial nature involving the conversion of credit bills into cash. Accounts receivables, bills recoverable and other credit dues resulting from credit sales appear, in the books of accounts as book credits. Here the risk of credit, risk of credit worthiness of the debtor and as number of incidental and consequential risks are involved. These risks are taken by the factor which purchase these credit receivables without recourse and collects them when due. These balance-sheet items are replaced by cash received from the factoring agent. Factoring is also called “Invoice Agent” or purchase and discount of all “receivables”. Although these can be with recourse or without recourse, normally the risk is taken by the factoring agent. The discount rate includes the loss of interest, risk of credit and risk of loss of both principal and interest on the amount involved.

**d. Net Income Approach**

Net income approach suggested by the Durand. According to this approach, the capital structure decision is relevant to the valuation of the firm. In other words, a change in the capital structure leads to a corresponding change in the overall cost of capital as well as the total value of the firm. According to this approach, use more debt finance to reduce the overall cost of capital and increase the value of firm. Net income approach is based on the following three important assumptions:

1. There are no corporate taxes.
2. The cost debt is less than the cost of equity.
3. The use of debt does not change the risk perception of the investor

where

V = S+B

V = Value of firm

S = Market value of equity

B = Market value of debt

Market value of the equity can be ascertained by the following formula:

$$S = \frac{NI}{K}$$

where

NI = Earnings available to equity shareholder

Ke = Cost of equity/equity capitalization rate

Format for calculating value of the firm on the basis of NI approach

| Particulars | Amount |
|---|---|
| Net operating income (EBIT) | XXX |
| Less: interest on debenture (i) | XXX |
| Earnings available to equity holder (NI) | XXX |
| Equity capitalization rate (Ke) | XXX |
| Market value of equity (S) | XXX |
| Market value of debt (B) | XXX |
| Total value of the firm (S+B) | XXX |
| Overall cost of capital = Ko = EBIT/V(%) | XXX% |

**Answer No 20**

**Write short note on**

**a. Trading on equity**

The term,, trading on equity ‟is derived from the fact that debts are contracted and loans are raised mainly on the basis of equity capital. Those who provide debt have a limited share in the firm's earnings and hence want to be protected in terms of earnings and values represented by equity capital. Since fixed charges do not vary with the firms earnings before interest and tax, a magnified effect is produced on earnings per share. Whether the leverage is favorable in the sense increase in earnings per share more proportionately to the increased earnings before interest and tax depends on the profitability of investment proposals. If the rate of return on investment exceeds their explicit cost financial leverage is said to be positive. In other words, it can be stated that trading on equity means using borrowed funds to generate returns in anticipation that the return would be more than the interest paid on those funds. Therefore, trading on equity occurs when a company uses bonds, preference shares or any other type of debt to increase its earnings on equity shares. For example, a company may use long term debt to purchase assets that are expected to generate earnings more than the interest on the debt. The earnings in excess of the interest on the debt will increase the earnings of the company's equity shareholders. This increase in earnings indicates that the company was successful in trading on equity.

**g. Miller Orr model of Cash Management**

It is a model for determinng the optimum cash when cash flws of the firm fluctuate ramdamly.If the demand for cash is not steady and cannot be known in advance, Boumol model is not suitable. Miller orr model helps in determining the optimum level of cash in such situation. It deals with cash management problem under the assumption of stochastic or ramdom cash flows by laying down control limits for cash balances. These limit consist of upper limit , lower limit and return point.When cash balance reaches the upper limit, a transfer of cash equal to excess of higher limit to return limit is effected to marketable securities . When it reaches the lower limit , a transfer equal to excess of return point to lower limit from the markertable securities to cash is done. No transcaition of transferring cash to marketable securities or from marketable secuirites to cash is done when the cash balance stays between the upper and lower limits

The upper and lower limits are set on the basis of

a. Opportunity cost of holding cash

b. degree of likely fluctuation in cash balance

c. Fixed cost associated withh securities transcation

$$\text{Return Point} = \left[\frac{3 * \text{Transaction cost per transaction X Variance of daily change in expected cash flow}}{4 \text{ x Daily interest rate}}\right]^{\frac{1}{3}} + \text{Lower limit}$$

**h. Securitisation**

Under securitisation , a group of illiquid assets ( mortgage or any assets that yield regular cash inflow) are pooled together and sold to intermediary. THe intermediary then issue securities which could be mortgage based securities or assets based securities. The securities are then sold to investors through merchant bankers. So the main advantage of securitizatin is that instead of locking of funds in loans the lender converts it into cash for further lending. The process is profitable if intrest rates are going higher.

**i. The Arbitage process**

The arbitrage process refers to undertaking by a person of two related actions or steps simultaneously in order to derive some benefits i.e buying in one market and selling the same at the same time in some other market, or selling one type of investment and investing the proceed in soe other investment, The profi or benefit from the arbitrage process may be in any form :

increased income from the same level of investment or some income from lesser investment.This process has been used by Modi Miller to testify their hypothesis of financial leverage, cost of capital and value of firm.MM hypotheisis is explained through teh functioning of arbritage process and subsitution of corporate leverage by personal leverage. Investors of the levered firm whose value is higher will sell their shares and instead buy the shares of the identical unlevered firm whose value is lower. Further, since the personal leverage and corporate leverage are perfect substitute , the arbitrageru shall borrow the required amount at the same rate of interest as that of the company.Investor in this hypothesis, first sell their existing holding in the levered company then he shall take the necesssary balance amount by way of debt to purchase the shares of unlivered company. At the end of the year he shall receive his share of earnings from unlevered company on which after paying interest on the amount borrowed, he make the arbitrary gain.

**j. Operating cycle**

Operating cucle refers to the avarage time elapses between the acquisition of raw materails and the final cash realisation from sale of finished goods, Cash is used to buy raw materials so cash is converted into raw materials inventory. Then the raw materials and store are issued to the productin department , Waes are paid and other expense are incurred in the process and work in process comses into exixtance. Work in process becomes finished goods , whichh are sold to customers on credit. In the course of time, these customers pay cash for the goods purchased by them, Cash is retried and the cycle is completed. So it is the length of time between the payment to firm's creditors and receipts from its debtors

Operating cycle = Raw material storage period + Work in progress holding period + Finished good storage period + debtor collection period - Creditors Payment period

**k. Pecking order theory**

TH peckingorder theroy argues against a target debt/ equity ratio. The theroy suggests that firms rely fo rfinance as much as they can on internall y generated funds. If not enough internally generated fund are available then they will move to additional debt finance. It is only when these two sources cannot provide enough funds to satisfy needs that the company will seek toobtain new equity finance. As intenally generated funds have the lowest issue cost than the new equity, firm obtain as much as they can of the easiest and least expensive fiance, which is mainly retained earnings before moving to the next least expensive debt.

# COST AND MANAGEMENT ACCOUNTING

## QUESTIONS

***Costs concepts and costing methods***

**Question No. 1**

**a.** Discuss the essential features of a good cost accounting system?

**b.** Discuss the four different methods of costing along with their applicability to concerned industry?

**c.** Briefly discuss how the synergetic effect helps in reduction in costs.

**d.** Distinguish between Operating Costing and Operation Costing.

**e.** Elaborate the practical application of Marginal Costing.

***Material Control***

**Question No. 2**

**a.** How is slow moving and non-moving item of stores detected and what steps are necessary to reduce such stocks?

**b.** (i) Compute E.O.Q. and the total variable cost for the following:

| | | |
|---|---|---|
| Annual Demand | = | 5,000 units |
| Unit price | = | Rs. 20.00 |
| Order cost | = | Rs.16.00 |
| Storage rate | = | 2% per annum |
| Interest rate | = | 12% per annum |
| Obsolescence rate | = | 6% per annum |

(ii) Determine the total variable cost that would result for the items if an incorrect price of Rs. 12.80 is used.

**c.** A company uses three raw materials A, B and C for a particular product for which the following data apply:–

| **Raw Material** | **Usage per unit of product** | **Re-order Quantity (Kg.)** | **Price per Kg.** (Rs. | **Delivery period (in weeks)** | | | **Re-order level (Kg.)** | **Minimum level (Kg.)** |
|---|---|---|---|---|---|---|---|---|
| | | | | **Minimum** | **Average** | **Maximum** | | |
| A | 10 | 10,000 | 0.10 | 1 | 2 | 3 | 8,000 | ? |
| B | 4 | 5,000 | 0.30 | 3 | 4 | 5 | 4,750 | ? |
| C | 6 | 10,000 | 0.15 | 2 | 3 | 4 | ? | 2,000 |

Weekly production varies from 175 to 225 units, averaging 200 units of the said product. What would be the following quantities:–

(i) Minimum Stock of A?

(ii) Maximum Stock of B?

(iii) Re-order level of C?

(iv) Average stock level of A?

***Labour Control***

**Question No. 3**

**a.** Mr. A. is working by employing 10 skilled workers. He is considering the introduction of some incentive scheme - either Halsey Scheme (with 50% bonus) or Rowan Scheme - of wage payment for increasing the labour productivity to cope with the increased demand for the product by 25%. He feels that if the proposed incentive scheme could bring about an average 20% increase over the present earnings of the workers, it could act as sufficient incentive for them to produce more and he has accordingly given this assurance to the workers.

As a result of the assurance, the increase in productivity has been observed as revealed by the following figures for the current month:

| | |
|---|---|
| Hourly rate of wages (guaranteed) | Rs. 2.00 |
| Average time for producing 1 piece | |
| by one worker at the previous performance | 2 hours |
| (This may be taken as time allowed) | |
| No. of working days in the month | 25 |
| No. of working hours per day for each worker | 8 |
| Actual production during the month | 1,250 units |

Required:

1. Calculate effective rate of earnings per hour under Halsey Scheme and Rowan Scheme.
2. Calculate the savings to Mr. A in terms of direct labour cost per piece under the schemes.

Advise Mr. A about the selection of the scheme to fulfill his assurance.

**b.** In a factory working six days in a week and eight hours each day, a worker is paid at the rate of Rs. 100 per day basic plus D.A. @ 120% of basic. He is allowed to take 30 minutes off during his hours shift for meals -break and a 10 minutes recess for rest. During a week, his card showed that his time was chargeable to:

| | |
|---|---|
| Job X | 15 hrs. |
| Job Y | 12 hrs. |
| Job Z | 13 hrs. |

The time not booked was wasted while waiting for a job. In Cost Accounting, how would you allocate the wages of the workers for the week?

***<u>Overhead</u>***

**Question No. 4**

**a.** Explain the treatment of over and under absorption of Overheads in Cost accounting.

**b.** Discuss in brief three main methods of allocating support departments costs to operating departments. Out of these three, which method is conceptually preferable?

**c.** In a manufacturing company factory overheads are charged as fixed percentage basis on direct labour and office overheads are charged on the basis of percentage of factory cost. The following information are available related to the year ending 31st Ashadh, 2072:

| | **Product A** | **Product B** |
|---|---|---|

| | | |
|---|---|---|
| Direct Materials | Rs. 19,000 | Rs. 15,000 |
| Direct Labour | Rs. 15,000 | Rs. 25,000 |
| Sales | Rs. 60,000 | Rs. 80,000 |
| Profit | 25% on cost | 25% on sales price |

You are required to find out:

(i) The percentage of factory overheads on direct labour.
(ii) The percentage of office overheads on factory cost.

***Costs Accounts System, Cost Control (Integrated and Non-integrated Accounting System)***

**Question No. 5**

You are given the following information of the cost department of a manufacturing company:

| | (Rs.) |
|---|---|
| Stores: | |
| Opening Balance | 12,60,000 |
| Purchases | 67,20,000 |
| Transfer from work-in-progress | 33,60,000 |
| Issue to work-in-progress | 67,20,000 |
| Issue to repairs and maintenance | 8,40,000 |
| Shortage found in stock taking | 2,52,000 |
| Work-in-progress: | |
| Opening Balance | 25,20,000 |
| Direct wages applied | 25,20,000 |
| Overhead applied | 90,08,000 |
| Closing Balance | 15,20,000 |

Finished products:

Entire output is sold at a profit of 12% on actual cost from work-in-progress.

Other information:

| | (Rs.) |
|---|---|
| Wages incurred | 29,40,000 |
| Overhead incurred | 95,50,000 |
| Income from Investment | 4,00,000 |
| Loss on sale of fixed assets | 8,40,000 |

Shortage in stock taking is treated as normal loss.

You are require to prepare:

(i) Stores control account;

(i) Work-in-progress control account;

(ii) Costing Profit and Loss account;

(iii) Profit and Loss account and

(v) Reconciliation statement

***Methods of Costing***

**Question No. 6**

**a.** PQR Construction Ltd. commenced a contract on Shrawan 1, 2072. The total contract was for Rs.27,12,500. It was decided to estimate the total profit and to take to the credit of Costing P & L A/c the proportion of estimated profit on cash basis which work completed bear to the total contract. Actual expenditure in 2072-73 and estimated expenditure in 2073-74 are given below:

| | **2072-73** **Actual** (Rs.) | **2073-74** **Estimated** (Rs.) |
|---|---|---|
| Material issued | 4,56,000 | 8,14,000 |
| Labour : Paid<br>: Outstanding at end | 3,05,000<br>24,000 | 3,80,000<br>37,500 |
| Plant purchased<br>Expenses : Paid<br>: Outstanding at the end<br>: Prepaid at the end | 2,25,000<br>1,00,000<br>-<br>22,500 | -<br>1,75,000<br>25,000<br>- |
| Plant returned to stores (a historical stores) | 75,000 | 1,50,000 (on Chaitra, 31 2073) |
| Material at site | 30,000 | 75,000 |
| Work-in progress certified | 12,75,000 | Full |
| Work-in-progress uncertified | 40,000 | ---- |
| Cash received | 10,00,000 | Full |

The plant is subject to annual depreciation @ 20% of WDV cost. The contract is likely to be completed on Chaitra 31, 2073.

Required:

*(i)* Prepare the Contract A/c for the year 2072-73.

*(ii)* Estimate the profit on the contract for the year 2072-73 on prudent basis which has to be credited to Costing P & L A/c.

**b.** Rio Limited undertakes to supply 1000 units of a component per month for the months of January, February and March 2016. Every month a batch order is opened against which materials and labour cost are booked at actual. Overheads are levied at a rate per labour hour. The selling price is contracted at Rs.15 per unit.

From the following data, present the profit per unit of each batch order and the overall position of the order for the 3000 units.

| **Month** | **Batch Output (Numbers)** | **Material Cost** (Rs.) | **Labour Cost** (Rs.) |
|---|---|---|---|
| January 2016 | 1250 | 6250 | 2500 |
| February 2016 | 1500 | 9000 | 3000 |
| March 2016 | 1000 | 5000 | 2000 |

Labour is paid at the rate of Rs. 2 per hour. The other details are:

| Month | Overheads (Rs.) | Total Labour Hours |
|---|---|---|
| January 2016 | 12000 | 4000 |
| February 2016 | 9000 | 4500 |
| March 2016 | 15000 | 5000 |

**c.** A transport company has 20 vehicles, which capacities are as follows:

| No. of Vehicles | Capacity per vehicle |
|---|---|
| 5 | 9 tonne |
| 6 | 12 tonne |
| 7 | 15 tonne |
| 2 | 20 tonne |

The company provides the goods transport service between stations 'A' to station 'B'. Distance between these stations is 200 kilometres. Each vehicle makes one round trip per day an average. Vehicles are loaded with an average of 90 per cent of capacity at the time of departure from station 'A' to station 'B' and at the time of return back loaded with 70 per cent of capacity. 10 per cent of vehicles are laid up for repairs every day. The following information are related to the month of Ashadh, 2073:

| | |
|---|---|
| Salary of Transport Manager | Rs. 30,000 |
| Salary of 30 drivers | Rs. 4,000 each driver |
| Wages of 25 Helpers | Rs. 2,000 each helper |
| Wages of 20 Labourers | Rs. 1,500 each labourer |
| Consumable stores | Rs. 45,000 |
| Insurance (Annual) | Rs. 24,000 |
| Road Licence (Annual) | Rs. 60,000 |
| Cost of Diesel per litre | Rs. 35 |
| Kilometres run per litre each vehicle | 5 Km. |
| Lubricant, Oil etc. | Rs. 23,500 |
| Cost of replacement of Tyres, Tubes, other parts etc. | Rs. 1,25,000 |
| Garage rent (Annual) | Rs. 90,000 |
| Transport Technical Service Charges | Rs. 10,000 |
| Electricity and Gas charges | Rs. 5,000 |
| Depreciation of vehicles | Rs.2,00,000 |

There is a workshop attached to transport department which repairs these vehicles and other vehicles also. 40 per cent of transport manager's salary is debited to the workshop. The transport department is charged Rs. 28,000 for the service rendered by the workshop during Ashadh, 2073. During the month of Ashadh, 2073 operation was 25 days.

You are required:

(i) Calculate per ton-km operating cost.

(ii) Find out the freight to be charged per ton-km, if the company earned a profit of 25 per cent on freight.

**d.** A product passes through three processes 'X', 'Y' and 'Z'. The output of process 'X' and 'Y' is transferred to next process at cost plus 20 per cent each on transfer price and the output of process 'Z' is transferred to finished stock at a profit of 25 per cent on transfer price. The following information are available in respect of the year ending 31st Ashadh, 2073:

| | **Process-X** | **Process-Y** | **Process-Z** | **Finished Stock** |
|---|---|---|---|---|
| | (Rs.) | (Rs.) | (Rs.) | (Rs.) |
| Opening stock | 15,000 | 27,000 | 40,000 | 45,000 |
| Material | 80,000 | 65,000 | 50,000 | -- |
| Wages | 1,25,000 | 1,08,000 | 92,000 | -- |
| Manufacturing Overheads | 96,000 | 72,000 | 66,500 | -- |
| Closing stock | 20,000 | 32,000 | 39,000 | 50,000 |
| Inter process profit included in Opening stock | NIL | 4,000 | 10,000 | 20,000 |

Stock in processes is valued at prime cost. The finished stock is valued at the price at which it is received from process 'Z'. Sales of the finished stock during the period was Rs.14,00,000.

You are required to prepare:

(i) Process accounts and finished stock account showing profit element at each stage.

(ii) Costing Profit and Loss account.

(iii) Show the relevant items in the Balance Sheet.

***Cost Concepts for Decision Making***

**Question No. 7**

**a.** Mega Company has just completed its first year of operations. The unit costs on a normal costing basis are as under:

| | | (Rs.) |
|---|---|---|
| Direct material 4 kg @ Rs. 4 | = | 16.00 |
| Direct labour 3 hrs @ Rs. 18 | = | 54.00 |
| Variable overhead 3 hrs @ Rs. 4 | = | 12.00 |
| Fixed overhead 3 hrs @ Rs. 6 | = | 18.00 |
| | | 100.00 |

Selling and administrative costs:

| | |
|---|---|
| Variable | Rs. 20 per unit |
| Fixed | Rs. 7,60,000 |

During the year the company has the following activity:

| | | |
|---|---|---|
| Units produced | = | 24,000 |
| Units sold | = | 21,500 |
| Unit selling price | = | Rs. 168 |
| Direct labour hours worked | = | 72,000 |

Actual fixed overhead was Rs. 48,000 less than the budgeted fixed overhead. Budgeted variable overhead was Rs 20,000 less than the actual variable overhead. The company used an expected actual activity level of 72,000 direct labour hours to compute the predetermine overhead rates.

Required:

(i) Compute the unit cost and total income under:

(a) Absorption costing

(b) Marginal costing

(ii) Under or over absorption of overhead.

(iii) Reconcile the difference between the total income under absorption and marginal costing.

**b.** MNP Ltd sold 2,75,000 units of its product at Rs. 37.50 per unit. Variable costs are Rs. 17.50 per unit (manufacturing costs of Rs. 14 and selling cost Rs. 3.50 per unit). Fixed costs are incurred uniformly throughout the year and amount to Rs. 35,00,000 (including depreciation of Rs.15,00,000). there are no beginning or ending inventories.

Required:

(i) Estimate breakeven sales level quantity and cash breakeven sales level quantity.

(ii) Estimate the P/V ratio.

(iii) Estimate the number of units that must be sold to earn an income (EBIT) of Rs. 2, 50,000.

(iv) Estimate the sales level achieve an after-tax income (PAT) of Rs. 2, 50,000.

Assume 40% corporate Income Tax rate.

***Costing for planning and Control –Budgets***

**Question No.8**

A company is engaged in the manufacture of specialised sub- assemblies required for certain electronic equipments. The company envisages that in the forthcoming month, December, 2016, the sales will take a pattern in the ratio of 3 : 4 : 2 respectively of sub-assemblies, ACB, MCB and DP.

The following is the schedule of components required for manufacture:

**Component requirements**

| Sub-assembly | Selling price | Base board | IC08 | IC12 | IC26 |
|---|---|---|---|---|---|
| ACB | 520 | 1 | 8 | 4 | 2 |
| MCB | 500 | 1 | 2 | 10 | 6 |
| DP | 350 | 1 | 2 | 4 | 8 |
| Purchase price (F) | | 60 | 20 | 12 | 8 |

The direct labour time and variable overheads required for each of the sub-assemblies are:

| | Labour hours per sub-assembly | | |
|---|---|---|---|
| | **Grade A** | **Grade B** | **Variable overheads per sub-assembly (Rs.)** |
| ACB | 8 | 16 | 36 |
| MCB | 6 | 12 | 24 |
| DP | 4 | 8 | 24 |
| Direct wage rate per hour (Rs.) | 5 | 4 | — |

The labourers work 8 hours a day for 25 days a month.
The opening stocks of sub-assemblies and components for December, 2016 are as under:

| Sub-assemblies | | Components | |
|---|---|---|---|
| ACB | 800 | Base Board | 1,600 |
| MCB | 1,200 | IC08 | 1,200 |
| DP | 2,800 | IC12 | 6,000 |
| | | IC26 | 4,000 |

Fixed overheads amounts to Rs. 7,57,200 for the month and a monthly profit target of Rs. 12 lacs has been set.

The company is eager for a reduction of closing inventories for December, 2016 of sub-assemblies and components by 10% of quantity as compared to the opening stock.

Prepare the following budgets for December 2016:

(i) Sales budget in quantity and value.

(ii) Production budget in quantity

(iii) Component usage budget in quantity.

(iv) Component purchase budget in quantity and value.

(v) Manpower budget showing the number of workers and the amount of wages payable.

***Standard Costing***

**Question No. 9**

KPR Limited operates a system of standard costing in respect of one of its products which is manufactured within a single cost centre. The Standard Cost Card of a product is as under:

| Standard | | Unit cost (Rs.) |
|---|---|---|
| Direct material | 5 kg. @ Rs. 4.20 | 21.00 |
| Direct labour | 3 hours @ Rs. 3.00 | 9.00 |
| Factory overhead | Rs. 1.20 per labour hour | 3.60 |

| | |
|---|---|
| Total manufacturing cost | 33.60 |

The production schedule for the month of June, 2016 required completion of 40,000 units. However, 40,960 units were completed during the month without opening and closing work-in- process inventories.

Purchases during the month of June, 2016, 2,25,000 kg. of material at the rate of Rs. 4.50 per kg. Production and Sales records for the month showed the following actual results.

| | |
|---|---|
| Material used | 2,05,600 kg. |
| Direct labour 1,21,200 hours; cost incurred | Rs. 3,87,840 |
| Total factory overhead cost incurred | Rs. 1,00,000 |
| Sales | 40,000 units |

Selling price to be so fixed as to allow a mark-up of 20 per cent on selling price.

Required:

(i) Calculate material variances based on consumption of material.

(ii) Calculate labour variances and the total variance for factory overhead.

(iii) Prepare Income statement for June, 2016 showing actual gross margin.

(iv) An incentive scheme is in operation in the company whereby employees are paid a bonus of 50% of direct labour hour saved at standard direct labour hour rate. Calculate the Bonus amount.

***Uniform Costing and Inter-firm comparison***

**Question No. 10**

**a.** What are the requisites for the installation of Uniform Costing system?

**b.** What are the advantages of Inter-firm Comparison?

***Cost control and cost reduction***

**Question No. 11**

Distinguish between 'Cost Reduction' and' cost management':

**SUGGESTED ANSWERS / HINTS**

**Answer 1 (a)**

The essential features, which a good Cost Accounting System should possess, are as follows:

**(a) Informative and Simple:** Cost Accounting System should be tailor-made, practical, simple and capable of meeting the requirements of a business concern. The system of costing should not sacrifice the utility by introducing meticulous and unnecessary details.

**(b) Accuracy:** The data to be used by the Cost Accounting System should be accurate; otherwise it may distort the output of the system and a wrong decision may be taken.

**(c) Support from Management and subordinates:** Necessary cooperation and participation of executives from various departments of the concern is essential for developing a good system of Cost Accounting.

**(d) Cost-Benefit:** The Cost of installing and operating the system should justify the results.

**(e) Procedure:** A carefully phased programme should be prepared by using network analysis for the introduction of the system.

**(f) Trust:** Management should have faith in the Costing System and should also provide a helping hand for its development and success.

**Answer 1 (b)**

Four different methods of costing along with their applicability to concerned industry have been discussed as below:

1. **Job Costing:** The objective under this method of costing is to ascertain the cost of each job order. A job card is prepared for each job to accumulate costs. The cost of the job is determined by adding all costs against the job it is incurred. This method of costing is used in printing press, foundries and general engineering workshops, advertising etc.
2. **Batch Costing:** This system of costing is used where small components/ parts of the same kind are required to be manufactured in large quantities. Here batch of similar products is treated as a job and cost of such a job is ascertained as discussed under (1), above. If in a cycle manufacturing unit, rims are produced in batches of 2,500 units each, then the cost will be determined in relation to a batch of 2,500 units.
3. **Contract Costing:** If a job is very big and takes a long time for its completion, then method used for costing is known as Contract Costing. Here the cost of each contract is ascertained separately. It is suitable for firms engaged in the construction of bridges, roads, buildings etc.
4. **Operating Costing:** The method of Costing used in service rendering undertakings is known as operating costing. This method of costing is used in undertakings like transport, supply of water, telephone services, hospitals, nursing homes etc.

**Answer 1 (c)**

Where two or more products which are following the same production pattern, consumes same materials and same set of labour skills are produced and managed together. This manufacturing synchronisation gives better efficiency in usage, production and handling of these products. Due to this synergetic effect idle time is reduced, effort is saved and in turn associated costs can also be saved.

**Answer 1 (d)**

**Operating Costing:** It is a method of costing applied by undertakings which provide service rather than production of commodities. Like unit costing and process costing, operating costing is thus a form of operation costing.

The emphasis under operating costing is on the ascertainment of cost of rendering services rather than on the cost of manufacturing a product. It is applied by transport companies, gas and water works, electricity supply companies, canteens, hospitals, theatres, school etc. Within an organisation itself certain departments too are known as service departments which provide ancillary services to the production departments. For example maintenance department; power house, boiler house, canteen, hospital, internal transport etc

**Operation Costing:** It represents a refinement of process costing. In this each operation instead of each process of stage of production is separately costed. This may offer better scope for control. At the end of each operation, the unit operation cost may be computed by dividing the total operation cost by total output.

**Answer 1 (e)**
**Practical applications of Marginal costing:**

- **(i)** **Pricing Policy:** Since marginal cost per unit is constant from period to period, firm decisions on pricing policy can be taken particularly in short term.
- **(ii)** **Decision Making:** Marginal costing helps the management in taking a number of business decisions like make or buy, discontinuance of a particular product, replacement of machines, etc.
- **(iii)** **Ascertaining Realistic Profit:** Under the marginal costing technique, the stock of finished goods and work-in-progress are carried on marginal cost basis and the fixed expenses are written off to profit and loss account as period cost. This shows the true profit of the period.
- **(iv)** **Determination of production level:** Marginal costing helps in the preparation of break-even analysis which shows the effect of increasing or decreasing production activity on the profitability of the company.

**Answer 2 (a)**
**Detection of slow moving and non-moving item of stores:**

The existence of slow moving and non-moving item of stores can be detected in the following ways.

- **(i)** By preparing and *perusing periodic reports* showing the status of different items or stores.
- **(ii)** By calculating the *inventory turnover period* of various items in terms of number of days/months of consumption.
- **(iii)** By computing *inventory turnover ratio* periodically, relating to the issues as a percentage of average stock held.
- **(iv)** By implementing the use of a well designed information system.

**Necessary steps to reduce stock of slow moving and non-moving item of stores:**

- **(i)** Proper procedure and guidelines should be laid down for the disposal of non-moving items, before they further deteriorates in value.
- **(ii)** Diversify production to use up such materials.
- **(iii)** Use these materials as substitute, in place of other materials.

**Answer 2 (b)**

(i) Carrying cost = Storage rate = 2%

Interest Rate = 12%

Obsolescence = 6 %

Total 20% per annum

C = 20% of *Rs.* 20 = *Rs.* 4 per unit per annum.

$$E.O.Q.= \sqrt{\frac{2AO}{C}} = \sqrt{\frac{2X500X16}{4}} = \sqrt{40,000} = 200 \text{ Units}$$

**Total variable cost:**

| | | | | |
|---|---|---|---|---|
| Purchase price of 5,000 units @ *Rs.* 20.00 per unit | | | = | Rs. 1,00,000 |
| Ordering cost | = $\frac{5000}{200}$ | =25 orders @ Rs. 16 | = | Rs. 400 |
| Carrying cost of average Inventory | = $\frac{200}{2}$ | = 100 units @ *Rs.* 4 | = | Rs. 400 |
| Total variable cost | | | | Rs. 1,00,800 |

(ii) If an incorrect price of Rs. 12.80 is used:

C = 20% of 12.80 = Rs. 2.56 per unit per annum.

$$E.O.Q. = \sqrt{\frac{2 \times 5,000 \times 16}{2.56}} = 250 \text{ units}$$

Total variable cost:

| | | | | |
|---|---|---|---|---|
| Purchase price of 5,000 units @ Rs. 12.80 per unit | | | = | Rs. 64,000 |
| Ordering cost | = $\frac{5,000}{250}$ | = 20 orders @ Rs. 16 | = | Rs. 320 |
| Carrying cost (of average inventory) = $\frac{250}{2}$ = | | 125 units @ Rs. 2.56 | = | Rs. 320 |
| Total variable cost | | | | Rs. 64,640 |

**Answer 2 (c)**

**(i) Minimum stock of A**

Re-order level – (Average consumption × Average time required to obtain delivery)

= 8,000 kg. – (200 units × 10 kg. × 2 weeks) = 4,000 kg.

**(ii) Maximum stock of B**

Re-order level – (Min. Consumption × Min. Re-order period) + Re-order quantity

= 4,750 kg. – (175 units × 4 kg. × 3 weeks) + 5,000 kg.

= 9,750 - 2,100 = 7,650 kg.

**(iii) Re-order level of C**

Maximum re-order period × Maximum Usage

= 4 weeks × (225units × 6 kg.) = 5,400 kg.

OR

= Minimum stock of C + (Average consumption × Average delivery time)

= 2,000 kg. + [(200units×6kg.)×3 weeks] = 5,600 kg.

**(iv) Average stock level of A**

= Minimum stock level of A + ½ * Re-order quantity

= 4,000 kg. + $\frac{1}{2}$ * 10,000 kg. = 4,000 + 5,000 = 9,000 kg.

OR

$= \frac{\text{Minimum stock + Maximum stock}}{2}$ (Refer to working note)

$= \frac{4000+16250}{2}$

= 10,125 Kg

**Working note**

Maximum stock of A = ROL + ROQ – (Minimum consumption × Minimum re-order period)

= 8,000 kg. + 10,000 kg. – [(175 units × 10 kg.) × 1 week] = 16,250 kg

**Answer 3 (a)**

**Working Notes:**

1. Total time wages of 10 workers per month:

   = No. of working days in the month × No. of working hours per day of each worker × Hourly rate of wages × No. of workers

   = 25 days × 8 hrs. × Rs. 2 × 10 workers = Rs. 4,000

2. *Time saved per month* :

| | |
|---|---|
| Time allowed per piece by a worker | 2 hours |
| No. of units produced during the month by 10 workers | 1,250 pieces |
| Total time allowed to produce 1,250 pieces (1,250 × 2 | 2,500 hours |

hours)

Actual time taken to produce 1,250 pieces 2,000 hours

Time saved (2,500 hours – 2,000 hours) 500 hours

3. Bonus under Halsey scheme to be paid to 10 workers :

Bonus = (50% of time saved) × hourly rate of wages = 50/100 × 500 hours × Rs. 2 = Rs. 500

Total wages to be paid to 10 workers are (Rs. 4,000 + Rs. 500) Rs. 4,500, if Mr. A considers the introduction of Halsey Incentive Scheme to increase the labour productivity.

4. Bonus under Rowan Scheme to be paid to 10 workers :

$$\text{Bonus} = \frac{\text{Time taken}}{\text{Time Allowed}} \times \text{Time saved} \times \text{hourly rate}$$

$$= \frac{2{,}000\text{hours}}{2{,}500\text{hours}} \times 500 \text{ hours} \times \text{Rs. } 2 = \text{Rs. } 800$$

Total wages to be paid to 10 workers are (Rs. 4,000 + Rs. 800) Rs. 4,800, if Mr. A considers the introduction of Rowan Incentive Scheme to increase the labour productivity.

**1. (i) Effective hourly rate of earnings under Halsey scheme :**

(Refer to Working Notes 1, 2 and 3)

$$= \frac{\text{Total time wages of 10 workers + Total bonus under Halsey scheme}}{\text{Total hours worked}}$$

$$= \frac{\text{Rs.}4{,}000 + \text{Rs. } 500}{2{,}000 \text{ hours}} = \text{Rs. } 2.25$$

**(ii) Effective hourly rate of earnings under Rowan scheme:**

(Refer to Working Notes 1, 2 and 4)

$$= \frac{\text{Total time wages of 10 workers+ Total bonus under Rowan scheme}}{\text{Total hours worked}}$$

$$= \frac{\text{Rs.}4{,}000 + \text{Rs. } 800}{2{,}000 \text{ hours}} = \text{Rs. } 2.40$$

**2. (i) Saving in terms of direct labour cost per piece under Halsey scheme :**

(Refer to Working Note 3)

Labour cost per piece (under time wage scheme) = 2 hours × Rs. 2 = Rs. 4

Labour cost per piece (under Halsey scheme)

$$= \frac{\text{Total wages paid under the scheme}}{\text{Total number of units produced}} = \frac{\text{Rs. } 4{,}500}{1{,}250} = \text{Rs. } 3.60$$

Saving per piece : (Rs. 4 – Rs.3.60) = Rs. 0.40.

**(ii) Saving in terms of direct labour cost per piece under Rowan Scheme :**

(Refer to Working Note 4)

Labour cost per piece under Rowan scheme = Rs. 4,800/1,250 units = Rs. 3.84

Saving per piece = Rs. 4 – Rs. 3.84 = Rs. 0.16.

**3.** From the labour cost per piece under Halsey scheme (Rs. 3.60) and Rowan scheme (Rs. 3.84), it is quite clear that Halsey scheme brings about more saving than Rowan scheme to the concern. But Halsey scheme does not fulfill the assurance given to the workers about 20% increase in their earnings as it secures only 12.5% [500/4,000 × 100] increase.

On the other hand, Rowan scheme secures 20% [800/4,000 × 100] increase in the earnings and it fulfills the assurance. Therefore, Rowan scheme may be adopted.

**Answer 3 (b)**

**Working notes:**

(i) *Total effective hours in a week :*
[(8 hrs. – (30 mts. + 10 mts.)] × 6 days = 44 hours

(ii) *Total wages for a week :*
(Rs. 100 + 120% of Rs. 100) × 6 days = Rs. 1,320

(iii) Wage rate per hour : = Rs. 30

(iv) Time wasted waiting for job (Abnormal idle time): = 44 hrs. – (15 hrs. + 12 hrs. + 13 hrs.) = 4 hrs.

**Allocation of wages in Cost Accounting**

| | | | (Rs.) |
|---|---|---|---|
| Allocated to Job X | : 15 hours × Rs. 30 | = | 450 |
| Allocated to Job Y | : 12 hours × Rs. 30 | = | 360 |
| Allocated to Job Z | : 13 hours × Rs. 30 | = | 390 |
| Charged to Costing Profit & Loss A/c | : 4 hours × Rs. 30 | = | 120 |
| Total | | | 1,320 |

**Answer 4 (a)**

Treatment of over and under absorption of overheads are:-

(i) **Writing off to costing P&L A/c:**– Small difference between the actual and absorbed amount should simply be transferred to costing P&L A/c, if difference is large then investigate the causes and after that abnormal loss shall be transferred to costing P&L A/c.

(ii) **Use of supplementary Rate**: Under this method the balance of under and over absorbed overheads may be charged to cost of W.I.P., finished stock and cost of sales proportionately with the help of supplementary rate of overhead.

(iii) **Carry Forward to Subsequent Year:** Difference should be carried forward in the expectation that next year the position will be automatically corrected. This would really mean that costing data of two years would be wrong.

**Answer 4 (b)**

The three main methods of allocating support departments costs to operating departments are:

(i) ***Direct re-distribution method:*** Under this method, support department costs are directly apportioned to various production departments only. This method does not consider the service provided by one support department to another support department.

(ii) ***Step method:*** Under this method the cost of the support departments that serves the maximum numbers of departments is first apportioned to other support departments and production departments. After this the cost of support department serving the next largest number of departments is apportioned. In this manner we finally arrive on the cost of production departments only.

(iii) ***Reciprocal service method:*** This method recognises the fact that where there are two or more support departments they may render services to each other and, therefore, these inter-departmental services are to be given due weight while re-distributing the expenses of the support departments. The methods available for dealing with reciprocal services are:

(a) Simultaneous equation method

(b) Repeated distribution method

(c) Trial and error method.

The reciprocal service method is conceptually preferable. This method is widely used even if the number of service departments is more than two because due to the availability of computer software it is not difficult to solve sets of simultaneous equations.

**Answer 4 (c)**

Let, the percentage of factory overheads on direct labour is 'x' and the percentage of office overheads on factory cost is 'y', then the total cost of product A and product B will be as follows:

| | ***Product A*** (Rs.) | ***Product B*** (Rs.) |
|---|---|---|
| Direct Materials | 19,000 | 15,000 |
| Direct labour | 15,000 | 25,000 |
| Prime Cost | 34,000 | 40,000 |
| Factory overheads (Direct labour × x) | 150 x | 250 x |
| Factory cost (i) | 34,000 + 150 x | 40,000 + 250 x |
| Office overheads (Factory cost × y) (ii) | 340 y + 1.5 x y | 400 *y* + 2.5 x y |
| Total Cost [(i) + (ii)] | 34,000 + 150 x + 340 y + 1.5 x y | 40,000 + 250 x +400 *y* + 2.5 x y |

Total cost on the basis of sales is:

| | ***Product A*** (Rs.) | ***Product B*** (Rs.) |
|---|---|---|
| Sales | 60,000 | 80,000 |
| Less: Profit | | |
| Product A – 25% on cost or 20% on | 12,000 | |
| Product B – 25% on sales | | 20,000 |
| Total Cost | 48,000 | 60,000 |

Thus,

Total Cost of A is $34,000 + 150x + 340y + 1.5\,xy = 48,000$

Or, $150x + 340y + 1.5\,xy = 14,000$ …………(i)

Total Cost of B is $40,000 + 250x + 400y + 2.5\,xy = 60,000$

Or, $250x + 400y + 2.5\,xy = 2,000$ ……..……(ii)

Equation (ii) multiplied by 0.6 and after deducting from equation (i), we get

$150x + 340y + 1.5xy = 14,000$ ……………(i)

$150x \pm 240y \pm 1.5xy = \_12,000$ ……….........…(ii)

$100y = 2,000$

Or, $y = 20$

Putting value of y in equation (i), we get

$150x + 340 \times 20 + 1.5x \times 20 = 14,000$

Or, $150x + 30x = 14,000 – 6,800$

Or, $180x = 7,200$

Or, $x = 40$

Hence, (i) the factory overheads on direct labour = 40% and

(ii) the office overheads on factory cost = 20%.

**Answer 5**

**Stores Leger Control Account**

Dr. Cr.

| | (Rs.) | | (Rs.) |
|---|---|---|---|
| To Balance b/d | 12,60,000 | By Work-in-progress control | 67,20,000 |
| To General ledger adjustment A/C | 67,20,000 | By Overhead control A/c | 8,40,000 |
| To Work-in progress Control A/c | 33,60,000 | By Overhead control A/c (Shortage) | 2,52,000 |
| | | By Balance c/d | 35,28,000 |
| | 1,13,40,000 | | 1,13,40,000 |

**W.I.P Control A/c**

Dr. Cr.

| | (Rs.) | | (Rs.) |
|---|---|---|---|
| To Balance b/d | 25,20,000 | By Stores ledger control A/c | 33,60,000 |
| To Stores ledger control A/c | 67,20,000 | By Costing P&L A/c (Cost of Sales) (Balancing figure) | 1,58,88,000 |
| To Direct wages Control A/c | 25,20,000 | | |
| To Overhead control A/c | 90,08,000 | By Balance c/d | 15,20,000 |
| | 2,07,68,000 | | 2,07,68,000 |

**Costing Profit and Loss A/c**

Dr. Cr.

| | (Rs.) | | (Rs.) |
|---|---|---|---|
| To W.I.P Control A/c<br>To General ledger Adj. A/c (Profit) | 1,58,88,000<br>19,06,560 | By General Ledger Adj. A/c 1,58,88,000<br>Cost of sales 19,06,560<br>Add 12%Profit | 1,77,94,560 |
| | 1,77,94,560 | | 1,77,94,560 |

**Financial Profit and Loss A/c**

Dr. Cr.

| | (Rs.) | (Rs.) | | (Rs.) | (Rs.) |
|---|---|---|---|---|---|
| To Opening stock : Stores | 12,60,000 | | By Sales | | 1,77,94,560 |
| W.I.P | 25,20,000 | 37,80,000 | By Income from | | 4,00,000 |
| To Purchases | | 67,20,000 | By Closing stock: | | |
| To Wages | | 29,40,000 | Stores | 35,28,000 | |
| | | | W.I.P | 15,20,000 | 50,48,000 |
| To Overhead | | 95,50,000 | By loss | | 5,87,440 |
| To Loss on sale of fixed assets | | 8,40,000 | | | |
| | | 2,38,30,000 | | | 2,38,30,000 |

**Reconciliation Statement**

Dr. Cr.

| | (Rs.) | (Rs.) |
|---|---|---|
| Profit as per Cost Accounts | | 19,06,560 |
| Add: Income from investments | | 4,00,000 |
| | | 23,06,560 |
| Less : Loss on sale of fixed assets | 8,40,000 | |
| Under absorption of overheads (Refer to Working Note) | 20,54,000 | 28,94,000 |
| Loss as per Financial Accounts | | 5,87,440 |

**Working Notes:**

**Overhead Control Account**

Dr. Cr.

| | (Rs.) | | (Rs.) |
|---|---|---|---|
| To General Ledger Adj. A/c | 9550000 | By W.I.P control | 90,08,000 |
| To Stores Ledger Control A/c | 252000 | By Balance c/d (under absorption | 20,54,000 |
| To Stores ledger control A/c | 8,40,000 | | |

| | | | |
|---|---|---|---|
| To Wages control A/c Indirect wages Rs. 29,40,000- | 4,20,000 | | |
| | 1,10,62,000 | | 1,10,62,000 |

**Answer 6(a)**

**PQR Construction Ltd.**
**Contract A/c**
**(Shrawan 1, 2072 to Ashadh 31, 2073)**

| **Particulars** | | **Amount (Rs.)** | **Particulars** | **Amount (Rs.)** |
|---|---|---|---|---|
| To Materials Issued | | 4,56,000 | By Plant returned to Stores (Working Note 1) | 60,000 |
| To Labour | 3,05,000 | | By Materials at Site | 30,000 |
| Add: Outstanding | 24,000 | 3,29,000 | By W.I.P. | |
| To Plant Purchased | | 2,25,000 | Certified 12,75,000 | |
| To Expenses | 1,00,000 | | Uncertified 40,000 | 13,15,000 |
| Less: Prepaid | 22,500 | 77,500 | By Plant at Site (Working Note 2) | 1,20,000 |
| To Notional Profit c/d | | 4,37,500 | | |
| | | 15,25,000 | | 15,25,000 |
| To Costing Profit & Loss A/c (Refer to Working Note 5) | | 53,763 | By Notional Profit b/d | 4,37,500 |
| To Work-in-Progress A/c (Profit-in-reserve) | | 3,83,737 | | |
| | | 4,37,500 | | 4,37,500 |

**PQR Construction Ltd.**
**Contract A/c**
**(Shrawan 1, 2072 to Chaitra 31, 2073)**
**(For Computing estimated profit)**

| **Particulars** | **Amount** (Rs.) | **Particulars** | **Amount** (Rs.) |
|---|---|---|---|
| To Materials Issued (` 4,56,000+ Rs. 8,14,000) | 12,70,000 | By Material at Site | 75,000 |
| To Labour Cost (Rs. 3,05,000 + Rs. 24,000 + Rs. 3,56,000* + Rs. 37,500) | 7,22,500 | By Plant returned To Stores on 31.3.2073. | 60,000 |
| To Plant purchased | 2,25,000 | By Plant returned to Stores on 31.12.2073 (Working Note 3) | 1,02,000 |
| To Expenses (Rs. 77,500 + Rs. 1,97,500 + Rs. 25,000) | 3,00,000 | By Contractee A/c | 27,12,500 |

| | | | |
|---|---|---|---|
| To Estimated profit | 4,32,000 | | |
| | 29,49,500 | | 29,49,500 |

* Labour paid in 2073-74: Rs. 3,80,000 – Rs. 24,000 = Rs. 3,56,000

**Working Notes**

| | (Rs.) |
|---|---|
| 1. **Value of the Plant returned to Stores on 31.03.2073**<br>Historical Cost of the Plant returned<br>Less: Depreciation @ 20% of WDV for one year | <br>75,000<br>(15,000)<br>60,000 |
| 2. **Value of Plant at Site 31.03.2073**<br>Historical Cost of Plant at Site (Rs. 2,25,000 – Rs. 75,000)<br>Less: Depreciation @ 20% on WDV for one year | <br>1,50,000<br>(30,000)<br>1,20,000 |
| 3. **Value of Plant returned to Stores on 31.12.2073**<br>Value of Plant (WDV) on 31.3.2073<br>Less: Depreciation @ 20% of WDV for a period of 9 months | <br>1,20,000<br>(18,000)<br>1,02,000 |
| 4. **Expenses Paid for the year 2072-73**<br>Total expenses paid Less: Pre-paid at the end | <br>1,00,000<br>(22,500)<br>77,500 |
| 5. **Profit to be credited to Costing Profit & Loss A/c** on Ashadh 31,2073 for the Contract likely to be completed on Chaitra 31,2073.<br>$\text{Notional Profit} \times \frac{\text{Work Certified}}{\text{Total Contract Price}} \times \frac{\text{Cash received}}{\text{Work Certified}}$<br>$= 4,32,000 \times \frac{12,75,000}{27,12,500} \times \frac{10,00,000}{27,12,500}$ | <br><br><br>53,763 |

**Answer 6 (b)**

**Statement of Cost and Profit per unit of each batch**

| | Jan. 2016 | Feb. 2016 | March. 2016 | Total |
|---|---|---|---|---|
| a) Batch Output (Nos.) | 1250 | 1500 | 1000 | 3750 |
| | (Rs.) | (Rs.) | (Rs.) | (Rs.) |
| b) Sales Value (@Rs. 15 per unit) | 18750 | 22500 | 15000 | 56250 |
| **Cost** | | | | |
| Material | 6250 | 9000 | 5000 | 20250 |

| | | | | |
|---|---|---|---|---|
| Wages | 2500 | 3000 | 2000 | 7500 |
| Overheads | 3750 | 3000 | 3000 | 9750 |
| c) Total | 12500 | 15000 | 10000 | 37500 |
| d) Profit per batch (b) – (c) | 6250 | 7500 | 5000 | 18750 |
| e) Cost per unit (c) ÷ (a) | 10 | 10 | 10 | |
| f) Profit per unit (d) ÷ (a) | 5 | 5 | 5 | |

**Overall Position of the Order for 3000 Units**

| | |
|---|---|
| Sales value (3000 units × Rs. 15) | Rs.45000 |
| *Less*: Total cost (3000 units × Rs. 10) | 30000 |
| **Profit** | 15000 |

Calculation of Overhead per hours:

| | Jan. 2016 | Feb. 2016 | March 2016 |
|---|---|---|---|
| i. Labour hours: | | | |
| $\frac{\text{Labour cost}}{\text{Labour rates per hour}}$ | $\frac{Rs.\ 2500}{2} = 1250$ | $\frac{Rs.\ 3000}{2} = 1500$ | $\frac{Rs.\ 2000}{2} = 1000$ |
| ii. Overhead per hour : | | | |
| $\frac{\text{Total Overheads}}{\text{Total labour hour}}$ = Total Labour hours | $\frac{Rs.\ 12000}{4000} = Rs.\ 3$ | $\frac{Rs.\ 9000}{4500} = Rs.\ 2$ | $\frac{Rs.\ 1500}{5000}$ Rs. 3 |
| iii. **Overhead for batch** (i) × (ii) | Rs. 3750 | Rs.3000 | Rs. 3000 |

**Answer 6 (C)**

**(i) Operating Cost Sheet for the month of Ashadh, 2073**

| **Particulars** | | **Amount** (Rs.) |
|---|---|---|
| A. | Fixed Charges: | |
| | Manager's salary (Rs. 30,000 × 60%) | 18,000 |

| | | |
|---|---|---|
| | Drivers' Salary (Rs. 4,000 × 30 drivers) | 1,20,000 |
| | Helpers' wages (Rs. 2,000 × 25 helpers) | 50,000 |
| | Labourer wages (Rs. 1,500 × 20 labourers) | 30,000 |
| | Insurance (Rs. 24,000 ÷ 12 months) | 2,000 |
| | Road licence (Rs. 60,000 ÷ 12 months) | 5,000 |
| | Garage rent (Rs. 90,000 ÷ 12 months) | 7,500 |
| | Transport Technical Service Charges | 10,000 |
| | Share in workshop expenses | 28,000 |
| | Total (A) | 2,70,500 |
| B. | Variable Charges: | |
| | Cost of diesel (Working Note 1) | 12,60,000 |
| | Lubricant, Oil etc. | 23,500 |
| | Depreciation | 2,00,000 |
| | Replacement of Tyres, Tubes & other parts | 1,25,000 |
| | Consumable Stores | 45,000 |
| | Electricity and Gas charges | 5,000 |
| | Total (B) | 16,58,500 |
| C. | Total Cost (A + B) | 19,29,000 |
| D. | Total Ton-Kms. (Working Note 2) | 18,86,400 |
| E. | Cost per ton-km. (C ÷ D) | 1.022 |

**(ii) Calculation of Chargeable Freight**

| | |
|---|---|
| Cost per ton-km. | Rs. 1.022 |
| *Add*: Profit @ 25% on freight or 33⅓% on cost | Rs. 0.341 |
| Chargeable freight per ton-km. | Rs.1.363 or Rs. 1.36 |

**Working Notes:**

**1. Cost of Diesel:**

Distance covered by each vehicle during Ashadh, 2073
= 200 k.m.× 2 × 25 days × 90 % = 9,000 km.

Consumption of diesel = $\frac{9{,}000\text{ k.m.} \times 20\text{ vehicles}}{5\text{ k.m.}}$ = 36,000 litres.

Cost of diesel = 36,000 litres × Rs.35 = Rs. 12,60,000.

**2. Calculation of total ton-km:**

Total Ton-Km. = Total Capacity × Distance covered by each vehicle × Average Capacity Utilisation ratio.

$= [(5 \times 9\text{ ton}) + (6 \times 12\text{ ton}) + (7 \times 15\text{ ton}) + (2 \times 20\text{ ton})] \times 9{,}000\text{ k.m.} \times (90\% + 70\%)/2$

$(45 + 72 + 105 + 40) \times 9{,}000\text{ k.m.} \times 80\%$

$= 262 \times 9{,}000 \times 80\%.$

= 18,86,400 ton-km.

**Answer 6 (d)**

**Process 'X' Account**

Dr. Cr.

| **Particulars** | **Cost (Rs.)** | **Profit (Rs.** | **Total (Rs.)** | **Particulars** | **Cost (Rs.)** | **Profit (Rs.)** | **Total (Rs.)** |
|---|---|---|---|---|---|---|---|
| To Opening Stock | 15,000 | – | 15,000 | By Process 'Y' A/c (Transfer) | 2,96,000 | 74,000 | 3,70,000 |
| To Material | 80,000 | – | 80,000 | | | | |
| To Wages | 1,25,000 | – | 1,25,000 | | | | |
| Total | 2,20,000 | – | 2,20,000 | | | | |
| *Less*: Closing stock | 20,000 | – | 20,000 | | | | |
| Prime Cost | 2,00,000 | | 2,00,000 | | | | |
| To Manufacturing Overheads | 96,000 | – | 96,000 | | | | |
| Total cost | 2,96,000 | – | 2,96,000 | | | | |
| To Costing Profit and Loss A/c (20% on transfer Price or 25% on cost) | | 74,000 | 74,000 | | | | |
| | | | | | | | |
| | 2,96,000 | 74,000 | 3,70,000 | | 2,96,000 | 74,000 | 3,70,000 |

**Process 'Y' Account**

Dr. Cr.

| **Particulars** | **Cost (Rs.)** | **Profit (Rs.)** | **Total (Rs.)** | **Particulars** | **Cost (Rs.)** | **Profit (Rs.)** | **Total (Rs.)** |
|---|---|---|---|---|---|---|---|
| To Opening Stock | 23,000 | 4,000 | 27,000 | By Process 'Z' A/c (Transfer) | 5,36,379 | 2,26,121 | 7,62,500 |
| To Process 'X' A/c | 2,96,00 | 74,000 | 3,70,000 | | | | |
| To Material | 65,000 | -- | 65,000 | | | | |
| To Wages | 1,08,00 | -- | 1,08,000 | | | | |
| Total | 4,92,00 | 78,000 | 5,70,000 | | | | |
| *Less*: Closing stock | 27,621 | 4,379 | 32,000 | | | | |
| Prime Cost | 4,64,37 | 73,621 | 5,38,000 | | | | |
| To Manufacturing Overheads | 72,000 | -- | 72,000 | | | | |
| Total cost | 5,36,37 | 73,621 | 6,10,000 | | | | |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| To Costing Profit and Loss A/c (20% on transfer Price or 25% on cost) | -- | 1,52,500 | 1,52,500 | | | | |
| | 5,36,37 | 2,26,12 | 7,62,500 | | 5,36,379 | 2,26,121 | 7,62,500 |

**Process 'Z' Account**

Dr. Cr.

| Particulars | Cost (Rs. | Profit (Rs.) | Total (Rs.) | Particulars | Cost (Rs.) | Profit (Rs.) | Total (Rs.) |
|---|---|---|---|---|---|---|---|
| To Opening Stock | 30,000 | 10,000 | 40,000 | By Finished Stock | 7,45,629 | 5,50,371 | 12,96,000 |
| To Process 'Y' A/c | 5,36,37 | 2,26,121 | 7,62,500 | | | | |
| To Material | 50,000 | -- | 50,000 | | | | |
| To Wages | 92,000 | -- | 92,000 | | | | |
| Total | 7,08,37 | 2,36,121 | 9,44,500 | | | | |
| *Less*: Closing stock | 29,250 | 9,750 | 39,000 | | | | |
| Prime Cost | 6,79,12 | 2,26,371 | 9,05,500 | | | | |
| To Manufacturing Overheads | 66,500 | -- | 66,500 | | | | |
| Total cost | 7,45,62 | 2,26,371 | 9,72,000 | | | | |
| To Costing Profit and Loss A/c (25% on transfer Price or 33 1/3% on cost) | -- | 3,24,000 | 3,24,000 | | | | |
| | 7,45,62 | 5,50,371 | 12,96,00 | | 7,45,629 | 5,50,371 | 12,96,000 |

**Finished Stock Account**

Dr. Cr

| Particulars | Cost (Rs.) | Profit (Rs.) | Total (Rs.) | Particulars | Cost (Rs.) | Profit (Rs.) | Total (Rs.) |
|---|---|---|---|---|---|---|---|
| To Opening Stock | 25,000 | 20,000 | 45,000 | By Costing P&L A/c A/c (Transfer) | 7,41,862 | 6,58,138 | 14,00,000 |
| To Process 'Z' A/c | 7,45,629 | 5,50,371 | 12,96,000 | | | | |
| Total | 7,70,629 | 5,70,371 | 13,41,000 | | | | |
| Less: Closing stock | 28,767 | 21,233 | 50,000 | | | | |
| To Costing Profit and Loss A/c | 7,41,862 | 5,49,138 | 12,91,000 | | | | |
| | | 1,09,000 | 1,09,000 | | | | |
| | 7,41,862 | 6,58,138 | 14,00,000 | | 7,41,862 | 6,58,138 | 14,00,000 |

**Costing Profit & Loss Account**

**for the year ending 31st Ashadh, 2073**

Dr. Cr.

| Particulars | Amount (Rs. | Particulars | Amount (Rs.) |
|---|---|---|---|
| To Provision for unrealized profit on closing stock (Rs. 4,379 + Rs. 9,750 + Rs. 21,233) | 35,362 | By Provision for unrealized profit on opening stock (Rs. 4,000 + Rs. 10,000 + Rs. 20,000) | 34,000 |
| To Net Profit | 6,58,138 | By Process X A/c | 74,000 |
| | | By Process Y A/c | 1,52,500 |
| | | By Process Z A/c | 3,24,000 |
| | | By Finished Stock A/c | 1,09,000 |
| | 6,93,500 | | 6,93,500 |

**Workings:**

Calculation of amount of unrealized profit on closing stock:

Process 'X' = Nil

Process 'Y' = $\frac{\text{Rs.}78{,}000 \times \text{Rs. }32{,}000}{\text{Rs. }5{,}70{,}000}$ = Rs. 4,379.

Process 'Z' = $\frac{\text{Rs. }2{,}36{,}121 \times 39{,}000}{\text{Rs. }9{,}44{,}500}$ =Rs. 9,750

Finished stock = $\frac{\text{Rs }5{,}50{,}371 \times \text{Rs. }50{,}000}{\text{Rs }12{,}96{,}000}$ = Rs 21,233.

**Balance Sheet as on 31st Ashadh, 2073 (Extract)**

| Liabilities | Amount (Rs.) | Assets | Amount (Rs.) |
|---|---|---|---|
| Net profit | 6,58,138 | Closing stock: | |
| | | Process – X | 20,000 |
| | | Process – Y | 32,000 |
| | | Process – Z | 39,000 |
| | | Finished stock | 50,000 |
| | | | 1,41,000 |
| | | *Less*: Provision for unrealized profit | 35,362 |
| | | | 1,05,638 |

**Answer 7 (a)**

**(i) Computation of Unit Cost & Total Income**

| Unit Cost | Absorption Costing | Marginal Costing |
|---|---|---|
| Direct Material | 16.0 | 16.00 |
| Direct Labour | 54.0 | 54.00 |
| Variable Overhead | 12.0 | 12.00 |
| Fixed Overhead | 18.0 | -- |
| Unit Cost | 100.0 | 82.00 |

**Income Statements**

| **Absorption Costing** | | **(Rs.)** |
|---|---|---|
| Sales (21,500 units × Rs.168) | | 36,12,000 |
| *Less*: Cost of goods sold (21,500 × Rs.100) | 21,50,000 | |
| *Less*: Over Absorption [Refer to calculation under (ii)] | 28,000 | 21,22,000 |
| | | 14,90,000 |
| *Less*: Selling & Distribution Expenses | | 11,90,000 |
| Profit | | 3,00,000 |

| **Marginal Costing** | | **(Rs.)** |
|---|---|---|
| Sales (as above) | | 36,12,000 |
| Less: Cost of goods sold (21,500 units × Rs. 82) | 17,63,000 | |
| *Add*: Under Absorption [Refer to calculation under (ii)] | 20,000 | 17,83,000 |
| | | 18,29,000 |
| Less: Selling & Distribution Expenses | | 4,30,000 |
| Contribution | | 13,99,000 |
| Less: Fixed Factory and Selling & Distribution Overhead (Rs. 38,400 + Rs. 7,60,000) | | 11,44,000 |
| Profit | | 2,55,000 |

Under or over absorption of overhead:

| | |
|---|---|
| Budgeted Fixed Overhead | (Rs.) |
| 72,000 hrs. × Rs. 6 | 4,32,000 |
| *Less:* Over-absorption | 48,000 |
| Actual Fixed Overhead | 3,84,000 |
| Budgeted Variable Overhead | |
| 72,000 Hrs. × Rs.4 | 2,88,000 |
| *Add:* Under- absorption | 20,000 |
| Actual Variable Overhead | 3,08,000 |
| Both Fixed & Variable Overhead applied | |
| 72,000 Hrs × Rs. 10 | 7,20,000 |
| Actual Overhead (3,84,000 + 3,08,000) | 6,92,000 |
| Over- Absorption | 28,000 |

Reconciliation of Profit

Difference in Profit: Rs. 3,00,000 – Rs. 2,55,000 = Rs. 45,000

Due to Fixed Factory Overhead being included in Closing Stock in Absorption Costing not in Marginal Costing.

Therefore, Difference in Profit = Fixed Overhead Rate (Production – Sale)

= Rs.18 (24,000 – 21,500) = Rs.45,000

**Answer 7 (b)**

**(i)** Contribution = Rs. 37.50 - Rs. 17.50 = Rs. 20 per unit.

$$\text{Break even Sales Quantity} = \frac{\text{Fixed cost}}{\text{Contribution margin per unit}}$$

$$= \frac{35{,}00{,}000}{20} = 1{,}75{,}000 \text{ units}$$

$$\text{Cash Break even Sales Qty} = \frac{\text{Cash Fixed Cost}}{\text{Contribution margin per unit}} = \frac{20{,}00{,}000}{20} = 1{,}00{,}000 \text{ units.}$$

**(ii)** $$\text{P/V ratio} = \frac{\text{Contribution / unit}}{\text{Selling Price / unit}} \times 100 = \frac{20}{\text{Rs.}37.50} \times 100 = 53.33\ \%$$

**(iii)** No. of units that must be sold to earn an Income (EBIT) of Rs. 2, 50,000

$$\frac{\text{Fixed cost + Desired EBIT level}}{\text{Contribution margin per unit}}$$

$$= \frac{35{,}00{,}000 + 2{,}50{,}000}{20}$$

= 1,87,500 units

**(iv)** After Tax Income (PAT) = Rs.2, 50,000

Tax rate = 40%

$$\text{Desired level of Profit before tax} = \frac{2{,}50{,}000}{60} \times 100 = \text{Rs.}4{,}16{,}667$$

$$\text{Estimate Sales Level} = \frac{\text{Fixed Cost + Desired Profit}}{\text{P / V ratio}}$$

$$= \text{Rs.}\frac{35{,}00{,}000 + 4{,}16{,}667}{53.33\%} = \text{Rs.}73{,}43{,}750$$

**Answer 8**

**Working Note**

**:**

1. Statement showing contribution:

| Sub assemblies | ABC | MCB | DP | Total |
|---|---|---|---|---|

| | (Rs.) | (Rs.) | (Rs.) | (Rs.) |
|---|---|---|---|---|
| Selling price per unit (p.u.) : (A) | 520 | 500 | 350 | |
| Marginal Cost p.u. | | | | |
| Components | | | | |
| Base board | 60 | 60 | 60 | |
| IC08 | 160 | 40 | 40 | |
| IC12 | 48 | 120 | 48 | |
| IC26 1 | 6 | 48 | 64 | |
| Labour | | | | |
| Grade A | 40 | 30 | 20 | |
| Grade B | 64 | 48 | 32 | |
| Variable production overhead | 36 | 24 | 24 | |
| Total marginal cost p.u. : (B) | 424 | 370 | 288 | |
| Contribution p.u. : (C) = (A) – (B) | 96 | 130 | 62 | |
| Sales ratio : (D) | 3 | 4 | 2 | |
| Contribution × Sales ratio : [(E) = (C) × (D)] | 288 | 520 | 124 | 932 |

2. Desired Contribution for the forthcoming month December, 2016

| | (Rs.) |
|---|---|
| Fixed Overheads | 7,57,200 |
| Desire Profit | 12,00,000 |
| Desire Contribution | 19,57,200 |

3. Sales mix required i.e. number of batches for the forthcoming month December, 2016
Sales mix required =Desired contribution/contribution × Sales ratio =Rs.

19,57,200/93 =2,100

**Budgets for December, 2016**

**i) Sales budget in quantity and value**

| **Sub-assemblies** | **ACB** | **MCB** | **DP** | **Total** |
|---|---|---|---|---|
| Sales (quantity) (2,100 × 3:4:2) | 6,300 | 8,400 | 4,200 | |
| Selling price p.u. (Rs. ) | 520 | 500 | 350 | |
| Sales value (Rs. ) | 32,76,000 | 42,00,000 | 14,70,000 | 89,46,000 |

**(ii) Production budget in quantity**

| **Sub-assemblies** | **ACB** | **MCB** | **DP** |
|---|---|---|---|
| Sales | 6,300 | 8,400 | 4,200 |
| Add : Closing stock | 720 | 1,080 | 2,520 |
| (Opening stock less 10%) | | | |
| Total quantity required | 7,020 | 9,480 | 6,720 |
| Less : Opening stock | 800 | 1,200 | 2,800 |
| Production | 6,220 | 8,280 | 3,920 |

**(iii) Component usage budget in quantity**

| **Sub-assemblies** | **ACB** | **MCB** | **DP** | **Total** |
|---|---|---|---|---|
| Production | 6,220 | 8,280 | 3,920 | — |
| Base board (1 each) | 6,220 | 8,280 | 3,920 | 18,420 |

| | | | | |
|---|---|---|---|---|
| Component IC08 (8 : 2 : 2) | 49,760 (6,220 × 8) | 16,560 (8,280 × 2) | 7,840 (3,920 × 2) | 74,160 |
| Component IC12 (4 : 10 : 4) | 24,880 (6,220 × 4) | 82,800 (8,280 × 10) | 15,680 (3,920 × 4) | 1,23,360 |
| Component IC26 (2 : 6 : 8) | 12,440 (6,220× 2) | 49,680 (8,280 × 6) | 31,360 (3,920 × 8) | 93,480 |

**(iv) Component Purchase budget in quantity and value**

| **Sub-assemblies** | **Base board** | **IC08** | **IC12** | **IC26** | **Total** |
|---|---|---|---|---|---|
| Usage in production | 18,420 | 74,160 | 1,23,360 | 93,480 | |
| Add : Closing stock (Opening stock less 10%) | 1,440 | 1,080 | 5,400 | 3,600 | |
| | 19,860 | 75,240 | 1,28,760 | 97,080 | |
| Less : Opening stock | 1,600 | 1,200 | 6,000 | 4,000 | |
| Purchase (Quantity) | 18,260 | 74,040 | 1,22,760 | 93,080 | |
| Purchase price (Rs. ) | 60 | 20 | 12 | 8 | |
| Purchase value ((Rs. ) | 10,95,600 | 14,80,8 00 | 14,73,120 | 7,44,640 | 47,94,160 |

**(v) Manpower budget showing the number of workers and the amount of wages payable**

| | | Direct labour | | | | |
|---|---|---|---|---|---|---|
| | | **Grade A** | | **Grade B** | | |
| **Sub-Assemblies** | **Budgeted Production** | **Hours per Unit** | **Total Hours** | **Hours per Unit** | **Total Hours** | **Total** |
| ACB | 6,220 | 8 | 49,760 | 16 | 99,520 | |
| MCB | 8,280 | 6 | 49,680 | 12 | 99,360 | |
| DP | 3,920 | 4 | 15,680 | 8 | 31,360 | |
| (A) Total hours | | | 1,15,120 | | 2,30,240 | |
| (B) Hours per man per month | | | 200 | | 200 | |
| (C) Number of workers per month : (A/B) | | | 576 | | 1,152 | |
| (D) Wage rate per month ((Rs. ) | | | 1,000 | | 800 | |
| (E) Wages payable ((Rs. ): (C × D) | | | 5,76,000 | | 9,21,600 | 14,97,600 |



**Answer 9**

**(i) Material variances:**

(a) Direct Material Cost Variance = Standard Cost – Actual Cost

= (40,960units × 5 kg× Rs. 4.20) – (2,05,600 kg.× Rs. 4.50)

= Rs. 8,60,160 – Rs. 9,25,200 = Rs. 65,040 (A)

(b) Material Price Variance

= Actual Qty. (Std. Price – Actual Price)

= 2, 05, 600*kg. (Rs. 4.20 – Rs. 4.50) = Rs. 61,680 (A)

(*Material variances are calculated on the basis of consumption)

(c) Material Usages Variance = Std. Price (Std. Qty. – Actual Qty.)
= Rs. 4.20 (40,960units × 5 kg. – 2, 05, 600 kg.)
= Rs. 3,360 (A)

**(ii) Labour Variances and Overhead Variances:**

(a) Labour Cost Variance = Standard cost – Actual cost
= (40,960 units × 3 hours × Rs. 3) – Rs. 3,87,840
= Rs. 19,200 (A)

(b) Labour Rate Variance = Actual Hours (Std. Rate – Actual Rate)
= 1,21,200 hours (Rs. 3 – Rs. 3.20)
= Rs. 24,240 (A)

(c) Labour Efficiency Variance = Std. Rate (Std. Hour – Actual Hour)

= Rs. 3 (40,960 units × 3 hour – 1,21,200 hour)

= Rs. 5,040 (F)

(d) Total Factory Overhead Variance

= Factory Overhead Absorbed – Actual Factory Overhead

= (Actual Hours × Std. Rate) – Actual Factory Overhead

= (40,960 units × 3 hours × Rs.1.20) – Rs.1,00,000

= Rs. 47,456 (F)

**(iii) Preparation of Income Statement**

| **Calculation of unit selling price** | (Rs.) |
|---|---|
| Direct material | 21.00 |
| Direct labour | 9.00 |
| Factory overhead | 3.60 |
| Factory cost | 33.60 |
| Margin 25% on factory cost | 8.40 |
| Selling price | 42.00 |

**Income Statement**

| | (Rs.) | (Rs.) |
|---|---|---|
| Sales (40,000 units × Rs. 42) | | 16,80,000 |
| *Less:* Standard cost of goods sold (40,000 units × Rs.33.60) | | 13,44,000 |
| | | 3,36,000 |
| *Less:* Adverse Variances: | | |

| | | |
|---|---|---|
| Material Price variance | 61,680 | |
| Material Usage variance | 3,360 | |
| Labour Rate variance | 24,240 | 89,280 |
| | | 2,46,720 |
| *Add:* Favourable variances: | | |
| Labour efficiency variance | 5,040 | |
| Factory overhead | 47,456 | 52,496 |
| Actual gross margin | | 2,99,216 |

**(iv)**

| **Labour hour saved** | (Rs.) |
|---|---|
| Standard labour hours (40,960 units × 3 hours) | 1,22,880 |
| Actual labour hour worked | 1,21,200 |
| Labour hour saved | 1,680 |

Bonus for saved labour = 50% (1,680 hours × Rs. 3) = Rs. 2,520.

**Answer 10 (a)**

Essential requisites for the installation of Uniform Costing are as under:

(i) The firm in the industry should be willing to share or furnish relevant data or information.

(ii) A sprit of co-operation and mutual trust should prevail among the participating firms.

(iii)Mutual exchange of ideas, methods used, special achievement made, research and know-how etc. should be frequent.

(iv)Bigger firm should take the lead towards sharing their experience and know-how with the smaller firm to enable the later to improve their performance.

(v) In case of accounting methods, principles, procedure and production method uniformity must be established.

**Answer 10 (b)**

The main advantages of Inter-Firm Comparison are:

(i) Such a comparison gives an overall view of the industry as a whole to its members. The present position of the industry, progress made during the past and future of the industry.

(ii) It helps a concern in knowing its strengths or weaknesses in relation to others so that remedial measures may be taken.

(iii)It ensures an unbiased specialized reporting on particular problems of the concern.

(iv)It develops cost consciousness among members of the industry.

(v) It helps Government in effecting price regulation.

(vi)It helps to improve the quality of products manufactured and to reduce the cost of production. It is thus advantageous to the industry to the industry as well as to the society.

**Answer 11**

**Cost reduction:**

- It is the achievement of permanent reduction in the unit cost of goods manufactured or services rendered without impairing their suitability for the use intended or diminution in the quality of product.

- It uses the techniques like value engineering, work study, quality management, operational research, market research etc.
- It is continuous of critical examination, analysis, and challenges of established standards.
- It helps to business in improving the efficiency and effectiveness so that costs are reduced.
- It is a corrective action.

**Cost Management:**

- It is a broader concept. It aims to optimal utilization of resources to enhance the operating income of the firm.
- It established linkage between costs revenues. It relates costs and revenues with product attributes to have insight into how various resources attributes generates revenue and create demand on resources.
- It provides information to management product attributes to optimize resources utilization.

## INCOME TAX AND VAT

### PART A : INCOME TAX

Concept of Resident Person

1. State whether the following persons are resident in Nepal:
   a. Mr. X has a sole proprietorship concern in Nepal manufacturing export items. He travels through various countries throughout the year to promote his products. As such, he stays in Nepal for 120 days during the year, and rest of the time at different countries of the world during Income Year 2071/72.
   b. Mr. Bale is an English national. He comes to Nepal on 1st January 2015 and resides in Nepal till 31st December 2015. Explain his residential status for I.Y. 2071/72 and 2072/73. (Ashad end of 2072 falls on 16th July 2015)
   c. Ram Hari Chamlagain is employee of Government of Nepal. He is in unpaid leave to complete his Ph.D. and residing in Australia since January 1st 2014. During the year 2072/73, he generated AUD 25,000 serving a restaurant at Australia. Whether Mr. Chamlagain is resident of Nepal for IY 2072/73.
   d. A US-based consulting company obtained a contract in Nepal for which it has to provide consulting service for three years beginning from 1st Magh 2072. Explain the company's residential status for IY 2072/73.
   e. A trust is registered in St. Kitts & Nevis, a Caribbean nation. The financial statements of the trust revealed the following information:
      i. X Ltd., located at Dubai is the immediate holding of the trust holding 90% of the stake of the trust, with 10% stake held by the nationals of Nevis.
      ii. X Ltd. is held by a company based on Singapore, C. Ltd., which holds 100% stake of X Ltd.
      iii. Mr. Ramji Acharya is the shareholder of C Ltd. who owns 60% of the shares of it. Mr. Achaya is resident person of Nepal.

Answer:

a. The definition of natural person in Sec. 2 (Sha-श) includes a sole proprietorship. It means a sole proprietorship concern is also a natural person. As per Sec. 2 (KaNga) (1), for a natural person to be resident of Nepal, s/he has to satisfy any of the following three conditions:
   i. His/her habitual place of abode is in Nepal,
   ii. S/he resides in Nepal for 183 days or more in any period of consecutive 365 days, or
   iii. S/he is a public servant of government of Nepal, deputed by the employer in any foreign country

Income Tax Manual, 2066 (Updated 2068) issued by Inland Revenue Department elaborated the meaning of habitual (normal) place of abode. It is the place where the major economic activities of the person are concentrated. Generally the places from where the person generates its major income are treated as the habitual place of abode, and are not determined solely because of having a permanent home.

As Mr. X's major economic activity for his living is derived from Nepal, we can conclude that Mr. X's habitual place of abode is in Nepal, as such he satisfies habitual place of abode test to become resident in Nepal. Thus, he is resident of Nepal.

b. The definition of natural person in Sec. 2 (Sha-श) includes a sole proprietorship. It means a sole proprietorship concern is also a natural person. As per Sec. 2 (KaNga) (1), for a natural person to be resident of Nepal, s/he has to satisfy any of the following three conditions:
   i. His/her habitual place of abode is in Nepal,
   ii. S/he resides in Nepal for 183 days or more in any period of consecutive 365 days, or
   iii. S/he is a public servant of government of Nepal, deputed by the employer in any foreign country

Income Tax Manual, 2066 (Updated 2068) issued by Inland Revenue Department interpreted a period of consecutive 365 days as an Income Year beginning from Shrawan 1 of any year and ending on Ashad end of next year.
As Mr. Bale does not satisfy 1st and 3rd test specified above, the only chance of him being resident of Nepal is determined by the fulfillment of second test, i.e. 183 days test. Following the interpretation by Income Tax Manual, his days of stay during 2071/72 is 197 days (31+28+31+30+31+30+16), and hence he satisfies 183 days test in that Income Year and is resident of Nepal. His days of stay at Nepal for 2072/73 are 168 days which does not satisfy the 183 days test. Since all the three conditions are not satisfied for the Income year, he is not resident in Nepal.

c. Habitual Place test and 183 days test are not satisfied. Though he is employee of GON, he is not deputed by the employer in foreign country. As such, all three conditions are not satisfied, and thus he is nonresident of Nepal for the said IY.

d. A foreign permanent establishment is resident of Nepal. If, in case any foreign company or organization satisfies any condition to be treated foreign permanent establishment in Nepal, they are resident for the works performed and income generated in Nepal in the form foreign permanent establishment.
   As per Sec. 2 (Ka Ana), a permanent establishment of a nonresident entity is a foreign permanent establishment.

   Permanent Establishment as defined by Sec. 2 (Kada) means a place where a person carries on its business either partially or completely, and the term includes the following:

   i. a place where a person is carrying on business partially or fully through an agent, other than a general agent of independent status acting in the ordinary course of business as such;
   ii. a place where a person has, is using, or is installing substantial equipment or substantial machinery;
   iii. one or more places of a country where a person provides technical, business or consultancy services through employee or otherwise for 90 days or more in any 12 months period

iv. a place where a person is engaged in a construction, assembly, or installation project for 90 days or more, including a place where a person is conducting supervisory activities in relation to such a project

Since US based consulting company is providing consulting business in Nepal for three years, thereby satisfying criteria (iii) above, the US based Consulting Company is deemed to have a permanent establishment in Nepal, which is deemed as foreign permanent establishment and is resident of Nepal.

e. A trust is resident of Nepal (as per Sec. 2 (Sha)), if it satisfies any of the following three conditions:
   i. The trust is established in Nepal.
   ii. The trustee of the trust is a resident of Nepal during the year.
   iii. A person or a group of persons of whom one of them is a resident in Nepal for the income year controls the trust, directly or indirectly through one or more interposed entities.

Though test specified in (i) and (ii) above is not satisfied, the trust is controlled by Mr. Ramji Acharya through two interposed entities (i.e. C Ltd. and X Ltd. where Mr. Acharya controls C Ltd., C. Ltd. controls X Ltd., and X Ltd. ultimately controls the trust). As such, test specified in (iii) above is satisfied and hence, the trust is resident of Nepal.

Concept of Turnover Tax and Presumptive Tax

2. Answer the following questions:
   a. Mr. Hari Prasad Phuyal is a sole trader doing retail business at Badki VDC of Jumla. During the Income Year 2072/73, his annual turnover from the business is Rs. 1,999,000 and the tentative profit is Rs. 250,000. He does not have any other source of business during the year, nor is he registered for Value Added Tax. Calculate tax liability of Mr. Phuyal.
      Would you answer be different if the profit from the business were Rs. 190,000 instead of Rs. 250,000?

      What would be your answer, if Mr. Phuyal is a VAT registered person?

   b. Mr. Sher Bahadur Deuba is a sole trader doing business at Hetaunda Sub-metropolitan City, Makawanpur. He is not registered for VAT purpose and his only income is sales of goods with profit margin exceeding 5% within the state of Nepal. The turnover of the business during IY 2072/73 is Rs. 4,500,000 and the business profit is Rs. 800,000. Calculate tax liability of Mr. Deuba for IY 2072/73.
      Would you answer be different if the turnover of the business were Rs. 1,900,000 and profit of the business was Rs. 150,000?

   c. Mr. Gauri Shankar Jaisawal is a lawyer and he generates income from his law firm, which is a sole proprietorship concern. He generates income only from that law firm and does not undertake any other foreign assignment. His consultancy fee during the year is Rs. 4,500,000. As his business income is between Rs. 20 Lakhs and Rs. 50 Lakhs, he wants to pay tax on the basis of his business's turnover and approached you for the advice. Advise him.

d. Ram Prit Paswan is a Manager at Ultra Nationalist Bank Ltd., a resident bank. He has no any other income than the employment income drawn from Ultra Nationalist Bank Ltd. His income during the year 2071/72 was Rs. 3,000,000, and he did not file any tax return in respect to that income. His employer calculates tax as per Sec. 87 and pays it to tax authority. He wants to know the legal provision whether he is required to file tax return or not.

Answer:

a. Mr. Phuyal's assessable income is Rs. 250,000 which is within basic exemption limit, as such; Mr. Phuyal has no any tax liability. In this case, to obtain tax clearance certificate he has to file D03 tax return.
In case when the business profit was Rs. 190,000; Mr. Phuyal could opt for payment of presumptive taxes and as such, he tax liability would be Rs. 1,500 for the year. D01 tax return could be filed. Alternatively, he has the option to go for full tax return instead of presumptive tax.

   In case he was registered for VAT, for Rs. 250,000 business income; there would be no change in the answer and for Rs. 190,000 business income; he would not be eligible for payment of presumptive tax.

b. In this case, Mr. Deuba has the option to choose turnover tax. The tax rate is 1.5% (for IY 2072/72 which has been decreased to 0.75% for IY 2073/74 by the order of Nepal Government as per Samayik Kar Asuli Ain) of turnover. That means, his tax liability is 1.5% of Rs. 4,500,000.
If his business income was Rs. 19 Lakhs with profit up to Rs. 200,000; he would be eligible to opt for presumptive taxation where the tax liability would be Rs. 2,500 (Sec. 1 (1) (7) of Schedule 1).

c. As per Sec. 4 (4A), for a person to be eligible to opt for turnover taxation, all the following conditions shall be satisfied:
   1. The person shall be a resident natural person,
   2. The person shall generate income only from business having source in Nepal,
   3. The person shall not claim Medical Tax Credit,
   4. The person shall not claim advance tax arising out of tax withheld by withholding agent as per Sec. 93,
   5. The person's turnover shall exceed Rs. 20 Lakhs, but shall be less than Rs. 50 Lakhs;
   6. The person shall not be registered for VAT purpose, and
   7. The person shall not be involved in generation income from consultancy or expert service to be provided by a natural person including doctor, engineer, auditor, lawyer, sportsperson, actors, consultants

Though he satisfies all the conditions from (1) to (6) specified above, he does not satisfy condition (7) as he is lawyer and thus, is not eligible to opt turnover taxation.

d. As per sec. 97 (2), a natural person having income exceeding Rs. 40 Lakhs during any Income year is mandatorily required to submit income tax return. Except for such person, as per Sec. 97 (1), the following persons are not required to submit income return:
   1. a person who has no income tax payable for the year under section 3 (a),
   2. a person who derives income exclusively from Final Withholding Payments (discussed in Chapter 8) during the Income Year,
   3. <u>A Resident Natural Person satisfying all the following conditions:</u>
   - The person's income for the year consists exclusively of income from any employment having a source in Nepal
   - The person has only one employment at a time during the year, even if the employment changes during the year, and each employment is by a resident employer; and
   - The person does not claim the following for the Income Year:
     - ✓ a medical tax credit under section 51, other than with respect to medical tax credit paid through the employer
     - ✓ a reduction in taxable income under section 63 (Contribution to Approved Retirement Fund), other than with respect to retirement contributions paid through the employer
     - ✓ a deduction from Assessable under Sec. 12 (Donation)
   4. In case a person who pays tax on income generated from operation of vehicles as per Sec. 1 (13) of Schedule 1 happens to be a natural person (The matter of vehicle tax is discussed in Chapter in 4)

Since Mr. Pashwan satisfies all the conditions specified in (3) above and his income does not exceed Rs. 40 Lakhs, he is not required to submit tax return.

Concept of Taxable Income, Assessable Income & Source of Income

3. Answer the following questions:
   a. Hari Sharan Pudasaini is a Nepali national currently being employed in Canada. He is awarded 30 days leave, and visited his hometown at Baglung Municipality Baglung from 5th January to 25th January 2016. Grabbing the opportunity, a local NGO at Baglung hired him for some specific work and paid Rs. 300,000 for the job. He also derived salary of Rs. 8,500,000 during the IY 2072/73 from Canada based employer. Discuss the taxability of the income derived by him from Nepal and Canada. If the amounts are taxable, what is his tax liability in Nepal?
   b. How do you derive taxable income from assessable income and what are the different heads of income?
   c. Determine the source of following payments:
      i. Mr. X, a resident natural person has a house at British Virgin Island. As he resides in Nepal, he has leased out the house located there and derives monthly rent of USD 600. Explain the source of rental income derived by Mr. X.
      ii. Himalayan Bank Ltd. deputed one of its staffs at Malaysia to conduct the affairs of one of its business, Himalayan Remit. The staff comes to Nepal only for 30 days during any year and resides all the time in Malaysia. His salary is paid in bank account maintained in Nepal by Himalayan Bank Ltd.
      iii. Government of Nepal has hired a law firm in the United Kingdom to look after the case of Mr. Kumar Lama, a high ranked army official arrested by UK. The law firm provides legal services in the UK, and GON pays UK Pound 500,000 a year.
      iv. A company at India distributes dividend to its shareholders.
      v. QFX Cinemas is distributor of Hindi Movie, "Fan" in Nepal, for which it paid Rs. 50,000,000 to the producer of Movie in India.

Answer:

a. Mr. Hari Sharan Pudasaini is non resident of Nepal as his habitual place of abode is in Canada, he stays in Nepal for less than 183 days and he is not public servant of Nepal government.

   As per Sec. 6, a nonresident is required to pay tax on business, employment, investment or windfall gain income having source in Nepal.

   As per Sec. 7 (2), service fee forms part of business income.

   For service fee to have source in Nepal (as per Sec. 67 (6) (jha)) it has to satisfy any of the following two conditions:

   - In case service fee's payment is made by Government of Nepal, or
   - In case of payment by any other person, where the service is provided within the territory of Nepal.

In this case, Mr. Pudasaini has provided service to a local NGO in the territory of Nepal, which means, the fee of Rs. 300,000 paid by NGO is having source in Nepal. For employment income from Canada, since the service is not provided within the territory of Canada, the income is not having source in Nepal. As such, the service fee paid by the local NGO in Baglung is taxable in Nepal.

As per Sec. 88 (1), the Baglung based NGO withholds tax at 15% while making the payment of service fee to Mr. Pudasaini. Sec. 92 (Cha) specifies that any payment attracting withholding taxes are final withholding payments.

As such, the tax withheld by NGO of Rs. 45,000 (15% of 300,000) is the tax liability of Mr. Pudasaini in Nepal.

b. Taxable income is derived from assessable income after deducting the reduction availed under Sec. 63 (contribution of natural person to approved retirement fund), Sec. 12 (donation or gift to exempt organization), Sec. 12A (expenditure incurred for the purpose of promotion of heritages and development of sports infrastructure, Sec. 12B (Contribution to PM Relief Fund and National Reconstruction Fund of GON) or under all four Sections

   The four different income heads chargeable to taxation as per Income Tax Act are:

   1. Business
   2. Employment
   3. Investment
   4. Windfall Gain

c.

   i. Rental Income is having source in Nepal when it is derived from the leasing out of property situated in Nepal. As per clarification clause to Sec. 67, any land and building situated outside the territory of Nepal is deemed not situated inside Nepal and as such, rental income derived from leasing of such property is having source in the country where it is situated. It means, the rental income has source in British Virgin Island.

   ii. For service fee to have source in Nepal in case when it is not paid by Government of Nepal, the service must be delivered within the state of Nepal. Since, the staff is delivering his service outside the state of Nepal, his employment income does not have source in Nepal and is having source in the country where he provides service, i.e. Malaysia.

   iii. Since the payment is made by government of Nepal, the income is having source in Nepal.

   iv. Dividend, if paid by resident of Nepal, is deemed to have source in Nepal. Assuming the Indian company not having effective management in Nepal, the dividend have source in India.

   v. Royalty is deemed to have source in Nepal when it is paid for any right to use any property in Nepal. Since QFX Cinemas has utilized the right to show the intellectual property in Nepal, the royalty payment has source in Nepal.

Concepts of Amounts Exempted from Tax

4. Explain the applicability of Income Tax in the following cases:

a. Alex Ferguson has been appointed as Coach of Nepali National Football Team, for which Government of Nepal pays USD 1 Million during IY 2072/73. A clause of contract of Mr. Alex with Government of Nepal read as follows:
"With approval from Ministry of Finance, it is agreed that Mr. Alex is not required to pay the applicable income tax as per Income Tax Act, 2002".

Would your answer be different if Mr. Alex were a Nepali national?

b. World Organization for Elder Care, an International Non Government Organization has obtained approval from Government of Nepal to distribute Rs. 5,000 per month as Elderly Allowance to all elder citizens exceeding 75 years of age in Jumla district of Nepal. As such, Dhan Bahadur Buda received Rs. 60,000 during the year 2072/73.
What would be your answer, if Dhan Bahadur obtained such allowance from Government of Nepal, itself?

c. Mekh Thapa, a Nepali national, is a retired civil servant of Indonesia. He derived pension income of Rs. 2,000,000 during Income year 2072/73 from the public fund of Indonesian government.
Would your answer be different: if he were retired army official of Indonesian national army?

d. ABC Club is an exempt organization registered with Inland Revenue Department. One of its objectives is to construct temple of Lord Bishnu in different parts of the countries. It received a sum of Rs. 1,000,000 from an international organization of devotees of lord Bishnu to construct the temple of lord Bishnu in Bhadaure Tamagi VDC, Kaski. As per the agreement, the temple shall cost no less than Rs. 1 Million, and any surplus shall be refunded.

Answer:

a. As per Sec. 10 (gha), a non Nepali national appointed by GON with a condition of exemption of tax is exempted from income tax in Nepal. As such, Mr. Ferguson is exempted under the same clause.
If he were a Nepali National, Sec. 10 (gha) could not be inflicted, and as such the amount would be taxable.

b. Allowance to elder citizens, widow or incapacitated person distributed by Government of Nepal is exempted from tax.
Since Mr. Buda receives elder citizens' allowance from an INGO, the amount is taxable.

If it were distributed by GON, it would be exempted from tax u/s 10 (Nga).

c. U/s 10 (Ja), pension derived by a Nepali national after the retirement from the service of army or police force of a foreign country from the public fund of such foreign country is exempted from tax.

In the given case, as Mr. Thapa is deriving pension income not as result of retirement from the service of army or police force, the amount is taxable in Nepal when he is resident of Nepal.

If his pension income was derived as a result of retirement from army force of Indonesian government, the amount would be exempted from tax.

d. As per Sec. 10 (Chha) of Income Tax Act, the following amounts derived by exempt organizations are exempted from tax:
   i. Donation or Gift
   ii. Any contribution directly related to the objective of the organization, where the contributor does not expect any benefit or consideration or does not derive any benefit or consideration from such contribution.

Receipt of amount of Rs. 1 Million to construct a temple is not a donation or gift, as the contributor has not provided it for any objective of the organization, but it's a restricted fund. So that it does not satisfy the first test of being donation or gift.
For it to be exempted it needs to satisfy the second test, i.e. It must be a contribution directly related to the objective of the organization and the contributor should not expect or obtain any consideration/benefit from the contribution. For this, as per question, the contribution is directly related to the objective of the organization but the contributor expects consideration of construction of lord Bishnu's temple and the amount of such contribution is restricted to the cost of construction. As such it does not satisfy the second test as well, which means, the amount is not exempted u/s 10 (Chha) of the Act and is taxable.

5. Compute tax liability in the following cases:
   a. Wong Xi II is ambassador of North Korea to Nepal. He is also very fond of Badminton and plays Badminton often. He also participates in Badminton competition held in Nepal. Similarly, he has a restaurant operated in Nepal. The following are the details of income generated by Mr. Xi II during Income Year 2072/73. Calculate tax liability for 2072/73 (using rates as per order of GON on 15th Jestha 2073):
      i. Salary received from North Korean Government 3,000,000
      ii. Allowances received from North Korean Government 2,000,000
      iii. Child Educational support from his government 500,000
      iv. Allowances to his wife from his government 1,200,000
      v. He won prize of Rs. 500,000 in open badminton competition held during the year
      vi. Gross sales of Restaurant 3,500,000
      vii. Expenses incurred:
         1. Children Educational Expenses 450,000
         2. Living Expenses 1,500,000
         3. Restaurant Expenses (as per Income Tax Act) 3,000,000
         4. Badminton Club Membership Fee 1,200,000
         5. Donation to a Political Party registered with Election Commission 10,000
   b. Mr. Hukum Bahadur Thapa is a Nepali national retired from the service of Indian army. After his retirement, he comes to his village at remote Lamjung and is involved in agricultural activities in the land, which is within the land limit prescribed by

Government of Nepal. He is also involved in poultry farming, the sales of which is Rs. 1,900,000 and profit is Rs. 199,000 during the income year 2072/73. His income from Pension from public fund of Government of India is Rs. 50,000 per month. He generated Rs. 500,000 from crop farming in his own land.

Answer:

a.

- Salary received from North Korean government are exempted u/s 10 (Kha)
- Allowances received from North Korean government, Child educational support, allowance to his wife from his government are exempted u/s 10 (Ga)
- Prize won under open badminton competition is a windfall gain and is subject to 25% Final Withholding Tax.
- Out of expenses, Child educational expenses, living expenses, are badminton club membership are expenses of personal and domestic nature, thus ineligible u/s 21 (1) (ka).
- The only amount taxable is Business Income and amounts deductible are business expenses along with the donation to an exempt organization as the amount so derive does not satisfy any conditions of Sec. 10 of the Act, nor is it exempted under any other provisions of the Act.

Calculation of taxable Income, and tax liability:

Assessable Income from Business (3,500,000-3,000,000) 500,000

Total Assessable Income 500,000

Less: Donation to exempt Organization: 10,000

Lower of following:

| | | |
|---|---|---|
| a. | Actual | Rs. 10,000 |
| b. | Max | Rs. 100,00 |
| c. Taxable Income | 5% of Adjusted | Rs. 25,000 |

Taxable Income 490,000

Calculation of tax Liability (assuming resident of Nepal and individual assessment)

| | | |
|---|---|---|
| 1st Rs. 350,000 | | - |
| Next Rs. 100,000 | 15% | 15,000 |
| Balance Rs. 40,000 | 25% | 10,000 |
| Total | | 25,000 |

b. Mr. Thapa's pension income is exempted u/s 10 (Ja) of the Act. The income derived by him from crop farming from the land within the limit prescribed by Government of Nepal as per Land Act, 2021 is also exempted u/s 11 (1) of the Act. Income from poultry farming is business income and the tax is payable on such income. As his business profit is Rs. 199,000 which is his total assessable income, there is no tax liability of Mr. Thapa.

Business Concessions and Facilities

6. Determine the appropriate tax rate in the following cases:

a. Jumla Manufacturing Ltd. is a new Jumla based medicine manufacturing company. The commercial operation of the company begun from 1st Ashad 2072. During the year 2072/73, it has employed 1500 Nepali nationals throughout the year. All of the employees of the company are citizens of Nepal. On scrutiny of the employee on roll, it was identified that the company employed 100 male incapacitated persons and 50 female incapacitated persons. The male dalits are 45 in number while the female dalits are 5 in number, none of whom are incapacitated. Apart from these, 350 ladies were hired and employed, who are neither incapacitated person, nor dalits.
The company is listed in Nepal Stock Exchange Ltd., and is 100% export oriented industry. The capital of the company is Rs. 2,000 million.

b. M Ltd., a special industry located at Taplejung was in commercial operation since 1st Ashad 2062. All the plant and machineries of the company were sold to J Ltd., a new special industry on 31st Bhadra 2069. J Ltd. is employing 500 Nepali nationals during the Income Year 2072/73, and three Indian Nationals. The entity is listed in Nepal Stock Exchange Ltd. Taplejung is underdeveloped district of Nepal.

c. Xylin Agro Ltd. is an agro industry employing 100 Nepali nationals throughout IY 2072/73. There are no other employees than as mentioned above.
Would your answer be different, if Xylin employs 1200 Nepali nationals throughout the Income Year?

d. Dandaghare Wine Industry Ltd. is a wine manufacturing industry using apple as raw material. It is established in Jajarkot district, which is remote area.

Answer:

a. Manufacturing company is a Special Industry as defined by Clarification Clause Sec. 11 of the Act. The applicable tax rate for special industry as per Sec. 2 of Schedule 1 is 20%. As per Sec. 11 (3), the following tax rates are effective to a Special Industry based on direct employment to Nepalese national and location of such special industry:

1. Direct employment to 1200 or more Nepali national throughout the year 16%
   (80% of applicable tax rate as the employee are 1500)

2. Direct employment to 300 or more Nepali national throughout the year 18%
   (90% of applicable tax rate as the number of employee is more than 300)

3. Direct employee to more than 100 Nepali nationals of which at least one-third are dalits, incapacitated or women 16%
   (Of 1500 total employees 550 falls under the category as above and the effective rate is 80% of applicable rate)

4. Direct employment to 100 or more persons, where all the employees are Nepali national 14%
   (70% of applicable tax rate)

5. In case of operation of special industry in remote area, for 10 Income years including the first Income Year of Operation 2%
   (this is first year of operation and effective tax rate is 10% of applicable rate)

6. In case of listing of production based industry in NEPSE 17%
   (Concession of 15% in applicable tax rate)

7. Export by Production based industry 15%
   (Concession of 25% on applicable tax rate)

8. Establishment of new special industry with more than Rs. 1 Billion as Capital and providing direct employment to more than 500 individuals 0%
   (For first five years of operation, such industry enjoys exemption of income tax)

As per Sec. 11 (5) of the Act, when multiple concessions as per Sec. 11, the concession as chosen by the taxpayer is applicable. As a rational taxpayer chooses lowest tax rate applicable to it when it has more than one options, as such, the applicable tax rate shall be 0% for IY 2072/73.

b. As per Sec. 11 (3) (Kha), a Special Industry located at underdeveloped area is entitled to effective tax rate of 30% of applicable tax rate for first 10 Income years including the first Income year of its commercial operation. As per Sec. 11 (6), in case when another person operates a special industry utilizing the fixed assets already used by a special industry in the past, the time period for which such fixed assets were used previously shall also be considered while calculating the 10 Income Years as specified in Sec. 11 (3).

   Since the industry first operated since 1st Ashad 2062, which means the industry established by using the assets that was first put to use on 1st Ashad 2062 can enjoy the facility upto ten Income years ending on 2070/71 (2061/62, 62/63, 63/64, 64/65, 65/66, 66/67, 67/68, 68/69, 69/70, 70/71). It means J Ltd. cannot enjoy reduced tax facility for IY 2072/73 as per Sec. 11 (6).

   Since J Ltd. is employing more than 300 Nepali nationals throughout the year, it is entitled to effective tax rate of 90% of applicable tax rate. As it is listed, it can enjoy reduced tax rate of 85% of applicable tax rate.

   As per Sec. 11 (5) of the Act, when multiple concessions as per Sec. 11, the concession as chosen by the taxpayer is applicable. As a rational taxpayer chooses lowest tax rate applicable to it when it has more than one options, as such, the effective tax rate shall be lower of 18% or 17%, which means the effective tax rate is 17%.

c. It's an agro based industry. In case agro based industry provides direct employment to 100 or more Nepali national, where all employees are Nepali national; the effective tax rate is 70% of applicable tax rate. It means the tax rate of Xylin Agro Ltd. is 14%.
As per the notification published by GON in Nepal Gazette pursuant to Samayik Kar Asuli Ain, agro based industry are also special industry. A special industry providing direct employment to 1200 or more Nepali national throughout the year is entitled to effective tax rate of 80% of applicable tax rate. When all employees are Nepali national, the lower tax rate is 14% as specified above and with the application of Sec. 11 (5), Xylin Agro Ltd. a rational tax payer chooses 14% as its tax rate.

d. As per Sec. 11 (3ja) of Income Tax Act, any industry producing wine based on fruits is entitled to 40% concessions in tax rate for 10 years from the date of operation. As the question is silent about the start of operation, it is assumed that 10 years from start of operation has not elapsed, so the effective tax rate of Dandaghare wine is 12% (20% - 40% of 20%)

7. Sansar Saving & Credit Cooperative Ltd. is located at Bhujung Village Development Committee of Lamjung District. Bhujung does not share its border with any metropolitan city or sub-metropolitan city of Nepal. During the Income 2072/73, it has the following Income statement, and abstract from its Notes to the Accounts:

| Particulars | Amount |
|---|---|
| Interest Income (recognized on Cash Basis) | 2,000,000 |
| Interest Expenses | 1,000,000 |
| Net Interest Income | 1,000,000 |
| Administrative Expenses | 200,000 |
| Depreciation (Calculated as per the rates and methods prescribed by Income Tax Act) | 100,000 |
| Net profit<br><br>(No Income Tax Provision made) | 700,000 |

Abstract from Notes to the Accounts:

- The board of the cooperative proposes Rs. 500,000 as dividend to be distributed to all its shareholders

You are required to calculate:

- Taxable Income & Tax Liability of the Cooperative

- Dividend tax to be withheld from shareholders

Would your answer be different, if the cooperative as located at Besisahar Municipality of Lamjung district instead of Bhujung VDC?

Answer:

Since Sansar Saving & Credit cooperate is a saving and Credit Cooperative based on Rural Community as it is located at VDC not sharing border with Sub/Metropolitan City, the income of the cooperative is exempt u/s 11 (2). Similarly, dividend distributed by such cooperative is also exempted u/s 11 (2) of the Act.

When the Cooperatives work location was Besisahar Municipality, it would not be located at Rural Community, and since it is not agro and forest based cooperatives, the income of the cooperative would be taxable at 20%. The dividend distributed by such cooperative is subject to 5% Final withholding tax.

Expenses not deductible:

8. Answer the following questions:
   a. As per the agreement between Akbar Lohani, CEO of Medhavi Bank Ltd. and the bank management, the bank is required to reimburse all expenses related to a foreign trip to the extent of Rs. 950,000 during any year to Mr. Lohani. As such, the bank has reimbursed Rs. 950,000; actual cost incurred by Mr. Lohani during his personal tour to Bali, during IY 2072/73. Is the expenditure deductible for tax purpose?
      What would be your answer if the visit was for official purpose of the bank?

   b. Mr. X is a trader based in New Baneshwar. He deals in retail sales of different consumer items, and he has no other income than the retail sales. During the Income Year 2072/73, he has total business turnover of Rs. 1,885,000. He made a payment of Rs. 60,000 on 1st Jestha 2073 in relation to purchase of Wai Wai Noodles from a dealer in cash. It was not a public holiday. Is the payment in cash deductible for tax purpose?
      What would be your answer if the payment was made in a place where there is no banking facility within the periphery of 10 KM of his business place?

   c. Lumbini Sugar Mills has turnover of Rs. 500 Million during the IY 2072/73. It paid Rs. 100,000 per farmer in cash to purchase sugarcane necessary for sugar production during the month of Fagun 2072, the total of which was Rs. 50 Million. Further, it purchased molasses from the farmers and paid in cash Rs. 30 Million on Chaitra 2072. Are the expenditures deductible for tax purpose?
   d. Define:
      i. A place where there is no banking facility
      ii. Expenditure of Capital Nature
   e. Mention the conditions when the private expenditure of a natural person is not treated as part of "Domestic & Personal Nature Expenses".

Answer:

   a. Expenses of Domestic and Person nature means the following expenses including *the interest incurred in the loan used for personal purpose* and *the private expenditure of a natural person*:

- Expenses of personal nature incurred for an individual while providing residence, meals, refreshment, entertainment, or other leisure activities.
- Expenses incurred by an individual on conveyance from residence to office and office to residence.
- Expenses incurred on an individual for clothing which is also suitable to wear outside of work.
- Expenses incurred on education and training. *But the expenses incurred on such training or education, that are directly related to the business, but that does not lead to a degree or diploma, are allowed for deduction.*

As per Clarification Clause (Ka) (2) of Sec. 21, if the following conditions are satisfied, the above expenditure are excluded from *Expenses of Personal and Domestic Nature.* But other expenditure incurred to make a payment to a natural person or the expenses incurred for a third person except to the extent of following are *Expenses of Personal and Domestic Nature:*

- In case the payment is included in calculating the income of the individual- *such as house rent, driver facility, gardener, servant, telephone in residence, or etc provided to an employee. If the expenses are included in the taxable income of the individual, the expenses are allowed for deduction to the person.*
- The individual makes a return payment of an equal market value to the person as a consideration for the payment.
- Small amount incurred in this respect for which keeping an individual account is impracticable, for tea, stationary, awards, emergency medical facility or any other expenses as provided by IRD up to Rs.500 at a time (*as per Rule 6*).

Since the payment is made for the private purpose of Mr. Akbar Lohani, the expenditure is expense of domestic and personal nature. This is ineligible for tax purpose, but when the payment is included as part of income of Mr. Lohani, under Clause (2) (a) of Clarification Clause (Ka) of Section 21, the amount would be taxable in the hand of Mr. Lohani, he is not entitled claim deduction of such amount and then the bank will be eligible to claim such expenditure as normal employee expenditure u/s 13 of the Act.

If the visit were for official purpose, the expenditure would be eligible for the bank u/s 13 without including the amount in the income of its CEO.

b. Any payment exceeding Rs. 50,000 at a time by a person is not deductible for tax purpose when the turnover of the person exceeds Rs. 2,000,000 and the payment does not satisfy the exceptions mentioned in Sec. 21 (2). Since the turnover of Mr. X does not exceed Rs. 20 Lakhs, any payment in cash is eligible for deduction provided conditions laid down by other provisions of the Act are satisfied.

The answer would be same when the payment was made in a place where there is no banking facility within the periphery of 10 KM of his business place, i.e. payment in cash is eligible for deduction provided conditions laid down by other provisions of the Act are satisfied.

c. Any payment exceeding Rs. 50,000 at a time by a person, the turnover of which exceed Rs. 20 Lakhs during the Income Year is not eligible for deduction u/s 21 (1) (Gha) and 21 (2), except when the payments are made as follows:
   1. Payment made to GON, Constitutional bodies, corporate having ownership of GON, Banks, and Financial institutions.
   2. Payment to a farmer or a producer for primary agro products even in the case where the farmer himself primarily processes the product.
   3. Payment of a retirement contribution or a retirement payment.
   4. Payment made in such areas where banking services are not available.
      *An area not having banking services means the area where there are no banking facilities within a periphery of 10 kilometers.*

   5. Payment made on the day when banking services are closed or there is unavoidable compulsion that the payment shall be made in cash.
   6. Payment is made through the bank account of the payee.

In the given case, assuming that each payment exceed Rs. 50,000 at a time and since any of the exceptions specified in (1) to (6) above is not satisfied, the cash payment is not deductible for tax purpose. Though the payment is made to producer for primary agro products, but the product so procured is not primary agro product but a secondary one, i.e. sugarcane could be primary agro product but molasses is secondary product. As such, this condition is also not satisfied.

d.
   i. An area not having banking services means the area where there are no banking facilities within a periphery of 10 kilometers.
   ii. The following expenditures are expenditure of capital nature:
   1. Expenses incurred in respect of prospecting, exploration, and development of natural resource.
   2. Expenses incurred in acquisition of assets having a useful life of more than twelve months.
   3. Expenses incurred on the disposal of a liability.

e. In case any of the following conditions are satisfied, private expenditure of a natural person is not treated as part *Expenses of Personal and Domestic Nature to the extent of following:*
   - In case the payment is included in calculating the income of the individual- *such as house rent, driver facility, gardener, servant, telephone in residence, or etc provided*

*to an employee. If the expenses are included in the taxable income of the individual, the expenses are allowed for deduction to the person.*

- The individual makes a return payment of an equal market value to the person as a consideration for the payment.
- Small amount incurred in this respect for which keeping an individual account is impracticable, for tea, stationary, awards, emergency medical facility or any other expenses as provided by IRD up to Rs.500 at a time (*as per Rule 6*).

Basis of Accounting

9. Prabin & Chandra Co., a partnership concern was following cash basis of accounting until IY 2071/72. On 1st Kartik 2072, the concern filed an application to change the basis of accounting to accrual from cash. IRD permitted the change in basis of accounting as it deemed the change will properly reflect the income of the firm on 15th Mangsir 2072 with effect from IY 2072/73. Your firm has been appointed as tax expert to scrutinize the effect of change in accounting on tax liability of the concern. Your firm decided to send you to identify the details, and you identified the following:
   a. The partners of the concern disclosed that firm has provided service to a company during previous Income Years, but the amount is still receivable as on the date of your scrutiny. Such outstanding service fee in relation to service provided but fee not received is Rs. 10 Lakhs. The amount is expected to be received in early 2073/74.
   b. The concern is operating at a premise. The owner of the premise is at America since eight years. The owner has no bank account in Nepal and there is no other means to send the rental expenses to the owner. As such, Rs. 400,000 related to rental expenses of last four years is still not paid and expected to be paid during IY 2074/75, when the owner of the premise returns to Nepal.
   c. The concern is implementing a multi- year service contract beginning from IY 1st Kartik 2070 and ending on 31st Chaitra 2075. The total service fee of Rs. 6,600,000 has been received in advance on 1st Jestha 2072, and included in income during the IY 2071/72.

   Prepare a memorandum to your partner indicating the correct treatment of the above matters as per Income Tax Act.

Answer:

Memorandum to Partner

From: XXXX

To: Mr. XXX, Tax Partner, XXX firm

Subject: Change in Basis of Accounting- Tax Treatment

As I have been appointed to identify the details and suggest correct tax treatment for the effect of change in basis of accounting in income of IY 2072/73 of M/s Prabin & Chandra Co.; here are the details identified that requires adjustment as per Sec. 22 of Income Tax Act:

a. Rs. 10 Lakhs is receivable with regard to the service provided in Previous Income Year, and still receivable. As the basis of accounting was cash, the amount was not included in income during the year when the service was provided. Now that basis of accounting has been changed, as per Sec. 22 (6) the taxpayer shall make necessary adjustments in income calculation in the Income Year when the basis of accounting is changed in such a way that no amount included, deducted, or to be included or deducted in calculating the person's income of the income year of the change is omitted or repeated. As such, amount shall be included in income during the Income year.

b. Rs. 400,000 is payable to house owner. As the house rent was not paid in cash, as per cash basis of accounting such expenses were not claimed during the filing of income return for previous Income Years pursuant to Sec. 23 of Income Tax Act. Now that basis of accounting has been changed, as per Sec. 22 (6) the taxpayer shall make necessary adjustments in income calculation in the Income Year when the basis of accounting is changed in such a way that no amount included, deducted, or to be included or deducted in calculating the person's income of the income year of the change is omitted or repeated. As such, amount shall be deductible during the Income year.

c. It was identified that total service fee of Rs. 5,500,000 has been received in advance on 1st Jestha 2072, and included in income during the IY 2071/72 against a multi- year service contract beginning from IY 1st Kartik 2070 and ending on 31st Chaitra 2075. As per accrual basis of accounting the income attributable to IY 2072/73, 73/74, 74/75 and 75/76 are Rs. 1,200,000 (6,600,000*12/66), 12 lakhs, 12 Lakhs, and 9 Lakhs respectively. As per Sec. 22 (6) the taxpayer shall make necessary adjustments in income calculation in the Income Year when the basis of accounting is changed in such a way that no amount included, deducted, or to be included or deducted in calculating the person's income of the income year of the change is omitted or repeated. Such adjustment is allowed during the IY when the change in basis of accounting is affected, as such, the income related to IY 73/74, 74/75 and 75/76 shall be a part of inclusion u/s 7 of such Income Year. So that, an amount equal to Rs. 33 Lakhs pertaining to service fee of IY 73/74, 74/75 and 75/76 shall be deductible as an adjustment under Sec. 22 (6).

Characterization & Quantification

10. Answer the following questions:

a. Mithun Prasad Acharya, a Chartered Accountant, was hired by Disco Dancer Restaurant Pvt. Ltd. as financial consultant to implement Nepal Financial Reporting Standards. As per the terms of agreement, Mr. Mithun is paid Rs. 100,000 per month for a period of six months, a flat for residence and a vehicle for commutation owned or hired by the company. The company hired an apartment for Rs. 50,000 per month and provided it for the residence of Mr. Acharya. Similarly, vehicle with a driver and bearing all associated cost was provided by the company for his personal purpose. The market value of the vehicle is Rs. 60 Lakhs.

   Calculate the amount to be included as service fee income of Mr. Acharya as per Sec. 27 and Rule 13 of Income Tax Act.

   What would be your answer, if Mr. Acharya was hired as employee with monthly pay of Rs. 100,000 for six months?

b. Describe "Khai Paai aaeko Talab" in light with Income Tax Regulation and Income Tax Manual issued by IRD, and its significance in quantification of benefits.

c. Ram, Shita, Gita and Krishna contributed Rs. 10 Lakhs, Rs. 20 Lakhs, Rs. 30 Lakhs and Rs. 40 Lakhs to invest at a particular portfolio. As they could not decide the portfolio so soon, they decided to keep the balance as Saving Deposit by opening a Joint account at a Commercial Bank. The rate of interest was 6% p.a. and the amount was kept in the account for 8 months; after which the amount along with the interest was invested at a plot land. The registration charge of the land was Rs. 100,000 and broker commission paid to purchase the land was Rs. 500,000. The land was sold within the same year for Rs. 15,000,000. The cost of registration and brokerage comes to Rs. 400,000 at the time of disposal. Calculate the amount to be included in each individual's income as per Sec. 30 of Income Tax Act, quoting relevant provisions of the Act.

   Describe the treatment of interest income in the hand of each individual.

d. Hari and Ram are father and son. Hari is distributor of a branded product in Nepal and Ram is dealer of the product. There are other dealers of the product in the country. The sales price charged by Hari to Ram's concern is Rs. 10,000 per unit while the same is sold at Rs. 15,000 per unit to other dealers.

   Based on the above fact:

   - Define Associated Persons and relatives, as per Income Tax Act 2002.
   - Is there any right with Inland Revenue Department to re-characterize the income and expenses of Hari and Ram in relation to transaction between associated persons? Give your opinion quoting the relevant provisions of the Act.

e. Shekhar and Umesh are friends, but cannot be treated as related party as per Income Tax law. Shekhar is distributor of varieties of goods and generated taxable profit of Rs. 2,000,000 during the Income Year 2072/73. While Umesh has a sole proprietorship concern and also works as a consultant. The sole proprietorship concern of Mr. Umesh is at loss since last several years and the carried forward loss pertaining to IY 2065/66 is Rs. 1,000,000 and there is no taxable profit for IY 2072/73.

   After a long time, Shekhar and Umesh met at a function when Shekhar came to know about Umesh's business condition and offered Umesh to issue an invoice of Rs. 1,000,000 as consultancy fee chargeable to Mr. Shekhar's business and the resultant tax surplus would be shared between them equally. As such, Umesh issued the consultancy fee invoice of Rs. 1,000,000 and shared the resulting tax profit of Rs. 250,000 equally.

   In light of the above fact; is there any power to IRD regarding the re-characterization of such arrangement so as to check the reduction of tax liability through income splitting arrangement?

f. Define "Tax Avoidance Scheme".

g. Write short notes on: "General Anti avoidance Rule".

Answer:

a. Amount to included as part of service, when he is a consultant, is:
Service fee Rs. 600,000

Vehicle facility Rs. 30,000

(1% p.a. of Market Value of vehicle- i.e. 1% of 60 Lakhs for 6 months)

Accommodation Facility Rs. 75,000

(25% of actual rent when the rent is paid in rental apartment for 6 months)

Total Amount as Service fee including facilities Rs. 705,000

Yes, the answer would be different as follows when he was hired as employee:

Salary Rs. 600,000

Vehicle Facility Rs. 3,000

(0.5% of Khai Paai Aaeko talab)

Accommodation Facility Rs. 12,000

(2% of Khai Paai aaeko talab)

Assessable Income from employment Rs. 615,000

b. Rule 13 prescribes 0.5% of Khai Paai aaeko talab as part of employment income while a employer provides vehicle facility to its employee and 2% of khai paai aarko talab while providing accommodation facility. There are debates on what constitutes Khai Paai aaeko talab, but Income Tax Manual, 2066 (Updated 2068) interpreted it as sum of basic salary (suru talab) and grade applicable to each employee (Page 79 of PDF version of the Manual and Example 7.2.6 of the Manual)

c. In case of jointly owned investment, the outgoings and incomings related to such investment is allocated to each owner and the tax on such gains, if any, is levied under "pass through approach". For all jointly owned investment, provisions of Sec. 30 are applicable.
As per Sec. 30 of the Act, for the purposes of calculating a person's income from an investment that is jointly owned with another person, amounts to be included and deducted in that calculation shall be apportioned among the joint owners in proportion to their respective interests in the investment.

In the given case, the total income, incomings and outgoings are calculated as under:

Income from bank interest (subject to 15% Final Withholding) net of TDS Rs. 340,000

(6% p.a. of Rs. 10 Million for 8 Months= Rs. 400,000, deducting 15% TDS)

Outgoings of the land

| | |
|---|---|
| Cost of Purchase | 10,340,000 |
| Registration Charge at the time of purchase | 100,000 |
| Broker Commission at the time of purchase | 500,000 |
| Cost of Registration and Commission at the time of disposal | 400,000 |
| Total Outgoings | 11,340,000 |
| | |
| Incomings from the land | 15,000,000 |

Allocation of outgoing and incoming of land to each individual and calculation of Income from Joint Investment:

| Particulars | Ram | Shita | Gita | Krishna |
|---|---|---|---|---|
| Incomings allocated on the basis of proportion of investment | 1,500,000 | 3,000,000 | 4,500,000 | 6,000,000 |
| Outgoings allocated on the basis of proportion of investment | 1,134,000 | 2,268,000 | 3,402,000 | 4,536,000 |
| Gain included in income of the individual | 366,000 | 732,000 | 1,098,000 | 1,464,000 |
| Allocation of Interest Income | 34,000 | 68,000 | 102,000 | 136,000 |

The bank interest income is also a part of joint investment, as such; it must be allocated to each person's income on the basis of proportion of investment in the portfolio. Since the bank account is opened under the name of all investment participants, the account cannot be treated as that of a natural person. This indicates that the WHT rate is 15% while providing interest by bank. As the income are allocated to each natural person in the investment pool, the interest income paid by resident banks and financial institutions not related to business and having source in Nepal by such natural person is final withholding. As such interest income net of TDS allocated as above are final withholding in the hand of each investment participant.

d.

Associated Person:

"Associated Person" means one or more persons or group of such persons where the relationship between the two is such that one may reasonably be expected to act in accordance with the intentions of the other, and the term includes:

1. an individual and a relative of the individual or
2. any person or his/her partner
3. Foreign Permanent Establishment and the person having ownership over such foreign permanent establishment, and
4. an entity and a person who
   a. either alone or together with an associate or associates, and
   b. whether directly or through one or more interposed entities

   controls or may benefit from 50 percent or more of the rights to income or contributed capital or voting power of the entity

Provided that the following persons are not associated persons:

a. Employee,
b. Persons prescribed by Department as "not an associated person"

Relatives (Sec. 2-Ba)

"Relatives" means husband, wife, son, daughter (including dharma putra and dharma putri), father, mother, grandfather, grandmother, brother, sister-in-law, sister, father-in-law, mother-in-law, brother-in-law, uncle, aunty, niece, nephew, son-in-law and daughter-in-law of a natural person.

Answer to question part (b)

As per Sec. 33, In any arrangements between associated persons; IRD or IRO may, by a notification in writing, distribute, apportion, or allocate the amounts to be included or deducted in the income between the persons as to reflect their taxable income or tax liability when the arrangements is operated by them according to general market practices (at arm's length).

IRD or IRO may, in the process of the notification:

a. Re-characterize the source and type of any income, loss, and amount of payment; or
b. Allocate costs, including the head office expenses, incurred by one person in conducting a business that benefits an associate or associates also in conducting their businesses, based on the comparative turnover of the businesses

It means, IRD has the right to re-characterize the income and expenses of Hari and Ram in relation to transaction between associated persons.

e. As per Sec. 34, in the case of a person attempts to split his/her income with another person in order to reduce his/her tax liability, IRD or IRO may, by a notification in writing, adjust the amount to be included or deducted in calculating the income of each of such persons to prevent any reduction in tax liability because of the splitting of the income.

The attempt to split the income includes, but not limited to, a transfer of the following amounts so as to reduce the total tax payable by the person or an associate, either directly or indirectly through one or more interposed entities:

a. Amounts to be derived or costs to be incurred: or
b. An amount received or enjoyed by the transferee of an asset (i.e. derived from the asset); or the amount paid or expenses incurred in owning the asset.

To determine whether a person is splitting his/her income, IRD or IRO shall consider the market value of any payment made for the transfer.

In the given case, as Mr. Shekhar is trying to reduce his tax liability through the use of hypothetical transaction, whereby Mr. Umesh's tax liability does not arise due to the effect of set off of carry forward losses, IRD may issue a notification in writing ordering an adjustment of such fake transactions such that Shekhar's tax liability increases ignoring the expenses paid to Mr. Umesh.

f. As per Clarification Clause to Sec. 35, "Tax Avoidance Scheme" means any arrangement made by a person with the purpose of avoiding or reducing the tax liability.
g. The power referred to IRD under Sec. 35 of Income Tax Act as "General Anti Avoidance" are as follows:
   IRD may, for the purpose of determination of tax liability as per the Income Tax Act, do the following:

   - Re-characterize an arrangement or part of an arrangement that is entered into or carried out as part of a tax avoidance scheme;
   - Avoid an arrangement or part of it that does not have any material economic effect: or
   - Re-characterize an arrangement or part of it, which does not reflect its materiality.

Disposal of Asset & Liability

11. Identify the time of disposal of asset and liability in the following cases:
   a. Amar Concern is a proprietorship concern of Mr. Amar Bartaula. Mr. Bartaula died on 30th Chaitra 2072. There is business asset of Rs. 5 lakhs, trading stock of Rs. 4 Lakhs, business liability of Rs. 3 lakhs and depreciable asset of Rs. 5 lakhs as on 30th Chaitra 2072.

b. The following is the information as to the "Pool B" of Depreciable asset of A Ltd. during the IY 2072/73:

Opening Depreciation Base 1,000,000

Purchase of assets:

28th Mangsir 2072 540,000

25th Chaitra 2072 600,000

3rd Jestha 2073900,000

Some of the assets of Pool B were sold on 1st Ashad 2073 through auction procedure and fetched Rs. 2,500,000.

c. Sipradi Trading deals in vehicles produced by Tata Motors, India. The board meeting dated 1st Baisakh 2073 of the trading decided to use two TATA Nano Car costing Rs. 1,000,000 each having market value of Rs. 1,200,000 for administrative purpose. The decision of the meeting was implemented on 1st Bhadra 2073.

d. Raju Khadka, is a resident Nepali national having following assets:

i. Land and building in Nepal Rs. 10,000,000

ii. Shares of Nabil Bank Ltd. Rs. 1,500,000 (cost)

iii. Debtors Rs. 1,000,000 (Cost)

He became nonresident of Nepal on 30th Magh 2072.

Answer:

a. As per Sec. 40 (3) (a), the asset and liability of a natural person is deemed to be disposed just before his/her death. In the given case, assets and liabilities of Mr. Bartaula are deemed to be disposed a fraction of second before his death on 30th Chaitra 2072.

b. As per Sec. 40 (3) (b), in case of an asset, the asset is deemed to be disposed when the incomings related to the asset exceed the outgoings of the asset. In case of depreciable asset, the sales proceeds are incomings as per Schedule 2 of the Act and sum of opening depreciation base and absorbed additions are Outgoings as per the same Schedule for a particular pool of asset. When Disposal proceeds exceed sum of opening depreciation base and absorbed additions of a particular pool, the pool is deemed to be disposed. The calculation, whether the pool is disposed or not is done only on yearend no matter when the assets are disposed. As such, in the given case:

Disposal Proceeds (Incomings for the Pool) 2,500,000

Opening Depreciation Base 1,000,000

Absorbed additions 1,240,000

(100% of 540,000+2/3 of 600,000+ 1/3 of 900,000)

Outgoings for the Pool 2,240,000

As the incomings are greater than outgoings, Pool B is deemed to be disposed on yearend of IY 2072/73.

c. As per Sec. 40 (3) (d), in case of an asset which is used after changing its form, the asset of the existing form is deemed to be disposed just before the use of the asset in new form. In the given case, Tata Nano car are trading stock of Sipradi Trading. When they are used for administrative purpose, these assets will be changed into depreciable asset. The asset in the form of trading asset is deemed to be disposed just before its use as depreciable asset. The date of use is 1st Bhadra 2073, as such, the trading stock is deemed to be disposed a fraction of second before the car is used as depreciable asset on 1st Bhadra.

d. As per Sec. 40 (3) (f), when a resident natural person becomes nonresident of Nepal, all assets except land and building situated in Nepal are deemed to be disposed just before the person becomes nonresident.
In the given case, land and building of Mr. Khadka is not deemed to be disposed, whereas shares of Nabil bank and debtors are deemed to be disposed just before he becomes nonresident on 30th Magh 2072.



12. Calculate "Incomings", "Outgoings" or "Gain on disposal of asset" in the following cases:

a. Mr. Shree Krishna Magar purchased a plot of land on 21st Mangsir 2070 for which he paid Rs. 20,000,000 to the owner of the land. He incurred Rs. 500,000 towards land registration and brokerage at the time of purchase of land. He further incurred Rs. 2,000,000 towards land refilling during IY 2071/72, and constructed a building incurring cost of Rs. 15,000,000; which was completed on 2nd Bhadra 2072. The land and building was sold on 11th Chaitra 2072 for Rs. 60,000,000, for which Mr. Magar incurred Rs. 2,000,000 towards brokerage to sales agent.

b. Gopal Sapkota purchased land during IY 2066/67 costing Rs. 4 Million. The following are the details of other expenses related to land:

i. Registration 100,000
ii. Development of Compound Wall 150,000
iii. Commission to Broker 300,000
iv. Party expenses on happiness of sales of land 400,000
v. Interest on loan for land purchase 700,000

The land was sold during IY 2072/73 for Rs. 10 Million, for which brokerage of Rs. 200,000 was paid.

Answer:

a. As per Sec. 38 (1), Outgoings for any asset or liability includes:

1. in the case of an asset, costs incurred by the person in the person's most recent acquisition of the asset including-

a. where relevant, costs of construction or production of the asset; and

b. any amount required to be included in calculating the person's income as a result of the acquisition;

2. costs incurred by the person in owning the asset or owing the liability between the date of the person's most recent acquisition of the asset or the incurring of the liability and the date of the asset or liability's next realisation by the person including costs of altering, improving, and maintaining the asset or liability and, in the case of an asset, repairing the asset;
3. costs incurred by the person for the next realisation of the asset or liability; and
4. incidental costs incurred by the person in the most recent acquisition of the asset or incurring of the liability and in the next realisation of the asset or liability by the person,

but excludes excluded costs (expenditure prescribed in Clause (a) to (e) of Sec. 21 (1)), and costs to the extent to which they may be deducted in calculating the person's income under the Income Tax Act

As per Sec. 39, incomings related an asset or a liability includes:

1. in the case of a liability, amounts derived by the person in respect of incurring the liability;
2. amounts derived by the person in respect of owning the asset or owing the liability between the date of the person's most recent acquisition of the asset or the incurring of the liability and the date of the asset or liability's next realisation by the person including amounts derived from altering or decreasing the value of the asset or liability or increasing the liability; and
3. amounts derived or to be derived by the person in respect of the next realisation of the asset or liability;

but excludes any amount to the extent that it is an exempt amount, a final withholding payment, or, and an amount to be included in calculating the person's income.

As such,

Incomings and outgoings of NBCA of Mr. Magar is as follows:

A. Incomings:60,000,000

B. Outgoings:

| | | |
|---|---|---|
| Acquisition Cost | 20,000,000 | |
| Cost towards land registration and brokerage | 500,000 | |
| Cost towards refilling of land | 2,000,000 | |
| Construction cost of building | 15,000,000 | |
| Brokerage at the time of disposal of asset | 2,000,000 | |
| Total Outgoings | | 39,500,000 |

C. Gain on Disposal of NBCA (A-B) 20,500,000

b. Calculation of Incomings, Outgoings and Gain on Disposal:

A. Incomings 10,000,000

B. Outgoings

| | |
|---|---|
| Cost of Acquisition | 4,000,000 |
| Development of Compound Wall | 150,000 |

| | | |
|---|---|---|
| Registration of Land | 100,000 | |
| Commission to Broker | 300,000 | |
| Party Expenses on happiness of sales of land | - | |
| (Not eligible under Sec. 38 as it is not deductible u/s 21) | | |
| Interest on loan for land purchase | 700,000 | |
| Brokerage at the time of sales | 200,000 | 5,450,000 |

C. Gain on Disposal (A-B) 4,550,000

Different Provisions

13. Write Short Notes on:
   a. Permanent Account Number
   b. Defective Documents
   c. Conditions when the Right to Privacy is not breached even when the information are disclosed
   d. Taxpayer's right
   e. Tax Treatment of Retirement Payments

Answer:

a. IRD can issue a unique identification number to identify a taxpayer. The unique identification number is Permanent Account number (interchangeably called Taxpayer's Identification number- TPIN), which is issued by IRD to identify a taxpayer under the power conferred by Sec. 78 (1) of the Act.
   Besides IRD, the PAN can also be issued by entity authorized by Department to issue such number. The list of such authorized department is produced in the website of IRD, and extracted (as on the date of writing this book) as part of End Note of this book. The authorized entity shall issue permanent account number by abiding the provisions of Income Tax Act. But there is restriction on such taxpayer obtaining PAN number from other authorized entity than IRD to conduct foreign trade, i.e. the taxpayer cannot conduct import or export transaction for particular period after obtaining PAN.

   IRD may order any taxpayer to use the Permanent Account Number in any income return, claim, notice, statement or other documents used for the purpose of Income Tax Act. IRD may also prescribe certain person to show or reveal the permanent account number. In case IRD specify certain persons to show or reveal permanent account number, the person shall obtain the number before the commencement of its business.

b. A document issued by IRD or IRO under this Act shall not be treated as defective when it observes the following procedures.
   i. The document is in substance and effect in conformity with the Act; and

ii. The documents are duly addressed to the person, to whom it is to be served, according to the common understanding.

The IRD or IRO can rectify a defect, detected in a document issued, in case the defect does not involve a dispute as to the interpretation of the Act or facts involving a particular person.

**c.** The taxpayer has the right to secrecy of tax matters and to keep it inviolable as per Section 74 as described above. Thus, Sec. 84 (1) requires every officer from IRD or IRO shall keep the documents and information coming to his possession or knowledge secret while performing his duties under this Act.

The blanket protection of taxpayers' right might put tax officer in risk in many occasion, as the professional duty require them to disclose those information for various reasons. That's why subsection 2 of Section 84 lists out different occasions when the tax officer can disclose the matters, yet it is believed the provisions of confidentiality is not breached. This can be done under the given circumstances:

- To the extent required in order to perform the officer's duties under this Act;
- To a court or tribunal as required by them in proceedings with respect to a matter under this Act;
- To the Finance Minister;
- To any person when the disclosure is necessary for the purpose of any other fiscal law;
- To any person in the service of GON, who requires the information for revenue or statistics related works;
- To the Auditor-General or any person authorized by the Auditor-General when such a disclosure is necessary for the performance of his official duties; or
- To the competent authority of the foreign government with which Nepal has entered into an international agreement, to the extent permitted under the agreement.

Any person, court, tribunal, or authority receiving such documents and information as discussed above is also required to keep them secret, except to the minimum extent to which the disclosure is necessary.

d. The following rights are available to a taxpayer:

- Right to get respectful behavior;
- Right to receive any information related to tax as per the prevailing Laws;
- Right to get an opportunity of submitting a proof in one's own favor in respect of tax matters;
- Right to appoint lawyers or auditors for defense; and
- Right to secrecy in respect of tax matters and to keep it inviolable.

e. As per Sec. 92, all retirement payments are final withholding to the extent receivable from resident persons. In case of retirement payments by nonresident retirement funds, the amount shall be included as part of income of the recipient.

The payments from approved retirement fund are subject to final withholding tax. 5% tax is withheld by approved retirement fund on gain and gain is calculated by deducting higher of 50% of payments and Rs. 500,000 from the payments. Similarly, 5% tax on gain is withheld by unapproved resident retirement fund while making such payments. Gain is calculated by deducting the beneficiary's contribution from the payment accrued to the beneficiary.

All noncontributory retirement payments are subject to 15% final withholding tax on payments, while making such payment by resident person. Noncontributory retirement payments from nonresident employer are included in income for a resident natural person.



14. Differentiate between:
    a. Taxable Income Vs. Assessable Income
    b. Approved Retirement Fund Vs. Unapproved Retirement Fund
    c. Public Circular Vs. Advance Ruling
    d. Tax Evasion Vs. Tax Planning
    e. Tax Avoidance Vs. Tax Mitigation

Answer:

a. Taxable Income Vs. Assessable Income

A resident person's assessable income includes income from business, employment, investment and windfall gain derived by such person all over the globe and a nonresident person's assessable income includes income from business, employment, investment and windfall gain derived by such person having source in Nepal, whereas

Taxable income is derived by deducting reductions availed u/s 63 (Contribution to approved retirement fund), 12 (Donation to exempt organization), 12A (Expenditure incurred to promote heritage and develop public infrastructure relating to Sports), 12B (Contribution to PM Relief and National Reconstruction Fund of GON) from total assessable income from a person.

b. Approved Retirement Fund Vs. Unapproved Retirement Fund

| Basis | Approved Retirement Fund | Unapproved Retirement Fund |
|---|---|---|
| Approval from IRD | It is a retirement fund that obtains IRD's approval for its operation | It is a retirement fund that does not obtain approved status from IRD |
| Restriction to conduct of | Income Tax Regulation prescribes terms and | No such restriction |

| | | |
|---|---|---|
| Business | conditions for the operation of business of ARF. For e.g. investment is restricted to that prescribed by Income Tax Regulation, there must be at least 1000 beneficiary to obtain approval, etc. | |
| Treatment of Retirement Contribution | Retirement contribution to ARF by a natural person to the extent of minimum actual, 1/3rd of assessable income or Rs. 300,000 is deducted while deriving Taxable Income from Assessable Income. | Contribution to URF is not a deductible amount |
| Tax Implications | The income of ARF is exempted from tax, and the retirement payments and retirement contribution are not income and expenditure of ARF. Similarly, retirement contribution is not treated as liability. | Tax on income of URF is levied as per normal provisions of the Act. |

c. Public Circular Vs. Advance Ruling

| Basis | Public Circulars | Advance Ruling |
|---|---|---|
| *Issuance* | Public circular is issued, *suo moto,* by Department to interpret any provisions of the Act for consistent implementation of Act. | An advance ruling is issued at the request of Tax payer when such taxpayer seeks IRD's opinion in confusing matters. |
| *Effect of Issuance* | The public circulars affect the whole class of taxpayers as indicated by the circular. | It affects the taxpayer for whom the ruling is issued. |
| *Superiority* | In case of conflict between matters prescribed in Public Circular & Advance Ruling, Public circular is valid for all taxpayers than the tax payer for whom advance ruling is issued | Advance ruling is valid for a taxpayer who obtains such ruling even when a contradictory interpretation is issued by IRD through public circular |

d. Tax Evasion Vs. Tax Planning

Tax evasion

Tax evasion is illegal. It involves reducing one's tax liability in a way that is not following the tax legislation.

- For example, tax evasion is deliberately omitting some investment income from a tax return in order not to pay tax on that source of income.
- Another example of tax evasion is to overstate expenses in order to reduce the tax liability.
- Another example may be issuance of under-invoiced VAT invoice

Any taxpayer who carries out tax evasion could face criminal prosecution, including penalties, surcharges, interest and sometimes imprisonment. The person assisting in tax evasion scheme of a taxpayer or advising to act on that behalf also faces the criminal prosecution and fines and penalties.

Tax Planning

Tax planning has been divided into two forms; "tax mitigation" which relates to the intentional tax reduction mechanism granted by tax law and "tax avoidance" which relates to the reduction in tax through the study of loopholes within the tax law.

e. Tax Avoidance Vs. Tax Mitigation

"Tax mitigation" relates to the intentional tax reduction mechanism granted by tax law whereas "tax avoidance" which relates to the reduction in tax through the study of loopholes within the tax law

Estimated Tax & Tax Returns

15. You are a tax expert and recently approached by a multinational company to provide some advice related to tax filing.

As the company started its business, there was massive earthquake hitting the country, they could not conduct substantial transaction, which resulted in loss during IY 2071/72. The company is willing to operate full-fledge after April 2016. The massive earthquake led the finance staff of the company who is a foreign national to flee from Nepal to his home country and is not expected to be reached until 1st March 2016. The company wants your advice regarding the due date of filing the tax return of IY 2071/72 and chance of extension of deadline until the return of finance staff.

Answer:

As per Sec. 96 (1), every person is required to submit tax return within THREE MONTHS of the end of Income Year subject to the provisions of Sec. 97, 98 & 100. Sec. 97 deals with the conditions where a person is not required to file income return, Sec. 98 allow a person to extend the tax filing deadline by another three months, and Sec. 100 prescribes the conditions when tax officer demand tax return even before the due date of three months of end of tax year has approached.

As per Sec. 98, in case a person who is required to file a return of income makes a written request to the IRD by the due date for filing the return, the IRD

(a) may, on such terms and conditions as IRD thinks appropriate and where reasonable cause is shown, extend the date by which the return is to be filed; and
(b) shall serve the person with written notice of IRD's decision on the application.

IRD may grant multiple extensions with respect to the filing of a return of income but the extensions shall not in total exceed 3 months from the date the return was originally to be filed.

As such, the due date of filing of income return of FY 2071/72 is Ashwin 2072 (i.e. three months from the end of Ashad 2072). The company can file an application to extend the deadline by another three months within Ashwin 2072 to submit its tax return. In case of receipt of application, IRD may grant the extension. In both cases of granting or not granting the permission, IRD shall serve a written notice. Such extensions can be granted for three months at once or there may be multiple extensions to the maximum of three months from Ashwin end.

There are no chances of granting the extension beyond Poush end. Due to the special provisions in Order of GON at Nepal Gazette as per Samayik Kar Asuli Ain published on 15th Jestha 2073, there shall be no additional fees or interest applicable when the taxpayer files it return for IY 2071/72 within Ashwin 2073.

16. State with reasons whether the following person requires submitting Income Tax Return as per Income tax Act:
    a. Hari Prasad Paudel is a transport operator, operating three microbus, eight taxis, four minibus and twenty-five trucks. These means of transportation pays vehicle tax as per Sec. 1 (13) of Schedule 1 of the Act.
    b. You are student currently pursuing CAP II Level of ICAN. You do not earn any income during the Income year.
    c. Mr. Robert Jung Shahi is a trader of shares and debentures. During the year, he has not sold any shares, but received Rs. 100 Million as dividend from various resident companies. He has no other income than the dividend receipt.
    d. Ram Hari Phuyal is Assistant Country Director for an INGO working in Nepal throughout Income Year 2072/73. His monthly remuneration is Rs. 500,000 inclusive of all benefits. The INGO deducts tax of Mr. Phuyal every month as per Sec. 87 of the Act and deposits it to revenue authority.

Answer:

a. As per Sec. 97 (1) (gha), unless otherwise required by IRD in writing or through public circular, in case a transport operator paying tax u/s 1 (13) of Schedule 1 is a natural person; the person is not required to submit income return. As per Sec. 97 (2), where a natural person's income for an Income Year exceeds Rs. 40 Lakhs, the person is required to submit tax return regardless of what is written in Sec. 97 (1).
   In the given case, Mr. Hari Prasad Paudel is a natural person and transport operator paying tax u/s 1 (13) of Schedule 1, and as such, if his income is up to Rs. 40 Lakhs, he is relieved from the obligation of submission of income return.

b. As per Sec. 97 (1) (Ka), unless otherwise required by IRD in writing or through public circular, a person who has no income tax payable for the year under section 3 (a) is not required to submit income return. Since you have no income tax payable during the income year, you are relieved from submission of income return.
c. As per Sec. 97 (1) (kha), unless otherwise required by IRD in writing or through public circular, a person deriving income exclusively from final withholding payments is not required to submit income return. As per Sec. 97 (2), where a natural person's income for an Income Year exceeds Rs. 40 Lakhs, the person is required to submit tax return regardless of what is written in Sec. 97 (1). Since, Mr. Shahi's income for the year exceed Rs. 40 Lakhs during the Income Year, he is required to submit tax return as per Sec. 97 (2).
d. As per Sec. 97 (1) (ga), A Resident Natural Person satisfying all the following conditions is not required to submit income return:
   - The person's income for the year consists exclusively of income from any employment having a source in Nepal
   - The person has only one employment at a time during the year, even if the employment changes during the year, and each employment is by a resident employer; and
   - The person does not claim the following for the Income Year:
     - ✓ a medical tax credit under section 51, other than with respect to medical tax credit paid through the employer
     - ✓ a reduction in taxable income under section 63 (Contribution to Approved Retirement Fund), other than with respect to retirement contributions paid through the employer
   - a deduction from Assessable under Sec. 12 (Donation)

As per Sec. 97 (2), where a natural person's income for an Income Year exceeds Rs. 40 Lakhs, the person is required to submit tax return regardless of what is written in Sec. 97 (1). Since, Mr. Phuyal's income exceed Rs. 40 lakhs durin the income year, he is required to submit tax return.

17. Calculate the estimated tax to be deposited in the following cases:
   a. Mr. Hari Kant Mainali is retail trader of gas, who is not registered for VAT. He estimates his business turnover to reach around Rs. 4.5 Million during the IY 2073/74. He has no

other source of income. The details of transactions of Mr. Mainali for IY 2073/74 as per his accounting record are as follows:

i. Actual Sales up to Poush 20, 2073 Rs. 1,500,000
ii. Estimated Sales up to Poush 30, 2073 Rs. 1,600,000
iii. Actual Sales up to Ashad 20, 2074 Rs. 3,400,000
iv. Estimated Sales for the year 2073/74 Rs. 3,600,000

Tax withheld and paid by agents during the year is as follows:

i. Up to Poush 10,000
ii. From Magh to Ashad 2,000

b. ABC Ltd., a 100% export oriented entity dealing agricultural products with 100 Nepali national as employee and one foreign national as Group CEO, has the following piece of information:

i. The estimated taxable profit for IY 2072/73 as estimated in Poush 2072 Rs. 100,000,000
ii. Revised estimated taxable profit for the year as on Chaitra Rs. 120,000,000
iii. There is no revision of estimated profit for the year

There are no withholding of taxes from agents, and carried forward tax credit of previous Income Years.

Answer:

a. In the given case, Mr. Hari Kant Mainali has turnover between Rs. 20L-50L, is not registered for VAT, has no other source of income than business having source in Nepal, is a resident natural person and if he rescinds the right to claim tax credit arising out of withholding taxes; he can be treated as turnover taxpayer. Let's assume he chooses to pay tax based on his business turnover. As such, his tax rate for IY 2073/74 is 0.75% of turnover (assume) as his gross profit exceed 3%.

In such case, as per Sec. 94 (1Ka) the person who opted for payment of tax based on the transaction (turnover) u/s 4 (4Ka) of the Act shall pay tax in two installments as follows:

1. By Poush end: Applicable Tax calculated on the basis of actual turnover of the person till Poush 20
2. By Ashad end: Remaining amount of Tax payable based on the estimation of turnover for the Income Year and calculated by applying the applicable tax rate. The turnover for the year shall be estimated on the basis of turnover till Ashad 20 of the Income year.

Thus, the installment payable on Poush and Ashad are as follows:

1. By Poush end: Rs. 1,500,000*0.75%= Rs. 11,250
2. BY Ashad end: Rs. 3,600,000*0.75%-Rs. 11,250= Rs. 15,750

The person cannot claim advance tax arising out of withholding taxes.

b. The applicable tax rate for the entity is 15% (75% of 20% as, its export oriented special industry).

As per Sec. 94 (1), any person having (who has already generated or is going to generate) assessable income from business or investment during any Income Year shall pay tax in installment as follows:

a. First installment- *payable on or before the end of Paush*- 40% of the estimated tax to the extent that it (such 40%) is in excess of the tax paid up to the period of estimation during the year.
b. Second installment- *payable on or before the end of Chaitra*- 70% of the estimated tax to the extent that it (such 70%) is in excess of the tax paid up to the period of estimation during the year.
c. Third and last installment- *payable on or before the end of Ashad*- 100% of the estimated tax to the extent that it (such 100%) is in excess of the tax paid up to the period of estimation during the year.

As such, the installment tax payable by the person is as follows:

a. By Poush end: 40% of Estimated tax Liability- Carried over Excess tax over tax liability of previous years- Withholding taxes paid until Poush= 40% of (100,000,000*15%)-0-0= Rs. 6,000,000
b. By Chaitra end: 70% of Revised Estimated tax Liability- Carried over Excess tax over tax liability of previous years- Withholding taxes paid until Poush- Installment taxes paid until Chaitra= 70% of (120,000,000*15%)- Rs. 6,000,000= Rs. 6,600,000
c. By Ashad end= 100% of Revised Estimated tax Liability- Carried over Excess tax over tax liability of previous years- Withholding taxes paid until Poush- Installment taxes paid until Ashad= 100% of (120,000,000*15%)- 12,600,000= Rs. 5,400,000

18. State the conditions when tax officer may demand tax returns before the due date of filing tax return or in the middle of any Income Year.
    Answer:

    As per Sec. 96 (5), in any of the following FOUR conditions, the tax authority may demand tax returns before the due date of filing tax return or in the middle of any Income Year:

    a. The person becomes bankrupt, is wound-up, or goes into liquidation;
    b. The person is about to leave Nepal indefinitely;
    c. The person is about to leave the business; or
    d. The IRD otherwise considers it appropriate.

Tax Assessment

19. You are an articled trainee of a Chartered Accountant firm. You are working under one of a manager who does not have adequate knowledge of Income Tax Act. As a team, you are

helping one of the clients of the firm in computing tax liability and assisting them to file tax return. Your audit manager asks you whether the firm is required to issue any report to your client certifying the tax return and the contents to be included in the report. Further he wants to know if there is any provision to deny certifying the tax return in extreme circumstances and whether that relieves the firm from issuing a report.

Answer:

As per Sec. 96 (3), a person who, in return for a payment, prepares or assists in the preparation of a return of income or an attachment to a return of income of another person (other than as employee of the other person). The person shall sign the return certifying that-

- the person has examined the relevant documents of the other person maintained under section 81, and
- to the best of the person's knowledge, the return or attachment correctly reflects the circumstances to which it relates.

As per Sec. 96 (4), Where a person, who, in return for a payment, prepares or assists in the preparation of a return of income or an attachment to a return of income of another person (other than as employee of the other person), refuses to sign a return of income as required, the person shall furnish the other person with a statement in writing of the reasons for such refusal.

As such, the matters as stated above shall be notified to the audit manager.

20. Asia Construction Company Ltd. is a China based company having a branch registered in Nepal. The board of the company in China decided to close the Nepal branch with effect from 1st Baisakh 2073. In light of the above, answer the following questions:
    a. What is the due date of filing tax return in the normal circumstances?
    b. In the cases as described above, can Nepal branch of Asia Construction Company Ltd. wait till the due date of filing tax return?
    c. If the branch closes the business and does not submit tax return before the due date of filing tax return, what are the powers of IRD as prescribed by Sec. 100 of the Act? Also mention the formalities to be observed by IRD.

Answer:

a. The due date for filing tax return in the normal circumstances is three months of the end of Income Year. As Income year ends on Ashad end, the due date fall by Ashwin end in normal circumstances.
b. As per Sec. 100 (1), where condition specified in Sec. 96 (5) arises the taxpayer shall immediately file income return. Sec. 96 (5) requires immediate filing of income return without waiting for normal due date in case where a person is about to leave the business. As the branch of Asian Construction Company Ltd. is going to be closed from Baisakh 2073, it must file tax return as soon as possible without waiting for normal due date as per Sec. 100 (1).
c. If the taxpayer does not file tax return even if the conditions specified in Sec. 96 (5) have arisen, respective IRO may serve a notice to the taxpayer to submit a tax return for the specified period of the year within specified days. In the case of a taxpayer who submits

the return as per the notification or does not submit it, in either case, the income tax assessment is supposed to be made as per the provisions of Sec. 100. But Section 100 (2) has given an authority to the respective IRO to make a jeopardy assessment in the above case on the basis of the best judgment adopted by the IRO.

Formalities to be observed:

Time period of Jeopardy Assessment & Effect of Assessment Order

The period taken by the IRO for such a jeopardy assessment may be a part of the year or the whole year. In such a case, the notice is meant for an assessment of the whole year, and the taxpayer has to file the return within the time specified in the notice but in no way can wait for the period as specified in Section 96.

The respective IRO can make a jeopardy assessment only if it has a reasonable belief that the figures produced or deemed to be produced by the taxpayer do not exhibit the real position of the tax liability of the taxpayer for the period.

Information to be considered for Jeopardy Assessment

According to Section 100 (2), the following pieces of information are considered for the jeopardy assessment:

a. Assessable income of the taxpayer from business, employment or investment, i.e. from all the sources;
b. Taxable income of the taxpayer during the year and the total amount of tax due to the taxpayer; and
c. In the case of a taxpayer, which is a foreign permanent establishment, the income remitted to a foreign country during the period and tax payable on such a remittance.

Opportunity to taxpayer to defend

Before issuing an order for the jeopardy assessment, the IRO has to serve a notice to the taxpayer stating the reason of disagreement over the figures given in the return filed or the figures available to the IRO. A period of seven days should be given to the taxpayer to explain and produce evidence against the IRO's contention.

21. D. Binod and Associates is a law firm registered in Nepal. It has been continuously submitting tax return since its establishment within due date. The proprietor of the firm, Mr. Binod Dahal has heard that Nepal Income Tax is based on Self Assessment System, but has not understood what constitute self assessment of tax. He also heard that tax paid by him as per Self assessment is final, and he is not required to pay any tax.

    You are a tax expert approached by Mr. Dahal to clarify his confusions. You need to clarify the following:

    a. Has D. Binod & Associates completed self assessment? Explain what constitute Self Tax Assessment as per Sec. 99 of the Act.
    b. Is tax paid by Binod under Self Tax Assessment System final? If not, describe the procedures set out in Income Tax Act to revise the self assessed income tax return submitted by Binod.

Answer:

a. The submission of income return as per Sec. 96 of the Act is self assessment.

As per Section 99, in case a person submits a tax return including the information regarding the total tax payable during the year and the tax due for payment on the date of submitting the return, it is believed that the income tax assessment is complete. In general terms the filing of an annual return is a self-assessment made by the taxpayer; which is treated as assessment unless the conditions under Sections 100 or 101 prevail.

Even in the case of a person who does not file the annual tax return, the income tax for the year is deemed as assessed on due date of filing return (i.e. Asoj-end of Year 20X2 for Income Year 20X1/X2) under following bases:

- The total tax liability of the taxpayer during the year is equal to the amount of withholding tax deducted by withholding agents on payments to it and the amount of advance tax paid by it; and
- The deemed tax assessment shows that there is no more tax payable for the year by the taxpayer.

As such, submission of income tax return by Mr. Dahal constitutes self assessment. In case Mr. Dahal fails to submit income return on due date, it also constitutes deemed self assessment as per Sec. 99 (2) as explained above.

b. No, the tax assessed and paid by Mr. Dahal is not final as the Act has conferred power to IRD to revise/amend the return submitted by Mr. Dahal and to assess additional tax liability. The power of IRD to make amended assessment and the procedures for such assessment is explained hereunder:

*Power of IRD to amend Tax returns*

Inland Revenue Department can make an amended assessment of any return filed by any taxpayer solely on the ground that the IRO thinks it appropriate to do so. The amended assessment shall be based on the IRO's best judgment and should be done in a manner that is consistent with the intention of the Act.

*Number of Amended Assessment*

In case IRD thinks it proper to do so, the assessments can be amended again and according to the IRO's best judgment for as many times as it thinks appropriate.

*Time Limit to make amendment in Assessment*

IRD may amend the assessment as many times as it deems appropriated but the power to make an amended assessment is within four years of:

- In the case of an assessment under Section 99, the due date for filing the return; or
- In the case of jeopardy assessment, the date on which the notice of assessment is served to the taxpayer under Section 102.

*Exception to the Time limit of Four Years*

- The above limitation of four years is effective for the conditions except that the tax assessment is affected by fraudulent work. In case it is proved that the tax assessment was affected by some fraudulent work, at any time, even if the four-year period has expired, the file can be reopened for amended assessment.

  The only limitation on such an amended assessment is that the amended assessment should be completed within one year of the IRO's receipt of such information of the fraud.

*Limitation of IRD if the competent court has settled the assessment*

- If the Revenue Tribunal or any other authorized Court has reduced the assessed tax liability, the IRO has no authority to make an amended assessment to the extent the tax liability is reduced by the Court. But, if the Court orders for a reinvestigation of the matter, the IRO can make an amended assessment.

*Reasonable opportunity to Taxpayer to defend*

- Before issuing an order for the amended assessment, the IRO has to serve a notice to the taxpayer stating the reason of disagreement over the figures given in the return filed or the figures available to the IRO. A period of fifteen days should be given to the taxpayer to explain and produce evidence against the IRO's contention.

22. You are appointed as tax consultant for Argentine Extraction and Production Ltd., a company registered under Companies Act, 2063. It has the history of submitting tax return irregularly in previous year and was subjected to huge financial penalties as per the law.
The tax returns related to previous years were submitted as follows:

| | |
|---|---|
| 2066/67 | Mangsir 25, 2070 |
| 2067/68 | Mangsir 25, 2070 |
| 2068/69 | Mangsir 25, 2070 |
| 2069/70 | Mangsir 25, 2070 |
| 2070/71 | Poush 29, 2071 |

The tax computation of IY 2068/69 and 2069/70 have been finalized by Revenue Tribunal.

The tax officer issued a 15-days notice u/s 101 (6) for the amended assessment of IY 2066/67 and IY 2067/68 on 2071 Chaitra 28, citing the reason that four years have not been elapsed since submission of tax return.

Similarly, the tax officer issued another notice u/s 101 (6) to clarify the matters in relation to tax return of 2068/69 and 2069/70. The company approached you for the possible course of action as per Income Tax Act. Advise your client.

Answer:

a. The tax officer issued a 15-days notice u/s 101 (6) for the amended assessment of IY 2066/67 and IY 2067/68 on 2071 Chaitra 28, is it valid under Sec. 101 of Income Tax Act?

As per Sec. 101 (3), IRD may amend the assessment as many times as it deems appropriate but the power to make an amended assessment is within four years of:

- In the case of an assessment under Section 99, the due date for filing the return

- In the case of jeopardy assessment, the date on which the notice of assessment is served to the taxpayer under Section 102

As this is the case of amended assessment of self assessed tax return, the deadline to complete the amended assessment shall be four years from the due date for filing the return, i.e 4 years from 2067 Ashwin, which is 2071 Ashoj for IY 2066/67 and four years from 2068 Ashwin, 2072 Ashoj for IY 2067/68. As such, issuance of order u/s 101 (6) to amend self assessed return of IY 2066/67 is not valid and that of 2067/68 is valid. But income return of IY 2066/67 can be amended at any time if the tax officer has the proof of fraud by taxpayer while submitting return, but within one year of obtaining the evidence of fraud.

b. The tax officer issued another notice u/s 101 (6) to clarify the matters in relation to tax return of 2068/69 and 2069/70. Is it valid under Sec. 101 of Income Tax Act?
   As per Sec. 101 (5), if the Revenue Tribunal or any other authorized Court has reduced the assessed tax liability, the IRO has no authority to make an amended assessment to the extent the tax liability is reduced by the Court. But, if the Court orders for a reinvestigation of the matter, the IRO can make an amended assessment. As such, even when the deadline to make amended assessment has not elapsed, unless Revenue Tribunal or other authorized court permits the reinvestigation of the matter, IRO cannot make amended assessment of IY 2068/69 and 2069/70 as the assessment is finalized by the court.

Collection of Tax in Arrears

23. Answer the following questions:

a. Inland Revenue Department has issued notice to Mr. Padhmanabh Timilsina, a renowned businessperson of Nepal to pay all tax defaults of Rs. 20 Million within 10th Baisakh 2073; which was also published in national newspaper. The matters as to the possibility of other appropriate actions were also notified, if the due is not paid within the time mentioned in the letter. Mr. Timilsina aggressively tried to arrange the money but could not manage to pay the same within the date specified in the notice. Meanwhile, he has prescheduled visit to Thailand to attend a marriage ceremony of his relative, and accordingly he arranged air ticket and travel to Tribhuwan International Airport to travel abroad. He was stopped by the Immigration Staff citing the reason that he has been barred of travelling abroad on request of IRD.
   In light of the above fact, examine whether the action of IRD is legal quoting the relevant provisions of the Act.

b. Define "Receiver" and the obligation of Receiver as per Income Tax Act, 2058.

c. Mr. Peter Mathews, CEO of TCell P. Ltd., company registered in Nepal and a subsidiary of Bundes Ltd. of Portugal is summoned by Large Taxpayers Office to pay the tax due in relation to IY 2071/72 of TCell P. Ltd. as if the tax due is related to his own personal tax default. Mr. Mathews had resigned from the position on 1st Magh 2072. Mr. Mathews approached you, a tax expert, to seek your opinion on the legal basis of tax office's demand of tax from him. Advise Mr. Mathews.

d. Bajaj N. is liquidator of Nepal Oxilium Bank Ltd. Upon receipt of information from Mr. Bajaj, the respective tax office notified him of the bank's tax arrears in relation withholding tax of Rs. 1 Million and other tax liability of Rs. 5 Million. The withholding tax is related to the tax withheld by the bank and not deposited in tax office. It took three years to complete the liquidation process, and Mr. Bajaj did not deposit any tax liability to tax office. Tax Office received information of completion of liquidation process through a local newspaper where shareholders were also paid some sum of money against their share.

The tax office demanded the TDS and tax as specified in its notice from Mr. Bajaj, as if it's his own personal tax liability. Examine the tax officer's contention in light with provisions of Income Tax Act.

Would your answer be different, if the liquidation procedure was completed without being able to meeting the total liquidation expenses, except to the extent of Rs. 2.5 Million?

Answer:

a. As per Sec. 106 of the Act, When a person becomes a tax defaulter, the related tax office may serve a notice in writing to the concerned Department of GON to prevent the tax defaulter from leaving Nepal for a period of not more than 72 hours from the time of the expiry of deadline mentioned in the notice served to the defaulter to pay due tax amount. In case the time limit is to be extended, the tax office has to take a prior approval of the concerned appellate court.

Once the tax defaulter pays the tax or makes an arrangement for payment in satisfaction to the tax office, the office may withdraw the order

In the given case, the deadline mentioned in the notice served to pay the due tax amount is 10th Baisakh 2073 and Mr. Timilisina could not make the payment of due amount within the deadline. As such, tax office may serve a notice in writing to the concerned Department of GON to prevent the tax defaulter from leaving Nepal for a period of not more than 72 hours from 10th Baisakh 2073.

In case the time limit is to be extended, the tax office has to take a prior approval of the concerned appellate court.

In case Mr. Timilsina is barred from travelling abroad until the end of 13th Baisakh 2073, the action of immigration officer is valid. Without the order of concerned appellate court, he cannot be barred from travelling abroad after the expiry of 72 hours from the time of the expiry of deadline mentioned in the notice served to the defaulter to pay due tax amount, i.e. from Baiskah 10th 2073.

b. As per Clarification Clause to Sec. 108, the Receiver means the following person:
   - A liquidator;
   - A receiver appointed by a court or out of a court in respect of an asset or an entity;
   - A person who has taken the assets in possession in case the asset is mortgaged to him;
   - An executor, administrator, or direct heir of a deceased individual's estate; or
   - Any person conducting the affairs of an incapacitated individual

Obligation of Receiver under Income Tax Act:
A person, who is appointed as a receiver of any asset, or an entity, shall notify the respective IRO in writing about his/her appointment in such capacity within *15 days of earlier of such appointment, or taking possession of an asset situated in Nepal*.
The tax office shall notify the receiver, in writing, about the amount of tax payable by the person. After receiving a notice from the tax office, the receiver shall be required to do as follows:

- Sell sufficient assets that come into the receiver's possession and appropriate the amount as follows:
  1. *Set aside an amount and pay to the Revenue, for any amount due to the defaulter for tax deducted at source, but not deposited*
  2. *Pay the amount having a priority over tax; and*
  3. *Set aside and pay the amount of tax on behalf of the taxpayer as notified by the tax office.*
- Deposit the amount that has been set aside on behalf of defaulter as tax in tax office

In case the receiver fails to set aside the amount of tax, he shall be personally liable to pay an amount equal to the tax payable to the tax office. But the receiver, on payment of the amount of tax to the tax office, gets a right to recover the amount from the tax defaulter.

c. Responsibility of Officer to pay tax due of any Entity:

As per Sec. 107, where an entity does not comply with the laws, the officer in charge at the time shall be responsible for that.
Where an entity fails to pay tax on or before the date on which the tax is payable, every person who is an officer of the entity at that time or was such an officer within the previous six months shall be jointly and severally liable to pay the tax. But an officer is not supposed to be liable under these circumstances:

- Where the offence is committed by the entity without the officer's knowledge or consent; and
- Where the officer has exercised a reasonable degree of care, diligence, skill, and prudence that would have been exercised in comparative circumstances to prevent such offence.

As per clarification clause to Sec. 107, Officer means a manager of the entity or a person purporting to act in the capacity of a manager. As per Sec. 2 of the Act, Manager means ny person who is involved in making management decision of the entity and the term includes trustee of a trust and the person having ownership over Foreign Permanent Establishment.

As such, CEO is the officer of the company, TCell P. Ltd. As Mr. Mathews was CEO of the entity for throughout the Income Year 2071/72, and CEO, being the executive person and having power of decision making, cannot refrain himself to be responsible; he is held responsible to pay the tax amount as per Sec. 107 of the Act. If he can demonstrate that the offence is committed by the entity his knowledge or consent; or he has exercised a reasonable degree of care, diligence, skill, and prudence that would have been exercised in comparative circumstances to prevent such offence, he is not supposed to be liable.

d. As per Sec. 108, Mr. Bajaj, a liquidator, is receiver of the entity. When he communicated his appointed as receiver, the tax office has notified him of the tax dues by the liquidating bank to the government of Nepal. After receiving the notice, he needs to do as follows with regard to the tax dues:
   - Sell sufficient assets that come into his possession and appropriate the amount as follows:
     1. *Set aside an amount and pay to the Revenue, for any amount due to the defaulter for tax deducted at source, but not deposited*
     2. *Pay the amount having a priority over tax; and*
     3. *Set aside and pay the amount of tax on behalf of the taxpayer as notified by the tax office.*
   - Deposit the amount that has been set aside on behalf of defaulter as tax in tax office

In case of failure to conduct as aforesaid, he shall be personally liable to pay an amount equal to the tax payable to the tax office.
In the given case, as Mr. Bajaj failed to set aside the amount as aforesaid tax officer's contention to held Mr. Bajaj personally liable for tax dues is correct in light with Sec. 108 of the Act.
When the liquidator could not fetch sufficient amount (i.e. just Rs. 2.5 Million) from the realization of asset, the amount realized to the extent of withholding taxes shall be paid first and then the payments having the priority over tax and then tax. It means, he has to pay Rs. 1 Million as withholding taxes, and as there were other amounts to be paid having the priority over tax as per prevailing law on insolvency, he need not set aside any amount for tax. As such, for his failure to set aside and pay the TDS and tax amount, the officer's contention to held him personally responsible for TDS is correct, but holding him responsible to pay tax dues is not correct as per Sec. 108.
Withholding of Taxes

24. As a tax expert, explain whether withholding tax is applicable or not in the following cases. Also mention the withholding tax rate and whether the payments are final withholding as per Sec. 92 of the Act.
    a. Mr. Robert Penner is an employee of M/s Xylum Inc. USA and comes to Nepal for a service to be provided by the company in Nepal for two months. The company paid USD 10000 for the service during the period.
    b. Nepal Airlines Corporation (NAC) has an office at Singapore, for which it has taken a building in rent from Mr. Wang Li. The monthly house rent is Singaporean Dollar 345. NAC pays rent directly to the bank account of Wang Li from Kathmandu.

c. Nepal Rastra Bank has hired a lawyer at USA to provide legal services against a law suit filed by a party sending money to Nepal, which has been confiscated in the order of NRB. The legal fee is US$ 100,000.
d. Nepal Clearing House Ltd. is a resident entity dealing in clearing services. Everest Bank Ltd. obtains Electronic Cheque Clearing Services from the company and paid Rs. 1,000,000 during the year as Service Fee.
e. Qatar Human Resources Services recently obtained an order from one of its client to hire 400 Nepali nationals for one of the client's project. The Qatari company reached M/s Outsource Nepal Manpower Agency to supply human resources to Qatar from Nepal, for which M/s Outsource Nepal is required to pay commission of Rs. 20,000 per person.
f. Hari Ram has a proprietorship concern for which he maintains a business account in bank. Apart from this, he has also maintained personal saving account. He received Rs. 100,000 as interest in the account maintained for business purpose, and Rs. 1,000,000 as interest in the personal account.
g. The Institute of Chartered Accountants of Nepal appointed Mr. Anurodh Dahal, Professor of TU to set question papers for Strategic Management Subject of CAP III Level, for which it pays Rs. 50,000 to Mr. Dahal.
h. You are an accountant of a company. You received an invoice of Rs. 65,000, for which the payment shall be made instantly in relation to purchase of a laptop.
i. You are an accountant of a bank. You received an invoice from M/s Greenline Transport operator which operates vehicle rental service. The invoice is Rs. 20,000 including VAT.
j. Aryal & Bhandari, Chartered Accountants is a partnership firm having five partners. It distributes dividend of Rs. 1 Million to each of its partners.

Answer:

a. Sec. 88 is applicable when both the following two conditions are satisfied:
   i. When the payer is resident, and
   ii. When the payment is having source in Nepal

   Since Xylum Inc. USA is not resident of Nepal, it cannot withhold tax under the provisions of Income Tax Act.

b. Sec. 88 is applicable when both the following two conditions are satisfied:
   i. When the payer is resident, and
   ii. When the payment is having source in Nepal

Nepal Airlines Corporation is resident person of Nepal, and as such condition (i) is satisfied. For rental payments to have source in Nepal, it must be paid on asset situated in Nepal. For a land and building to be situated in Nepal; it must be land or building within the territory of Nepal. Since the building is situated in Singapore, the asset is not situated in Nepal, implying that the rental payment does not have source in Nepal. As the source test as specified in (ii) above could not be satisfied, tax cannot be withheld u/s 88 of the Act.

c. Sec. 88 is applicable when both the following two conditions are satisfied:
   i. When the payer is resident, and
   ii. When the payment is having source in Nepal

The payer, NRB, is resident entity of Nepal; and is a part of GON. Where government line agencies make payment of service fee, the service has source in Nepal regardless of whether the service is provided. As such, the legal fee (service fee) attracts withholding of taxes u/s 88 of the Act, the rate of which is 15%. It is final withholding for law firm in USA as it is nonresident person.

d. Both the conditions are satisfied, as hence, provisions of Sec. 88 are applicable. As per proviso (4) to Sec. 88 (1), when a person makes payment of service fee to resident entity dealing in VAT exempted services, the rate of withholding taxes shall be 1.5%. As clearing services are exempted from VAT, and NCHL is a resident entity, Everest Bank Ltd. shall withhold tax at 1.5% against the payment of such services.
e. As per Proviso (2) to Sec. 88 (1), when a resident human resource agency makes payment of commission to a nonresident person, the rate of withholding taxes shall be 5%. Hence, Outsource Nepal Manpower Agency shall withhold tax at 5% while making payment of commission to Qatar Human Resource Services.
f. As per Sec. 88 (3), notwithstanding anything written in Sec. 88 (1), where a resident bank or financial institutions, entities authorized to issue debentures, or listed entity pays interest having source in Nepal to a natural person on his/her deposit, loan paper, debentures or government bond, and when the receipt of interest is not in connection to operation of business; the rate of WHT is 5%. But in all cases when interest having source in Nepal is paid by resident person, the rate of WHT is 15%.
   In the given case, the interest received by Hari Ram in personal saving account satisfies all conditions mentioned in Sec. 88 (3), and hence the rate of WHT shall be 5% (WHT= 5% of Rs. 10 Lakhs).

   When the account is maintained for business purpose, the interest so received by Mr. Hari Ram is in connection to operation business, which implies the rate of WHT is 15% on the account maintained in the name of sole proprietorship concern.

g. As per Sec. 88 (4) (Ka1), the requirement to withhold tax is exempted where the payment is made for the services of setting up of question paper. As such, the Institute of Chartered Accountants of Nepal shall not withhold tax while making payment against the service of setting up of question paper to Mr. Anurodh Dahal.
h. As per Sec. 89 of the Act, where the payment related contract or agreement by a resident person exceed Rs. 50,000; tax shall be withheld at the rate 1.5%.
   Clarification clause to Sec. 89 defines Contract or Agreement as an act of supply of goods or human resources, contract related to construction, installation or establishment of tangible asset or structure, delivering the service in construction, installation or establishment of tangible asset or structure as per the terms of same contract document or other works prescribed as contract by IRD.

   Since supply of goods is also a part of contract as defined by Sec. 89 of the Act, when the payment exceeds Rs. 50,000; tax shall be withheld at 1.5%. In the given case, 1.5% of Rs. 65000 shall be withheld as tax at the time of payment as per Sec. 89.

i. As per Proviso (5) to Sec. 88 (1), where rent is paid to a vehicle service provider registered in VAT; the rate of WHT shall be 1.5%. As such, 1.5% of Rs. 200,000 shall be withheld by the bank while making payment of vehicle rental service to Greenline Transport Operator.

j. As per Sec. 54 and Sec. 88 (2), when a partnership firm distributes dividend, tax shall be withheld at 5%. As such, Aryal & Bhandari shall withheld tax at 5% of Rs. 1 Million from each partner.

Nonresident Air & Water Transport and Telecommunication Operator

25. Answer the following questions:

a. Define "nonresident" in relation to Sec. 70 of the Act.

b. Discuss the taxability of following transactions in relation to Sec. 70 of the Act:

i. A Den airline registered in Denmark, having contact office in Nepal and is operating its airlines business. During Income Year 2072/73, it has sold the tickets in Nepal as follows:

Sale of tickets from the passengers departing from Nepal Rs. 500 Million

Sale of tickets in Nepal, for the passengers departing from country other than Nepal Rs. 100 Million

ii. Singtel Ltd. is a company registered in Singapore. The company, with its objective to transmit information and storing data, has a communication hub in Nepal (without any office in Nepal). Through such system, the companies in Europe and America are storing data and transmitting information. Singtel has received USD 1 million for such services.

Answer:

a. As per clarification Clause to Sec. 70, "nonresident", for the purpose of Sec. 70, as a resident entity which is under the group of associated entities, the head office of which is located outside the state of Nepal.

b.

i. As per Sec. 70 (1), the income of a nonresident (a resident entity, the head office of which is outside Nepal) operating air, water transportation or chartered service shall include the following, except as a result of transshipment:

1. Transportation of passengers who disembark from Nepal, and
2. Transportation of goods, mail or livestock who disembark from Nepal

Since Den Airlines sold air tickets from the passengers departing from Nepal of Rs. 500 Million, as per Sec. 70 (1) (a) explained above, the amount is taxable. The tax rate is 5%. No expenses related to any flight are deductible.

As the collection of Rs. 100 Million is for the passengers departing from other countries; Sec. 70 is not applicable. However, as per restrictive clause of Sec. 2 (7) of Schedule 1 of the Act; in case when the disembarkment is not from Nepal and from any country outside Nepal but the airlines sells ticket in Nepal, 2% tax is applicable.

ii. As per Sec. 70 (2), the income of a nonresident (a resident entity, the head office of which is outside Nepal) operating telecommunication service includes any amount received by the person in respect of the transmission of messages by apparatus established in Nepal; whether or not such message originate in Nepal.
As Singtel Ltd. has a communication hub in Nepal, the information is transmitted through apparatus established in Nepal. Any amount received in that respect is taxable in Nepal. As such, USD 1 Million is taxable in Nepal.

Revenue Administration

26. Explain with reasons whether the following statements are "True" or "False":

a. Director General may delegate his authority to issue a public circular to Deputy Director or other tax officers.
b. A tax officer other than Director General, Deputy Director General, Chief Tax Administrator, Director, Chief Tax Officer or Tax Officer acting as Head of Office shall not delegate the powers conferred to him/her.
c. Director General can delegate all powers to Deputy Director General or other tax officers.
d. The different types of tax offices, as established by Government of Nepal's notification in Nepal Gazette, may be Large Taxpayers Office, Middle Level Taxpayers Office, Inland Revenue Offices and Taxpayers Service Office.
e. Every taxpayer shall keep their documents in safe custody for five years from the date of expiry of Income year for Income Tax purpose.

Answer:

a. False.
As per Sec. 72 (4) (Ga), Director General can delegate all the authorities conferred to him under the Act except the following:

i. To issue of Public Circular u/s 75
ii. To prescribe format of different documents and return u/s 77
iii. To defer or otherwise affect the reviewable decisions u/s 115 (5)
iv. To accept or reject wholly or partly the matters sought through administrative review procedure by an applicant u/s 115 (7)
v. To levy penalty u/s 129
vi. To delegate the power u/s 82

As such, the power to issue public circular cannot be delegated by the Director General to any other Officer of IRD.

b. True
As per Sec. 72 (6) (Kha), tax officer other than Director General, Deputy Director General, Chief Tax Administrator, Director, Chief Tax Officer or Tax Officer acting as Head of Office shall not delegate the powers conferred to him/her.

c. False.
As explained in answer (a) above, the seven powers conferred to Director General by the Act cannot be delegated.

d. True

As per Sec. 72 (2), the different types of tax offices, as established by Government of Nepal's notification in Nepal Gazette, may be Large Taxpayers Office, Middle Level Taxpayers Office, Inland Revenue Offices and Taxpayers Service Office.

e. True

As per Sec. 81 (2), every taxpayer shall keep their documents in safe custody for five years from the date of expiry of Income year for Income Tax purpose.

International Taxation

27. Answer the following:

a. Discuss the power of Nepal Government to conduct International Agreement in relation to Avoidance of Double taxation and elimination of Fiscal Evasion.

b. Mr. Manohar Lal Lohiya is an Indian National living in Nepal since last three years. There is no tax due of Mr. Lohiya to Nepal Government as he has paid all taxes applicable as per Income Tax Act, 2058. On 1st Chaitra 2072 Inland Revenue Department issued a notice to Mr. Lohiya requiring him to pay INR 100 Million of his taxes due to Government of India; citing the reason that Nepal and India has an agreement on Avoidance of Double Taxation and Elimination of Fiscal Evasion and the competent authority of Government of India requested Inland Revenue Department to recover such tax dues from Mr. Lohiya as per the Agreement.

Mr. Lohiya approached you as tax expert to seek your opinion on the legality of the letter of Inland Revenue Department. Advise Mr. Lohiya in relation to the power of the Department as per Sec. 73.

c. Describe Limitation of Benefits in relation to Sec. 73 of the Act.

Answer:

a. As per Sec. 73 (1), in case any income of a person is subject to income tax under Income Tax Act or any other prevailing law of Nepal during any Income year and the same income is subject to tax under laws of any other country, Government of Nepal may conclude a double tax avoidance agreement to avoid such double taxation on same income.

As per Sec. 73 (4) and 73 (5), In case where an international agreement provides Nepal to exempt income or a payment or subject income or a payment to reduced tax; the exemption or reduction is not available to any entity:

i. Who, for the purpose of the agreement, is the resident of the other contracting state;
ii. 50 percent or more of whose underlying ownership is owned by individuals or entities in which no individual has an interest who, for the purposes of the agreement, are not residents of the other contracting state or Nepal.

b. As per Sec. 73 (2) & 73 (3), Where Inland Revenue Department receives a request pursuant to an international agreement from the competent authority of another country for the collection in Nepal of an amount payable by a person ("tax debtor") under the tax laws of the other country; IRD may, by service of a notice in writing, require the tax debtor to pay the amount to IRD by the date specified in the notice and for transmission to the competent authority.

In the given case, Mr. Manohar Lal Lohiya is the tax debtor of India, with which Nepal has a treaty. As IRD receives a request pursuant to treaty to collect tax dues of Mr. Lohiya to Indian government, u/s 73 (2) and 73 (3), IRD by service of a notice in writing, require the tax debtor to pay the amount to IRD by the date specified in the notice and for transmission to the competent authority.

As such, the notice issued by IRD to Mr. Lohiya is valid as per Income Tax Act and Mr. Lohiya should be advised to act as per the order of IRD to satisy tax due to India.

c. Limitation of Benefit:

As per Sec. 73 (4) and 73 (5), In case where an international agreement provides Nepal to exempt income or a payment or subject income or a payment to reduced tax; the exemption or reduction is not available to any entity:

i. Who, for the purpose of the agreement, is the resident of the other contracting state;
ii. 50 percent or more of whose underlying ownership is owned by individuals or entities in which no individual has an interest who, for the purposes of the agreement, are not residents of the other contracting state or Nepal.

It means treaty benefit is applicable to residents of other contracting state, except to those as specified above.

Entity and Distribution

28. What are the principles in case of entity? Answer as per Sec. 52 of the Act.

Answer:

Sec. 52 of the Act prescribes tax principles in case of an entity, which are as follows:

a. An entity shall be liable to tax separately from the beneficiaries.
b. Distribution of entities shall be as either Repayment of Capital or distribution of profit.
c. Amount derived and expenses incurred by an entity, whether or not derived or incurred on behalf of another person, shall be treated as derived or incurred by the entity.
d. Assets owned and liabilities owed by an entity shall be treated as owned or owed by the entity and not by any other person.
e. Foreign income tax paid with respect to the income of an entity, which may be paid by a manager, beneficiary, or an entity, shall be treated as paid by the entity.
f. A transaction between an entity and its manager and/or beneficiaries shall be recognized as actual transaction subject to:
    - Otherwise than as stated in the Chapter 7: Quantification, allocation and characterization of amounts;
    - Otherwise as stated in Section 45: Transfers between associates and other non-market transfers.

29. Calculate dividend tax to be withheld in the following cases:

a. M/s Siddhartha Investment Co. Ltd. which generates income from dividend to be received from its investment. During the year, the company's income is composed of the dividend from resident company and distributed Rs. 1 Million as dividend to its shareholders.

b. The abstract of Balance Sheet, Income Statement & Notes to the Accounts of Apple Ltd., resident company of Nepal, is as follows:

Abstract of Balance Sheet

Share Capital:

| | |
|---|---|
| Authorized Capital (1 Lakh kitta of General Shares of Rs. 100 each) | 10,000,000 |
| Issued, Subscribed and Paid up Capital | 8,000,000 |
| *(80,000 kitta of General Shares of Rs. 100 each)* | |
| *Reserve & Surplus* | |
| Accumulated Profit | 2,000,000 |

Notes to the Accounts:

The board of directors of the company proposes to issue 15% bonus share and cash dividend to cover the tax applicable on the bonus shares.

The Annual General meeting of the company approved the proposal of the company.

c. A foreign Permanent Establishment has the taxable income of Rs. 10 Million. It has the history of repatriating all after tax profits to its head office in United States of America after paying all applicable taxes in Nepal.

Answer:

a. As per Sec. 54 (3), notwithstanding anything written in Sec. 54 (1), there shall be no distribution tax on such distribution where dividend is distributed out of the profit on which distribution tax has already been levied.

In the given case, as all the income of M/s Siddhartha Investment Co. Ltd. is composed of dividend received from resident companies, it means the income of the company is the income where distribution tax is already levied under the Income Tax Act. As such, there shall be no additional distribution tax on redistribution of such dividend.

b. Dividend is distributed as a percentage of paid up capital of the company. Dividend tax is 5% of amount distributed by the company, which means the recipient receives 95% of amount so distributed.

Distribution of bonus share is also a part of dividend. Therefore if we assume, the amount of total dividend (i.e. cash dividend plus bonus share) be x, then the shareholder receives bonus shares which is 95% of x.

Here, Amounts to be set aside for Bonus shares= 15% of 8,000,000= 1,200,000

95% of x = 1,200,000

X= 1,200,000/0.95 = 1,263,157.895

As total dividend is bonus share plus cash dividend, therefore, amount of cash dividend = 1,263,157.895-1,200,000 = 63,157.895

c. As per Sec. 2 (6) of Schedule 1 of the Act, the repatriation tax payable by a foreign permanent establishment u/s 3 (Kha) of the Act is 5% of amount repatriated. As Foreign Permanent Establishment is a resident entity, it shall pay 25% of taxable income as tax as per Sec. 3 (Ka) of the Act. As such, the amount including repatriation tax that can be repatriated is as follows:

| | |
|---|---|
| Taxable Income | 1,000,000 |
| Tax Liability @ 25% | 2,500,000 |
| Amount available for repatriation including repatriation tax | 7,500,000 |

There are two schools of thought regarding calculation of repatriation tax. One thought represents that the repatriation tax is paid by FPE, not by the recipient and is calculated on the amount to be repatriated; as such total amount of Rs. 7,500,000 is 105% of amounts to be repatriated. The repatriation tax would be (7500000/1.05*5%=) 357,142.86. This thought is the interpretation of Sec. 68 (1) and 68 (3) of the Act.

The other school of thought is derived from the interpretation of Sec. 68 (4) of the Act, where the Act prescribes the treatment of repatriation tax as like dividend. The Income Tax Manual issued by IRD also interprets the provision in the same line. With this interpretation, repatriation tax would be 5% of 7,500,000 = Rs. 375,000.

30. Identify whether there is any change of control in the following cases:

a. A P. Ltd. is an entity registered on 1st Shrawan 2071 with three equal shareholders. All the shares of A P. Ltd. were sold to another person not related to previous shareholders on 1st Baisakh 2073.

b. The following is the shareholding structure of M. Ltd. on 15th Baisakh 2070:

| | |
|---|---|
| Ram Hari Chamlagain | 25% |
| Sita Ram Chaurasia | 30% |
| Harihar Awasthi | 25% |
| Padam Pantha | 15% |
| Krishna Ram Halwai | 3% |
| Gyanhari Deuja | 0.75% |
| Rhita Pathak | 0.5% |
| Drishya Pandey | 0.125% |
| Amit Barakoti | 0.625% |

Mr. Padam Panthi and Rhita Pathak are husband and wife whilst other shareholders are not associated to one another.

On 15th Baisakh 2073, all the shares of Sita Ram Chaurasia, Padam Panthi, Krishna Ram Halwai, Gyanhari Deuja, Rhita Pathak, Drishya Pandey, and Amit Barakoti were sold to Mr. Sher Bahadur Oli.

Answer:

a. As per Sec. 57 (1), where there is a change of 50 percent or more in the underlying ownership of an entity as compared with that ownership three years previously, the entity is treated as realizing any assets owned by it and any liabilities owed by it immediately before the change.

Sec. 57 (1ka) requires computing the change in ownership considering the ownership as follows:

i. Ownership held by such beneficiaries holding 1% or more shares of the entity, and
ii. Ownership held by beneficiaries holding less than 1% shares of the entity, only when such beneficiaries are associated person of the beneficiary holding 1% or more shares of the entity

As Sec. 57 (1) can be applicable when there can be comparison between the shareholding structure as of now with the shareholding pattern three years previously, without the data of shareholding pattern of three years previously, the computation whether there is change in control is impossible.

In the given case, there is change of shareholding pattern on 1st Baisakh 2073. To determine whether there is change in control information of shareholding structure of 1st Baisakh 2070 is required. As the company is incorporated on 1st Shrawan 2071, the change in control can be tested only on 1st Shrawan 2074. Thus, there is no change in control.

b. As per Sec. 57 (1), where there is a change of 50 percent or more in the underlying ownership of an entity as compared with that ownership three years previously, the entity is treated as realizing any assets owned by it and any liabilities owed by it immediately before the change.

Sec. 57 (1ka) requires computing the change in ownership considering the ownership as follows:

i. Ownership held by such beneficiaries holding 1% or more shares of the entity, and
ii. Ownership held by beneficiaries holding less than 1% shares of the entity, only when such beneficiaries are associated person of the beneficiary holding 1% or more shares of the entity

As such, when the shares of Ram Hari Chamlagain, Sita ram Chaurasia, Harihar Awasthi, Padam Panthi, and Krishna Ram Halwai (all holding 1% or more shares) are sold, such change is considered; whereas for the transaction of shares of remaining shareholders holding less than 1% shares of the company, the changes attributable to such shareholders who is associated person of shareholders holding 1% or more shares shall only be considered. As such, out of such shareholders, if the shares are sold by Rhita Pathak (spouse of Padam Panthi holding more than 1% shares), it shall only be considered.

Decision Column- from sellers point of view

| Name of ]Shareholders | Existing share holding pattern | Consideration? | New shareholding pattern | Changes as per sec. 57 |
|---|---|---|---|---|
| Ram Hari Chamlagain | 25% | No, as not sold | 25% | - |
| Sita Ram Chaurasia | 30% | Yes, >1% | - | 30% |
| Harihar Awasthi | 25% | No, as not sold | 25% | - |
| Padam Pantha | 15% | Yes, >1% | - | 15% |
| Krishna Ram Halwai | 3% | Yes, >1% | - | 3% |
| Gyanhari Deuja | 0.75% | No, <1% and no relation to >1% shareholders | - | - |
| Rhita Pathak | 0.5% | Yes, association to >1% shareholder Padam panthi | - | 0.5% |
| Drishya Pandey | 0.125% | No, <1% and no relation to >1% shareholders | - | - |
| Amit Barakoti | 0.625% | No, <1% and no relation to >1% shareholders | - | - |
| Total Change | | | | 48.5% |

Since change computed u/s 57 (1) and 57 (1Ka) is less than 50%, though there is 50% transfer of shares actually, there is no change in control.

31. A company incorporated under Companies Act 2063 has two shareholders having equal shares. The company has taxable carried forward accumulated loss of Rs. 100 Million in related to five previous Income Years since its inception. As the shareholders could not manage operating the company further, they introduced a third person as shareholder diluting their interest to 20% each and the interest of third person is 60% on 31st Ashad 2072. The company managed to earn Rs. 50 Million of Assessable Income from Business during 2072/73. The shareholders of the company want to set off the carried forward loss as per Sec. 20 of the Act and seek your advice for the same.

Answer

Since both the shareholders having more than 1% interest in the entity sold 30% shares of each to a new shareholder, the effective change as per Sec. 57 is 60%, which is greater than 50%. As such there is change in control on 31st Ashad 2072. As per Sec. 57 (2) (Kha), the loss pursuant to period before change in control cannot be set off against the income generated after change in control. This means, the loss sustained before change in control cannot be utilized to reduce tax liability after change in control, but the loss can be utilized to reduce tax liability before change in control.

The assessable income of Rs. 50 Million is relation to the period before change in control when the set off of carried forward loss is absolutely allowed.

As such, the assessable income for IY 2072/73 (period before change in control) is Nil.

With the adjustment of loss against income as such, there is still Rs. 50 Million leftover as loss, but this loss cannot be utilized to set off against income of IY 2073/74 as the tax period is pertaining the period after change in control.

Retirement Funds

32. Prime Retirement Fund is an approved Retirement Fund. It has following income during the income year 2072/73:

| | |
|---|---|
| Retirement Contribution received from Beneficiaries | 100 Million |
| Interest paid to Beneficiaries' Accounts | 7 Million |
| Interest Income from different Investments | 20 Million |
| Retirement Payments to beneficiaries | 3 Million |
| Administrative Expenses | 5 Million |

Calculate taxable income and tax liability on the basis of above information.

Answer:

As per Sec. 64 (1) of the Act, for the purpose of determining the income of retirement fund, the amount to be included or amount to be deducted as per the provisions of the Act shall be included or deducted. Provided that:

a. The contribution to the fund shall not be the incomings of the fund and it shall be included as incomings of the fund
b. Retirement payments are not the expenses of the fund and such payments shall not be deductible while calculating assessable income of the fund
c. The interest of a beneficiary in a retirement fund shall not be the liability of the fund

As per Sec. 64 (2), no tax shall be levied in the income of retirement fund.

As such, interest income from different investments form part of income of a retirement, and administrative expenses form part of deductible expenses. However, there shall be no tax liability of the fund as per Sec. 64 (2).

33. An approved retirement fund, approved on Ashad 2069 could not manage to act as per the conditions prescribed by Income Tax Regulation and Inland Revenue Department converted the retirement fund to Unapproved Retirement Fund on 1st Shrawan 2072. The following are the information related to the fund's asset and liability as on the date of conversion into unapproved retirement fund:

| | |
|---|---|
| Retirement Contribution from beneficiaries (2069/70) | 2,500,000 |
| Investment Income (2069/70) | 150,000 |
| Retirement Payments (2069/70) | 1,200,000 |
| Operating Expenses of Retirement Fund (2069/70) | 400,000 |
| Retirement Contribution from beneficiaries (2070/71) | 3,000,000 |
| Investment Income (2070/71) | 400,000 |
| Retirement Payments (2070/71) | 1,300,000 |
| Operating Expenses of Retirement Fund (2070/71) | 450,000 |
| Retirement Contribution from beneficiaries (2071/72) | 4,000,000 |
| Investment Income (2071/72) | 500,000 |
| Retirement Payments (2071/72) | 1,800,000 |
| Operating Expenses of Retirement Fund (2071/72) | 650,000 |

Calculate tax liability as an effect of conversion into unapproved retirement Fund.

Answer:
As per Sec. 64 (3), where an approved retirement fund ceases to be an approved retirement fund, it shall pay income tax in an amount equal to the income tax rate referred to in section 2(1) of Schedule 1 applied to:

a. all retirement contributions received by and taxable income of the fund (calculated ignoring the effect of being Approved Retirement Fund) during the period from its most recent approval as an approved retirement fund to when it ceased to be so approved, less
b. all retirement payments made by the fund from its most recent approval as an approved retirement fund to when it ceased to be so approved

i.e. the tax shall be calculated as 25% of the result of the following:

a. Contributions received by the fund from the day when approval is granted to the day when the approval is withdrawn Plus
b. Any other amount that would be included in the income if the approval were not granted Less
c. Retirement payments made from the day when the approval is granted to the day when the approval is withdrawn.

As such, the tax liability on conversion of ARF to URF on the date of such conversion is calculated as under:

| Particulars | IY 2069/70 | IY 2070/71 | IY 2071/72 | Total |
|---|---|---|---|---|
| A. Contributions received by the fund from the day when approval is granted to the day when the approval is withdrawn | 2,500,000 | 3,000,000 | 4,000,000 | 9,500,000 |
| B. Any other amount that would be included in the income if the approval were not granted | 150,000 | 400,000 | 500,000 | 1,050,000 |
| C. Retirement payments made from the day when the approval is granted to the day when the approval is withdrawn | 1,200,000 | 1,300,000 | 1,800,000 | 4,300,000 |
| D. Taxable value (A + B – C) | | | | 6,250,000 |
| E. Tax payable (25% of D) | | | | 1,562,500 |

Income from Business

34. Answer the following questions:

a. Rajdhani Investment Ltd. is a public company dealing in purchase and sales of various types of securities. As part of its business, it needs to maintain some deposit in bank. It earned following income during IY 2072/73:

| | |
|---|---|
| Dividend from Resident Companies | Rs. 2,500,000 |
| Interest from Resident Bank & Financial Institutions against deposit | Rs. 5,000,000 |
| Dividend from Nonresident Companies | Rs. 800,000 |
| Service Fee from Investment Consultancy Services | Rs. 8,000,000 |

It accepted a restriction from a similar company. As per the terms of restriction, it obtains Rs. 500,000 for the year for which it cannot quote on auction of unsubscribed securities by Nepal Investment Bank Ltd.

Your are required to answer whether the following statements are "True" or "False" quoting the relevant provision of the Act:

i. Dividend from Resident companies are not included in income of the company as these are investment income, and are part of inclusion u/s 9, not u/s 7.
ii. Interest from resident banks and financial institutions are final withholding income, and thus, not included in income from Business as per Sec. 7 (3).
iii. All dividends are final withholding incomes, and as such, the dividend from nonresident companies does not form part of income of the company.
iv. Service fee is part of inclusion while calculating assessable income from business.
v. There is no treatment for amount of Rs. 500,000 received by the company against acceptance of restriction to compete a bid to purchase unsubscribed shares of Nepal Investment Bank Ltd.

b. Katha Inc. Nepal Ltd. is a resident company operating in Nepal, having turnover in billions. The company has retained your firm as tax consultant. Recently your principal received an email from the company which is as follows:

"Dear Mr. XXXXX,

How are you doing?

We are having our audit for FY 2072/73 right now. We have problems with following tax issues and our auditors are quite offensive on these issues. We would like you to look into the matters and provide us an appropriate advice and course of action on these matters:

i. There is an invoice of a consultant for his service to organization during FY 2070/71 of Rs. 25 Lakhs. The invoice could not be obtained and the payment was not made during that FY as there was dispute regarding the fee at that time. As this has been settled; we have made the payment of the fee and obtained invoice during this year. Since the payment is made this year, we want to claim this as expenditure for the year 2072/73, but our auditors are reluctant on this and have insisted to issue some qualification point on this issue if we move further with our stand.
ii. We have been enjoying fixed term loan facility from one of the commercial bank to construct a building which is in use during the IY, and have paid interest of Rs. 15 Lakhs on such loan. Some of our directors have asked advances to travel abroad for business purpose of the company on Ashad 1 2073, which is outstanding as of yearend date as follows:

Ram Hari Deuja, Executive Director Rs. 20 Lakhs

Kumar Kunwar, Executive Director Rs. 30 Lakhs

The same has been settled on Shrawan 25th after the visit is completed.

The loan outstanding is uniform during the year, as the installment payment is annually in the beginning of fiscal year, which is Rs. 150 Lakhs.

Our auditor insists that since the loan is misused in the form of advances to director, the interest applicable to such advances is not deductible.

iii. We have 70 of our staffs retiring on Ashad 1st 2073. We paid retirement payments to 68 employees through wire transfer in their bank accounts. Roshan Pandit and Sachindra Dhungana are two of our staffs, who obtained their retirement payments in cash as they asked the amount in cash for their urgent requirement. The amount so paid in cash is Rs. 50 Lakhs. Our auditor insists that since these expenses are paid in cash, these are not deductible for tax purpose.

iv. Since you know that we are involved in pollution control activities as part of our corporate social relationship since this year. With the permission of Pashupati Area Development Trust, we incurred Rs. 100 Million for an infrastructure to infiltrate the polluted water of Bagmati River and convert them in pure form in Guheshori area. Since this is Pollution Control cost incurred by our company; our management wants to claim it as expenditure u/s 17 of the Act.

v. We are also involved in hire purchase trading. Our hire purchase trading unit sells vehicles in installments, but the ownership of these vehicles will be in the name of our company until the last installment is paid by hire purchaser. As the asset is legally in our name, our management wants to claim depreciation on such asset u/s 19 of the Act.

We look forward to your prompt response.
Sincerely Yours,
XXXXX"

Your principal forwarded you the email and asks you to prepare the answer for each query of the client.

You are required to draft an email for the response to the client.

c. You are a tax expert. One of the potential investor approached you to explain him about the difference between the computation of cost of goods sold as per Income Tax Act and as per Nepal Financial Reporting Standards. He also wants to understand how the closing stock is valued for tax purpose. You are required to advise him.

Answer:

a.

i. False, as these are excluded as a result of application of Sec. 7 (3) which exempts final withholding payments from inclusion in income; this should not be included in income.

ii. False

Interest from resident banks and financial institutions are final withholding only when these are paid to natural person not in connection with operation of business or to an exempt organization. In this case, it is not a final withholding income and as such, it forms part of inclusions in business income as income from investment in nature directly related to the business objective of the person u/s 7 (2) (Chha).

iii. False
Dividend paid by resident company or partnership are final withholding whereas as per Sec. 54 (2) dividend received from nonresident person shall be included as part of income.

iv. True, it is part of inclusion as per Sec. 7 (2) (Ka)

v. False
U/s 7 (2) (Cha), any amount received in connection to acceptance of restriction related to business form part of business income.

b. Email for the response of the client:
Dear Sir,

I have reviewed the tax questionnaire of one of the clients, you have assigned. Please find the following response to their specific query:

i. As per Sec. 13 of the Act, three basic conditions shall be fulfilled for an expenditure to be eligible as deduction for tax purpose, which are as follows:
   1. The expenditure shall be incurred by the person, i.e. by the client in our case
   2. The expenditure shall be incurred during the income year, and
   3. The expenditure shall be incurred to generate income from business.

   As the consultancy expenses for IY 2070/71 satisfies the conditions (1) and (3) above, the expenditure is not incurred for the IY 2072/73. Had the client calculating tax liability of IY 2070/71, the expenditure would be eligible, but not for the 2072/73, as "incurring of expenditure during the year" is not satisfied. The auditor of the client is correct in this regard.

ii. As per Sec. 14 (1), in case of a interest expenses on loan that is utilized for the purpose of production/construction of fixed asset, the expenses are eligible when the asset procured/constructed from loan are used during the income year.
   In this case, since the client has used fixed term has been used to construct a building, the use of building during the IY satisfies the condition to claim interest income for deduction. Furthermore, travel advances for official visit of executive directors are part of normal business dealing, and obtaining such advances cannot justify the misuse of loan. As such, the interest expense is eligible for deduction.

iii. As per Sec. 21 (2) (ga), any retirement payments can be made in cash and still the expenditure is eligible for deductions. As such, retirement payments to Mr. Pandit and Mr. Dhungana in cash in excess of Rs. 50,000 are deductible as per the said clause.

iv. As per Sec. 17 (1), Pollution control cost incurred by a person during any Income Year for the operation of business of such person is eligible as deduction under the Section. As the expenditure so incurred in Pashupati Area does not have any business connection to Katha Inc., the expenditure is not deductible u/s 17 of the Act.
This may be treated as expenditure u/s 12A and to the extent eligible under the said provision; the expenditure can be deducted while calculating taxable income.

v. As per Sec. 32 (7) of the Act, the lessee is deemed to be the owner of the asset and the lessor is deemed to have debt claim over the lessee as a result of such sales in finance lease arrangement. Since Katha Inc. is lessor, it cannot be treated as the owner of the assets so sold in installment basis.
As per Sec. 19 (1), the depreciation expenses can be claimed on such assets which are owned by the person. As such, the company cannot claim depreciation expenses of such asset sold in installment basis.

c. Section 15 of the Income Tax Act deals with calculation of cost of trading stocks.

- As per the provisions of the section, cost of trading stock calculated as sum of opening stock and purchases/cost of conversion less value of closing stock are deductible for tax purpose.
- The value of opening stock of any year shall be equal to the value of closing stock of immediately preceding income year.
- Closing stock shall be valued as lower of cost and market value.
- In case the value of closing stock of any year cannot be ascertaining by using Specific Identification Method, the value shall be determined by using FIFO or Weighted Average Cost formula.
- Cost of conversion/production shall be computed under Absorption Costing Method by all such persons using accrual basis of accounting while the person following cash basis of account may choose either of Absorption Costing method or Prime Costing Method.
- Under Absorption Costing Method, cost shall be computed as the sum of direct material cost, direct labor cost and factory overhead. But the factory overhead shall not include depreciation and repair and improvement expenses of depreciable asset as part of cost.
- Under Prime Costing Method, cost shall be computed as the sum of direct material cost, direct labor cost and variable factory overhead. But the variable factory overhead shall not include depreciation and repair and improvement expenses of depreciable asset as part of cost.

Difference between Method under Income Tax Act & NFRS:

| Basis | Under Income Tax Act | Under NFRS |
|---|---|---|
| Valuation of closing stock | Cost or Market Value whichever is lower | Cost or Net Realizable Value, whichever is lower |

| | | |
|---|---|---|
| Method of Costing | Allows both Absorption Costing or Prime Costing Method | The method shall be absorption costing |
| Charge of Depreciation and Repair and Improvement Cost as Inventorial Cost | Depreciation and Repair and Improvement Cost of Depreciable asset should be excluded | Depreciation and Repair and Improvement Cost of factory building, plant and machinery forms part of cost |

35. M/s XYZ Limited has produced the following Trading and Profit & Loss Account for the year ending on 31st Ashad 2073.

Dr. Cr.

| Particulars | Amount | Particulars | Amount |
|---|---|---|---|
| To Opening Stock | 4,000,000 | By Sales A/c | 25,000,000 |
| To Purchase | 15,000,000 | By Purchase Return | 1,500,000 |
| To Sales Return | 500,000 | By Closing Stock | 4,500,000 |
| To Wages | 1,000,000 | | |
| To Carriage Inwards | 1,200,000 | | |
| To Gross Profit c/d | 9,300,000 | | |
| | 31,000,000 | | 31,000,000 |
| To Salaries | 5,000,000 | By Gross Profit b/d | 9,300,000 |
| To Carriage Outward | 150,000 | By Discount Received | 500,000 |
| To Interest Expenses | 2,500,000 | By Dividend income from A Ltd., a nonresident company | 1,000,000 |
| To Depreciation | 2,000,000 | By Rental Income (net of WHT) | 1,800,000 |
| To Provision for Doubtful Debt | 500,000 | By Windfall Gain | 1,000,000 |
| To Bad Debt Written off | 1,200,000 | By Written back of Provision for Doubtful Debts | 1,000,000 |
| To Repair & Maintenance | 800,000 | By Recovery of Bad Debts | 1,200,000 |

| | | | |
|---|---|---|---|
| Expenses | | | |
| To Expenses for Corporate Social Responsibility | 2,500,000 | By Dividend from Nepal Bank Ltd., a resident Bank | 3,000,000 |
| To Fines & Penalties | 120,000 | By Gain on Sale of Land | 1,000,000 |
| To Advertisement Expenses | 1,500,000 | By Miscellaneous Income | 200,000 |
| To Business Promotion Expenses | 200,000 | | |
| To Legal Expenses | 550,000 | | |
| To Loss on Sale of Furniture | 200,000 | | |
| To Provision for Staff Bonus | 407,000 | | |
| To Current Tax Expenses | 1,200,000 | | |
| To Net Profit Carried to Balance Sheet | 1,373,000 | | |
| | 20,200,000 | | 20,200,000 |

Additional Information:

a. Out of total purchase, Rs. 1,500,000 was paid in cash to a party on the day when there was strike called on by a political parties. All, except the bank on which the company has bank account, was open on that day.
b. Interest Expenses is paid on bank loan, of which 60% was utilized by the directors. The company charged interest to directors, which is included in P& L Account as income.
c. The bad debts during the year were written off after complying all procedures as set out by Sec. 40 (3) (c) of the Act.
d. The total disposal proceeds of the sold land were Rs. 2,500,000.
e. The bad debts recovered were from one debtor, which was written off during previous Income Year. As the provisions of Sec. 40 (3) (c) were not fulfilled, it was not claimed as expenses at that Income Year.
f. The details of opening depreciation base of different pools of assets of the company are as follows:

| | |
|---|---|
| Pool A | Rs. 15,000,000 |
| Pool B | Rs. 1,800,000 |
| Pool C | Rs. 2,500,000 |

Pool D Rs. 2,200,000

g. The company's record shows the following expenditure was incurred to purchase new fixed assets:

| | |
|---|---|
| Furniture (on Chaitra 2072) | 600,000 |
| Car for office purpose (on Ashad 23, 2073) | 3,000,000 |
| Gas Cylinder (on Ashwin 2072) | 15,000 |
| Generator (on Magh 2072) | 200,000 |

h. Some furniture having WDV of Rs. 800,000 were sold during the year for Rs. 600,000. The loss is charged to P&L Account.

i. On scrutiny of plant account, it has been identified that total repair and maintenance cost of Rs. 250,000 has been capitalized to the plant as the expenditure increased useful life of plan.

j. The break up of repair expenses are as follows:

| | |
|---|---|
| Pool A | 200,000 |
| Pool B | 300,000 |
| Pool C | 100,000 |
| Pool D | 200,000 |

k. The company's ledger of Expenses for Corporate Social Responsibility shows the expenses incurred to maintain the local goons.

l. The company was operating in losses for 12 years during its initial business phases. A total of Rs. 800,000 business losses sustained during such year could not be set off as a result of the maximum timelimit prescribed in Sec. 20 of the Act.

You are required to calculate:

a. Assessable Income from Business
b. Assessable Income from Investment
c. Taxable Income
d. Corporate Tax Liability (assuming the tax rate of 25%)

Answer:

A. Calculation of Assessable Income from Business:

| Particulars | W.N. Ref | Sec. Ref | Amount |
|---|---|---|---|
| Inclusions: | | | |
| Sales Less Sales Return | | 7.2 | 24,500,000 |

| | | | |
|---|---|---|---|
| Discount Received (as gain on disposal of business liability) | | 7.2 | 500,000 |
| Write Back of Provision for Doubtful Debt | 1 | | - |
| Recovery of Bad Debts | 2 | 25 | - |
| Gain on Disposal of Business Asset (Land) | 3 | 7.2 | 500,000 |
| Miscellaneous Income | | 7.2 | 200,000 |
| Total Inclusions (I) | | | 25,700,000 |
| Deductions: | | | |
| Interest Expenses | 4 | 14 | 1,000,000 |
| Cost of Trading Stock | 6 | 15 | 15,200,000 |
| Repair & Improvement Expenses | 7 | 16 | 1,050,000 |
| Pollution Control Cost | | 17 | - |
| Research & Development Cost | | 18 | - |
| Depreciation | 7 | 19 | 2,302,250 |
| Salaries | 8 | 13 | 5,000,000 |
| Carriage Outward | 8 | 13 | 150,000 |
| Provision for Doubtful Debt | 1 | | - |
| Bad Debts Written Off | 9 | 40 | 1,200,000 |
| Fines and Penalties | | 21 | - |
| Advertisement Expenses | 8 | 13 | 1,500,000 |
| Business Promotion Expenses | 8 | 13 | 200,000 |
| Legal Expenses | 8 | 13 | 550,000 |
| Loss on Sale of Furniture | 10 | | - |
| Provision for Staff Bonus | 11 | 13 | 407,000 |
| Total Deductions (B) | | | 28,559,250 |

| | | | |
|---|---|---|---|
| Assessable income from Business/ (Business Loss) (A-B) | | | (2,859,250) |

B. Calculation of Assessable Income from Investment:

| Particulars | W.N. Ref | Sec. Ref | Amount |
|---|---|---|---|
| Inclusions<br><br>Dividend from nonresident company | 12 | 9.2/54 | 1,000,000 |
| Rental Income | | 9.2 | 2,000,000 |
| Windfall Gain | 13 | 92 | - |
| Dividend from Resident bank | 13 | 92 | - |
| Assessable Income from Investment | | | 3,000,000 |

C. Calculation of Total Assessable Income and Taxable Income:
As per Sec. 20 of the Act, the business loss of any year can be set off from the investment income of same year. As such, total assessable income shall be Rs. 140,750.

As there are no deductions u/s 12, 12A and 12B; the total assessable income forms part of taxable income.

D. Calculation of Corporate Tax Liability
Corporate tax liability is 25% of Rs. 140,750, which is Rs. 35,187.50

Working Notes:

1. As the provision for doubtful debts are accounting estimates and not the expenditures qualifying the criteria of Sec. 13, these are not deductible expenses when such provisions are made. Similarly, reversal of such provision of doubtful debt cannot be included in income as the related expenses could not be allowed at the time of provision.
2. Under Sec. 25, Reversal of bad debts shall be adjusted on a rational basis when the bad debts expenses were allowed as expenses at the time of such write offs. Since, the bad debt was not allowed deductible as per Sec. 40 (3) at the time of write offs, the reversal of such bad debt should not be included in income.
3. As land is business asset of the company, no matter what the selling price is, the gain on disposal of land form part of business income.

4. Gain on Disposal of Land

As per Sec. 36, any gain on disposal of business asset shall be utilized towards set off of unrelieved carried forward business loss of previous years that could not be set off as a result of maximum period prescribed in Sec. 20 of the Act. As such, carried forward business loss of Rs. 800,000 can be deducted from gain on disposal of land. The net gain on disposal of land is Rs. 500,000 which shall be included in income.

5. As per Sec. 14, interest on loan utilized to generate income from business in any purpose is deductible for tax purpose. When the loan is utilized by directors, the interest on such loan is deemed to be the interest on loan utilized for personal purpose and as such, the interest to the extent loan utilized by directors shall not be deductible expense u/s 21 of the Act. Therefore, 40% of total interest expenses are deductible.

6. Calculation of Cost of Trading Stock

| | |
|---|---|
| Opening Stock | 4,000,000 |
| Add: Purchase | 15,000,000 |
| Add: Wages | 1,000,000 |
| Add: Carriage Inwards | 1,200,000 |
| Less: Purchase Return | 1,500,000 |
| Less: Closing Stock | 4,500,000 |
| Cost of Trading Stock | 15,200,000 |

Since the bank was closed, cash purchase of Rs. 1,500,000 is eligible for deduction.

7. Calculation of Eligible Depreciation & Repair and Improvement Expenses

| Particulars | Pool A | Pool B | Pool C | Pool D | Total |
|---|---|---|---|---|---|
| I. pening Depreciation Base | 15,000,000 | 1,800,000 | 2,500,000 | 2,200,000 | |
| II. bsorbed Additions | | | | | |
| 1. Up to Poush (100%) | | | | 15,000 | |
| 2. rom Magh to Chaitra (2/3) | | 400,000 | | 133,333 | |
| 3. rom Baisakh to Ashad (1/3) | | | 1,000,000 | | |

| | | | | | |
|---|---|---|---|---|---|
| III. isposal Proceeds | | 600,000 | | | |
| IV. epreciation Base (I+II-III) | 15,000,000 | 2,000,000 | 3,500,000 | 2,348,333 | |
| V. epreciation Rate | 5% | 25% | 20% | 15% | |
| VI. epreciation | 750,000 | 500,000 | 700,000 | 352,250 | 2,302,250 |

Repair & Improvement:

| Particulars | Pool A | Pool B | Pool C | Pool D | Total |
|---|---|---|---|---|---|
| I. epreciation Base (from IV above) | 15,000,000 | 2,000,000 | 3,500,000 | 2,348,333 | |
| II. % of (I) above | 1,050,000 | 140,000 | 245,000 | 164,383 | |
| III. ctual Repair & Improvement Expenses | 200,000 | 300,000 | 100,000 | 450,000 * | |
| IV. ower of (II) and (III) | 200,000 | 300,000 | 100,000 | 450,000 | 1,050,000 |

* The capitalized portion for accounting purpose of repair and maintenance expenses is also treated as part of repair and improvement expenses. Any further expenses after purchase of asset is routed through repair expenditure for tax accounting.

8. It is assumed that these expenses satisfy all conditions of Sec. 13 of the Act.
9. Bad debts written off are deductible expenses u/s 40 (3) (c) as these are written off after complying all provisions in the said section.
10. Loss on sale of furniture is treated as part of disposal proceeds in the calculation of depreciation base of Depreciable asset.
11. Bonus is the allocation of expenses for the purpose of distribution to the employee as per the statute (Bonus Act) of the country. These amounts will be taxable in the hand of employees as and when these are distributed. As per accrual basis of account being mandatory for company, these are accrued expense of the year satisfying all three conditions of Sec. 13 and deductible.
12. Dividend from nonresident company form part of investment income of the person.
13. These are final withholding payments and thus not included as per sec. 9 (3).

14. As the expenses for corporate social responsibility were paid to maintain relationship with local goons, these are not business expenses; as such, the expenses are not deductible.

Income from Employment

36. Answer the following questions:

a. Ram Krishna Niraula is managing director of M/s Kabita Enterprises P. Ltd., drawing basic salary of Rs. 120,000 per month. He is not eligible for any grades. He is deriving entertainment allowance, dearness allowance, uniform allowance and medical allowance of Rs. 10,000 p.m., Rs. 25,000 p.m., Rs. 18,000 p.m., and Rs. 25,000 per year respectively. The company has purchased a new vehicle worth Rs. 35 lakhs and provided the vehicle for personal purpose of Mr. Niraula. He resides in an apartment. He negotiated the rental charge of the apartment, entered into an agreement with the apartment owner for his residence at rental charge of Rs. 56,000 per month. The company reimburses the rental expenses and other utility expenses of the apartment of Rs. 65,000 per month in lumpsum. The company has entered into an agreement with Employee Provident Fund to deposit retirement contribution of its employee, as such the employer adds 10% of the basic salary and deducts 10% from the basic salary and deposits it to Employee Provident Fund. Mr. Niraula has an account at NIBL Retirement Fund, a retirement Fund approved by Inland Revenue Department, where he contributes Rs. 25,000 per month. He is entitled to one months' gross salary as festive allowance. The work station is based at Kathmandu. The employer has obtained Medical Insurance Policy for him paying annual premium of Rs. 50,000 to resident insurance company. 50% of the insurance premium is deducted at the time of payment of salary to Mr. Niraula. (*All information related to IY 2072/73)*

   You are required to calculate taxable income and tax liability of Mr. Niraula for IY 2072/73; use tax rates applicable for IY 2073/74 introduced by order as per Samayik Kar Asuli Ain, 2012.

b. Ram Binod is Chief of Marketing Department of M/s Noodles Production P. Ltd., a leading noodles production house. He has attained the age of 65 and resigned from the company. The company, knowing that Mr. Binod has crucial information of supply chain of the company, offered him not to join any rival companies for next three years for which it will be paying Rs. 10 Lakhs per annum as compensation. Mr. Binod agreed the proposal of the company.

   Mr. Binod is unknown about the tax implication of described arrangement and sought your help to make him understand about the same. Suggest the possible tax implication as per Income Tax Act.

c. Tax officer completed the assessment of Taxes withheld by ABC Limited and raised the following notes to continue with assessment of additional Withholding Tax Liability:

   i. The company has provided lunch facilities to all its staffs through the canteen in the premise of the company. All staffs are free to choose any combination of meals offered with nominal fee. The additional cost on such meals is borne by the employer, which is

Rs. 1,200,000 for IY 2072/73. Since the amount so borne by the employer is other payments related to employment, thus, the amount should be included as part of employment income. As the company has not included such amounts in employee's income, the same shall be included and revised tax shall be calculated.

ii. The company paid gratuity to some of its employees during IY 2072/73, on retirement of these employees. As gratuity is retirement payment and retirement payments form part of employment income u/s 8 (2), the gratuity should be included in income. Since the company has deducted 15% Withholding Taxed on such payments without including the amount in income calculation u/s 87, the company's practice is wrong; and such shall be adjusted accordingly.

iii. The company is required to follow accrual basis of accounting for tax purpose u/s 22 of the Act. As such, the company has made provision for gratuity, accumulated unavailed leave and other retirement benefits for each of the employee and charged the same to Income statement of the company. However, the company failed to include the same in the calculation of employee's tax liability as per Sec. 87 of the Act. Therefore, the calculation of tax liability of each individual calculated under Sec. 87 shall be revised after including such amounts.

You are the tax consultant of ABC Limited. The management seeks your support to deal with the contention of tax officer in the above cases. You are required to advise the client.

d. As a tax expert, provide your professional opinion on the inclusion of the following amounts in the income as per Income Tax Act:

i. Your client conducts a Sporting Events in its anniversary every year, where only the employee of your client is eligible to participate. It distributes gold medal, silver medal and bronze medal for each participant winning the first, second and third place respectively. Your client opines that since it is prize, the market value of such medals shall be treated as Windfall gain and tax shall be calculated accordingly.

ii. Your client is running out of money and as such, it pays the salary of each employee by providing the product it sales. Ms. Nikita, an employee of your client receives 3 cartoons of such product as salary, the cost of which is Rs. 15,000 per cartoon and market value is Rs. 18,000 per cartoon. Your client wants to include the cost of the product as part of the employment income of Ms. Nikita.

iii. Your client is an individual wishing to start up a business dealing in different food items. Unknown about the tax rates for the individuals; it seeks your professional help on tax rates applicable to an individual. You are required to advise your client about the tax rate applicable to an individual under Schedule 1 of Income Tax Act.

Answer:

a. Calculation of Assessable Income from Employment

| Particulars | W.N. Ref | Sec. Ref | Amount |
|---|---|---|---|
| Salary | | 8.2 | 1,440,000 |

| | | | |
|---|---|---|---|
| Entertainment Allowance | | 8.2 | 120,000 |
| Dearness Allowance | | 8.2 | 300,000 |
| Uniform Allowance | | 8.2 | 216,000 |
| Medical Allowance | | 8.2 | 300,000 |
| Vehicle Facility | 1 | 8.2/27 | 7,200 |
| Reimbursement of Rental and utility Expenses | 2 | 8.2/27 | 780,000 |
| Contribution to Retirement Fund account of employee by employer | | 8.2 | 144,000 |
| Festive Allowance | | 8.2 | 120,000 |
| Payment of Medical Insurance Premium by employer, as 50% is borne by him | | 8.2 | 25,000 |
| Assessable Income from Employment | | | 3,452,000 |

Calculation of Total Assessable Income, Taxable Income & balance taxable income

| Particulars | W.N. Ref | Sec. Ref | Amount |
|---|---|---|---|
| Assessable Income from Business | | | - |
| Assessable Income from Employment | | | 3,452,000 |
| Assessable Income from Investment | | | - |
| Assessable Income from Windfall Gain | | | - |
| Total Assessable Income | | | 3,452,000 |
| Less: Allowable Deductions: | | | |
| A. ontribution to Approved Retirement Fund Minimum of Following:<br>a. ctual 588,000<br>b. /3rd of Assessable Income 1,150,733<br>c. | | 63 | 300,000 |

| | | | |
|---|---|---|---|
| aximum 300,000 | | | |
| B.<br>ontribution u/s 12B<br>C.<br>onation u/s 12 | | | -<br><br>- |
| Taxable Income | | | 3,152,000 |
| Less: Reductions availed under Sec 1 of Schedule 1 | | | |
| Reduction availed for residing in remote area | | | - |
| Reduction for foreign allowance | | | - |
| Reduction in case of pension income | | | - |
| Reduction in case of Incapacitated person | | | - |
| Reduction in case of payment of investment insurance premium | | | - |
| Reduction in case of payment of medical insurance premium to resident insurance company (lower of actual or Rs. 20,000; i.e. lower of Rs. 50,000 or Rs. 20,000) | | | 20,000 |
| Balance taxable Income | | | 3,132,000 |

Calculation of Tax Liability:

| | | |
|---|---|---|
| 1st Rs. 350,000 | 1% | 3,500 |
| Next Rs. 100,000 | 15% | 15,000 |
| Next Rs. 2,050,000 | 25% | 512,500 |
| Balance Rs. 632,000 | 35% | 221,200 |
| Total tax liability | | 752,200 |

Working Notes:

1. Vehicle facility to employee is quantified as 0.5% of khai paai aaeko talab, which has been interpreted as sum of basic salary and grade drawn by the employee during the year from the employer providing such facility by Income Tax manual issued by IRD. Therefore, the amount to be included is 0.5% of 1,440,000, i.e. Rs. 7,200
2. As the company reimburses the apartment rent and utilities expenses in lumpsum, this is not accommodation facility but the facilities where the actual cost of employer

shall be included in income of employee. Therefore, the amount to be included is Rs. 65,000 p.m.

3. Individual assessment is assumed.

b. As per Sec. 8 (Gha), any payment in connection to acceptance of any terms of employment shall be included as part of employment income. As per Sec. 22, a natural person shall follow cash basis of accounting while calculating his/her employment income. As such, the amount received by Mr. Ram Binod against the acceptance of conditions not to serve rival organization of the current employment should be a part of employment income. Such amount shall be included in income during the IY when such amount is received in cash.

c.

i. As per Sec. 8 (3) (Kha), Meals or refreshments provided in premises operated by or on behalf of an employer to the employer's employees that are available to all the employees on similar terms shall not form part of employment income of the employee. As such, the amount is exempted from employment tax and the company's treatment not to include the amount is correct. The tax officer's contention in this regard is not correct.

ii. As per Sec. 8 (3) (Ka), final withholding payments shall not form part of employment income. Payment of gratuity by a resident person attract withholding taxes at 15% at the time of payment u/s 88 (1) of the Act, and such payments are final withholding u/s 92 of the Act. As Sec. 8 (3) expressly require not including this final withholding income as part of employment income, the treatment of the company is correct.

iii. As per Sec. 22 of the Act, employment income of a natural person must be computed following cash basis of accounting. Rule 29 of the Income Tax regulation requires an employer to withhold tax on installment basis by computing the tax liability of each employee as if the employee is calculating his/her tax liability. Since, gratuity, leave encashment, etc. are due to be paid at the time of retirement, these amounts form part of income only when these payments are made cash. As such, the company's treatment is correct.

d.

i. As per Sec. 8 (2) (ka) of Income Tax Act, prize received in connection to employment is part of employment income. When an employer conducts any competition within the employee, the payment of prizes is considered part of employment activities. Therefore, as prize is received in connection to employment, these form part of employment income and not treated as windfall gain. The market value of each medal shall be included in income while employee tax liability by the employee.

ii. As per Sec. 27 (1), when any payment is made in kind, the market value of such kind shall be included as part of income. As such, Mr. Nikita's income shall include market value of the product not the cost in the given case.

iii. Hint: Refer Sec. 1 of Schedule 1 of the Act. It is expected that all provisions must be cited.

Income from Investment

37. From the following information, calculate tax liability of Mr. A, a Nepali citizen who is a nonresident natural person for I.Y. 2072/73:

| | |
|---|---|
| Income earned from lending to a private company of Nepal (net of TDS) | Rs. 1,275,000 |
| House Rent Income earned | Rs. 900,000 |
| Dividend from Australian Company not having effective management in Nepal | Rs. 500,000 |
| Dividend from a partnership firm in Nepal | Rs. 300,000 |
| Royalty from a book publisher in Nepal (gross) | Rs. 250,000 |
| Income from right to use his land in Nepal by a water supplier against extraction of water (net of TDS) | Rs. 170,000 |
| House rent income from leasing of his property at Australia | Rs. 100,000 |
| Gain from a resident Investment Insurance company (net of TDS) | Rs. 190,000 |
| Market Value of Gift received by him at the time of attending AGM of a resident company | Rs. 80,000 |
| Gain on Disposal of land situated in Nepal (Disposal proceed of Rs. 5 Million) | Rs. 500,000 |

Mr. A is a married individual residing most of his time at Australia.

Answer:

Calculation of Assessable Income from Investment

| Particulars | Ref W. N. | Sec. | Amount |
|---|---|---|---|
| Income earned from lending to a private company of Nepal (net of TDS) | 1 | 9.3/92 | - |
| House Rent Income earned | 1 | 9.3/92 | - |
| Dividend from Australian Company not having effective | 2 | 6 | - |

| | | | |
|---|---|---|---|
| management in Nepal | | | |
| Dividend from a partnership firm in Nepal | 1 | 9.3/92 | - |
| Royalty from a book publisher in Nepal (gross) | 1 | 9.3/92 | - |
| Income from right to use his land in Nepal by a water supplier against extraction of water (net of TDS) | 1 | 9.3/92 | - |
| House rent income from leasing of his property at Australia | 2 | 6 | - |
| Gain from a resident Investment Insurance company (net of TDS) | 1 | 9.3/92 | - |
| Market Value of Gift received by him at the time of attending AGM of a resident company | 1/3 | 9.3/92 | - |
| Gain on Disposal of land situated in Nepal (Disposal proceed of Rs. 5 Million) | | 9.2 | Rs. 500,000 |
| Assessable Income from Investment | | | 500,000 |

As there are no deductions availed u/s 63, 12, 12A and 12B and no reductions available u/s 1 of Schedule 1 of the Act, the taxable income and balance taxable income is Rs. 500,000

The tax rate for nonresident natural person is 25%. As such, tax liability is Rs. 125,000.

Working Notes:

1. Payments attracting withholding taxes u/s 87, 88, 88A and 89 are final withholding for a nonresident person. Thus, the amounts are not included in income.
2. Nonresident person is required to pay tax in Nepal on such incomes which have source in Nepal. Dividend from Australian company and rental income from leasing of property in Australia have source in Australia, as such, these are not taxable u/s 6 of the Act.
3. As gift given by company in AGM is distribution of profit, it is assumed that tax has been withheld at the time of giving gift and is final withholding for nonresident person.
4.

Mixed Provisions

38. From the following information, calculated eligible interest expenses u/s 14, pollution control cost u/s 17, Research & Development Cost u/s 18 and Donation u/s 12(1) and 12 (2) of a company:

| | |
|---|---|
| Sales | Rs. 10,000,000 |
| Interest Income | Rs. 100,000 |

| | |
|---|---|
| Salaries & wages | Rs. 800,000 |
| Opening Stock of Trading Assets | Rs. 2,000,000 |
| Purchases (including a cash purchase of Rs. 100,000 even when the banking facility was available and without having any unavoidable compulsion for cash payment) | Rs. 2,800,000 |
| Closing Stock of Trading Assets | Rs. 800,000 |
| Repair & Improvement Cost (eligible as per Income Tax Act) | Rs. 200,000 |
| Total expenditure to install Pollution Control Equipment | Rs. 2,000,000 |
| Research expenditure | Rs. 1,000,000 |
| Development Expenditure | Rs. 200,000 |
| Interest Expenses to Banks | Rs. 100,000 |
| Interest Expenses to controlling exempt person | Rs. 1,500,000 |
| Donation to an Exempt Organization | Rs. 200,000 |
| Depreciation (eligible as per Income Tax Act) | Rs. 500,000 |

Answer: Calculation of eligible interest expenses u/s 14, pollution control cost u/s 17, Research & Development Cost u/s 18 and Donation u/s 12(1) and 12 (2) of a company (using interpretation of Income Tax manual:

| Particulars | Expense eligible u/s 14 (2) | Expense eligible u/s 17 | Expense eligible u/s 18 | Donation eligible u/s 12(1) & 12(2) |
|---|---|---|---|---|
| Sales | 10,000,000 | 10,000,000 | 10,000,000 | 10,000,000 |
| Interest Income | | 100,000 | 100,000 | 100,000 |
| Inclusions (A) | 10,000,000 | 10,100,000 | 10,100,000 | 10,100,000 |
| Salaries & wages | 800,000 | 800,000 | 800,000 | 800,000 |
| Cost of Trading Stock | 3,900,000 | 3,900,000 | 3,900,000 | 3,900,000 |
| Repair & Improvement Cost (eligible as per Income Tax Act) | 200,000 | 200,000 | 200,000 | 200,000 |

| | | | | |
|---|---|---|---|---|
| Total expenditure to install Pollution Control Equipment | 2,000,000 | - | 2,000,000 | 2,000,000 |
| Research expenditure | 1,000,000 | 1,000,000 | - | 1,000,000 |
| Development Expenditure | 200,000 | 200,000 | - | 200,000 |
| Interest Expenses to Banks | - | 100,000 | 100,000 | 100,000 |
| Interest Expenses to controlling exempt person | - | 1,500,000 | 1,500,000 | 1,500,000 |
| Depreciation (eligible as per Income Tax Act) | 500,000 | 500,000 | 500,000 | 500,000 |
| Total Deductions (B) | 8,600,000 | 8,200,000 | 9,000,000 | 10,200,000 |
| Adjusted Taxable Income (A-B) | 1,400,000 | 1,900,000 | 1,100,000 | (100,000) |
| 50% of ATI | 700,000 | 950,000 | 550,000 | - |
| Interest Income | 100,000 | | | |
| Max. Eligible | 800,000 | 950,000 | 550,000 | - |
| Actual under respective provision of the Act | 1,500,000 | 2,000,000 | 1,200,000 | 200,000 |
| Max. | | | | 100,000 |
| Eligible | 800,000 | 950,000 | 550,000 | - |
| Add: Interest Exp to BFI | 100,000 | - | - | - |
| Total Eligible | 900,000 | 950,000 | 550,000 | - |

**PART B : VALUE ADDED TAX**

1. Answer the following questions:
   a. Rambo Noodles Industries P. Ltd. is newly established noodles industries and has started producing noodles in the brand "Miththo Chauchau". As part of its promotional activities, the company set up some stalls in major cities and district headquarters of Nepal and distributed 800,000 (75gm) packets of "Miththo Chauchau" as sample, which costs Rs. 8 per 75gm packet. The market value is yet to be decided by the company.
   Quoting the relevant provisions of VAT Act, describe whether VAT is applicable on the above transactions.

   Show your acquaintance with the provisions of VAT regulation regarding the recording formalities when goods are distributed as sample.

   b. Nepal Overseas Pashmina Industries P. Ltd. has a Sales Outlet at Thamel, from where it sells its Pashmina Products in foreign currency. The details of transactions during 28th Shrawan 2073 are as follows:

| Particulars | Amount | Exchange Rate on date of transaction (NPR per FCY) | | Exchange rate when the amounts were deposited (NPR per FCY) | |
|---|---|---|---|---|---|
| | | Buying Rate | Selling rate | Buying Rate | Selling rate |
| Sales in Pound Sterling | 1,200 | 150.50 | 152.15 | 155.25 | 156.80 |
| USD Sales | 1,000 | 104.23 | 104.94 | 106.28 | 107.04 |
| Sales in Euro | 2,200 | 123.23 | 124.04 | 128.05 | 128.67 |

   Based on the above fact:

   i. Calculate taxable value and VAT to be collected in the above cases.
   ii. Can the outlet issue VAT Invoice in Foreign Currency? If not so, what is the procedure for issuing invoice when the sales are affected in Foreign Currency?

   c. Ram Krishna Kanajo wants to set up a business in Nepal, which deals exclusively in VAT attractive products. He does not expect to make large sales, and believes his sales would be around Rs. 45-48 lakhs in any year. He further wants to obtain business loan from M/s New Business Commercial Bank Ltd., which is tentatively around Rs. 15 Lakhs at 10% p.a. to manage his business. His major supply line is Line Agencies of

Government of Nepal. He is commerce graduate and do not have knowledge of VAT; but he has heard of VAT and he wants to conduct business after fulfilling all compliance requirement. He has the following queries, he noted down in his diary regarding the Value added tax:

- Who is required to register for VAT? Who are exempted from VAT registration requirement?
- Where should he visit for registration purpose? What should he do to get registered?
- Based on his business plan, is he required to get registered for VAT?
- If he has to get registered for VAT, what are the formalities he has to observe?

As such, he appointed you as his tax advisor. You are required to advise him as per Sec. 10 of VAT Act, 2052.

d. Ram Preet Agrahari is a trader of liquor items registered for VAT purpose. During the month of Bhadra 2073, he has the following transactions:

- Sales to the final consumer (not a registered person), 100 cartoons of Tuborg beer with MRP of Rs. 3,000 per cartoon at discount of 5% on sales price.
- Sales to registered persons, 1000 cartoons of Turborg beer with MRP of Rs. 3,000 per cartoon at discount of 6% on sales price.

He collected VAT on the selling price after discount. All taxable purchases during the month were Rs. 2 Million excluding VAT. He paid the difference of VAT collected on sales and purchases to the government revenue. As per IRD's notification, the trading of liquor items can be done only when the maximum retail price at different level of such items are published in national daily by the authorized distributor or manufacturer. As such, Mr. Agrahari's business also falls under the same category.
Tax Officer exercised the power under Sec. 20 of VAT Act on Mangsir $10^{th}$ 2073, and revised the VAT assessment of month of Bhadra. He argued that the VAT collected on sales by Mr. Agrahari must be Rs. 429,000 instead of Rs. 403,650.
Is the contention of tax officer correct?

e. M/s MNJ Exporting House is a manufacturer of handicraft products, which exports majority of its products. The following are the details of transactions of seven consecutive months for the person:

| Month | Total Sales | Purchase | Export Sales |
|---|---|---|---|
| Baisakh | 500,000 | 600,000 | 225,000 |
| Jestha | 520,000 | 500,000 | 130,000 |
| Ashad | 600,000 | 500,000 | 270,000 |
| Shrawan | 450,000 | 500,000 | 157,500 |

| | | | |
|---|---|---|---|
| Bhadra | 320,000 | 500,000 | 144,000 |
| Ashwin | 400,000 | 500,000 | 100,000 |
| Kartik | 350,000 | 300,000 | 125,000 |

Calculate:

- VAT collected on sales and paid on purchases for each month
- Amount of VAT payable or carried over excess Input tax Credit

Answer:

a. As per Sec. 5, VAT is applicable on import of goods or services into Nepal, export of goods or services from Nepal and transaction of goods or services inside the territory of Nepal.
Transaction as per Sec. 2 (Kha) means supply of goods of services.

The definition of Supply includes the act of selling, distributing, exchanging of goods or services with or without consideration.

It means, the act of distribution without consideration is also a part of transaction, and if the transaction is taxable as per the Act (i.e. not covered by Schedule 1 of the Act), VAT is applicable on it. As such, Rambo Noodles act of free distribution of noodles is taxable.

**Records to be maintained for Goods distributed as Sample (Rule 24)**

The following details shall be maintained by the registered person in relation to goods distributed as sample:

- Details of goods received or distributed as sample for promotion of business
- Details of Goods received or distributed free of cost

b.

i. As per Rule 21, invoice shall be issued in Nepalese currency by the converting the FCY into NPR using the rate prescribed by IRD at the time of supply of goods or services, when goods or services are supplied in Foreign Currency.
In the given case, the exchange rate to be used shall be Selling rate of date of transaction.

As such, taxable value and VAT is as follows:

| Particulars | Amount | Selling rate | Taxable Value | VAT Liability |
|---|---|---|---|---|

| | | | | |
|---|---|---|---|---|
| Sales in Pound Sterling | 1,200 | 152.15 | 182,580 | 23,735.4 |
| USD Sales | 1,000 | 104.94 | 104,940 | 13,642.2 |
| Sales in Euro | 2,200 | 124.04 | 272,888 | 35,475.44 |

ii. No, the outlet cannot issue VAT invoice in Foreign Currency. As per Rule 221, in case the supplier receives consideration against the supply of goods or services in Foreign Currency, the supplier shall issue a tax invoice in Nepali currency by converting the foreign currency into local currency applying the exchange rate as prescribed by Nepal Rastra Bank for the date of transaction.

c.

i. As per Sec. 10 of the Act, a person dealing is taxable transaction shall get registered for VAT purpose. Sec. 9 of the Act exempts small businesspersons dealing to the extent of prescribed turnover from VAT registration even in the cases where the person deals in taxable transaction.

Rule 6 of VAT regulation prescribes such turnover for a period of consecutive 12 months to be Rs. 50 Lakhs for person dealing in goods and Rs. 20 Laks for persons dealing in services or mixed transaction of goods and services.

Similarly, as per Rule 7 (5) of VAT regulation, any person fulfilling any of the following two conditions shall get registered for VAT purpose:

- In case the person obtains business loan exceeding Rs. 10 Lakhs annually from any banks or financial institutions.
- In case the tax officer finds that the stock is greater than the amount prescribed by IRD as per the nature of goods at the time of investigation

The person dealing exclusively in goods and services covered by Schedule 1 of the Act and small businessperson having turnover to the prescribed limit (i.e. Rs. 50 Lakhs for person dealing in goods and Rs. 20 Laks for persons dealing in services or mixed transaction of goods and services) are exempted from VAT registration.

ii. He should visit respective Inland Revenue Department or Taxpayers' service office based on his location of business for the registration.

He should file an application as per Sec. 10 of the Act. The time limit to file application shall be:

- In case of a person dealing in taxable transaction after the implementation of the Act, the person shall make an application in the prescribed format before the commencement of business.

1. This is the case when the person estimates its business to exceed Rs. 50 lakhs or Rs. 20 Lakhs as the case may be, during 12 months period.
2. In case of a person that estimates the turnover of the business to not exceed Rs. 50 Lakhs or 20 lakhs, as the case may be, during any 12 months period and does not register itself as per the exemption granted u/s, but the turnover exceed Rs. 50 lakhs or Rs. 20 Lakhs, as the case may be, in last 12 months: the person shall apply for VAT registration with 30 days of happening of such event for registration
3. In case of a person, the transaction of which was exempted under Schedule 1 of the Act and which becomes taxable as a result of amendment in VAT Law: the person shall apply for registration within 30 days of amendment in law
4. In case of a partnership firm, the application shall include complete details of partnership

After filing the application, tax officer shall examine the application where s/he may demand additional documents and details if s/he deems it necessary while examining the documents, details and application for registration purpose. The applicant shall provide such additional documents and details within 7 days of demand by tax officer.
In case the person dealing exclusively in exempted items specified in Schedule 1 of the Act applies for registration, the tax officer shall notify the matter of failure to registration within 7 days of application to the applicant.
After examination of application, In case the tax officer deems it appropriate to register the person, the tax officer shall issue a registration certificate along with the registration number within 30 days of making of application.
The Permanent Account Number issued by IRD for Income Tax purpose is also used for VAT purpose.

iii. As he is obtaining business loan exceeding Rs. 10 Lakhs annually, he should get registered for VAT purpose.

iv. The formalities to be observed are:

1. He must submit VAT return monthly.
2. He must display his PAN number in eye-catching place.
3. He must issue VAT Invoice.
4. He must use his PAN number in the following:
   - Documents relating to income tax;
   - Documents relating loan application for commercial or industrial purpose from any bank or finance company for an amount of Rs. 1 lakh or more;
   - Documents relating to import and export.
   - Documents relating to VAT (invoice, credit note, debit note, purchase book, sales book etc.) or excise or custom

d. As per Sec. 14 (7), where IRD has issued a notification to taxpayer to conduct transaction after publishing maximum retail price of such goods, the taxpayer shall issue VAT invoice on goods or services at the maximum retail price published while conducting transaction with non registered person.
This means, VAT shall be collected on MRP while conducting transaction with unregistered person, and not with the registered person.

In the given case, VAT on sales to final consumer (not a registered person) shall be based on the retail price before discount, i.e. VAT shall be collected as 13% of Rs. 3,000 per cartoon, which comes to Rs. 39,000 for 100 cartoons.

When the sales are made to registered persons, VAT must be collected on discounted price of Rs. 2,820 per Cartoon. VAT per cartoon = Rs. 366.60 and for 1000 cartoons is Rs. 366,600.

Total VAT collected on Sales shall be Rs. 405,600.

Hence, the tax officers' contention and Mr. Agrahari's collection of VAT, both, are incorrect as per VAT Act.

e. **Calculation of VAT Collected on Sales, Paid on Purchase, Excess VAT and the treatment of such excess VAT (In '000)**

| Month | Total Sales | Purchase | Export Sales | Local Sales | VAT on Sales | VAT on Purchase | % of Export sales | Excess VAT | Tretament of Excess VAT |
|---|---|---|---|---|---|---|---|---|---|
| Baisakh | 500 | 600 | 225 | 275 | 35.75 | 78 | 45% | 42.25 | Note 1 |
| Jestha | 520 | 500 | 130 | 390 | 50.7 | 65 | 25% | 14.3 | Note 2 |
| Ashad | 600 | 500 | 270 | 330 | 42.9 | 65 | 45% | 22.1 | Note 1 |
| Shrawan | 450 | 500 | 157.5 | 292.5 | 38.025 | 65 | 35% | 26.975 | Note 2 |
| Bhadra | 320 | 500 | 144 | 176 | 22.88 | 65 | 45% | 42.12 | Note 1 |
| Ashwin | 400 | 500 | 100 | 300 | 39 | 65 | 25% | 26 | Note 2 |
| Kartik | 350 | 300 | 125 | 225 | 29.25 | 39 | 36% | 9.75 | Note 2 |

Calculation of Carried Over Input Tax Credit

| **Month** | **Excess VAT** | **Remarks** |
|---|---|---|
| Baisakh | 42.25 | The amount may be claimed for refund by filing an application on Jestha, after which the tax set off cannot be made for any payable VAT of Jestha month. Assuming application for refund will be filed, there will be no carried forward for the month of Baisakh. |
| Jestha | 14.3 | Since, export sales is less than 40% of total sales during the month, this amount will be carried forward till Poush for set off. In case of excess failing to set off payable VAT of Ashad, Shrawan, Bhadra, Ashwin, Kartik and Mangsir; any residual excess can be claimed as refund. |
| Ashad | 22.1 | The amount may be claimed for refund by filing an application on Shrawan, after which the tax set off cannot be made for any payable VAT of Shrawan month. Assuming application for refund will be filed, there will be no carried forward for the month of Ashad. But the carried forward amount of Jestha of Rs. 14,300 is still outstanding for set off during following months. |
| Shrawan | 26.975 | Since, export sales is less than 40% of total sales during the month, this amount will be carried forward till Falgun for set off. In case of excess failing to set off payable VAT of Bhadra, Ashwin, Kartik, Mangsir, Poush and Magh; any residual excess can be claimed as refund. As such, total carried forward VAT is Rs. 14,300 of Jestha and Rs. 26,975 of Shrawan. |
| Bhadra | 42.12 | The amount may be claimed for refund by filing an application on Ashwin, after which the tax set off cannot be made for any payable VAT of Ashwin month. Assuming application for refund will be filed, there will be no carried forward for the month of Bhadra. But the carried forward amount of Jestha and Shrawan of Rs. 14,300 and Rs. 26,975 respectively is still outstanding for set off during following months. |
| Ashwin | 26 | Since, export sales is less than 40% of total sales during the month, this amount will be carried forward till Baisakh for set off. In case of excess failing to set off payable VAT of Kartik, Mangsir, Poush, Magh, Falgun, and Chaitra; any residual excess can be claimed as refund. As such, total carried forward VAT is Rs. 14,300 of Jestha, Rs. 26,975 of Shrawan and Rs. 26,000 of Ashwin. |
| Kartik | 9.75 | Since, export sales is less than 40% of total sales during the month, this amount will be carried forward till Jestha for set off. In case of excess failing to set off payable VAT of Mangsir, Poush, Magh, Falgun, Chaitra and Baisakh; any residual excess can be claimed as refund. As such, total carried forward VAT is Rs. 14,300 of Jestha and Rs. 26,975 of Shrawan, Rs. 26,000 of Ashwin and Rs. 9750 of Kartik. |

Notes:

It is assumed that the person applies for VAT refund when the conditions for refund are fulfilled.

1. The export sales for the month is greater than 40% of total sales, as such the excess VAT of each can be claimed as refund by filing an application immediately after the end of the month after filing VAT return. The VAT shall be refunded within 30 days of application in such cases.
2. As the export sales for the month is less than 40 % of total sales, excess VAT for the month shall be utilized to set off VAT liability for next six months, if any. When there remains excess VAT even after set off of any VAT liability of next six months, the person can file an application for refund. In such case the refundable amount must be refunded within 60 days of refund application.

2. Write short notes on:
   a. Special Provisions related to retention of VAT registration by Small Businesses having turnover less than the threshold prescribed
   b. Reverse Charging
   c. Refund of VAT to unregistered Person
   d. Cash grant/subsidy on the basis of VAT collection by registered person
   e. Administrative Review
   f. VAT Assessment

Answers:

a. As per Sec. 11 (1) (Cha), tax officer shall order for cancellation of registration of a person in case the turnover of consecutive 12 months of the registered person does not exceed Rs. 50 lakhs in case of persons dealing in goods and Rs. 20 Lakhs in case of person dealing in services or mixed transactions of goods or services.
   In such case the VAT registration status of a voluntarily registered person (person dealing in taxable transaction, but the turnover of consecutive 12 months of whom does not exceed Rs. 50 lakhs in case of persons dealing in goods and Rs. 20 Lakhs in case of person dealing in services or mixed transactions of goods or services) can by retained at the option of the voluntarily registered person. As per Sec. 11 (2) as inserted by the order of GON under Samayik Kar Asulu Ain, in case such person desires to retain its registration status, they need to file an application along with the verified VAT return of $12^{th}$ month of immediately preceding last 12 months in the format as prescribed by IRD. In such case, the registration status will be retained.

b. There are two reverse charging provision in the VAT Act, which are as follows:
   1. **Person receiving Service from foreigners** [Sec. 8-2]:
      Any person, whether registered or not, in Nepal receiving service from person outside Nepal (the person who is not registered for VAT purpose in Nepal) shall pay VAT for

that service. *In this case, person delivering the service cannot issue VAT Invoice, so the person receiving the service shall declare it and pay applicable VAT to Revenue Authority*. If the person is registered person, it can set off such payment as other purchases.

2. **Persons developing Commercial Complexes [**Sec. 8-3]
   Any person (registered or not) in Nepal engaged in construction of commercial buildings, apartments, shopping malls or similar constructions ***for commercial purpose***, the cost of which is more than Rs. 5 millions shall collect VAT on the construction cost from themselves and deposit it to Revenue Authority ***in case the construction work is not carried out through a registered person***.

   In case of failure to levy tax as such, the tax shall be assessed and recovered from the owner of such building or structure.

   *Definition of Commercial purpose*

   For the purpose of Sec. 8 (3), Commercial Purpose means construction of building, apartment, shopping complex or similar other structures prescribed by IRD for the purpose of sales or using such asset by accounting the asset as current or fixed asset.

c. The following are the provisions of VAT Act for the refund of VAT to unregistered persons:

1. **Diplomats (Sec. 25-1 (ka))**
   Tax paid by diplomatic persons privileged on a reciprocal basis from Ministry of Foreign Affairs, or person having diplomatic privileges engaged in Regional or International Organization or missions shall be eligible for refund.
   The application for refund shall be made directly to Inland Revenue Department.
   *Conditions for refund (Sec. 25-1Ka)*
   The tax shall not be refunded for a purchase of less than Rs. 5,000 at a time; means *the diplomats shall make purchase of Rs. 5,000 or more for the expenditure to be eligible for VAT refund.* The person paying the VAT shall make the claim of refund.
   The application for refund shall be made directly to Inland Revenue Department.

   *Time period to apply for VAT refund (Sec. 25-1)*
   The refund application shall be filed within ***three*** years of such transactions.

2. **International institution (Sec. 25 (1 (kha))**
   Institutions or VAT paid by such institution for which Ministry of Finance has granted the privileges of tax exemption.
   The application for refund shall be made directly to Inland Revenue Department.

   *Time period to apply for VAT refund (Sec. 25-1)*
   The refund application shall be filed within ***three*** years of such transactions.

3. **Projects under bilateral or multilateral agreement (Sec. 25 (1 (Ga)))**
   Tax paid on projects operated undertaken within the state of Nepal under bilateral and multilateral agreement *for which Ministry of Finance has granted permission to exempt it from VAT.*
   The application for refund shall be made directly to Inland Revenue Department.

*Time period to apply for VAT refund (Sec. 25-1)*
The refund application shall be filed within ***three*** years of such transactions.

4. **Collection by mistake (Sec. 25 (1 (Gha) & Sec. 25-2)**
   Any tax collected by mistake shall be refunded. Such tax shall be refunded to the person who has actually borne the burden of tax.
   The application for refund shall be made directly to Inland Revenue Department.
   Time period to apply for VAT refund (Sec. 25-1)
   The refund application shall be filed within three years of such transactions.
5. **Tax refund to a foreign tourist (Sec. 25Ka)**
   *Conditions to be satisfied*
   ***All*** the following conditions shall be satisfied for the claim of refund:
   a. The foreign tourist visiting in Nepal shall leave Nepal from air transport,
   b. The tourist shall accompany such goods with himself while leaving Nepal, i.e. goods cannot be gifted in Nepal and it shall be taken away by the tourist; and
   c. The cost of goods shall be more than Rs. ***25,000.***

   *Service Fee on such Refund*
   The revenue authority shall deduct ***3% of refundable amount*** as service charge.

d. Group 11 of Schedule 1 of VAT Act contains the provision of Cash grant/subsidy to a registered person, in case the person sells taxable by issuing VAT invoice. Persons entitled to such facility and the degree of cash grant/subsidy are as follows:

| ***Name of Industry*** | ***Amount of Refund*** |
|---|---|
| Industry producing *Match Stick (producing only the match stick- not the match),* ***dhoop*** *(incest stick), Tyre, Tube* | Amount equal to the tax collected on sales ***less*** the tax paid on purchase |
| *Maida Industry* | Amount equal to the 25% of following:<br>VAT Collected on Sales<br>*Less:* VAT paid on purchases |
| *Sales of Mustard Oil, Vanaspati Ghee from domestic production, or other processed edible oil produced by Domestic Industries to Registered Persons*<br>*(This facility is not availed to packaging industries that import processed oil in bulk and sales it in Nepal through refilling in consumer packages)* | Amount equal to the 40% of following:<br>VAT Collected on Sales to Registered Person |

| | |
|---|---|
| *Sales of Taxable Production by Dairy Industries transacting Dairy Products* | 50% of VAT collected on Taxable Sales |
| *Sales of Products to VAT registered persons or auction house by Domestic Industries producing and processing Tea* | 50% of VAT collected on Taxable Sales to Registered Persons |
| *Sales of products to Registered Persons by Domestic Industries producing Sheet, Circles and Utensils using Scrap of Copper and Pittal* | 25% of VAT collected on Taxable Sales to Registered Persons |
| *Sales of products to VAT Registered Persons or Agencies of GON by Domestic Clothes Industry except for such Domestic Clothes industries that produces 100% **Suti Clothes*** | 70% of VAT collected on Taxable Sales to Registered Persons |
| *Domestic Clothes industries producing 100% Suti Clothes* | The amount as follows:<br><br>VAT Collected on Sales to any person whether registered or not<br>***Less***: VAT paid on Purchases |
| *Domestic Industries producing Cellular Mobile Phone-set or Persons importing it* | Refund of ***40% of*** VAT paid on purchase of Raw Materials or Finished Goods, in case the producer or importer produces evidence that the mobile set is sold to a registered persons. |
| *Domestic Industries producing Sugar Industries* | 90% of VAT collected on Sales to a registered person |

e. Administrative Review:

***Application for Review & Time Limit (Sec. 31Ka-1)***

Every person who is dissatisfied with the tax officer's decision of assessment of tax shall make an application for administrative review at Inland Revenue Department within 30 days of receipt of the Final Assessment Order.

***Extension of Time Limit for Application (Sec. 31Ka-2)***

In case the taxpayer cannot file application within 30 days of receipt of Final Assessment Order, the tax payer may file an application for extension of time limit to file Review Application within 7 days of expiry of such 30 days.

After receiving such extension application, the IRD may extend the deadline for Review Application for additional 30 days counted from the expiry of first deadline of 30 days, i.e. the maximum time limit to file a review application is 60 days from the date of receipt of notice.

***Formality to File Application (Sec. 31Ka- 6 & 31Ka-8)***

The taxpayer shall deposit 100% of undisputed tax amount and one-third of disputed tax amount before filing the review application. Such deposit shall not be refunded unless the final verdict on the issue is declared.

In case the taxpayer has not submitted any VAT return in connection to the dispute involved in Review Application, the taxpayer shall file such return prior to submission of Review Application. (Rule 34)

***Effect of Application (Sec. 31Ka-3)***

The Director General shall examine the documents and other proofs. In case the matters raised by the taxpayer is true while examining documents and proofs, the DG shall nullify the decision of the tax officer and order for reassessment to the concerned tax officer or any other officer.

***Time Limit to Decide on Review Application (Sec. 31Ka-4 & 31Ka-5)***

The Department must decide on Review application within 60 days of filing of Review Application. In case of failure to do so, the taxpayer may deem the application be rejected and choose to appeal in Revenue Tribunal

f. VAT Assessment:
There are three types of VAT assessment under the Act,

- *Self assessment (Sec. 18)*
- *Jeopardy assessment (Sec. 22)*
- *Assessment by Tax Officer (Sec. 20)*

**Self-assessment:**

The registered person shall file a VAT return within 25 days of end of a tax period. The returns may be filed in documentary form or through electronic means, often called e-return. When such return filed to the tax office, the self assessment is deemed to be conducted.

**Assessment in case of Special Circumstances (Jeopardy assessment):**

In case there is sufficient basis to believe that any of the following conditions is happening; the tax officer, ***with prior approval of Director General,*** may assess and collect VAT:

- In case the taxpayer is leaving Nepal and there is chance of non recovery of tax, or
- In case the taxpayer is transferring, removing or concealing the asset and there is chance of non recovery of tax

**Assessment by Tax Officer**

***Grounds and Conditions for assessment by Tax Officer (Sec. 20 (1)***

Under the following grounds and conditions Tax Officer can make tax assessment:

- In case VAT return is not submitted within the time limit;
- In case of filing of an incomplete or erroneous return;
- In case of filing of a fraudulent return;
- In case the Tax Officer has a reason to believe that the amount of tax is understated or otherwise incorrect;
- In case the Tax Officer has a reason to believe that the taxpayer has caused *under-invoicing*;
- In case of supply to group companies through *under-invoicing*;
- In case person requiring registration operates business without registration;
- In case of sales without issuing invoices;
- In case an unregistered person collects the tax;
- In case a person does not deposit Reverse VAT levied u/s 8 (2) or 8 (3); or
- In case a person does not levy VAT on goods that are left to be used for taxable transaction for which input tax credit was enjoyed as per Sec. 17 (4)

3. Answer the following questions:

   a. Dairy Development Corporation is public enterprises dealing in dairy products. It sold following items, excluding VAT, during the month of Shrawan 2073:

| Particulars | Amount (NRs.) |
|---|---|
| Pasteurized Milk | 200,000 |
| Ice Cream | 500,000 |
| Rasbari, and other sweet items | 300,000 |

   The purchases during the month are sugar and additives for ice-cream and other sweet items of Rs. 100,000; excluding VAT.

   Calculate the amount of cash subsidy to M/s Dairy Development Corporation as per Schedule 1 of the Act, based on sales of VAT attractive items.

   b. Basulinga Sugar Mills is an industry located at Dhangadi producing sugar. During the month of Bhadra 2073, it has following transactions that is exclusive of VAT:

| Sales | Amount (NRs.) | Purchase | Amount (NRs.) |
|---|---|---|---|
| Sugar to unregistered persons | 1,200,000 | Sugarcane | 250,000 |
| Sugar to Registered Persons | 1,500,000 | Other taxable items | 100,000 |

Calculate the amount of cash subsidy as per Schedule 1 of VAT Act.

c. HNT P. Ltd. is a Maida industry located at Makwanpur. It produces Wheat flour and Maida. The details of transaction for the month of Ashad 2073 are as follows:

- Sales of Maida
  - To unregistered persons Rs. 432,000
  - To registered persons Rs. 505,000
- Sales of Wheat Flour Rs. 300,000
- Purchase of Wheat Rs. 500,000
- Telephone Expenses Rs. 8,000
- Petrol to operate Generator Rs. 40,000
- Salary Expenses Rs. 300,000
- Consultancy services from a VAT Registered Party Rs. 300,000

All figures above are exclusive of VAT.
Calculate the amount of cash subsidy by HNT P. Ltd. on the basis of sales of VAT attractive items.
Answer:

a. Pasteurized Milk is exempted from VAT. Sales of Ice Cream and Rasabari and other sweet items are VAT attractive on Sales.
As per Schedule 1 of the Act, *Sales of Taxable Production by Dairy Industries transacting Dairy Products is subject to cash grant of* 50% of VAT collected on Taxable Sales.

In this case, VAT collected on taxable sales is 13% of 800,000, which is Rs. 104,000.

Therefore, cash subsidy shall be 50% of VAT collected on Taxable Sales, which comes to Rs. 52,000.

b. As per Schedule 1 of VAT Act, *Domestic Industries producing Sugar Industries are entitled to cash subsidy to the extent of* 90% of VAT collected on Sales to a registered person.
In the given case, VAT collected on Sales to a Registered person is 13% of Rs. 1,500,000; i.e. Rs. 195,000; and cash grant is 90% of Rs. 195,000; i.e. Rs. 175,500.

c. As per Schedule 1 of VAT Act, cash grant to a maida industry producing Maida in Nepal is as follows:
25% of the result as follows:

i. VAT collected on Sales ***Less***
ii. VAT paid on purchases

In the given case, VAT collected on Sales is 13% of Rs. 937,000 (432,000+505,000), which is Rs. 121,810.
VAT on purchase is calculated as under:

| | |
|---|---|
| Purchase of Wheat | Non Taxable |
| Telephone Expenses (proportionate- 937/1237*13% of 8,000) | 787.78 |
| Petro to operate Generator (proportionate- 937/1237*13% of 40,000) | 3,938.88 |
| Salary Expenses | non Taxable |
| Consultancy Services (proportionate- 937/1237*13% of 300,000) | 29,541.63 |
| Total VAT on Purchase | 34,268.29 |

Therefore Cash subsidy= 25% of (121,810-34,268.29)= 21,885.43

4. Write short notes on:
   a. Debit and Credit Note
   b. Rights of Tax Officer under VAT Act
   c. Records to be maintained by dealer of Used Goods
   d. Tax Period
   e. Market Value Concept in VAT

Answer:
   a. Debit and Credit Note

For any change in matters of issued invoice due to any reason, the person shall issue debit note or credit note for such changes in value of the goods. Conceptually, person issuing invoice issues a credit note. Credit note is a crucial matter in tax accounting as many countries has policy of using *pre-printed credit notes issued by government*. Rule 20 has not prescribed format for debit or credit note, but person need to keep a register of such notes.
Debit or credit note include following information:

- Serial Number of the debit or credit note,
- Date of issue,
- Name, address and PAN of the supplier,
- Recipient's name, address, and PAN if a registered person,
- Serial number and date of the tax invoice concerned,
- Particulars of the goods or services and reason of issuing to credit or debit,
- Amount credited or debited,
- Tax amount credited or debited.

Credit or Debit Note shall be maintained in the issued note.

   b. R
   ights of Tax Officer under VAT Act

Value Added Tax Act has conferred following powers to a Tax Officer:

- Assessment of Tax by Tax Officer (Discussed in Chapter 15)
- Collection of Tax from VAT defaulter (Sec. 21)
- Assessment of Tax in Jeopardy (Discussed in Chapter 15)

- Power conferred to combat Tax Avoidance Schemes (Sec. 22Ka)
- Rights in relation to Examination & Review (Sec. 23)
- Purchase of Goods sold through Under-invoicing (Sec. 23Ga)
- Right to demand deposit or imprison a person or seizure (Sec. 23Gha)
- Right to Obtain Expert Service with Regard to Tax Assessment (Sec. 34Ka)

c. Records to be maintained by dealer of Used Goods

The Dealers of *USED GOODS* shall keep separate records for each deal of used goods, in case the purchase price of the goods exceeds Rs. 10,000. In case a registered person dealing used goods is found not to have satisfactorily maintained the records as prescribe, Tax Officer may impose VAT on the total selling price of the goods sold by such taxpayer, and the tax officer may issue a written order requiring him to pay such tax along with the next tax return. The following are the matters to be maintained in Sales and Purchase Book of Dealer of Used Goods:

**I. In relation to Purchase**

- Date of purchase
- Information as to the complete details of the goods
- Purchase price excluding VAT
- Tax Rate
- Tax Amount
- Total Amount paid

**II. In relation to Sales**

- Date of Sales
- Selling Price excluding VAT
- Difference between Selling Price & Purchase Price
- Rate of Tax
- Tax Amount
- Total Amount Received

d. Tax Period

It is the period prescribed by VAT Act & Regulation for the collection and submission of VAT return and VAT amount. The tax period is prescribed by Rule 26 as follows for different persons:

- **Every Nepalese Calendar Month as Tax Period (Rule 26-1)**

  The VAT Act has envisioned every Nepalese Calendar month as a separate tax period except in cases where the registered person opts bimonthly or trimester tax period as per the legal provisions. The tax period may be shorter than a month in case a person commences business at the middle of the month. For example, tax period for a person commencing business from Baisakh 25 begins from Baisakh 25 and ends on Baisakh end.

- **Bimonthly Tax period (Rule 26-2 & 26-3Ka)**

  In case registered person carrying on business related to hotel and tourism sector or production of brick desires to choose a bimonthly tax period, a bimonthly tax period is allowed for them.

  There are six tax periods during a fiscal year which covers Shrawan and Bhadra, Ashwin and Kartik, Marg and Paush, Magh and Falgun, Chaitra and Baisakh and Jestha and Ashad as tax period.
- **Trimester Tax period (Rule 26-3Kha)**
  In case a businessperson conducting transaction on newspaper or publication of newspaper (newspaper seller and publisher of newspaper) desires to opt for a four-monthly tax period, IRD may allow the persons to submit tax return on trimester (four-monthly basis).
- **Different tax period (Rule 26-2)**
  In case of a registered person that has maintained its accounts using software cannot generate the required report in Nepalese Calendar system; it may file an application to Tax Officer to adopt different tax period date with same period. If the Tax Office thinks it appropriate, the person may be granted a different tax period.
- **First Tax period (Rule 26-5)**
  First tax period of a registered person shall be period of day of registration to end of concerned tax period.
- **No-tax period (Sec. 11-2)**
  In case any registered person applied for cancellation registration, it need to file its VAT return within 3 months from apply for deregistration; if tax officer could not decide to deregistration, then such person (even it is registered person) need not file its tax return. Badly, if tax officer, decides to not to deregister, then VAT return from tax period when the decision is made, need to be filed.

e. Market Value Concept in VAT

Market value of supplied goods or services shall be determined on the basis of the fair value of consideration received or receivable in the transaction between unrelated independent parties at arm's length under similar circumstances as to characteristics, quality, quantity of materials, and any other relevant factors.

**Procedure for determination of Market Value (Rule 22)**

Tax Officer has right to fix the market price based on the transaction of similar goods. In case a Tax Officer cannot ascertain market price, the Director General has the right to prescribe the method on the basis of price of similar goods transacted by different suppliers.

5. As a tax expert, provide your professional opinion in the following cases:

a. Application of rule of "Circumstances beyond Control" relieves a person from payment of fees u/s 19 and interest u/s 26 of VAT Act

b. A branch office in London of a Kathmandu based VAT registered person is required to collect VAT on every tax attractive transactions while doing business in London

c. VAT shall not applicable on transfer of business to an unregistered heir of a VAT registered individual as a result of insanity of the individual

d. The term "Zero VAT" and "No VAT" has same meaning

e. There is only one VAT rate of 13% as per VAT Act

f. Telecommunication companies are required to collect VAT on telecommunication services when the service is provided, or invoice is issued or consideration is received; whichever happens earlier

g. The threshold for exemption of VAT registration for a person dealing only in goods listed in Schedule 1 of the Act is Rs. 50 Lakhs

h. Unregistered persons cannot collect VAT

i. When a tax officer demands VAT registration, the burden to prove that the conditions for registration as per VAT Act is met lie with the tax officer

j. The responsibility to submit VAT return is only upon the registered person



Answer:

a. Application of rule of "Circumstances beyond Control" relieves a person from payment of fees u/s 19. Interest u/s 26 is applicable if the payable VAT could not be paid on due even in the event of application of Circumstances beyond control provisions.

b. VAT is levied on import of goods or services into Nepal, export of goods or services from Nepal, or transaction of goods or services within the territory of Nepal. In the given case, as the transaction by branch office in London is not an import or export or transaction within the territory of Nepal; VAT shall not be applicable on such transactions.

**c.** As per Sec. 5A, Under either of the following two conditions, value added tax will not be applicable on the *transfer of ownership of a business*:

(a) When a registered person sells its business to any other registered person; or

(b) A business is transferred to any inheritor after the death of an owner.

*In the said case, the transfer to legal heir is as a result of insanity of the registered person, and the transferee is not registered for VAT. As such, both the above two conditions are not satisfied which implies that VAT shall be collected on such transfer.*

d. The term "Zero VAT" and "No VAT" has different meaning, which is elaborated below:

| **Basis** | **Zero Rate** | **No VAT** |
|---|---|---|
| Rate of VAT | VAT is levied at Zero Percent | VAT is not levied at all |
| VAT Invoice | A VAT Invoice shall be issued as per the format prescribed by VAT regulation | VAT Invoice shall not be issued at all |
| Registration Requirement | The person dealing in Zero rated items shall be registered for VAT purpose. | The person dealing exclusively in No VAT items is relieved from registration formality |
| Other formalities as per the Act | The person dealing in Zero Rated Items shall observe other formality as per VAT Act, such as- maintenance of sales and purchase register duly certified from Tax Officer, submission of VAT return, etc. | The person dealing exclusively in No VAT items is relieved from all formalities to be observed as per the Act |
| List of Items | List of Zero rated items are prescribed in Schedule 2 of the Act | List of No VAT items are prescribed in Schedule 1 of the Act, but Schedule 1 also contains some VAT applicable items on which the producer is entitled to refund of VAT collected by it. |

e. As per Sec. 7 of the Act, there shall be a single VAT rate of 13%.
But the VAT rate on transaction of goods or services listed in Schedule 2 of the Act is 0% and there shall be no VAT for transactions of goods or services listed in Schedule 1 of the Act.

As such, the statement is partially correct.

f. As per Sec. 6 (3) (ka) of the Act, the time of supply of services by telecommunication service provider or such service provider that provides continuous service shall be at the time of issuance of invoice. Therefore, the VAT shall be collected at the time of issuance of invoice rather than earlier of service is provided, or invoice is issued or consideration is received.

g. As per Sec. 5 (3), there shall be no VAT for items listed in Schedule 1 of the Act. Sec. 10 (2) requires a person to get registered for VAT in cases when the person is involved in VAT attractive transactions. As such, person dealing exclusively in items of Schedule 1 is not required to get registered; no matter how much is its turnover for the year.

h. As per Sec. 15 (1), unregistered person cannot collect VAT. But Sec. 15 (3) of the Act listed the following persons, even when they are not registered for VAT purpose, requiring collection of VAT:

- Local Bodies (Village Development Committee, Municipality, District Development Committee)
- International agencies or diplomatic mission located in Nepal
- Nepal Government, or
- Public Enterprises dealing basically on exempted goods or services

Similarly Sec. 12A requires the national forest, community committee looking after community forest or owner of private forest collecting VAT while selling woods for commercial purpose, even if they are unregistered.

Therefore, unregistered persons may also collect VAT subject to the power given by the Act.

i. As per Sec. 5B of VAT Act, in case tax officer identifies that a person requiring registration as per the Act is conducting business without registration and reasonably believes so, s/he may demand VAT registration of such person.
In case the person defends the exemption of registration requirement as a result of turnover of the person for any period of consecutive 12 months not exceeding the threshold (i.e. Rs. 50 lakhs), the onus to prove the same is upon the person on whom the registration is demanded.

It means, the person with whom the registration is demanded must prove that he should not be registered, and it’s not upon tax officer to prove that registration is required.

j. Responsibility to file VAT return:

**Responsibility of a Registered Person**
The registered person is responsible to submit VAT Return.
**Responsibility of Rightful Beneficiary or Legal Representative (Rule 27)**

In case of death or permanent physical or mental incapacity of an individual, the tax officer may demand VAT Return from rightful beneficiary or legal representative of such persons assuming the end of tax period in the immediately preceding date of such death or incapacity.

**Joint or Several Responsibility of different Persons (Rule 28)**

The following persons have joint and several responsibilities over submission of VAT Return in the following conditions:

- In case when the registered person is a legal person: the director, chief executive or any employee prescribed by the Management
- In case when a registered legal person is liquidated or wound up: the liquidator
- In all other cases except as specified above: the person who has concern with registered person as prescribed by Tax Officer

As such, responsibility to file VAT return is not only upon a registered person.

6. Calculate VAT collected on Sales, Eligible Input Tax Credit and VAT liability based on the following information:

   a. The details of transactions during the month of Shrawan of M/s Importers Deal P. Ltd. having a publishing house and dealing in books and stationery items are as follows:

Sales:

| | |
|---|---|
| Sales of Printed books | Rs. 250,000 |
| Sales of Stationery Items- Others | Rs. 300,000 |
| Sales of e-book | Rs. 450,000 |

Purchase:

Import of stationery items

| | |
|---|---|
| Invoice Price | Rs. 400,000 |
| Insurance up to Birgunj Custom Office | Rs. 2,000 |
| Freight up to Birgunj Custom Office | Rs. 20,000 |
| Freight & Insurance from Birgunj Custom Office to Kathmandu | Rs. 12,000 |

Other expenses:

| | |
|---|---|
| Salary Expenses | Rs. 100,000 |

| | |
|---|---|
| Telephone Expenses | Rs. 20,000 |
| Diesel Purchased for office vehicle | Rs. 20,000 |
| Diesel consumed for office vehicle | Rs. 12,000 |
| Petrol for Generator used in office | Rs. 15,000 |
| Restaurant Expenses for potential supplier from India | Rs. 25,000 |
| Local Purchase of Stationery Items | Rs. 300,000 |
| Purchase of Office computer | Rs. 60,000 |
| Purchase of Aqua 100 Mineral Water for office purpose | Rs. 12,000 |
| Purchase of vehicle for managing director | Rs. 1,400,000 |

Additional Information:

i. The imported stationery items were released from custom office by keeping deposit as the custom office failed to fix the taxable value of the goods. The amount kept as deposit for VAT was Rs. 70,000.

ii. Of the total diesel purchased during the month, the company obtained various Abbreviated Tax Invoices for the expenses of Rs. 12,000.

b. Mr. X is a trader dealing in second hand vehicles. The following is the details of Mr. X's transactions during the month of Bhadra 2073. Calculate Taxable Value and VAT liability of Mr. X for the month of Bhadra 2073:

i. Purchase of second hand car Ba 6 Cha 7756 from President International, a VAT registered person at the cost of Rs. 400,000. President International charged VAT of Rs. 52,000 in addition to the selling price. Mr. X incurred Rs. 50,000 for repairs and denting painting of vehicle for which he paid Rs. 6,500 as VAT.
The vehicle was sold on Bhadra 15 at Rs. 900,000 (exclusive of VAT)

ii. Purchase of Jeep, Ba 5 Cha 5728, from Ram Narayan Bidari at Rs. 450,000. Mr. Bidari is not registered for VAT. He incurred Rs. 200,000 for repairs of the vehicle from an unregistered person; and sold the vehicle on Bhadra 28 at Rs. 630,000.

iii. Purchase of Santro car, Ba 7 cha 2235, from Hari Shankar Basnet at Rs. 1,200,000 and incurred Rs. 20,000 for repairs. In addition to repair cost of Rs. 20,000; he paid Rs. 2,600 as VAT to garage. The car is still in the stock.

iv. Sales of Car (Ba 1 cha 2278) on Bhadra 5 at Rs. 900,000 (excluding VAT). The car was purchased on Ashad at Rs. 650,000 (excluding VAT) from a VAT registered manufacturing concern. Mr. X incurred Rs. 126,000 including VAT for the repair of vehicle during the month of Shrawan.

What would be your answer if Mr. X's main business is not the dealing in second hand vehicles but something else and is selling his second hand asset?

Answer:

a.

A. Calculation of VAT Collected on Sales

| Particulars | W. N. | Taxable Value | VAT |
|---|---|---|---|
| Sales of Printed Book | 1 | - | - |
| Sales of Stationery Items- Others | | 300,000 | 39,000 |
| Sales of e-book | 2 | 450,000 | 58,500 |
| **Total VAT collected on Sales** | | | **97,500** |

B. Calculation of Eligible VAT Credit

| Particulars | W. N. | Taxable Value | VAT |
|---|---|---|---|
| Import of Stationery Items | 3 | - | - |
| Salary Expenses | 4 | - | - |
| Diesel purchased for office Vehicle | 5 | 20,000 | 884 |
| Diesel Consumed for Office Vehicle | 6 | - | - |
| Petrol for Generator used in Office | 7 | 15,000 | 1,657.50 |
| Restaurant Expenses for Potential supplier | 8 | - | - |

| | | | |
|---|---|---|---|
| from India | | | |
| Local Purchase of stationery Items | 9 | 300,000 | 33,150 |
| Purchase of Office Computer | 10 | 60,000 | 6,630 |
| Purchas of Aqua 100 Mineral water for office purpose | 11 | - | - |
| Purchase of Vehicle for Managing Director | 12 | 1,400,000 | 61,880 |
| **Total Eligible VAT Credit for the Month** | | | **104,201.50** |

C. VAT Payable on Service procured from Foreign Party not registered for VAT — Nil

D. Input Tax credit on Reverse Charging VAT as described in (C) above — Nil

E. Carried Over Excess VAT Credit from Previous Period(s) — Nil

**F. VAT Liability/ (Excess VAT Credit) (A-B+C-D-E)= — (6,701.50)**

Working Note:

1. Sales of Printed Book are exempted from VAT.
2. As per the order of Supreme Court, only the printed books are exempted from VAT and not the e-book. As such, e-books are taxable.
3. As per Rule 49 (3) of VAT Regulation, Custom office may release goods by demanding deposit when the taxable value of goods cannot be determined at the time of import due to any reason. In such cases where the goods are imported by providing cash deposit without determining taxable value, such deposit for VAT shall not be considered for Input VAT credit unless taxable value is determined. As the stationery items are released from custom office without determining taxable value, the deposit on release of such stationery items cannot be treated as part of eligible VAT credit.
4. These are exempted from VAT

5. Petrol used for office vehicle is included in No VAT Credit item, not the diesel. So, VAT Credit is eligible in purchase of diesel for office vehicle. As there are both taxable and non taxable sales, and use vehicle cannot be linked into taxable or non taxable transactions, there must be proportionate tax credit. But when abbreviated tax invoice is used, there shall be no tax credit on such purchases. As such, eligible VAT credit on purchase of diesel is Rs. 884 (850/100*13% of (20,000-12,000))

6. VAT Credit is available on purchase basis on production of invoice. As such, there shall be no treatment of consumption for VAT purpose.

7. Petrol used for office vehicle is included in No VAT Credit item. So, VAT Credit is eligible in purchase of petrol for use in generator. As there are both taxable and non taxable sales, and use of generator cannot be linked directly into taxable or non taxable transactions, there must be proportionate tax credit. As such, eligible VAT credit on purchase of petrol is Rs. 1,657.50 (850/100*13% of 15,000)

8. As per Rule 41, there shall be no VAT Credit for Entertainment Expenses.\

9. Stationery is used both for production of books and other taxable items. As such, there shall be proportionate VAT credit. As such, eligible VAT credit on purchase of stationery is Rs. 33,150 (850/100*13% of 300,000)

10. Computer is used both for production of books and other taxable items. As such, there shall be proportionate VAT credit. As such, eligible VAT credit on purchase of computer is Rs. 6,630 (850/100*13% of 60,000)

11. As per Rule 41, purchase of beverages attract no VAT credit unless as part of main business.

12. As per Rule 41, there shall be partial tax credit, i.e. 40% on VAT paid on purchase, while purchasing vehicle for administrative purpose by the person dealing exclusively in taxable items. In case the vehicle for the said purpose is used by the person having mixed transaction of taxable and non taxable items, the VAT credit shall be proportionate on partial. Therefore, eligible VAT Credit is Rs. 61,880 (850/1000* 13% of 40% of 1,400,000)

b. As per Rule 33, the taxable value for the person dealing in used goods shall be profit between selling price and purchase price of each good. The purchase price shall be VAT included purchase price, and includes all direct cost to bring the asset to saleable condition.

It means, the taxable value of the used goods in case it is sold by dealer of used goods can be determined only at the time of sales of goods. Based on this provision, the VAT liability for the month of the trader when the trader is dealing in used goods on the basis of provided information is as under:

| Vehicle No. [A] | Selling Price (excluding VAT) [B] | Purchase price including VAT [C] | Other direct cost including VAT [D] | Taxable Value [E= B-C-D] | VAT amount [E*13 %] | Remarks |
|---|---|---|---|---|---|---|
| Ba 6 Cha 7756 | 900,000 | 452,000 | 56,500 | 391,500 | 50,895 | |
| Ba 5 Cha 5728 | 630,000 | 450,000 | 200,000 | (20,000) | - | Since there is no profit, taxable value is Nil and no VAT Liability |
| Ba 7 Cha 2235 | Still in Stock | | | | | VAT cannot computed as taxable value cannot be determined until the vehicle is at stock |
| Ba 1 Cha 2278 | 900,000 | 734,500 | 126,000 | 39,500 | 5135 | |
| **Total VAT Liability** | | | | | **56,030** | |

If Mr. X's main business was not the dealing in second hand vehicles and was selling his second hand asset, the taxable value would be the selling price of the goods sold, which is Rs. 2,430,000 and the VAT shall be collected as 13% of Rs. 2,430,000 (total selling price excluding VAT of three vehicles sold).

7. You have been deputed as audit staff by your principal in one of his client's audit. You identified the following cases. You are required to prepare a note on possible impact on client's profit or loss of FY 2072/73 due to your client's failure in the following cases:

a. A tax officer inspected the warehouse of your client. After inspection, he found that the goods are held in excess of limit prescribed by IRD and instantly ordered your client for VAT registration as per the power conferred in Sec. 5B of VAT Act. Your client did not honor the tax officer's order; neither had it defended the claim of tax officer. The

officer's order was communicated to your client on 1st Chaitra 2072, and your client is a dealer of wine.
Would your answer be different if it were brick producer and choosing bi-monthly tax period?

b. A tax officer visited your client's premise. But your client obstructed him to inspect records and documents.

c. You are auditing the financial statements of FY 2072/73. On review for compliance of VAT Act and Regulation, you identified that you client is maintaining sales register and purchase register. Further enquiry revealed that the client failed to get the registers attested from tax officer till the period of your audit.

d. Your client is dealing in sanitary ware and its business turnover is less than Rs. 50 Lakhs. As it was dealing in sanitary ware in Kathmandu Metropolitan City, as per the requirement of previous VAT Act before the amendment by Finance Bill 2072, it is registered for VAT purpose. It has not cancelled its registration yet. But as it heard that the Finance Bill 2072 increased the turnover threshold to Rs. 50 Lakhs for registration, assuming that it need not file VAT return; it did not file any VAT return for the year 2072/73. There is no VAT liability during the year, as the person's input tax credit is greater than VAT collected on Sales.

Answer:
Students are expected to know that the impact of fines and penalties as expenses would be in the Profit and loss account of the client.

a. When tax officer demands VAT registration, the person shall register for VAT purpose or submit proof and satisfy the tax officer that there must be no registration at all. When it submits proof for non registration, it has to obtain clearance from tax officer. Failing to defend the demand or registration, the person is liable to pay penalty u/s 29 (1) (Ka) of the Act, which is Rs. 10,000 per tax period. In the given case, the tax period for the client is monthly. It means, the fines are applicable for the four tax period i.e. tax period of month of Chaitra, Baisakh, Jestha and Ashad; which means the accrued fine until yearend of FY 2072/73 is Rs. 40,000; which shall be charged as expenses to P&L account.
Where the client was dealing in brick and choosing bimonthly tax period, the fine would be accrued for two tax periods, i.e. for tax period of Chaitra/Baisakh and Jestha/Ashad. The impact on P&L account of the client would be Rs. 20,000 for FY 2072/73.

b. Where a registered person obstructed a tax officer to inspect records and documents, as per Sec. 29 (1) (Nga), the fine shall be Rs. 20,000 every time. In the given case, the client has obstructed the officer for one time, as such; the impact on client's P&L A/c shall be Rs. 20,000.

c. Where a registered person fails to attest the sales and purchase register from concerned tax officer, as per Sec. 29 (1) Chha), the fine shall be Rs. 10,000. As such, the impact on client's P&L A/c shall be Rs. 10,000.

d. Unless the VAT registration is cancelled, the person is required to submit VAT return for every tax period. Tax period assigned to person dealing in sanitaryware is monthly tax period. Failure to submit VAT return for a tax period attracts penalty as per Sec. 29 (1) (ja), which shall be higher of following:

   i. 0.05% per day of VAT amount

   ii. Rs. 1,000 per Tax period

As there is no VAT liability, the penalty shall be Rs. 1,000 per tax period means, the impact on P&L account for the year shall be Rs. 12,000.

## VALUE ADDED TAX

8. Answer the following questions:

   a. Rambo Noodles Industries P. Ltd. is newly established noodles industries and has started producing noodles in the brand “Miththo Chauchau”. As part of its promotional activities, the company set up some stalls in major cities and district headquarters of Nepal and distributed 800,000 (75gm) packets of “Miththo Chauchau” as sample, which costs Rs. 8 per 75gm packet. The market value is yet to be decided by the company.
   Quoting the relevant provisions of VAT Act, describe whether VAT is applicable on the above transactions.

   Show your acquaintance with the provisions of VAT regulation regarding the recording formalities when goods are distributed as sample.

   b. Nepal Overseas Pashmina Industries P. Ltd. has a Sales Outlet at Thamel, from where it sells its Pashmina Products in foreign currency. The details of transactions during 28th Shrawan 2073 are as follows:

| Particulars | Amount | Exchange Rate on date of transaction (NPR per FCY) | | Exchange rate when the amounts were deposited (NPR per FCY) | |
|---|---|---|---|---|---|
| | | Buying Rate | Selling rate | Buying Rate | Selling rate |
| Sales in Pound Sterling | 1,200 | 150.50 | 152.15 | 155.25 | 156.80 |
| USD Sales | 1,000 | 104.23 | 104.94 | 106.28 | 107.04 |
| Sales in Euro | 2,200 | 123.23 | 124.04 | 128.05 | 128.67 |

   Based on the above fact:

   iii. Calculate taxable value and VAT to be collected in the above cases.

   iv. Can the outlet issue VAT Invoice in Foreign Currency? If not so, what is the procedure for issuing invoice when the sales are affected in Foreign Currency?

   c. Ram Krishna Kanajo wants to set up a business in Nepal, which deals exclusively in VAT attractive products. He does not expect to make large sales, and believes his sales would be around Rs. 45-48 lakhs in any year. He further wants to obtain business loan from M/s New Business Commercial Bank Ltd., which is tentatively around Rs. 15 Lakhs at 10% p.a. to manage his business. His major supply line is Line Agencies of Government of Nepal. He is commerce graduate and do not have knowledge of VAT; but he has heard of VAT and he wants to conduct business after fulfilling all compliance requirement. He has the following queries, he noted down in his diary regarding the Value added tax:

- Who is required to register for VAT? Who are exempted from VAT registration requirement?
- Where should he visit for registration purpose? What should he do to get registered?
- Based on his business plan, is he required to get registered for VAT?
- If he has to get registered for VAT, what are the formalities he has to observe?

As such, he appointed you as his tax advisor. You are required to advise him as per Sec. 10 of VAT Act, 2052.

d. Ram Preet Agrahari is a trader of liquor items registered for VAT purpose. During the month of Bhadra 2073, he has the following transactions:

- Sales to the final consumer (not a registered person), 100 cartoons of Tuborg beer with MRP of Rs. 3,000 per cartoon at discount of 5% on sales price.
- Sales to registered persons, 1000 cartoons of Turborg beer with MRP of Rs. 3,000 per cartoon at discount of 6% on sales price.

He collected VAT on the selling price after discount. All taxable purchases during the month were Rs. 2 Million excluding VAT. He paid the difference of VAT collected on sales and purchases to the government revenue. As per IRD's notification, the trading of liquor items can be done only when the maximum retail price at different level of such items are published in national daily by the authorized distributor or manufacturer. As such, Mr. Agrahari's business also falls under the same category.
Tax Officer exercised the power under Sec. 20 of VAT Act on Mangsir 10th 2073, and revised the VAT assessment of month of Bhadra. He argued that the VAT collected on sales by Mr. Agrahari must be Rs. 429,000 instead of Rs. 403,650.
Is the contention of tax officer correct?

e. M/s MNJ Exporting House is a manufacturer of handicraft products, which exports majority of its products. The following are the details of transactions of seven consecutive months for the person:

| Month | Total Sales | Purchase | Export Sales |
|---|---|---|---|
| Baisakh | 500,000 | 600,000 | 225,000 |
| Jestha | 520,000 | 500,000 | 130,000 |
| Ashad | 600,000 | 500,000 | 270,000 |
| Shrawan | 450,000 | 500,000 | 157,500 |
| Bhadra | 320,000 | 500,000 | 144,000 |
| Ashwin | 400,000 | 500,000 | 100,000 |

| | | | |
|---|---|---|---|
| Kartik | 350,000 | 300,000 | 125,000 |

Calculate:

- VAT collected on sales and paid on purchases for each month
- Amount of VAT payable or carried over excess Input tax Credit

Answer:

f. As per Sec. 5, VAT is applicable on import of goods or services into Nepal, export of goods or services from Nepal and transaction of goods or services inside the territory of Nepal.
Transaction as per Sec. 2 (Kha) means supply of goods of services.

The definition of Supply includes the act of selling, distributing, exchanging of goods or services with or without consideration.

It means, the act of distribution without consideration is also a part of transaction, and if the transaction is taxable as per the Act (i.e. not covered by Schedule 1 of the Act), VAT is applicable on it. As such, Rambo Noodles act of free distribution of noodles is taxable.

**Records to be maintained for Goods distributed as Sample (Rule 24)**

The following details shall be maintained by the registered person in relation to goods distributed as sample:

- Details of goods received or distributed as sample for promotion of business
- Details of Goods received or distributed free of cost

g.

iii. As per Rule 21, invoice shall be issued in Nepalese currency by the converting the FCY into NPR using the rate prescribed by IRD at the time of supply of goods or services, when goods or services are supplied in Foreign Currency.
In the given case, the exchange rate to be used shall be Selling rate of date of transaction.

As such, taxable value and VAT is as follows:

| Particulars | Amount | Selling rate | Taxable Value | VAT Liability |
|---|---|---|---|---|
| Sales in Pound Sterling | 1,200 | 152.15 | 182,580 | 23,735.4 |
| USD Sales | 1,000 | 104.94 | 104,940 | 13,642.2 |

| | | | | |
|---|---|---|---|---|
| Sales in Euro | 2,200 | 124.04 | 272,888 | 35,475.44 |

iv. No, the outlet cannot issue VAT invoice in Foreign Currency. As per Rule 221, in case the supplier receives consideration against the supply of goods or services in Foreign Currency, the supplier shall issue a tax invoice in Nepali currency by converting the foreign currency into local currency applying the exchange rate as prescribed by Nepal Rastra Bank for the date of transaction.

h.

i. As per Sec. 10 of the Act, a person dealing is taxable transaction shall get registered for VAT purpose. Sec. 9 of the Act exempts small businesspersons dealing to the extent of prescribed turnover from VAT registration even in the cases where the person deals in taxable transaction.
Rule 6 of VAT regulation prescribes such turnover for a period of consecutive 12 months to be Rs. 50 Lakhs for person dealing in goods and Rs. 20 Laks for persons dealing in services or mixed transaction of goods and services.

Similarly, as per Rule 7 (5) of VAT regulation, any person fulfilling any of the following two conditions shall get registered for VAT purpose:

- In case the person obtains business loan exceeding Rs. 10 Lakhs annually from any banks or financial institutions.
- In case the tax officer finds that the stock is greater than the amount prescribed by IRD as per the nature of goods at the time of investigation

The person dealing exclusively in goods and services covered by Schedule 1 of the Act and small businessperson having turnover to the prescribed limit (i.e. Rs. 50 Lakhs for person dealing in goods and Rs. 20 Laks for persons dealing in services or mixed transaction of goods and services) are exempted from VAT registration.

ii. He should visit respective Inland Revenue Department or Taxpayers' service office based on his location of business for the registration.
He should file an application as per Sec. 10 of the Act. The time limit to file application shall be:

- In case of a person dealing in taxable transaction after the implementation of the Act, the person shall make an application in the prescribed format before the commencement of business.
    5. This is the case when the person estimates its business to exceed Rs. 50 lakhs or Rs. 20 Lakhs as the case may be, during 12 months period.
    6. In case of a person that estimates the turnover of the business to not exceed Rs. 50 Lakhs or 20 lakhs, as the case may be, during any 12 months period

and does not register itself as per the exemption granted u/s, but the turnover exceed Rs. 50 lakhs or Rs. 20 Lakhs, as the case may be, in last 12 months: the person shall apply for VAT registration with 30 days of happening of such event for registration

7. In case of a person, the transaction of which was exempted under Schedule 1 of the Act and which becomes taxable as a result of amendment in VAT Law: the person shall apply for registration within 30 days of amendment in law
8. In case of a partnership firm, the application shall include complete details of partnership

After filing the application, tax officer shall examine the application where s/he may demand additional documents and details if s/he deems it necessary while examining the documents, details and application for registration purpose. The applicant shall provide such additional documents and details within 7 days of demand by tax officer.

In case the person dealing exclusively in exempted items specified in Schedule 1 of the Act applies for registration, the tax officer shall notify the matter of failure to registration within 7 days of application to the applicant.

After examination of application, In case the tax officer deems it appropriate to register the person, the tax officer shall issue a registration certificate along with the registration number within 30 days of making of application.

The Permanent Account Number issued by IRD for Income Tax purpose is also used for VAT purpose.

iii. As he is obtaining business loan exceeding Rs. 10 Lakhs annually, he should get registered for VAT purpose.

iv. The formalities to be observed are:

1. He must submit VAT return monthly.
2. He must display his PAN number in eye-catching place.
3. He must issue VAT Invoice.
4. He must use his PAN number in the following:
   - Documents relating to income tax;
   - Documents relating loan application for commercial or industrial purpose from any bank or finance company for an amount of Rs. 1 lakh or more;
   - Documents relating to import and export.
   - Documents relating to VAT (invoice, credit note, debit note, purchase book, sales book etc.) or excise or custom

i. As per Sec. 14 (7), where IRD has issued a notification to taxpayer to conduct transaction after publishing maximum retail price of such goods, the taxpayer shall issue VAT invoice on goods or services at the maximum retail price published while conducting transaction with non registered person.

This means, VAT shall be collected on MRP while conducting transaction with unregistered person, and not with the registered person.

In the given case, VAT on sales to final consumer (not a registered person) shall be based on the retail price before discount, i.e. VAT shall be collected as 13% of Rs. 3,000 per cartoon, which comes to Rs. 39,000 for 100 cartoons.

When the sales are made to registered persons, VAT must be collected on discounted price of Rs. 2,820 per Cartoon. VAT per cartoon = Rs. 366.60 and for 1000 cartoons is Rs. 366,600.

Total VAT collected on Sales shall be Rs. 405,600.

Hence, the tax officers' contention and Mr. Agrahari's collection of VAT, both, are incorrect as per VAT Act.

**j. Calculation of VAT Collected on Sales, Paid on Purchase, Excess VAT and the treatment of such excess VAT (In '000)**

| Month | Total Sales | Purchase | Export Sales | Local Sales | VAT on Sales | VAT on Purchase | % of Export sales | Excess VAT | Tretament of Excess VAT |
|---|---|---|---|---|---|---|---|---|---|
| Baisakh | 500 | 600 | 225 | 275 | 35.75 | 78 | 45% | 42.25 | Note 1 |
| Jestha | 520 | 500 | 130 | 390 | 50.7 | 65 | 25% | 14.3 | Note 2 |
| Ashad | 600 | 500 | 270 | 330 | 42.9 | 65 | 45% | 22.1 | Note 1 |
| Shrawan | 450 | 500 | 157.5 | 292.5 | 38.025 | 65 | 35% | 26.975 | Note 2 |
| Bhadra | 320 | 500 | 144 | 176 | 22.88 | 65 | 45% | 42.12 | Note 1 |
| Ashwin | 400 | 500 | 100 | 300 | 39 | 65 | 25% | 26 | Note 2 |
| Kartik | 350 | 300 | 125 | 225 | 29.25 | 39 | 36% | 9.75 | Note 2 |

Calculation of Carried Over Input Tax Credit

| Month | Excess | Remarks |
|---|---|---|

| | VAT | |
|---|---|---|
| Baisakh | 42.25 | The amount may be claimed for refund by filing an application on Jestha, after which the tax set off cannot be made for any payable VAT of Jestha month. Assuming application for refund will be filed, there will be no carried forward for the month of Baisakh. |
| Jestha | 14.3 | Since, export sales is less than 40% of total sales during the month, this amount will be carried forward till Poush for set off. In case of excess failing to set off payable VAT of Ashad, Shrawan, Bhadra, Ashwin, Kartik and Mangsir; any residual excess can be claimed as refund. |
| Ashad | 22.1 | The amount may be claimed for refund by filing an application on Shrawan, after which the tax set off cannot be made for any payable VAT of Shrawan month. Assuming application for refund will be filed, there will be no carried forward for the month of Ashad. But the carried forward amount of Jestha of Rs. 14,300 is still outstanding for set off during following months. |
| Shrawan | 26.975 | Since, export sales is less than 40% of total sales during the month, this amount will be carried forward till Falgun for set off. In case of excess failing to set off payable VAT of Bhadra, Ashwin, Kartik, Mangsir, Poush and Magh; any residual excess can be claimed as refund. As such, total carried forward VAT is Rs. 14,300 of Jestha and Rs. 26,975 of Shrawan. |
| Bhadra | 42.12 | The amount may be claimed for refund by filing an application on Ashwin, after which the tax set off cannot be made for any payable VAT of Ashwin month. Assuming application for refund will be filed, there will be no carried forward for the month of Bhadra. But the carried forward amount of Jestha and Shrawan of Rs. 14,300 and Rs. 26,975 respectively is still outstanding for set off during following months. |
| Ashwin | 26 | Since, export sales is less than 40% of total sales during the month, this amount will be carried forward till Baisakh for set off. In case of excess failing to set off payable VAT of Kartik, Mangsir, Poush, Magh, Falgun, and Chaitra; any residual excess can be claimed as refund. As such, total carried forward VAT is Rs. 14,300 of Jestha, Rs. 26,975 of Shrawan and Rs. 26,000 of Ashwin. |
| Kartik | 9.75 | Since, export sales is less than 40% of total sales during the month, this amount will be carried forward till Jestha for set off. In case of excess failing to set off payable VAT of Mangsir, Poush, Magh, Falgun, Chaitra and Baisakh; any residual excess can be claimed as refund. As such, total carried forward VAT is Rs. 14,300 of Jestha and Rs. 26,975 of Shrawan, Rs. 26,000 of Ashwin and Rs. 9750 of Kartik. |

Notes:

It is assumed that the person applies for VAT refund when the conditions for refund are fulfilled.

3. The export sales for the month is greater than 40% of total sales, as such the excess VAT of each can be claimed as refund by filing an application immediately after the end of the month after filing VAT return. The VAT shall be refunded within 30 days of application in such cases.
4. As the export sales for the month is less than 40 % of total sales, excess VAT for the month shall be utilized to set off VAT liability for next six months, if any. When there remains excess VAT even after set off of any VAT liability of next six months, the person can file an application for refund. In such case the refundable amount must be refunded within 60 days of refund application.

9. Write short notes on:
   a. Special Provisions related to retention of VAT registration by Small Businesses having turnover less than the threshold prescribed
   b. Reverse Charging
   c. Refund of VAT to unregistered Person
   d. Cash grant/subsidy on the basis of VAT collection by registered person
   e. Administrative Review
   f. VAT Assessment

Answers:

g. As per Sec. 11 (1) (Cha), tax officer shall order for cancellation of registration of a person in case the turnover of consecutive 12 months of the registered person does not exceed Rs. 50 lakhs in case of persons dealing in goods and Rs. 20 Lakhs in case of person dealing in services or mixed transactions of goods or services.
   In such case the VAT registration status of a voluntarily registered person (person dealing in taxable transaction, but the turnover of consecutive 12 months of whom does not exceed Rs. 50 lakhs in case of persons dealing in goods and Rs. 20 Lakhs in case of person dealing in services or mixed transactions of goods or services) can by retained at the option of the voluntarily registered person. As per Sec. 11 (2) as inserted by the order of GON under Samayik Kar Asulu Ain, in case such person desires to retain its registration status, they need to file an application along with the verified VAT return of 12th month of immediately preceding last 12 months in the format as prescribed by IRD. In such case, the registration status will be retained.

h. There are two reverse charging provision in the VAT Act, which are as follows:
   3. **Person receiving Service from foreigners** [Sec. 8-2]:
      Any person, whether registered or not, in Nepal receiving service from person outside Nepal (the person who is not registered for VAT purpose in Nepal) shall pay VAT for that service. *In this case, person delivering the service cannot issue VAT Invoice, so the person receiving the service shall declare it and pay applicable VAT to Revenue*

*Authority*. If the person is registered person, it can set off such payment as other purchases.

4. **Persons developing Commercial Complexes [**Sec. 8-3]
   Any person (registered or not) in Nepal engaged in construction of commercial buildings, apartments, shopping malls or similar constructions ***for commercial purpose***, the cost of which is more than Rs. 5 millions shall collect VAT on the construction cost from themselves and deposit it to Revenue Authority ***in case the construction work is not carried out through a registered person***.

   In case of failure to levy tax as such, the tax shall be assessed and recovered from the owner of such building or structure.

   *Definition of Commercial purpose*

   For the purpose of Sec. 8 (3), Commercial Purpose means construction of building, apartment, shopping complex or similar other structures prescribed by IRD for the purpose of sales or using such asset by accounting the asset as current or fixed asset.

i. The following are the provisions of VAT Act for the refund of VAT to unregistered persons:

1. **Diplomats (Sec. 25-1 (ka))**
   Tax paid by diplomatic persons privileged on a reciprocal basis from Ministry of Foreign Affairs, or person having diplomatic privileges engaged in Regional or International Organization or missions shall be eligible for refund.
   The application for refund shall be made directly to Inland Revenue Department.
   *Conditions for refund (Sec. 25-1Ka)*
   The tax shall not be refunded for a purchase of less than Rs. 5,000 at a time; means *the diplomats shall make purchase of Rs. 5,000 or more for the expenditure to be eligible for VAT refund.* The person paying the VAT shall make the claim of refund. The application for refund shall be made directly to Inland Revenue Department.

   *Time period to apply for VAT refund (Sec. 25-1)*
   The refund application shall be filed within ***three*** years of such transactions.

2. **International institution (Sec. 25 (1 (kha))**
   Institutions or VAT paid by such institution for which Ministry of Finance has granted the privileges of tax exemption.
   The application for refund shall be made directly to Inland Revenue Department.

   *Time period to apply for VAT refund (Sec. 25-1)*
   The refund application shall be filed within ***three*** years of such transactions.

3. **Projects under bilateral or multilateral agreement (Sec. 25 (1 (Ga)))**
   Tax paid on projects operated undertaken within the state of Nepal under bilateral and multilateral agreement *for which Ministry of Finance has granted permission to exempt it from VAT.*
   The application for refund shall be made directly to Inland Revenue Department.

   *Time period to apply for VAT refund (Sec. 25-1)*

The refund application shall be filed within ***three*** years of such transactions.

4. **Collection by mistake (Sec. 25 (1 (Gha) & Sec. 25-2)**
   Any tax collected by mistake shall be refunded. Such tax shall be refunded to the person who has actually borne the burden of tax.
   The application for refund shall be made directly to Inland Revenue Department.
   Time period to apply for VAT refund (Sec. 25-1)
   The refund application shall be filed within three years of such transactions.
5. **Tax refund to a foreign tourist (Sec. 25Ka)**
   *Conditions to be satisfied*
   ***All*** the following conditions shall be satisfied for the claim of refund:
   d. The foreign tourist visiting in Nepal shall leave Nepal from air transport,
   e. The tourist shall accompany such goods with himself while leaving Nepal, i.e. goods cannot be gifted in Nepal and it shall be taken away by the tourist; and
   f. The cost of goods shall be more than Rs. ***25,000.***

   *Service Fee on such Refund*
   The revenue authority shall deduct ***3% of refundable amount*** as service charge.

j. Group 11 of Schedule 1 of VAT Act contains the provision of Cash grant/subsidy to a registered person, in case the person sells taxable by issuing VAT invoice. Persons entitled to such facility and the degree of cash grant/subsidy are as follows:

| ***Name of Industry*** | ***Amount of Refund*** |
|---|---|
| Industry producing *Match Stick (producing only the match stick- not the match),* ***dhoop*** *(incest stick), Tyre, Tube* | Amount equal to the tax collected on sales ***less*** the tax paid on purchase |
| *Maida Industry* | Amount equal to the 25% of following:<br>VAT Collected on Sales<br>*Less:* VAT paid on purchases |
| *Sales of Mustard Oil, Vanaspati Ghee from domestic production, or other processed edible oil produced by Domestic Industries to Registered Persons*<br>*(This facility is not availed to packaging industries that import processed oil in bulk and sales it in Nepal through refilling in consumer packages)* | Amount equal to the 40% of following:<br>VAT Collected on Sales to Registered Person |

| | |
|---|---|
| *Sales of Taxable Production by Dairy Industries transacting Dairy Products* | 50% of VAT collected on Taxable Sales |
| *Sales of Products to VAT registered persons or auction house by Domestic Industries producing and processing Tea* | 50% of VAT collected on Taxable Sales to Registered Persons |
| *Sales of products to Registered Persons by Domestic Industries producing Sheet, Circles and Utensils using Scrap of Copper and Pittal* | 25% of VAT collected on Taxable Sales to Registered Persons |
| *Sales of products to VAT Registered Persons or Agencies of GON by Domestic Clothes Industry except for such Domestic Clothes industries that produces 100%* ***Suti Clothes*** | 70% of VAT collected on Taxable Sales to Registered Persons |
| *Domestic Clothes industries producing 100% Suti Clothes* | The amount as follows:<br><br>VAT Collected on Sales to any person whether registered or not<br>***Less***: VAT paid on Purchases |
| *Domestic Industries producing Cellular Mobile Phone-set or Persons importing it* | Refund of ***40% of*** VAT paid on purchase of Raw Materials or Finished Goods, in case the producer or importer produces evidence that the mobile set is sold to a registered persons. |
| *Domestic Industries producing Sugar Industries* | 90% of VAT collected on Sales to a registered person |

k. Administrative Review:

***Application for Review & Time Limit (Sec. 31Ka-1)***

Every person who is dissatisfied with the tax officer's decision of assessment of tax shall make an application for administrative review at Inland Revenue Department within 30 days of receipt of the Final Assessment Order.

***Extension of Time Limit for Application (Sec. 31Ka-2)***

In case the taxpayer cannot file application within 30 days of receipt of Final Assessment Order, the tax payer may file an application for extension of time limit to file Review Application within 7 days of expiry of such 30 days.

After receiving such extension application, the IRD may extend the deadline for Review Application for additional 30 days counted from the expiry of first deadline of 30 days, i.e. the maximum time limit to file a review application is 60 days from the date of receipt of notice.

***Formality to File Application (Sec. 31Ka- 6 & 31Ka-8)***

The taxpayer shall deposit 100% of undisputed tax amount and one-third of disputed tax amount before filing the review application. Such deposit shall not be refunded unless the final verdict on the issue is declared.

In case the taxpayer has not submitted any VAT return in connection to the dispute involved in Review Application, the taxpayer shall file such return prior to submission of Review Application. (Rule 34)

***Effect of Application (Sec. 31Ka-3)***

The Director General shall examine the documents and other proofs. In case the matters raised by the taxpayer is true while examining documents and proofs, the DG shall nullify the decision of the tax officer and order for reassessment to the concerned tax officer or any other officer.

***Time Limit to Decide on Review Application (Sec. 31Ka-4 & 31Ka-5)***

The Department must decide on Review application within 60 days of filing of Review Application. In case of failure to do so, the taxpayer may deem the application be rejected and choose to appeal in Revenue Tribunal

l. VAT Assessment:
There are three types of VAT assessment under the Act,

- *Self assessment (Sec. 18)*
- *Jeopardy assessment (Sec. 22)*
- *Assessment by Tax Officer (Sec. 20)*

**<u>Self-assessment:</u>**

The registered person shall file a VAT return within 25 days of end of a tax period. The returns may be filed in documentary form or through electronic means, often called e-return. When such return filed to the tax office, the self assessment is deemed to be conducted.

**<u>Assessment in case of Special Circumstances (Jeopardy assessment):</u>**

In case there is sufficient basis to believe that any of the following conditions is happening; the tax officer, ***with prior approval of Director General,*** may assess and collect VAT:

- In case the taxpayer is leaving Nepal and there is chance of non recovery of tax, or
- In case the taxpayer is transferring, removing or concealing the asset and there is chance of non recovery of tax

**Assessment by Tax Officer**

***Grounds and Conditions for assessment by Tax Officer (Sec. 20 (1)***

Under the following grounds and conditions Tax Officer can make tax assessment:

- In case VAT return is not submitted within the time limit;
- In case of filing of an incomplete or erroneous return;
- In case of filing of a fraudulent return;
- In case the Tax Officer has a reason to believe that the amount of tax is understated or otherwise incorrect;
- In case the Tax Officer has a reason to believe that the taxpayer has caused *under-invoicing*;
- In case of supply to group companies through *under-invoicing*;
- In case person requiring registration operates business without registration;
- In case of sales without issuing invoices;
- In case an unregistered person collects the tax;
- In case a person does not deposit Reverse VAT levied u/s 8 (2) or 8 (3); or
- In case a person does not levy VAT on goods that are left to be used for taxable transaction for which input tax credit was enjoyed as per Sec. 17 (4)

10. Answer the following questions:

a. Dairy Development Corporation is public enterprises dealing in dairy products. It sold following items, excluding VAT, during the month of Shrawan 2073:

| Particulars | Amount (NRs.) |
|---|---|
| Pasteurized Milk | 200,000 |
| Ice Cream | 500,000 |
| Rasbari, and other sweet items | 300,000 |

The purchases during the month are sugar and additives for ice-cream and other sweet items of Rs. 100,000; excluding VAT.

Calculate the amount of cash subsidy to M/s Dairy Development Corporation as per Schedule 1 of the Act, based on sales of VAT attractive items.

b. Basulinga Sugar Mills is an industry located at Dhangadi producing sugar. During the month of Bhadra 2073, it has following transactions that is exclusive of VAT:

| Sales | Amount (NRs.) | Purchase | Amount (NRs.) |
|---|---|---|---|
| Sugar to unregistered persons | 1,200,000 | Sugarcane | 250,000 |
| Sugar to Registered Persons | 1,500,000 | Other taxable items | 100,000 |

Calculate the amount of cash subsidy as per Schedule 1 of VAT Act.

c. HNT P. Ltd. is a Maida industry located at Makwanpur. It produces Wheat flour and Maida. The details of transaction for the month of Ashad 2073 are as follows:

- Sales of Maida
  - To unregistered persons Rs. 432,000
  - To registered persons Rs. 505,000
- Sales of Wheat Flour Rs. 300,000
- Purchase of Wheat Rs. 500,000
- Telephone Expenses Rs. 8,000
- Petrol to operate Generator Rs. 40,000
- Salary Expenses Rs. 300,000
- Consultancy services from a VAT Registered Party Rs. 300,000

All figures above are exclusive of VAT.
Calculate the amount of cash subsidy by HNT P. Ltd. on the basis of sales of VAT attractive items.
Answer:

d. Pasteurized Milk is exempted from VAT. Sales of Ice Cream and Rasabari and other sweet items are VAT attractive on Sales.
As per Schedule 1 of the Act, *Sales of Taxable Production by Dairy Industries transacting Dairy Products is subject to cash grant of* 50% of VAT collected on Taxable Sales.

In this case, VAT collected on taxable sales is 13% of 800,000, which is Rs. 104,000.

Therefore, cash subsidy shall be 50% of VAT collected on Taxable Sales, which comes to Rs. 52,000.

e. As per Schedule 1 of VAT Act, *Domestic Industries producing Sugar Industries are entitled to cash subsidy to the extent of* 90% of VAT collected on Sales to a registered person.
In the given case, VAT collected on Sales to a Registered person is 13% of Rs. 1,500,000; i.e. Rs. 195,000; and cash grant is 90% of Rs. 195,000; i.e. Rs. 175,500.

f. As per Schedule 1 of VAT Act, cash grant to a maida industry producing Maida in Nepal is as follows:
25% of the result as follows:

i. VAT collected on Sales ***Less***
ii. VAT paid on purchases

In the given case, VAT collected on Sales is 13% of Rs. 937,000 (432,000+505,000), which is Rs. 121,810.
VAT on purchase is calculated as under:

| | |
|---|---|
| Purchase of Wheat | Non Taxable |
| Telephone Expenses (proportionate- 937/1237*13% of 8,000) | 787.78 |
| Petro to operate Generator (proportionate- 937/1237*13% of 40,000) | 3,938.88 |
| Salary Expenses | non Taxable |
| Consultancy Services (proportionate- 937/1237*13% of 300,000) | 29,541.63 |
| Total VAT on Purchase | 34,268.29 |

Therefore Cash subsidy= 25% of (121,810-34,268.29)= 21,885.43

11. Write short notes on:
   a. Debit and Credit Note
   b. Rights of Tax Officer under VAT Act
   c. Records to be maintained by dealer of Used Goods
   d. Tax Period
   e. Market Value Concept in VAT

Answer:
   f. Debit and Credit Note

For any change in matters of issued invoice due to any reason, the person shall issue debit note or credit note for such changes in value of the goods. Conceptually, person issuing invoice issues a credit note. Credit note is a crucial matter in tax accounting as many countries has policy of using *pre-printed credit notes issued by government*. Rule 20 has not prescribed format for debit or credit note, but person need to keep a register of such notes.
Debit or credit note include following information:

- Serial Number of the debit or credit note,
- Date of issue,
- Name, address and PAN of the supplier,
- Recipient's name, address, and PAN if a registered person,
- Serial number and date of the tax invoice concerned,
- Particulars of the goods or services and reason of issuing to credit or debit,
- Amount credited or debited,
- Tax amount credited or debited.

Credit or Debit Note shall be maintained in the issued note.

   g. Rights of Tax Officer under VAT Act

Value Added Tax Act has conferred following powers to a Tax Officer:

- Assessment of Tax by Tax Officer (Discussed in Chapter 15)
- Collection of Tax from VAT defaulter (Sec. 21)
- Assessment of Tax in Jeopardy (Discussed in Chapter 15)
- Power conferred to combat Tax Avoidance Schemes (Sec. 22Ka)

- Rights in relation to Examination & Review (Sec. 23)
- Purchase of Goods sold through Under-invoicing (Sec. 23Ga)
- Right to demand deposit or imprison a person or seizure (Sec. 23Gha)
- Right to Obtain Expert Service with Regard to Tax Assessment (Sec. 34Ka)

h. Records to be maintained by dealer of Used Goods

The Dealers of *USED GOODS* shall keep separate records for each deal of used goods, in case the purchase price of the goods exceeds Rs. 10,000. In case a registered person dealing used goods is found not to have satisfactorily maintained the records as prescribe, Tax Officer may impose VAT on the total selling price of the goods sold by such taxpayer, and the tax officer may issue a written order requiring him to pay such tax along with the next tax return. The following are the matters to be maintained in Sales and Purchase Book of Dealer of Used Goods:

**III. In relation to Purchase**

- Date of purchase
- Information as to the complete details of the goods
- Purchase price excluding VAT
- Tax Rate
- Tax Amount
- Total Amount paid

**IV. In relation to Sales**

- Date of Sales
- Selling Price excluding VAT
- Difference between Selling Price & Purchase Price
- Rate of Tax
- Tax Amount
- Total Amount Received

i. Tax Period

It is the period prescribed by VAT Act & Regulation for the collection and submission of VAT return and VAT amount. The tax period is prescribed by Rule 26 as follows for different persons:

- **Every Nepalese Calendar Month as Tax Period (Rule 26-1)**

  The VAT Act has envisioned every Nepalese Calendar month as a separate tax period except in cases where the registered person opts bimonthly or trimester tax period as per the legal provisions. The tax period may be shorter than a month in case a person commences business at the middle of the month. For example, tax period for a person commencing business from Baisakh 25 begins from Baisakh 25 and ends on Baisakh end.
- **Bimonthly Tax period (Rule 26-2 & 26-3Ka)**

In case registered person carrying on business related to hotel and tourism sector or production of brick desires to choose a bimonthly tax period, a bimonthly tax period is allowed for them.

There are six tax periods during a fiscal year which covers Shrawan and Bhadra, Ashwin and Kartik, Marg and Paush, Magh and Falgun, Chaitra and Baisakh and Jestha and Ashad as tax period.

- **Trimester Tax period (Rule 26-3Kha)**
  In case a businessperson conducting transaction on newspaper or publication of newspaper (newspaper seller and publisher of newspaper) desires to opt for a four-monthly tax period, IRD may allow the persons to submit tax return on trimester (four-monthly basis).
- **Different tax period (Rule 26-2)**
  In case of a registered person that has maintained its accounts using software cannot generate the required report in Nepalese Calendar system; it may file an application to Tax Officer to adopt different tax period date with same period. If the Tax Office thinks it appropriate, the person may be granted a different tax period.
- **First Tax period (Rule 26-5)**
  First tax period of a registered person shall be period of day of registration to end of concerned tax period.
- **No-tax period (Sec. 11-2)**
  In case any registered person applied for cancellation registration, it need to file its VAT return within 3 months from apply for deregistration; if tax officer could not decide to deregistration, then such person (even it is registered person) need not file its tax return. Badly, if tax officer, decides to not to deregister, then VAT return from tax period when the decision is made, need to be filed.

j. Market Value Concept in VAT

Market value of supplied goods or services shall be determined on the basis of the fair value of consideration received or receivable in the transaction between unrelated independent parties at arm's length under similar circumstances as to characteristics, quality, quantity of materials, and any other relevant factors.

**Procedure for determination of Market Value (Rule 22)**

Tax Officer has right to fix the market price based on the transaction of similar goods. In case a Tax Officer cannot ascertain market price, the Director General has the right to prescribe the method on the basis of price of similar goods transacted by different suppliers.

12. As a tax expert, provide your professional opinion in the following cases:
    a. Application of rule of "Circumstances beyond Control" relieves a person from payment of fees u/s 19 and interest u/s 26 of VAT Act
    b. A branch office in London of a Kathmandu based VAT registered person is required to collect VAT on every tax attractive transactions while doing business in London

c. VAT shall not applicable on transfer of business to an unregistered heir of a VAT registered individual as a result of insanity of the individual
d. The term “Zero VAT” and “No VAT” has same meaning
e. There is only one VAT rate of 13% as per VAT Act
f. Telecommunication companies are required to collect VAT on telecommunication services when the service is provided, or invoice is issued or consideration is received; whichever happens earlier
g. The threshold for exemption of VAT registration for a person dealing only in goods listed in Schedule 1 of the Act is Rs. 50 Lakhs
h. Unregistered persons cannot collect VAT
i. When a tax officer demands VAT registration, the burden to prove that the conditions for registration as per VAT Act is met lie with the tax officer
j. The responsibility to submit VAT return is only upon the registered person

Answer:

k. Application of rule of “Circumstances beyond Control” relieves a person from payment of fees u/s 19. Interest u/s 26 is applicable if the payable VAT could not be paid on due even in the event of application of Circumstances beyond control provisions.
l. VAT is levied on import of goods or services into Nepal, export of goods or services from Nepal, or transaction of goods or services within the territory of Nepal. In the given case, as the transaction by branch office in London is not an import or export or transaction within the territory of Nepal; VAT shall not be applicable on such transactions.
**m.** As per Sec. 5A, Under either of the following two conditions, value added tax will not be applicable on the *transfer of ownership of a business*:
(c) When a registered person sells its business to any other registered person; or
(d) A business is transferred to any inheritor after the death of an owner.

*In the said case, the transfer to legal heir is as a result of insanity of the registered person, and the transferee is not registered for VAT. As such, both the above two conditions are not satisfied which implies that VAT shall be collected on such transfer.*

n. The term “Zero VAT” and “No VAT” has different meaning, which is elaborated below:

| **Basis** | **Zero Rate** | **No VAT** |
|---|---|---|
| Rate of VAT | VAT is levied at Zero Percent | VAT is not levied at all |
| VAT Invoice | A VAT Invoice shall be issued as per the format prescribed by VAT regulation | VAT Invoice shall not be issued at all |
| Registration Requirement | The person dealing in Zero rated items shall be registered for VAT purpose. | The person dealing exclusively in No VAT items is relieved from registration formality |

| | | |
|---|---|---|
| Other formalities as per the Act | The person dealing in Zero Rated Items shall observe other formality as per VAT Act, such as- maintenance of sales and purchase register duly certified from Tax Officer, submission of VAT return, etc. | The person dealing exclusively in No VAT items is relieved from all formalities to be observed as per the Act |
| List of Items | List of Zero rated items are prescribed in Schedule 2 of the Act | List of No VAT items are prescribed in Schedule 1 of the Act, but Schedule 1 also contains some VAT applicable items on which the producer is entitled to refund of VAT collected by it. |

o. As per Sec. 7 of the Act, there shall be a single VAT rate of 13%.
But the VAT rate on transaction of goods or services listed in Schedule 2 of the Act is 0% and there shall be no VAT for transactions of goods or services listed in Schedule 1 of the Act.

As such, the statement is partially correct.

p. As per Sec. 6 (3) (ka) of the Act, the time of supply of services by telecommunication service provider or such service provider that provides continuous service shall be at the time of issuance of invoice. Therefore, the VAT shall be collected at the time of issuance of invoice rather than earlier of service is provided, or invoice is issued or consideration is received.

q. As per Sec. 5 (3), there shall be no VAT for items listed in Schedule 1 of the Act. Sec. 10 (2) requires a person to get registered for VAT in cases when the person is involved in VAT attractive transactions. As such, person dealing exclusively in items of Schedule 1 is not required to get registered; no matter how much is its turnover for the year.

r. As per Sec. 15 (1), unregistered person cannot collect VAT. But Sec. 15 (3) of the Act listed the following persons, even when they are not registered for VAT purpose, requiring collection of VAT:
- Local Bodies (Village Development Committee, Municipality, District Development Committee)
- International agencies or diplomatic mission located in Nepal
- Nepal Government, or
- Public Enterprises dealing basically on exempted goods or services

Similarly Sec. 12A requires the national forest, community committee looking after community forest or owner of private forest collecting VAT while selling woods for commercial purpose, even if they are unregistered.

Therefore, unregistered persons may also collect VAT subject to the power given by the Act.

s. As per Sec. 5B of VAT Act, in case tax officer identifies that a person requiring registration as per the Act is conducting business without registration and reasonably believes so, s/he may demand VAT registration of such person.
In case the person defends the exemption of registration requirement as a result of turnover of the person for any period of consecutive 12 months not exceeding the threshold (i.e. Rs. 50 lakhs), the onus to prove the same is upon the person on whom the registration is demanded.

It means, the person with whom the registration is demanded must prove that he should not be registered, and it's not upon tax officer to prove that registration is required.

t. Responsibility to file VAT return:

**Responsibility of a Registered Person**
The registered person is responsible to submit VAT Return.
**Responsibility of Rightful Beneficiary or Legal Representative (Rule 27)**
In case of death or permanent physical or mental incapacity of an individual, the tax officer may demand VAT Return from rightful beneficiary or legal representative of such persons assuming the end of tax period in the immediately preceding date of such death or incapacity.
**Joint or Several Responsibility of different Persons (Rule 28)**
The following persons have joint and several responsibilities over submission of VAT Return in the following conditions:

- In case when the registered person is a legal person: the director, chief executive or any employee prescribed by the Management
- In case when a registered legal person is liquidated or wound up: the liquidator
- In all other cases except as specified above: the person who has concern with registered person as prescribed by Tax Officer

As such, responsibility to file VAT return is not only upon a registered person.

13. Calculate VAT collected on Sales, Eligible Input Tax Credit and VAT liability based on the following information:

a. The details of transactions during the month of Shrawan of M/s Importers Deal P. Ltd. having a publishing house and dealing in books and stationery items are as follows:
Sales:

| | |
|---|---|
| Sales of Printed books | Rs. 250,000 |
| Sales of Stationery Items- Others | Rs. 300,000 |

| | |
|---|---|
| Sales of e-book | Rs. 450,000 |

Purchase:

| | |
|---|---|
| Import of stationery items | |
| Invoice Price | Rs. 400,000 |
| Insurance up to Birgunj Custom Office | Rs. 2,000 |
| Freight up to Birgunj Custom Office | Rs. 20,000 |
| Freight & Insurance from Birgunj Custom Office to Kathmandu | Rs. 12,000 |

Other expenses:

| | |
|---|---|
| Salary Expenses | Rs. 100,000 |
| Telephone Expenses | Rs. 20,000 |
| Diesel Purchased for office vehicle | Rs. 20,000 |
| Diesel consumed for office vehicle | Rs. 12,000 |
| Petrol for Generator used in office | Rs. 15,000 |
| Restaurant Expenses for potential supplier from India | Rs. 25,000 |
| Local Purchase of Stationery Items | Rs. 300,000 |
| Purchase of Office computer | Rs. 60,000 |
| Purchase of Aqua 100 Mineral Water for office purpose | Rs. 12,000 |
| Purchase of vehicle for managing director | Rs. 1,400,000 |

Additional Information:

i. The imported stationery items were released from custom office by keeping deposit as the custom office failed to fix the taxable value of the goods. The amount kept as deposit for VAT was Rs. 70,000.

ii.

Of the total diesel purchased during the month, the company obtained various Abbreviated Tax Invoices for the expenses of Rs. 12,000.

b. Mr. X is a trader dealing in second hand vehicles. The following is the details of Mr. X's transactions during the month of Bhadra 2073. Calculate Taxable Value and VAT liability of Mr. X for the month of Bhadra 2073:

i. Purchase of second hand car Ba 6 Cha 7756 from President International, a VAT registered person at the cost of Rs. 400,000. President International charged VAT of Rs. 52,000 in addition to the selling price. Mr. X incurred Rs. 50,000 for repairs and denting painting of vehicle for which he paid Rs. 6,500 as VAT.
The vehicle was sold on Bhadra 15 at Rs. 900,000 (exclusive of VAT)

ii. Purchase of Jeep, Ba 5 Cha 5728, from Ram Narayan Bidari at Rs. 450,000. Mr. Bidari is not registered for VAT. He incurred Rs. 200,000 for repairs of the vehicle from an unregistered person; and sold the vehicle on Bhadra 28 at Rs. 630,000.

iii. Purchase of Santro car, Ba 7 cha 2235, from Hari Shankar Basnet at Rs. 1,200,000 and incurred Rs. 20,000 for repairs. In addition to repair cost of Rs. 20,000; he paid Rs. 2,600 as VAT to garage. The car is still in the stock.

iv. Sales of Car (Ba 1 cha 2278) on Bhadra 5 at Rs. 900,000 (excluding VAT). The car was purchased on Ashad at Rs. 650,000 (excluding VAT) from a VAT registered manufacturing concern. Mr. X incurred Rs. 126,000 including VAT for the repair of vehicle during the month of Shrawan.
What would be your answer if Mr. X's main business is not the dealing in second hand vehicles but something else and is selling his second hand asset?

Answer:

c.

G. Calculation of VAT Collected on Sales

| Particulars | W. N. | Taxable Value | VAT |
|---|---|---|---|
| Sales of Printed Book | 1 | - | - |
| Sales of Stationery Items- Others | | 300,000 | 39,000 |
| Sales of e-book | 2 | 450,000 | 58,500 |
| **Total VAT collected on Sales** | | | **97,500** |

H. Calculation of Eligible VAT Credit

| Particulars | W. N. | Taxable Value | VAT |
|---|---|---|---|
| Import of Stationery Items | 3 | - | - |
| Salary Expenses | 4 | - | - |
| Diesel purchased for office Vehicle | 5 | 20,000 | 884 |
| Diesel Consumed for Office Vehicle | 6 | - | - |
| Petrol for Generator used in Office | 7 | 15,000 | 1,657.50 |
| Restaurant Expenses for Potential supplier from India | 8 | - | - |
| Local Purchase of stationery Items | 9 | 300,000 | 33,150 |
| Purchase of Office Computer | 10 | 60,000 | 6,630 |
| Purchas of Aqua 100 Mineral water for office purpose | 11 | - | - |
| Purchase of Vehicle for Managing Director | 12 | 1,400,000 | 61,880 |
| **Total Eligible VAT Credit for the Month** | | | **104,201.50** |

I. VAT Payable on Service procured from Foreign Party not registered for VAT Nil
J. Input Tax credit on Reverse Charging VAT as described in (C) above Nil
K. Carried Over Excess VAT Credit from Previous Period(s) Nil
**L. VAT Liability/ (Excess VAT Credit) (A-B+C-D-E)= (6,701.50)**

Working Note:

1. Sales of Printed Book are exempted from VAT.
2. As per the order of Supreme Court, only the printed books are exempted from VAT and not the e-book. As such, e-books are taxable.
3. As per Rule 49 (3) of VAT Regulation, Custom office may release goods by demanding deposit when the taxable value of goods cannot be determined at the time of import due to any reason. In such cases where the goods are imported by providing cash deposit without determining taxable value, such deposit for VAT shall not be

considered for Input VAT credit unless taxable value is determined. As the stationery items are released from custom office without determining taxable value, the deposit on release of such stationery items cannot be treated as part of eligible VAT credit.

4. These are exempted from VAT
5. Petrol used for office vehicle is included in No VAT Credit item, not the diesel. So, VAT Credit is eligible in purchase of diesel for office vehicle. As there are both taxable and non taxable sales, and use vehicle cannot be linked into taxable or non taxable transactions, there must be proportionate tax credit. But when abbreviated tax invoice is used, there shall be no tax credit on such purchases. As such, eligible VAT credit on purchase of diesel is Rs. 884 (850/100*13% of (20,000-12,000))
6. VAT Credit is available on purchase basis on production of invoice. As such, there shall be no treatment of consumption for VAT purpose.
7. Petrol used for office vehicle is included in No VAT Credit item. So, VAT Credit is eligible in purchase of petrol for use in generator. As there are both taxable and non taxable sales, and use of generator cannot be linked directly into taxable or non taxable transactions, there must be proportionate tax credit. As such, eligible VAT credit on purchase of petrol is Rs. 1,657.50 (850/100*13% of 15,000)
8. As per Rule 41, there shall be no VAT Credit for Entertainment Expenses.
9. Stationery is used both for production of books and other taxable items. As such, there shall be proportionate VAT credit. As such, eligible VAT credit on purchase of stationery is Rs. 33,150 (850/100*13% of 300,000)
10. Computer is used both for production of books and other taxable items. As such, there shall be proportionate VAT credit. As such, eligible VAT credit on purchase of computer is Rs. 6,630 (850/100*13% of 60,000)
11. As per Rule 41, purchase of beverages attract no VAT credit unless as part of main business.
12. As per Rule 41, there shall be partial tax credit, i.e. 40% on VAT paid on purchase, while purchasing vehicle for administrative purpose by the person dealing exclusively in taxable items. In case the vehicle for the said purpose is used by the person having mixed transaction of taxable and non taxable items, the VAT credit shall be proportionate on partial. Therefore, eligible VAT Credit is Rs. 61,880 (850/1000* 13% of 40% of 1,400,000)

d. As per Rule 33, the taxable value for the person dealing in used goods shall be profit between selling price and purchase price of each good. The purchase price shall be VAT included purchase price, and includes all direct cost to bring the asset to saleable condition.

   It means, the taxable value of the used goods in case it is sold by dealer of used goods can be determined only at the time of sales of goods. Based on this provision, the VAT liability for the month of the trader when the trader is dealing in used goods on the basis of provided information is as under:

| Vehicle | Selling Price | Purchase | Other direct | Taxable Value | VAT amou | Remarks |
|---|---|---|---|---|---|---|

| No. [A] | (excluding VAT) [B] | price including VAT [C] | cost including VAT [D] | [E= B-C-D] | nt [E*13%] | |
|---|---|---|---|---|---|---|
| Ba 6 Cha 7756 | 900,000 | 452,000 | 56,500 | 391,500 | 50,895 | |
| Ba 5 Cha 5728 | 630,000 | 450,000 | 200,000 | (20,000) | - | Since there is no profit, taxable value is Nil and no VAT Liability |
| Ba 7 Cha 2235 | Still in Stock | | | | | VAT cannot computed as taxable value cannot be determined until the vehicle is at stock |
| Ba 1 Cha 2278 | 900,000 | 734,500 | 126,000 | 39,500 | 5135 | |
| **Total VAT Liability** | | | | | **56,030** | |

If Mr. X's main business was not the dealing in second hand vehicles and was selling his second hand asset, the taxable value would be the selling price of the goods sold, which is Rs. 2,430,000 and the VAT shall be collected as 13% of Rs. 2,430,000 (total selling price excluding VAT of three vehicles sold).

14. You have been deputed as audit staff by your principal in one of his client's audit. You identified the following cases. You are required to prepare a note on possible impact on client's profit or loss of FY 2072/73 due to your client's failure in the following cases:

a. A tax officer inspected the warehouse of your client. After inspection, he found that the goods are held in excess of limit prescribed by IRD and instantly ordered your client for VAT registration as per the power conferred in Sec. 5B of VAT Act. Your client did not honor the tax officer's order; neither had it defended the claim of tax officer. The officer's order was communicated to your client on 1st Chaitra 2072, and your client is a dealer of wine.

   Would your answer be different if it were brick producer and choosing bi-monthly tax period?

b. A tax officer visited your client's premise. But your client obstructed him to inspect records and documents.

c. You are auditing the financial statements of FY 2072/73. On review for compliance of VAT Act and Regulation, you identified that you client is maintaining sales register and purchase register. Further enquiry revealed that the client failed to get the registers attested from tax officer till the period of your audit.

d. Your client is dealing in sanitary ware and its business turnover is less than Rs. 50 Lakhs. As it was dealing in sanitary ware in Kathmandu Metropolitan City, as per the requirement of previous VAT Act before the amendment by Finance Bill 2072, it is registered for VAT purpose. It has not cancelled its registration yet. But as it heard that the Finance Bill 2072 increased the turnover threshold to Rs. 50 Lakhs for registration, assuming that it need not file VAT return; it did not file any VAT return for the year 2072/73. There is no VAT liability during the year, as the person's input tax credit is greater than VAT collected on Sales.

Answer:
Students are expected to know that the impact of fines and penalties as expenses would be in the Profit and loss account of the client.

e. When tax officer demands VAT registration, the person shall register for VAT purpose or submit proof and satisfy the tax officer that there must be no registration at all. When it submits proof for non registration, it has to obtain clearance from tax officer. Failing to defend the demand or registration, the person is liable to pay penalty u/s 29 (1) (Ka) of the Act, which is Rs. 10,000 per tax period. In the given case, the tax period for the client is monthly. It means, the fines are applicable for the four tax period i.e. tax period of month of Chaitra, Baisakh, Jestha and Ashad; which means the accrued fine until yearend of FY 2072/73 is Rs. 40,000; which shall be charged as expenses to P&L account.
Where the client was dealing in brick and choosing bimonthly tax period, the fine would be accrued for two tax periods, i.e. for tax period of Chaitra/Baisakh and Jestha/Ashad. The impact on P&L account of the client would be Rs. 20,000 for FY 2072/73.

f. Where a registered person obstructed a tax officer to inspect records and documents, as per Sec. 29 (1) (Nga), the fine shall be Rs. 20,000 every time. In the given case, the client has obstructed the officer for one time, as such; the impact on client's P&L A/c shall be Rs. 20,000.

g. Where a registered person fails to attest the sales and purchase register from concerned tax officer, as per Sec. 29 (1) Chha), the fine shall be Rs. 10,000. As such, the impact on client's P&L A/c shall be Rs. 10,000.

h. Unless the VAT registration is cancelled, the person is required to submit VAT return for every tax period. Tax period assigned to person dealing in sanitaryware is monthly tax period. Failure to submit VAT return for a tax period attracts penalty as per Sec. 29 (1) (ja), which shall be higher of following:
   i. 0.05% per day of VAT amount
   ii. Rs. 1,000 per Tax period

As there is no VAT liability, the penalty shall be Rs. 1,000 per tax period means, the impact on P&L account for the year shall be Rs. 12,000.