CHAPTER 15

Audit under Fiscal Laws

Question 1

State with reasons whether an auditor conducting tax audit 'certifies' or 'reports' on information contained in the statement of particulars attached to the tax audit report under Section 44 AB of Income-tax Act, 1961.

Answer

Section 44AB of the Income-tax Act, 1961 requires the auditor to submit the audit report in the prescribed form and setting forth prescribed particulars. The statement of particulars as required in Form 3CD (assessee carrying on a business) or Form 3CE (assessee carrying on a profession) are required to be annexed to the main audit report. The audit report is in two parts. The first part requires the auditor to give his opinion as to whether or not the accounts audited by him give a true and fair view and the second part of the report is in the form of an "Annexure" containing statement of particulars in respect of certain specified matters. The tax auditor has to report whether particulars are true and correct.

In this context, it is important to appreciate the distinction between the terms "report" and "certificate". Briefly speaking, the term "certificate" is used where the auditor verifies the accuracy of facts while the term "report" is used in case the auditor is expressing an opinion. Strictly speaking, having regard to the usage of the word true and correct, these particulars require definitive information compiled from the books of account. Hence, it can be said that an auditor conducting tax audit 'certifies" the information contained in the statement of particulars. However, having regard to the distinction, it is significant to examine whether all thirty two clauses included in the statement of particulars are capable of being simply certified on the basis of books of account or there are some clauses in respect of which different auditor(s) may hold different opinion. For instance, clause 12 dealing with valuation of closing stock would require the auditor to examine and opine on the basis adopted for ascertaining the cost and, thus, to ensure that method followed for valuation of stock results in disclosure of correct profits and gains. Similarly clause 14 relating to depreciation would require the auditor to exercise judgement having regard to the facts and circumstances of the case, etc. Thus, there are several matters on which the auditor is required to exercise judgement while giving his report on various amounts included in the statement of particulars. No doubt that the auditor obtains the statement of particulars in Form No.3CD duly authenticated by the assessee, it does not merely involve checking the corresponding figures with the documents and books of account but requires the auditor to exercise his judgement which may at times lead to different figures by different persons reporting thereon. There can also be situations leading to difference of opinion between the tax auditor and the assessee. Therefore, it can be said that an auditor conducting tax audit "reports" on certain information, apart from certifying

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certain factual information contained in the statement of particulars annexed to the tax audit report under section 44AB of the Income-tax Act, 1961.

Question 2

Mr. X, who conducts the tax audit u/s 44AB of the Income-tax Act, 1961 of M/s ABC, a partnership firm has received the entire audit fees of ₹ 25,000 in April, 2012 in respect of the tax audit for the year ended 31.3.2012. The audit report was however signed in September, 2012. Comment.

Answer

Receipt of Tax Audit Fees in Advance: Under section 226(3)(d) of the Companies Act, 1956, a person is disqualified from being an auditor if he is indebted to the company for more than ₹ 1,000. This provision for disqualification would apply only in case of an auditor appointed under the Companies Act, 1956. The intention of the Companies Act, 1956 is to ensure that the auditor is not under any financial obligation of the company.

When a chartered accountant is appointed to conduct a tax audit u/s 44AB of the Income -tax Act, 1961, his appointment is not under the Companies Act, 1956 but under the Income-tax Act, 1961. In the Income-tax Act, 1961 there is no such provision for a person to be disqualified on his becoming indebted to the company. Thus in the instant case, though the entire audit fees are taken in advance, Mr X would still be able to carry out the audit and he would not be disqualified. However, having regard to be professional ethics in general an auditor must avoid such situations and may consider disclosing the same.

Question 3

In the context of tax audit under Section 44AB of the Income-tax Act, 1961, discuss the provisions of Section 145 of the said Act regarding the method of accounting and accounting standards notified thereunder.

Answer

Accounting Standards and the Income-tax Act, 1961: As per Section 145 of the Income-tax Act, 1961 "

(1) Income chargeable under the head 'Profits and gains of business or profession' or "Income from other sources' shall, subject to the provisions of sub-section (2), be computed in accordance with either cash or mercantile system of accounting regularly employed by the assessee.

(2) The Central Government may notify in the Official Gazette from time to time accounting standards to be followed by any class of assessees or in respect of any class of income.

(3) Where the Assessing Officer is not satisfied about the correctness or completeness of the accounts of the assessee, or where the method of accounting provided in sub-section (1) or accounting standards as notified under sub-section (2), have not been regularly followed by the assessee, the Assessing Officer may make an assessment in the manner provided in Section 144."

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Standards notified by Government -AS(IT) - In exercise of the powers conferred by section 145(2), the Central Government has by Notification No. S.O.69(E), dated 25th January, 1996 notified two AS(IT). This notification came into force with effect from 1st day of April, 1996, and is accordingly applicable from assessment year 1997-98 and subsequent assessment years.

These AS (IT) are given below :

Accounting Standards to be followed by all assessees following mercantile system of accounting.

A. Accounting Standard I relating to disclosure of accounting policies.

B. Accounting Standard II relating to disclosure of prior period and extraordinary items and changes in accounting policies.

The above Accounting Standards are to be followed by all assessees following mercantile system of accounting. Therefore, it is clear that those assessees who are following cash system of accounting need not follow the Accounting Standards notified above.

Section 145 provides that the AS(IT) notified under that section should be followed by the assessees to whom they are made applicable. It should be noted that the tax auditor auditing accounts under section 44AB is not computing the income but is - (a) reporting on accounts, and (b) reporting on the relevant information furnished in Form No. 3CD. Now, the revised Form No. 3CD vide clause 11(d) requires reporting of the details of deviation, if any, in the method of accounting employed in the previous year from accounting standards prescribed under section 145 and the effect thereof on the profit or loss. Further, it may be noted that there is no material difference between AS(IT)-I and AS(IT)-2 notified by the Government and the corresponding AS-1 and AS-5 of the ICAI respectively.

Question 4

A leading jewellery merchant used to value his inventory at cost on LIFO basis. However, for the current year, in view of requirements of AS 2, he changed over to FIFO method of valuation. The difference in value of stock amounted to ₹ 55 lakhs which is higher than that under the previous method. In such a situation, what are the reporting responsibilities of a Tax Auditor under Section 44AB of Income-tax Act, 1961.

Answer

The change in the method of valuation of stock is not a change in method of accounting, as it is only a change in accounting policy. However in the Income-tax Act, 1961 this is considered under method of accounting. Under the Income-tax Act, 1961, if the change in method of valuation is bonafide, and is regularly and consistently adopted in the subsequent years as well, such change would be permitted to be made for tax purposes. In the instant case, the change in the valuation of stock from LIFO basis to FIFO basis is pursuant to mandatory requirements of the AS 2 'Valuation of Inventories' and therefore should be viewed as bonafide change.

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This apart, the tax auditor in his report has to specifically refer to the method of valuation of stock under Clause 12 in Form 3CD.

(a) Method of valuation of closing stock employed in the previous year.

(b) Details of deviation, if any, from the method of valuation prescribed under section 145A and the effect thereof on profit or loss.

The auditor has to see that the method of stock valuation is followed consistently from year to year. It is also necessary to ensure that method followed for valuation of stock results is correct profits or gain. The change from LIFO to FIFO is bonafide, the disclosure of which would have to be made the financial statements. As far as section 145A is concerned, the tax auditor need not change the method of valuation of purchases, sales and inventories which is regularly employed by the assessee. All that he has to do is to adjust the valuation for any tax, duty, cess or fee actually paid or incurred by the assessee, if the same had not already been adjusted.

Question 5

XYZ Private Limited is engaged in the wholesale business of buying and selling silk sarees. The accounts are maintained under the Companies Act from 1st October to 30th September each year. The Chief Accountant of the Company is requesting the tax auditor to conduct tax audit U/S 44AB of the I.T. Act for the period for which accounts have been maintained under the Companies Act. As the tax auditor of XYZ Private Limited, how will you react to the Chief Accountant's request?

Answer

Accounting Period under Section 44AB: In relation to the question as to whether u/s 44AB the tax auditor can audit and certify the amounts for the period for which accounts have been maintained under the Companies Act (in this case from October to September) or whether the tax auditor will have to certify the accounts for the relevant financial year which is the uniform accounting year for tax purposes, the CBDT have considered the matter and are of the opinion that as the income of the previous year is chargeable to tax and for the purposes of Income-tax Act, 1961, the previous year is the financial year, the tax auditor would have to carry out the audit u/s 44AB in respect of the period covered by the previous year i.e., the relevant financial year. The proviso for the aforesaid section 44AB, therefore, covers only the cases where the accounts are audited under any other law in respect of the financial year. Where the accounting year is different from the financial year, the proviso to section 44AB will not apply. Consequently the tax auditors would have to carry out the tax audit in respect of the period covered by the relevant financial year and submit has report Form 3CB, as required in rule 6G(I) (b) of the I.T. Rules (Circular No. 561. dated 22.5.90).

Question 6

As a tax auditor, which are the accounting ratios required to be mentioned in the report in case of manufacturing entities? Explain in detail any one of the above ratios and how does it help

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the tax auditor in his analytical review.

Answer

The ratios which are to be calculated for manufacturing entities are:

- Gross profit / Turnover
- Net Profit / Turnover
- Stock-in-trade/Turnover
- Material consumed / Finished goods provided

Ratio analysis constitutes a substantive auditing procedure designed to obtain evidence as to the completeness, accuracy and validity of the data produced by the accounting system. Such assessment is necessary in organisation having large volumes of transactions and in the organisation following mechanised accounting system where it is not possible to check each and every transaction. It has the merit of bringing to focus the abnormal deviations and unexpected variations which the normal routine checking in auditing may fall to reveal. Ratios highlight only symptoms and that too as of a particular day and the auditor should study these symptoms properly, correlate them and reach definite conclusions or identify areas for further enquiries. The auditor should by relating sales with the net profit, various items of direct and indirect costs and gross profit gather information about the profitability and operating efficiency of an enterprise; variations in any of these ratios in a particular year should be inquired by the auditor. The fall in the gross profit ratio and profitability ratio should alert the auditor who should ask the management for the reasons thereof and which should be carefully examined by him. The auditor should by relating sales with the net profit, various items of direct and indirect costs and gross profit gather information about the profitability and operating efficiency of an enterprise; variations in any of these ratios in a particular year should be inquired by the auditor. The fall in the gross profit ratio and profitability ratio should alert the auditor who should ask the management for the reasons thereof and which should be carefully examined by him.

These ratios have to be given for the business as a whole and not product wise. While calculating these ratios, the tax auditor should assign a meaning to the terms used in the above ratios having due regard to the generally accepted accounting principles. All the ratios mentioned in the clause are to be calculated in terms of value only.

The relationship of stock-in-trade to turnover over a period of time would reveal whether the entity has been accumulating stocks or there is a decline in the same. The auditor may obtain data for about 7-10 years, compute ratio of stock-in-trade/turnover and plot it on a graph paper over a period of time. This may give rise to several possibilities such as parallel horizontal lines, vertical rising line or a vertical falling line. A study of this relationship would reveal whether stocks are being accumulated or they are dwindling over a period. Such information would provide an input to tax auditor as to whether figures of either stock or turnover are being manipulated. Sometimes, while studying the relationship, it may show sudden decline or increase at a point of time which reflect that there is definitely something wrong with the

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figures of stock. Therefore, a close examination of such ratios helps the tax auditor to focus on major deviations and consequently reasons for the same.

Question 7

Write short notes on the following:

(a) Recognition of Deferred Tax Assets

(b) Deferred Taxation

Answer

(a) Recognition of Deferred Tax Assets: Deferred Tax Assets (DTA) are to be recognised as laid down by AS 22 "Accounting for Taxes on Income" a DTA arises on account of a timing difference in which the taxable income is more than the book income. A deferred tax asset (and the corresponding tax saving) should be recognised only after applying the test of prudence. Thus, where the enterprise does not have unabsorbed depreciation and carried forward losses as per the tax laws, deferred tax assets should be recognised and carried forward to the extent that there is a reasonable certainty that sufficient future taxable income will be available against which such deferred tax assets can be realized. In other words, no deferred tax asset should be created if there is no reasonable certainty about the requisite future taxable income. The existence or absence of a reasonable level of certainty would normally be determined by examining the past record of the reasonable and by making realistic estimates of profits for the future.

A much stricter test of prudence has to be satisfied where the enterprise has unabsorbed depreciation or carried forward losses under tax laws. In such a situation, deferred tax assets should be recognised only to the extent that there is virtual certainty supported by convincing evidence that sufficient future taxable income will be available against which such deferred tax assets can be realized. The existence of unabsorbed depreciation or carried forward losses under tax laws is strong evidence that future taxable income may not be available. Therefore, in such a situation, the enterprise can recognise deferred tax assets only to the extent that it has timing differences the reversal of which will result in sufficient taxable income or there is other convincing evidence of virtual certainty of availability of sufficient taxable income against which deferred tax assets can be realized.

ICAI has stated that virtual certainty refers to the extent of certainty which, for all practical purposes, can be considered certain. Determination of virtual certainty of availability of sufficient future taxable income is a matter of judgement which will have to be made on a case-to-case basis.

(b) Deferred Taxation: AS 22, Accounting for Taxes on Income, prescribes the accounting treatment for taxes on income. The amount of taxable income for a period and the amount of profit (or loss) as shown by the profit and loss account for that period are seldom the same. The difference between accounting income and taxable income arise due to the fact that taxable income is calculated in accordance with tax laws whose

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requirements regarding computation of taxable income differ from the accounting policies applied to determine accounting income. The difference between taxable income and accounting income can be classified into 'permanent differences' and 'timing differences'. 'Permanent differences' are the differences between taxable income and accounting income for a period that originate in one period and do not reverse subsequently. Timing differences, on the other hand, are those differences between taxable income and accounting income for a period that originate in one period and are capable of reversal in one or more subsequent periods. The standard requires that deferred tax should be recognized for all timing differences, subject to the consideration of prudence in respect of deferred tax assets. Deferred tax represents the future tax effects of timing differences. Some timing differences are such that their reversal in future year(s) would result in the taxable income for the year(s) of reversal being higher than the accounting income for that year (or those years).

Question 8

As a tax auditor, how would you report on the following?

(i) Labour charges paid on which tax is deducted at source at an inappropriate rate.

(ii) Capital expenditure incurred for Scientific Research Assets.

Answer

(i) Section 40(a) of the Income-tax Act, 1961 specifies that amounts payable to a contractor or sub-contractor, being resident, for carrying out any work (including supply or labour for carrying out any work) on which tax is deductible under Chapter XVII-B and such tax has not been deducted or after deduction has not been paid on or before the due date specified in sub section (1) of section 139 of IT Act, 1961. Therefore, if tax is deducted at an inappropriate rate, the amount is disallowable u/s 40(a)(ia) of the Income-tax Act. This fact needs to be reported in Clause 17(f) of Form 3CD where all amounts inadmissible u/s 40(a) are to be reported. In case, the assessee submits that the rate is proper, though in the auditor's view it is improper, the tax auditor should exercise his judgement and accordingly report in Clause 17(f) of Form 3CD.

(ii) Expenditure on Scientific Research (capital as well as revenue) covered u/s 35 of the Income-tax Act, 1961. The same is to be reported by a tax auditor in clauses 15(a) and (b) of Form 3CD. The tax auditor is required to report amount debited to the profit and loss account (showing the amount debited and deduction allowable (15a) and (ii) not debited to the profit and loss account (15b). Accordingly, the auditor should report in Clause 15(b) the amount of capital expenditure not debited to the Profit and Loss Account which is eligible for deduction u/s 35 as Scientific Research Expenditure.

Question 9

Write a short note on - Method of accounting in Form No. 3CD of Tax Audit.

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Answer

Method of accounting in Form No. 3CD of Tax Audit: Clause 11 of Form No. 3CD of the tax audit requires to state

(a) Method of accounting employed in the previous year.

(b) Whether there has been any change in the method of accounting employed vis-a-vis the method employed in the immediately preceding previous year.

(c) If answer to (b) above is in the affirmative, give details of such change, and the effect thereof on the profit or loss.

(d) Details of deviation, if any, in the method of accounting employed in the previous year from accounting standards prescribed under Section 145 and the effect thereof on the profit or loss.

Section 145 provide that method of accounting be either cash or mercantile. Hybrid system is not permitted.

Question 10

What are the steps for the Audit under the State level 'Value Added Tax' (VAT)?

Answer

VAT is a tax on the value added to the commodity at each stage in the production and distribution chain. VAT is an indirect Tax on consumption. It is a tax on the value at the retail point of sale which is collected at each stage of sale.

The essence of VAT is that it provides credit set off for input tax i.e. tax paid on purchases against the output tax i.e. tax payable on sales.

The following steps have to be taken by the auditors while auditing under VAT.

(i) Knowledge of business - After accepting the audit assignment the auditor should familiarize himself with the business of the auditee. In this regard, the auditor should refer to the SA 315- "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment" issued by the Council of the Institute of Chartered Accountants of India. Before starting the audit, the auditor should have a preliminary knowledge of the industry/ business and of the nature of ownership, management etc. More detailed information should be obtained and should be assessed and updated during the course of audit. For this purpose the various sources of information may be tapped. The knowledge of business is important not only to the auditor but also to his staff engaged in the audit. The auditor has to ensure that the audit staff assigned to an audit engagement obtains sufficient knowledge of the business to carry out the audit work delegated to them and further 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 in the returns should be consistent with the auditor's knowledge of the business. The auditor should also make himself familiar with

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the process of production and the distribution chain. The auditor should also obtain information about whether the auditee is a manufacturer/ importer/ retailer, the details of major customers to whom the sales are effected and the details of sales which are outside the scope of VAT law. Similarly the sources of purchase and the items sold should be listed out. Further it should be ascertained whether the auditee has opted for the composition scheme or not.

(ii) 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 transactions are recorded, the various source documents in which the entries are recorded in the books of account and the process of their generation. VAT is a state subject and therefore each state has a separate legislation governing VAT, wherein the prescribed format are provided in respect to various accounting records prescribed to be maintained by VAT legislation.

(iii) Ascertaining the major accounting policies adopted by the auditee - The auditor should know the major accounting polices based on which books of account have been recorded. 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. While conducting an audit under VAT, special care is required to be taken in respect to accounting policy and treatment of stock transfer to branches. According to VAT/CST provisions, stock transfers are also included in the turnover whereas stock transfer is not part of turnover as for generally accepted accounting principles.

(iv) Evaluation of internal control etc. - Before determining the extent of audit checks to be applied i.e. whether to go in- depth or to do only test check, the auditor should ascertain whether there is an internal check system in operation in the entity. He should particularly find out how the purchases and sales gets initiated. For example, in case of purchase, receipt of indent by the purchase department, determining the need for purchases, initiation of purchase order, receipt of material, preparation of MRN, entries made in the books of accounts etc. should be verified. For sales, receipt of inquiry, acceptance of sales order, execution of sales, preparation of sale invoice and 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.

(v) Knowledge about the VAT law and allied laws - The auditor and his staff should obtain a thorough knowledge of the State VAT law under which the audit is to be conducted. The auditor should study the VAT law starting 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, and the various notifications issued.

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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.

Question 11

Write a short note on - Accounting ratios in Form 3 CD of Tax Audit.

Answer

Accounting Ratios in Form 3CD of Tax Audit

(a) Gross profit/Turnover;

(b) Net profit/Turnover;

(c) Stock-in-trade / Turnover;

(d) Material consumed/Finished goods produced.

These ratios have to be calculated only for assessees who are engaged in manufacturing or trading activities. This clause is not applicable to assessees carrying on profession. Moreover, the ratios have to be given for the business as a whole and need not be given product wise. Further, the ratio mentioned in sub-clause (d) need not be given for trading concern.

While calculating these ratios, the tax auditor should assign a meaning to the terms used in the above ratios having due regard to the generally accepted accounting principles. All the ratios mentioned above are to be calculated in terms of value only

Question 12

Discuss the reporting requirement in Form 3CD of Tax Audit Report under Section 44AB of the Income-tax Act, 1961 for the following:

(i) Tax deducted at source.

(ii) Expenditure incurred at clubs.

Answer

(i) Under clause 27, following particulars as to tax deduction has to be furnished in Form 3CD as under:

(a) Whether the assessee has complied with the provisions of Chapter XVII-B regarding deduction of tax at source and regarding the payment thereof to the credit of the Central Government [Yes/No]

(b) If the provisions of Chapter XVII-B have not been complied with please give the following details*, namely:

		Amount
(i)	Tax deductible and not deducted at all	.....

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(ii)	Shortfall on account of lesser deduction than required to be deducted	.....
(iii)	Tax deducted late	.....
(iv)	tax deducted but not paid to the credit of the Central Government	.....

In case test checking has been done for the above (in case of voluminous data) an appropriate disclosure for the same is to be given.

(ii) Reporting for expenditure incurred at clubs is to be given as per clause 17(d) of Form 3CD. The payments may be for entrance fees as well as membership subscription and for catering and other services by the club, both in respect of directors and other employees in case of companies and for partners or proprietors in other cases. The fact whether such expenses are incurred in the course of business or whether they are of personal nature should be ascertained. If they are personal in nature, they are to be shown separately under Clause 17(b)

Question 13

What is your understanding about the term "Audit of Indirect Taxes"? Explain the steps involved in the Indirect Tax Audit.

Answer

Audit of Indirect Taxes: The components of central indirect tax which form a part of the cost could be basic customs duty, additional duty of customs, special additional duty, excise duty special excise duty, additional duties of excise, service tax etc. The various components have a relationship with each other and also with central and local sales tax. The audits in this area, are governed under sections 14A and 14AA of the Central Excise Act, 1944. All these audits are conducted by or on behalf of the Government. The steps involved in conducting indirect tax audit are as under:

1. Evaluate the internal control systems in general with specific weight given to the strength of the systems in aiming at the quantification and discharge of the indirect taxes. The auditor should ensure that the accounting system and related internal control in this area are covered appropriately. Internal control questionnaire may be designed specifically for the area of indirect taxation.
2. Obtains information about the company and the industry. Specific information on amount of imports, percentage of customs, amount of removals, and quantum of cenvat-proportion of credit could also be calculated. The walk through of the process from the point of ordering of materials till the receipt of the payment from the customer is advisable.
3. Formulating an audit programme to assist in the actual conduct of the audit. The actual extent of verification would be dependent on the results of the evaluation of the internal controls.

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4. Ensure that the audit staff is knowledgeable in the law and the procedures governing the indirect taxes. The examination of the documents, physical verification, reconciliation tracing techniques, comparison of ratios, observation of the activities and discussions of the weaknesses observed should be part of an effective audit.
5. Prepare a report on the indirect tax audit providing specific comments on the statutory information, material matters reported by way of an executive summary and the assertion/qualification that the acceptable accounting policies are in vogue.

Question 14

Enumerate some of the areas of concern in an audit of indirect taxes.

Answer

Audit of Indirect Taxes: Some areas of concern in an audit of indirect taxes would be:

(i) Non availment or short / excess availment of export incentives.

(ii) Goods imported duty free or payment at concessional rates without properly complying with conditions.

(iii) Valuation Issues – valuation not in line with customs rules.

(iv) Applicability of the relevant export /excise exemptions.

(v) Valuation of goods not removed in normal course using valuation methods not in line with Central Excise Valuation Rules.

(vi) Ignoring Liability under Service Tax on services provided or availed.

(vii) Procedural non-compliance.

(viii) Passing on of duty suffered on imported goods and of locally manufactured goods in excess of actual.

(ix) Utilisation / Availability of credit of duty/ tax paid on inputs, capital goods of input services.

Questions 15

State whether a Tax audit report can be revised and if so state those circumstances.

Answer

Normally, the report of the tax auditor cannot be revised later. However, when the accounts are revised in the following circumstances, the tax Auditor may have to revise his Tax audit report also.

(i) Revision of accounts of a company after it adoption in the annual general meeting.

(ii) Change in law with retrospective effect.

(iii) Change in interpretation of law (e.g.) CBDT Circular, Notifications, Judgments, etc.

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The Tax Auditor should state it is a revised Report, clearly specifying the reasons for such revision with a reference to the earlier report.

Question 16

Draft an Audit programme for conducting the audit of a Public Trust registered under section 12A of the Income-tax Act, 1961.

Answer

An auditor should conduct routine checking during the course of audit of a public trust, in the following manner:

(i) Check the books of account and other records having regard to the system of accounting and internal control

(ii) Vouch the transactions of the trust to satisfy that:

  (a) the transaction falls within the ambit of the trust

  (b) the transaction is properly authorized by the trustees or other delegated authority as may be permissible in law;

  (c) all incomes due to the trust have been properly accounted for on the basis of the system of accounting followed by the trust;

  (d) all expenses and outgoings appertaining to the trust have been recorded on the basis of the system of accounting followed by the trust;

  (e) amounts shown as applied towards the object of the trust are covered by the objects of trust as specified in the document governing the trust.

(iii) Obtain trial balance on the closing date certified by the trustees' duly certified by the trustee;

(iv) Obtain Balance Sheet and Profit & Loss Account of the trust authenticated by the trustees and check the same with the trial balance with which they should agree.

Question 17

As the tax auditor of a non-corporate entity u/s 44AB of the Income-tax Act, 1961, how would you ensure compliance of section 145 of the Income-tax Act, 1961?

Answer

Income under the head Profit & Gains of business or profession or income from other sources has to be computed under mercantile or cash system of accounting as regularly maintained by the assessee.

The Central Government may notify in the official Gazette from time to time the accounting standards to be followed by any class or assesses or in respect of any class of income. The following Accounting Standards have been notified.

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(i) AS (IT)-1: Disclosure of accounting policies.

(ii) AS (IT)-2: Disclosure of prior period and extra ordinary items and disclosure of accounting policies.

The above AS are corresponding to AS-1 and AS-5 issued by the ICAI as per 145(3) the Assessing Officer may make a best judgement assessment under section 144 in the following situation:

(i) Where the Assessing Officer is not satisfied about the correctness or complete ness of the accounts of the assessee

(ii) Where the method of accounting has not been regularly followed by the assessee.

(iii) Where the AS notified u/s 145(2) have not been regularly followed by the assessee.

The auditor has to therefore ensure that:

(a) the entity follows either the cash or accrual method of accounting and same is to be reported in 11(a) of form 3CD.

(b) Accounting policies are required by AS (IT) -1 has been disclosed needs to be verified for compliance with ASI (11) of AS5 (11).

(c) Other provisions of AS 1 (IT) and AS (IT) -2 have been complied with.

Question 18

'A' Limited has paid minimum alternate tax under Section 115 JB of the Income-tax Act, 1961, for the year ended 31st March, 2012. The company wants to disclose the same as an 'Asset' since the company is eligible to claim credit for the same. Comment.

Answer

As per para 6 of the Guidance Note issued by ICAI on "Accounting for credit available in respect of MAT under the IT Act, 1961", although MAT credit is not a deferred tax asset under AS 22, yet it gives rise to expected future economic benefit in the form of adjustment of future income tax liability arising within the specific period.

The Framework for the preparation and presentation of financial statements, issued by the ICAI, defines the term 'asset' is a resource controlled by the enterprise as a result of past events from which future economic benefits are expected to flow to the enterprise.

MAT paid in a year in respect of which the credit is allowed during the specified period under the *Income-tax Act, 1961* is a resource controlled by the company as a result of past event, namely the payment of MAT. The MAT credit has expected future economic benefits in the form of its adjustment against the discharge of the normal tax liability if the same arises during the specified period. Accordingly, such credit is an asset.

According to the Framework, once an item meets the definition of the term 'Asset', it has to meet the criteria for recognition of an asset, so that it may be recognised as such in the financial statements.

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Para 88 of the Framework provide the following criteria for recognition of an asset:

An asset is recognised in the balance sheet when it is probable that the future economic benefits associated with it will flow to the enterprise and the asset has a cost or value that can be measured reliably.

In addition to the above, the auditor shall take a confirmation letter from the assessee for the said facts.

Thus, if the auditor is satisfied that the probability of the company to claim the said credit is high, it could recognise the same as an asset. In balance sheet it could be shown under the head "Loans and Advances" as MAT credit entitlement.

Question 19

Answer the following:

(a) ABC Printing Press, a proprietary concern, made a turnover of above ₹ 43 lacs for the year ended 31.03.2012. The Management explained its auditor Mr. Z, that it undertakes different job work orders from customers. The raw materials required for every job are dissimilar. It purchases the raw materials as per specification/requirements of each customer, and there is hardly any balance of raw materials remaining in the stock, except pending work-in-progress at the year end. Because of variety and complexity of materials, it is rather impossible to maintain a stock-register. Give your comments.

(b) A Co-operative Society having receipts above ₹ 60 lakhs gets its accounts audited by a person eligible to do audit under Co-operative Societies Act, 1912, who is not a Chartered Accountant. State with reasons whether such audit report can be furnished as tax audit report under Section 44 AB of the Income-tax Act, 1961?

Answer

(a) The explanation of the entity for the use of varieties of raw materials for different jobs undertaken may be valid. But the auditor needs to verify the specified job-orders received and the different raw materials purchased for each job separately. The use of different papers (quality, quantity and size) ink, colour etc. may be examined. If possible, the auditor may also enquire with the other similar printers in the locality to ensure the prevailing custom. At the same time, he has to report and certify under the Para 28(b) and Para 9(b) of Form 3CD read with the Rule 6G(2) of the *Income-tax Act, 1961*, about the details of stock and account books (including stock register) maintained. He (or his deputy) must verify the closing stock of raw materials, work-in-progress and finished goods of the concern, at least on the date of its balance sheet. In case the said details are not properly maintained, he has to specifically mention the same with reasons for non-maintenance of stock register by the entity.

(b) As per Section 44AB read with Explanation to Section 288 of the Income Tax Act, 1961,"accountant" means a chartered accountant within the meaning of the Chartered Accountants Act, 1949 (38 of 1949), and includes, in relation to any State, any person

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who by virtue of the provisions of sub-section (2) of section 226 of the Companies Act, 1956 (1 of 1956), is entitled to be appointed to act as an auditor of companies registered in that State.

Accordingly, the person who is not a Chartered Accountant as mentioned in the question, though is eligible to act as auditor of Cooperative Society under the Cooperative Society Act, 1912, but is not eligible to carry out tax audit under Section 44AB of the Income Tax Act, 1961.

Hence, such audit report cannot be furnished as tax audit report under Section 44 AB of the Income-tax Act, 1961

Question 20

Discuss briefly Accounting standards to be followed by assessees under the Income-tax Law.

Answer

Accounting Standards under the Income Tax Law: The Finance Act, 1995, substituted a new Section 145 w.e.f. 1997-98. The section deals with method of accounting as under:

145 (1) Income chargeable under the head 'Profit and gains of business and profession' or 'Income from other sources' shall, subject to the provisions of sub-section (2), be computed in accordance with either cash or mercantile system of accounting regularly employed by the assessee.

145 (2) The Central Government may notify in the Official Gazette from time to time accounting standards to be followed by any class of assessees or in respect of any class of income.

145 (3) Where the Assessing Officer is not satisfied about the correctness or completeness of the accounts of the assessee, or where method of accounting provided in the Sub-section 10 or accounting standards as notified under Section (2) above have not been regularly followed by the assessee. The Assessing Officer may make an assessment in a manner provided in Section 144 of the *Income-tax Act, 1961*.

The Central Government has by Notification No. S. O. 69 (E), dated 25.01.1996, prescribed. As (IT) as under:

A. Accounting Standard I relating to Disclosure of accounting policies.

B. Accounting Standard II relating to Disclosure of Prior Period and Extraordinary Items and Changes in Accounting Policies.

The above Accounting Standards are to be followed by all assessee following mercantile system of accounting. Therefore, it is clear that those assessees who are following cash system of accounting need not follow the Accounting Standards notified above.

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Question 21

T Ltd. an Indian company, subject to Indian Income tax Act, 1961, discloses advance Income-tax paid (Current tax asset) and provision for Income-tax (Current tax liability), separately in Balance Sheet for the year ended 31.3.2012, i.e., it does not offset the amount. Comment.

Answer

As per paragraph 27 of Accounting Standard(AS) 22 – Accounting for Taxes on Income, an enterprise should offset assets and liabilities representing current tax if the enterprise:

(i) has a legally enforceable right to set off the recognized amounts and

(ii) intends to settle the asset and liability on a net basis.

An enterprise will normally have a legally enforceable right to set off an asset and liability representing current tax when they relate to income taxes levied under the same governing taxation laws and the taxation laws permit the enterprise to make or receive a single net payment.

Since T Ltd is an Indian Company, and as per Income Tax Act, 1961, such set off is allowed which is legally enforceable. Thus, in view of Provisions of AS 22 and Income Tax Laws, T Ltd. should off set advance tax paid against provision for income tax and show only the net amount in the balance sheet.

Question 22

Mr. R, the Tax Auditor finds that some payments inadmissible under Section 40 A(3) were made, and advised the client to report the same in form 3CD. The client contends that cash payments were made since the other parties insisted upon the same and did not have Bank Accounts. Comment.

Answer

Form 3 CD: The audit under section 44 AB of the Income Tax Act 1961 requires that the tax auditor should report whether in his opinion the particulars in respect of Form 3CD are true and correct. It is the primary responsibility of the assessee to prepare the information in form 3 CD. The auditor has to examine whether the information given is true and correct. The form 3 CD is not a report of Tax Auditor. The report is in the form of 3 CA or 3 CB depending on the nature of the organization of the entity. If the tax auditor is satisfied that the information contained in form 3 CD is true and correct then he can give unqualified report in form 3 CA or 3 CB saying" in my opinion and to the best of my information and according to the explanations given to me and considering the materiality the particulars given in form 3 CD are true and correct." But in the given case the tax auditor has found that the form 3 CD contains the incomplete, misleading and false information.

Disallowance under section 40A(3) is attracted if the assessee incurs any expenses in respect of which payment of aggregate of payments made to a person in a day, otherwise than by an account payee cheque drawn on bank or account payee draft exceeds ₹20,000/- . However,

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exemption is provided in respect of certain expenditure in Rule 6DD. In such cases, disallowance under section 40A (3) would not be attracted.

Under clause 17 (h) of Form 3CD, amounts inadmissible under section 40A (3), read with Rule 6DD, have to be reported. Cash payment made on insistence of other parties on the contention that they do not have bank accounts is not covered under the list of exceptions provided under Rule 6DD.

Mr. R has to report the payments inadmissible under section 40A (3) under clause 17(h) of Form 3CD.

Question 23

While conducting the tax audit of A & Co. you observed that it made an escalation claim to one of its customers but which was not accounted as income. What is your reporting responsibility?

Answer

Clause 13(c) of Form 3 CD: A tax auditor has to report under clause 13(c) of Form 3 CD on any escalation claim accepted during the previous year and not credited to the profit and loss account under clause 13(c) of Form 3 CD.

The escalation claim accepted during the year would normally mean "accepted during the relevant previous year." If such amount are not credited to Profit and Loss Account the fact should be reported. The system of accounting followed in respect of this particular item may also be brought out in appropriate cases. If the assessee is following cash basis of accounting with reference to this item, it should be clearly brought out since acceptance of claims during the relevant previous year without actual receipt has no significance in cases where cash method of accounting is followed.

Escalation claims should normally arise pursuant to a contract (including contracts entered into in earlier years), if so permitted by the contract. Only those claims to which the other party has signified unconditional acceptance could constitute accepted claims. Mere making claims by the assessee or claims under negotiations cannot constitute accepted claims. After ascertaining the relevant factors as outlined above, a decision whether to report or not, can be taken.

Question 24

T Ltd's previous year ended on 31st March 2012. During that period it made a claim for refund of customs duty which was admitted as due by the customs authorities during April 2012. T Ltd neither credited the claim in the profit and loss account nor reported the same in clause 13(b) of Form 3CD for the reason that this has been admitted as due by the authorities only in the next financial year. Further T Ltd had changed the method of determination of cost formula for the purpose of stock valuation from FIFO basis to Weighted Average Cost basis, but that was also not reflected in clause I1(b) of Form 3CD which requires reporting on change in accounting method employed. Comment.

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Answer

Reporting requirement under Form 3CD :

As per Clause 13(b) of Form 3CD, the details of the Refund duty of custom, if admitted as due by the concerned authorities but not credited to the profit and loss account, are to be stated. But the Credits/Claims which have been admitted as due after the relevant previous year need not be reported in Form 3 CD.

In the instant case, the action of T Ltd in not crediting the claim to the profit and loss account and also not reporting of the same in Clause 13(b) of Form 3CD is in order.

Further Clause 11(b) requires reporting when there has been any change in the method of accounting employed vis-a-vis the accounting method employed in the immediately preceding year. However, change in an accounting policy will not amount to a change in the method of accounting and hence such change in the accounting policy need not be mentioned under Clause 11(b). It may be noted that change in the method of valuation of stock will amount to a change in accounting policy. However, it should be disclosed in the financial statements.

In the instant case, non-reporting of the change in the method of determination of cost formula of valuation of stock from FIFO to Weighted average Cost basis, in clause 11(b) of Form 3CD is in order.

Hence in the above situation, there is no reporting requirement under Clause 13(b) and Clause 11(b).

Question 25

As a tax auditor how would you deal and report the following:

(i) An assesses has borrowed ₹ 50 lakhs from various persons. Some of them by way of cash and some of them by way of Account payee cheque /Draft.

(ii) An assesses has paid Rent to his brother ₹ 2,50,000/- and paid interest to his sister ₹ 4,00,000/-

(iii) An assesses has incurred payment to clubs.

Answer

Tax Audit Report

(i) Borrowal of ₹ 50 Lakhs : As per Clause 24 of Form 3CD the particulars of each loan or deposit taken or accepted during the previous year have to be stated in the Tax Audit Report.

Further, Clause 24 (a) requires reporting in case if the loan or deposit was taken or accepted otherwise than by an account payee cheque or an account payee bank draft". In addition, as per Clause 24(c) the tax auditor has to state whether a certificate has been obtained from the assessee regarding taking or accepting loan or deposit ,

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through an account payee cheque or an account payee bank draft. The mere obtaining of such certificate does not reduce the responsibility of the tax auditor to verify the compliance with the provisions of section 269SS and 269T of the Income Tax Act.

Therefore, in the present case, where the assessee has borrowed ₹ 50 Lakhs by way of cash and some of them by way of Account payee cheque/ draft, needs to be verified and to be reported in compliance with Clause 24 of Form 3CD.

(ii) Payment of Rent and Interest: A tax auditor has to report under Clause 18 of Form 3CD which deals with the particulars of payments made to persons specified under Section 40A (2) (b). The specified persons include Husband, Wife, Brother, Sister or any other Lineal Ascendant or Descendant.

In the present case, an assessee has paid rent to his brother ₹ 2, 50,000 and interest to his sister of ₹ 4,00,000 may be disallowed if, in the opinion of the Assessing Officer, such expenditure is excessive or unreasonable having regard to:

(1) the fair market value of the goods, services or facilities for which the payment is made; or

(2) for the legitimate needs of business or profession of the assessee; or

(3) the benefit derived by or accruing to the assessee from such expenditure.

Hence this fact needs to be reported in the Tax Audit Report accordingly.

(iii) Payment to Club : As per Clause 17(d) of Form 3CD the amount of payments made to clubs by the assessee during the year should be indicated.

The payments may be for entrance fees as well as membership subscription and for catering and other services by the club, both in respect of directors and other employees in case of companies and for partners or proprietors in other cases. The fact whether such expenses are incurred in the course of business or whether they are of personal nature should be ascertained. If they are personal in nature, they are to be shown separately under Clause 17(b).

Hence, the tax auditor has to report the payments to clubs under Clause 17 (d) of Form 3CD.

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