

# Audit under Value Added Tax



Although the implementation of Value Added Tax System poses certain teething problems, it also gives ample professional opportunity to the Auditing Profession in India in helping both the trade and industries and the tax administrators to resolve such problems. This article analyses the necessity of the Audit under VAT regime and the role of the professionals in this regard.

**T**he implementation of State Level Value Added Tax System for Commodity Taxation in 21 States of our country effective from 1.4.2005 is seen as a major change in the Commodity Taxation System. Some have described this event as the most important and radical change in the Taxation System of India in post independence era. While the implementation of Value Added Tax System poses certain teething problems attached to any change, at the same time it gives ample professional opportunity to the Auditing Profession in India in helping both the trade and industries and the tax administrators to resolve such problems.

Chartered Accountants, as professionals are today involved in ensuring financial discipline, transparency in financial transactions maintaining of financial authorities and analysing of the financial state-



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Institute of Chartered Accountants of India have been playing a key role since long. Considering the in-depth training and special aptitude, the responsibility of audit under the VAT Law naturally has to be shouldered by the Members of the Institute. The Members of the CA Profession have been contributing a lot to the economic world by rendering value added Services. The various tax laws framed by the State legislatures to implement State Level VAT System have reposed confidence in CA fraternity by making suitable provisions warranting Tax Audits by Chartered Accountants only.

The State Legislatures provid-

ments prepared by the business entities.

Since the Auditing Function is the core area where the members of the

ing for VAT Audit by Chartered Accountants have reaffirmed the faith and confidence reposed by the society in Chartered Accountants. Even the Hon'ble Supreme Court in *TD Venkatarao Vs. Union of India* (1999) 237 ITR 315 (SC) has recognised the supremacy and competence of the Chartered Accountants in the matter of Audits under tax laws in following words:

“Chartered Accountants, by reason of their training have special aptitude in the matter of Audit. It is reasonable that they, who form a class by themselves, should be required to audit the accounts of business, whose income exceeds...”

The confidence in the members of Chartered Accountants profession is not baseless. The education and training programme of the Institute for qualification of Chartered Accountancy is designed to ensure that CAs have a variety of skills ranging from financial

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accounting to costing, legal skills, etc.

The Institute of Chartered Accountants of India has a stringent code of conduct to be followed by all its members. No other profession has such strict norms for monitoring and regulating the conduct of its members while discharging their professional duties. Further it's not that after qualifying as a Chartered Accountant, the members stop learning further. They are required to continuously upgrade their knowledge by acquiring constant training by attending various seminars, conferences, workshops, and lecture meetings to acquire latest knowledge and to keep pace with changing environment. To achieve the objective of constant professional education of the members the Institute has made it mandatory for its members to achieve a minimum prescribed hours of CPE Credit by attending to the eligible programmes of the Institute like seminars, conferences and workshops on the current topics of professional interest. All these taken together give upper hand to the Chartered Accountants over other professionals to conduct the audit. And hence, the tax audit under the VAT Laws should be assigned only to Chartered Accountants.

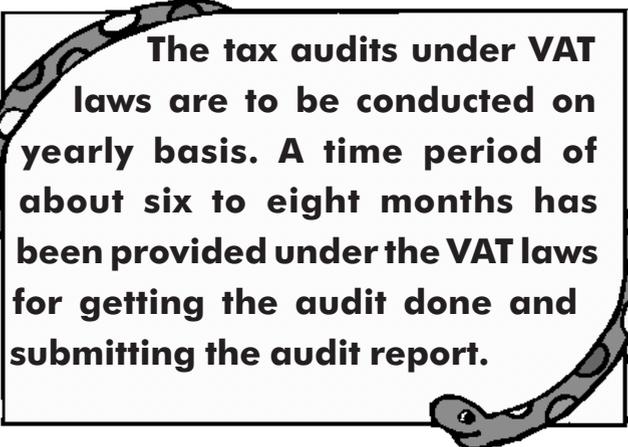
### Necessity of Audit

Like majority of the developing economies, our country is also facing the problem of lack of education and awareness about tax laws, more particularly amongst the trading community. Further, the VAT System of taxation is new to them. Since the trading community is not that educated and equipped to understand the implications of the VAT System of Taxation imme-

diately there is every possibility that they may not be in a position to arrange their business affairs to fall in line with the requirements of the State Level VAT, calculate and discharge their exact tax liability under the Value Added

Tax Law. On the other hand, the tax administrator i.e. the authorities in the taxation department also find themselves devoid of sufficient resources to educate the tax payers and inform them about the procedural and accounting changes that are necessitated by the implementation of Value Added Tax System.

Another reason for prescribing an audit under the Value Added Tax Law by a Chartered Accountant, is this that under the Value Added Tax System a major thrust is to be laid on the 'self assessment' meaning thereby that the tax liability calculated and paid by the tax payers through their periodical returns will be accepted by and large and the taxpayers will not be called to substantiate the tax liability shown by them in the returns by producing books of accounts and other relevant material. The Assessments with books of Accounts will be an exception. Therefore, there is a strong need to see that the taxpayers discharge the proper tax liability while filing the returns. This can be insured only where the particulars furnished by the taxpayers are verified by an independent auditor in minute details by going not only through the books of accounts but also by



**The tax audits under VAT laws are to be conducted on yearly basis. A time period of about six to eight months has been provided under the VAT laws for getting the audit done and submitting the audit report.**

analysing and interpreting the provisions of the State level VAT Laws and reporting, whether there was any under assessment made by the dealer requiring additional payment or whether there was any excess payment of tax warranting refund to the tax payer. In most of the countries tax evasion is rampant under the existing tax systems. In India too evasion of excise and Sales Tax is estimated to be very high. If no audit is prescribed under VAT law, the chances of evasion of VAT tax will increase causing revenue leakage for the Government. It is, therefore, essential that the audit of the proposed VAT system is attempted on a regular basis. However, it is not possible to conduct the audit of all the VAT dealers. Therefore, the criteria for audit can be the amount of turnover or the class of dealer dealing in specified commodities.

The concept of audit is popular even in Foreign Countries where the system of Value Added Tax is in practice since long in the field of indirect taxation. In countries like France and Korea the audit has proved to be an effective tool to check the evasion of tax, which was mostly done by producing fake invoices etc.

## Company Audit, Tax Audit under Income Tax Act and Audit under VAT

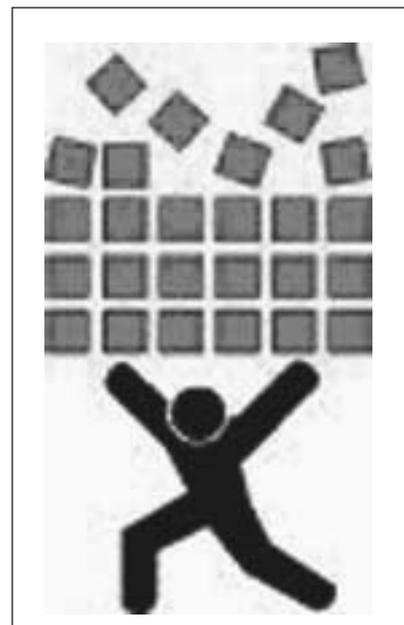
Though the basic principles of audit remain the same for all types of audit yet the audits differ to a great extent so far as the reporting requirements are concerned. The purpose of audit under the company's Act, is different than the purpose of audit under the Income Tax Act. The above two audits may also differ from the audit under VAT Law as all the three audits are undertaken with different objectives which are divergent from each other. While the audit under the Companies Act, 1956 is undertaken with a view in mind that the auditor has to report on the true and fair view of the financial statements of a company placed before him for an audit. Here the auditor gives simply his opinion that the balance sheet of the company portrays a true and fair view of the Assets and Liabilities and the Profit & Loss Account gives a true and fair picture of the profit or loss made. In a report for Audit Under Section 44AB of the Income Tax Act the auditor has to simply give the information about certain expenses, payments, loans and deposits. He does not comment upon the admissibility or non-admissibility of various expenses and therefore does not calculate and certify the tax liability under the Income Tax Act. The audit under the VAT Law differs from the earlier two audits to a great degree in the sense that so far as the books of accounts etc. are concerned the auditor gives his opinion as to whether the financial statements give a true and fair picture and whether they are in conformity with the book of accounts or not at the same time it also certifies the turnover of sales and purchases,

calculations of output tax, the various exemptions and deductions claimed, the certification of input tax credit, etc. Therefore, the audit under the VAT law is far more comprehensive.

### Role of Tax Auditor

The role of tax auditor in the initial years of implementation of VAT would be that of an advisor to the taxpayers. This role will cast upon him the responsibility to educate and guide the auditee regarding the maintenance of proper records and in assisting the auditees in maintaining accounting records in such a manner so as to get the information needed for filing of return without delay and extra efforts. In playing the advisory role the auditor will have to help in devising a proper accounting system as will generate the required information regarding the output tax, input tax credit etc. While doing so, the auditor may take the guidance from the guidance notes issued by the Institute of Chartered Accountants of India, New Delhi.

The role of Tax auditor vis-a-vis the tax administrators is this that the auditor while discharging his function finds out whether the turnover of sales/purchases is shown correctly in the returns and is backed up by the accounts and other relevant documents. The deductions claimed by the taxpayer from the turnover of sales are genuine and are supported by valid documents. The claim of Input Tax Credit has been properly made i.e. it has not been claimed on the higher side or on such purchases, which are not eligible for grant of Input Tax Credit. There may be certain instances wherein at the time of purchases goods may be eligible for set-off and accordingly the



same was claimed in the returns but subsequent events suggest that the Input Tax Credit is not admissible. In such circumstances whether the inadmissible Input Tax Credit has been reversed or not, if not then to point it out in his report. Thus to a certain degree the tax auditor is expected to assist the tax administrators in proper quantification of tax liability of the tax payer and see that State exchequer gets its revenue which is legally due.

### Preparation for Tax Audit under VAT

A tax auditor has to make certain preliminary preparation before actual execution of tax audit under the VAT law. The major steps required to be undertaken for preparation are as under:

1. After accepting the audit assignment the auditor should first get familiar with the business of the audit. In this regards the auditor should refer to the AAS-20. 'Knowledge of the business' issued by the council of Institute of

Chartered Accountants of India. Before starting the audit, the auditor should have a preliminary knowledge of the industry/ business & of the nature of ownership management etc. The more detailed information should be obtained and should be assessed & updated during the course of audit. For this purpose the various sources for information may be tapped. The knowledge of business is important not only to the auditor but also to his staff engaged in the audit. As the auditor has to ensure that the audit staff assigned to an audit engagement obtained sufficient knowledge of the business to carry out the audit work delegated to them. Not only that they should make effective use of the knowledge about the business and should consider how it affects the tax liability reported in the return. The facts and figures of the returns are consistent with the auditor knowledge of the business. The auditor should also make himself familiar with the process of production so also the distribution chain. The auditor should also obtain the information about whether the auditee is a manufacturer/ importer/ retailer, what are the customers to whom the sales are effected whether the auditee effects any sales, which are outside the scope of VAT law. Similarly the sources of purchase, the items sold should be listed out. Further it should be ascertained whether the auditee has opted for composition scheme or not.

**2. Obtaining a list of all the Accounting records maintained by the Auditee:** The auditor should obtain a complete list of all the accounting records relating to sale/purchase of goods, stocks. The various registers, the ledgers etc. maintained, in which the transac-

tions are recorded. The various source documents in which the entries are recorded in the books of accounts and the process of their generation.

**3. Ascertaining the Major Accounting Policies Adopted by the Auditee:** The auditor should know the major accounting policies based on which the accounting is done. The accounting policy regarding recording of sales, purchases and valuation of inventory must be made known and the auditor should also find out whether there has been any change in those policies during the year covered by audit? If there is any significant change in the accounting policy giving rise to some material effect on the tax liability, the same should be invariably reported.

**4. Evaluation of Internal Control etc:** Before determining the extent of audit checks to be applied i.e. to go in depth or test check, the auditor should ascertain whether there is internal check system in operation in the entity. He should particularly find out how the purchase/sale gets initiated and materialised. In case of purchase from the stage of receipt of indent by the purchase department, determining whether there is need for purchases, initiation of purchase order, receipt of material, preparation of MRN, entries made in the books of accounts etc. For sales starting from receipt of inquiry, acceptance of sales order, execution of sales, preparation of sale invoice & realization of transaction. If the internal control is reliable the extent of audit may be reduced and should be focused only on those areas where the auditor feels that greater degree of audit risk is involved.

**5. Knowledge about the VAT Law and Allied Laws:** The auditor & his staff should obtain the thorough knowledge of the state VAT law under which the audit is to be conducted. The auditor should study the VAT law stating from the definition of various terms, the procedure to be adopted, the provisions regarding issue of invoices, claiming of input tax credit, composition schedule in the VAT law, the manner in which the output tax is to be calculated, the provisions of audit, the contents of the audit report, the periodicity of the return to be filed, the format of the forms of returns the various notifications issued. Further the auditor should know the Central Sales Tax law, as he has to comment on the liability under that law also. The auditor should also have some knowledge about the judicial pronouncements made by the Tribunals and the Courts on the various facets of these laws.

### Approach to Tax Audit Under VAT

The Audit approach of the tax auditor under the Value Added Tax System will be more or less similar to the approach which is adopted by the auditor while conducting the tax audit under the provisions of Section 44AB of the Income Tax Act, 1961. However, the reporting requirements vary to a considerable extent.

While the auditor has to apply the basic principles of audit in all the audits, yet the requirements of VAT Audit are different and accordingly the tax auditor under the VAT Law is expected to design his audit programme.

While designing the audit program the auditor has to ensure that program includes the performance of such audit checks as will enable the auditor to get the information

which he needs to be analysed for reporting —

❖ The turnover of sales /purchases of goods has been properly determined keeping in view not only the generally accepted accounting policies but the definition of turnover of sales in the relevant VAT law. The sales turnover arrived at by applying the generally accepted accounting policies may not be the same as required to be under the VAT law. To take an example, the sale proceeds of fixed asset will not form a part of turnover sales as per the generally accepted accounting policies but will form a part of turnover of sales for the purpose of VAT law. Similarly the price of goods returned is deducted from the turnover of sales even if the returns are from the sales effected in the previous years, while under VAT laws, the goods returns are to be deducted only if they are made within the prescribed time, say six months from the date of sale. Thus, the results of the audit procedure adopted by the auditor should be such as would give the auditor a reasonable assurance regarding the figures of sales reported in the returns. Not only that, he should also be able to get the

exact quantum of the sales under reported or over reported duly classified for different tax rates and it's impact on overall tax liability. The sales as per the financial statement may include the turnover of sales effected by all the branches, but for the purposes of VAT law the turnover of sales of only those branches will be included which are included in one registration certificate.

❖ The turnover of purchases should be tested by applying audit checks as will enable the auditor to get the purchases eligible for grant of input tax credit segregated from other purchases. Further, the purchases on which the input tax credit is available in full and the purchases on which it is available partially should also be ascertained correctly. Thereafter, the auditor should get the exact amount of input tax credit available, compare the same with the credit claimed in the returns and report on the excess/short claim of the credit in the returns filed.

❖ The auditor is also required to comment on the timely filing of the returns under the VAT law. For this purpose the auditor is expected to list out the due dates of filing of returns and find out the reasons for delay in filing the returns if any.

❖ The auditor is also required to give his report on the composition scheme, the auditor should apply such compliance tests as will be able him to ascertain that

the auditee is eligible for composition, it has paid the requisite composition and all the procedural formality in relation thereto are complied.

❖ The auditor has to give his report on the TDS. Therefore, such test are to be applied as will enable him to report on the applicability of TDS provisions, the accuracy of the amount deducted and paid, timely issue of TDS certificate, filing of TDS returns.

❖ The auditor is also expected to check the consolidation of the returns filed for all the periods covered in the year under Audit. Both under the State level Value Added Tax Law and the Central Sales Tax Act, 1956. These returns are to be compared with the books of accounts and the documentary evidences available. The auditor is suppose to apply such substantive step as enable him to judge that all the transactions relating to sale and purchase are entered in the books of accounts and have been taken into consideration while filing the returns. In case of any inconsistency a proper reconciliation of book figures and the returned figures should be made and also the correct quantification of tax liability is to be done.

The above are only the major areas, which are to be tested by the auditor while conducting the tax audit under VAT Laws. The auditor has to take a judgment of his own regarding the adequacy and appropriateness of the audit checks to be applied and the areas where the tests are to be applied, so as to give him all the information needed to form a view not only on the authenticity of the books of accounts, correctness of the returns filed but also in the quantification of tax liability.

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## Audit Report Under VAT

All State Level VAT Laws have been framed by following a common VAT Law Module suggested by the Central Government. Further the empowered committee, which pioneered the concept of model VAT Law based on certain common principles also insisted that the basic framework of all the VAT Laws in various State should be common. It is felt that there should be a common design for VAT Audit Report also so that the auditor should not find it difficult to conduct the audit and the reports can be made more meaningful and comprehensible to all. The Institute of Chartered Accountants of India already took a step in this direction before hand and had already developed a standard format of the audit report. The standard format of audit report was also submitted to the Empowered Committee and was accepted and released by the Secretary of the Empowered Committee Mr. Ramesh Chandra. State can take the benefit of the same and incorporate the format of audit report suggested by the ICAI in their VAT Laws with a liberty to provide for some additional information to be reported depending upon their specific needs and requirement.

At the end of the audit the auditor has to arrive at his conclusion on the matters to be reported in the audit report. The format of audit report is generally prescribed under the relevant VAT law and the auditor has to fill in all the columns of the audit report that are applicable. While performing the audit under VAT law the auditor is expected to conduct the audit presuming himself to be the tax assessor. His audit report will therefore has to be comprehensive commenting on each

and every aspect which goes to the root of quantification of tax liability. The auditor is expected to give his opinion on the adequacy of accounting records, correctness

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and completeness and arithmetical consistency of returns filed. Further he has to state the basis of his opinion i.e. the accounts, financial statements, documents verified by him to arrive at the above conclusion. The auditor is also expected to give the summary of additional tax liability/additional refund arising on his verification of the returns together with books of accounts. While the auditor is giving a general opinion on the truth and fairness of books and account he can make a qualified opinion or an unqualified opinion. He can also resort to disclaimer where he finds that the accounting records were insufficient to enable him to frame either an unqualified opinion or a

qualified opinion.

So far as the comment on the variation of tax liability is concerned the auditor has to quantify exactly the amount by which the liability increases or decreases. He has also to state the transactions against which there is variation in tax liability. Therefore, either he has to state that the tax liability shown in the return is correct or it is incorrect by what extent. Thus, an amount of certification of tax liability is involved therein, which casts greater responsibility on the auditor.

## Conclusion

The tax audit under the Sales Tax Laws is being introduced for the first time in many States. Further the concept of VAT system of taxation is also new, the tax audit under VAT Laws being technical in nature, there is a strong need for training the members and updating their knowledge concerning audit under VAT laws. The Institute of Chartered Accountants of India can play a vital role in educating the members in the area of VAT law and equipping the members for conducting the tax audit under VAT law. For this purpose there is an emergent need of holding chain seminars throughout the country and publication of guidance note etc. to enable the members to update their knowledge and sharpen their skills to cope with the tax audit, which is a new and challenging area for the profession as a whole.

Fortunately the tax audits under VAT laws are to be conducted on yearly basis. A time period of about six to eight months is given in the VAT laws to get the audit done and submit the audit report. This time can be utilised by the profession in preparing for the tax audits by sharpening their tools. ■