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Audit under Fiscal Laws

Question 1

XYZ Ltd. pays ₹ 90000 for its 6 employees to a Hotel as boarding and lodging expenses of such employees for a conference. The Company pays the amount in cash to the Hotel. The Hotel gives 6 bills each amounting to ₹ 15000. The Company contends that each bill is within the limit, so there is no violation of the provisions of the Income Tax Act, 1961. As the tax auditor, how would you deal with the matter in your tax audit report for the Assessment Year 2014-15? (4 Marks, November, 2014)

Answer

Reporting for Payment in Cash above ₹ 20,000: As per section 44AB of the Income Tax Act, 1961, 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 3CD.

Disallowance under section 40A(3) of the Income Tax Act, 1961 is attracted if the assessee incurs any expenses in respect of which payment or 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, exemption is provided in respect of certain expenditure in Rule 6DD. In such cases, disallowance under section 40A(3) would not be attracted.

In the given case, the tax auditor found that a hotel issued 6 bills to XYZ Ltd. each amounting to ₹ 15,000 for boarding & lodging expenses of 6 employees. XYZ Ltd. in aggregate has paid ₹ 90,000 to the hotel in cash. Consequently, no expenditure shall be allowed for deduction as per the provisions of section 40A(3).

Furthermore, under clause 21(d)(A) of Form 3CD, the tax auditor has to scrutinize on the basis of the examination of books of account and other relevant documents/evidence, whether the expenditure covered under section 40A(3) read with rule 6DD were made by account payee cheque drawn on a bank or account payee bank draft. If not, the same has to be reported under abovementioned clause. Contention of the company that each bill is within the limit is not tenable since aggregate of payments need to be considered.

Therefore, the payments made by the XYZ Ltd. are inadmissible under section 40A(3) of the Income Tax Act, 1961 and hence, needs to be reported under clause 21(d)(A) of Form 3CD.

Question 2

Mr. A engaged in business as a sole proprietor presented the following information to you for the FY 12-13. Turnover made during the year ₹ 124 lacs. Goods returned in respect of sales made during FY 10-11 is ₹ 20 lacs not included in the above. Cash discount allowed to his customers ₹ 1 lac for prompt payment. Special rebate allowed to customer in the nature of trade discount ₹ 5 lacs. Kindly advice him whether he has to get his accounts audited u/s 44AB of the Income Tax Act, 1961. *(4 Marks, November, 2013)*

Answer

Turnover Limit for the Purpose of Tax Audit: The following points merit consideration as stated in the Guidance note on Tax Audit issued by the Institute of Chartered Accountants of India-

(i) Price of goods returned should be deducted from the figure of turnover even if the return are from the sales made in the earlier years.

(ii) Cash discount otherwise than that allowed in a cash memo/sales invoice is in the nature of a financing charge and is not related to turnover. The same should not be deducted from the figure of turnover.

(iii) Special rebate allowed to a customer can be deducted from the sales if it is in the nature of trade discount.

Applying the above stated points to the given problem,

1.	Total Turnover	₹ 124 Lacs
2.	Less – (i) Goods Returned	₹ 20 Lacs
	(ii) Special rebate allowed to customer in the nature of trade discount would be deducted.	₹ 5 Lacs
	Balance	₹ 99 Lacs

As the limit for tax audit is ₹ 1 crore, therefore, he would not be required to get his accounts audited under section 44AB of the Income Tax Act, 1961.

Question 3

While writing the audit program for tax audit in respect of A Ltd you wish toinclude possible instances of capital receipt if not credited to Profit & Loss Account which needs to be reported under clause 13(e) of form 3CD. Please elucidate possible instances.

(4 Marks, May, 2013)

Answer

This question is redundant in view of the latest Form 3CD issued dated 25th July, 2014.

Question 4

As an auditor of a partnership firm under section 44AB of the Income Tax Act, 1961, how would you report on the following:

(i) Capital expenditure incurred for scientific research assets.

(2 Marks, November, 2012) (4 Marks, May, 2006)

(ii) Expenditure incurred at clubs. *(2 Marks, November, 2012)*

Answer

(i) Capital Expenditure incurred for Scientific Research Assets: Expenditure on Scientific Research (capital as well as revenue) covered under section 35 of the Income-Tax Act, 1961, is to be reported by a tax auditor under clause 19 of Form 3CD. The tax auditor is required to report the following -

(a) amount debited to the profit and loss account, and

(b) amounts admissible as per the provisions of the Income-tax Act, 1961 and also fulfils the conditions, if any specified under the relevant provisions of Income-tax Act, 1961 or Income-tax Rules, 1962 or any other guidelines, circular, etc., issued in this behalf.

(ii) Payment to Club: As per Clause 21(a) of Form 3CD, the amount of expenditure incurred at clubs by the assessee during the year being entrance fees and subscriptions, and being cost for club services and facilities used should be indicated.

The payments made may be 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. The tax auditor is required to furnish the details of amounts debited to the profit and loss account, being in the nature of capital, personal, advertisement expenditure etc.

Question 5

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 l1(b) of Form 3CD which requires reporting on change in accounting method employed. Comment. *(6 Marks, May, 2012)*

Answer

This question is redundant in view of the latest Form 3CD issued dated 25th July, 2014.

Question 6

Briefly explain the steps involved in Audit under Indirect Tax. *(8 Marks, November, 2011)*

Answer

Steps involved in Audit under 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:

(i) 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.

(ii) 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.

(iii) 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.

(iv) 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.

(v) 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 7

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

(i) An assesse 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. *(3+2+2=7 Marks, November, 2011)*

Answer

Tax Audit Report

(i) Borrowal of ₹ 50 Lakhs: As per Clause 31 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 31(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 31(c) the tax auditor has to state whether the taking or accepting loan or deposit, or repayment of the same were made by account payee cheque drawn on a bank or account payee bank draft based on the examination of books of account and other relevant documents. Furthermore, the tax auditor has the responsibility 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 31 of Form 3CD.

(ii) Payment of Rent and Interest: A tax auditor has to report under Clause 23 of Form 3CD which deals with the particulars of payments made to persons specified under Section 40A(2)(b) of the Income Tax Act, 1961. Where the assessee is an individual, the specified persons include any relative of the assessee (i.e. 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 which 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 21(a) of Form 3CD, the amount of expenditure incurred at clubs by the assessee during the year being entrance fees and subscriptions, and being cost for club services and facilities used should be indicated.

The payments made may be 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. The tax auditor is required to furnish the details of amounts debited to the profit and loss account, being in the nature of capital, personal, advertisement expenditure etc.

Question 8

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? *(4 Marks, May, 2011)*

Answer

Reporting of Escalation Claim: A tax auditor has to report under clause 16(c) of Form 3CD on any escalation claim accepted during the previous year and not credited to the profit and loss account under clause 16(c) of Form 3CD.

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 9

Mr. R, the Tax Auditor finds that some payments inadmissible under Section 40A(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. *(5 Marks, November, 2010)*

Answer

Form 3CD: The audit under section 44AB 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 3CD. The auditor has to examine whether the information given is true and correct. The form 3CD is not a report of Tax Auditor. The report is in the form of 3CA or 3CB depending on the nature of the organization of the entity. If the tax auditor is satisfied that the information contained in form 3CD is true and correct then he can give unqualified report in form 3CA or 3CB 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 3CD are true and correct." But in the given case the tax auditor has found that the form 3CD 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,

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 21(d)(A) of Form 3CD, the tax auditor has to scrutinize on the basis of the examination of books of account and other relevant documents/evidence, whether the expenditure covered under section 40A(3) read with rule 6DD were made by account payee cheque drawn on a bank or account payee bank draft. If not, the same has to be reported under abovementioned clause.

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. Therefore, Mr. R has to report the payments inadmissible under section 40A(3) under clause 21(d)(A) of Form 3CD.

Question 10

Write a short note on Major steps required in preparation of Tax audit under VAT.

(5 Marks, May, 2010)

Or

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

(8 Marks, November, 2007)

Answer

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

(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

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.

(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.

(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. 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

(a) *ABC Printing Press, a proprietary concern, made a turnover of above ₹ 43 lacs for the year ended 31.03.2009. 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.*

(5 Marks, November, 2009)

(b) *A Co-operative Society having receipts above ₹ 40 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?*

(3 Marks, November, 2009)

Answer

(a) This question is redundant in view of the latest provisions regarding applicability of tax audit.

(b) This question is redundant in view of the latest provisions regarding applicability of tax audit.

Question 12

Discuss briefly Accounting standards to be followed by assessees under the Income-tax Law. *(4 Marks, November, 2009)*

Answer

Accounting Standards under the Income Tax Law: Section 145 of the Income Tax Act, 1961 deals with the method of accounting as under-

145(1) Income chargeable under the head 'Profit 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.

145(2) The Central Government may notify in the Official Gazette from time to time income computation and disclosure 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 (1) or accounting standards as notified under sub-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.

The Central Government, by Notification No. 32/2015, F.No.134/48/2010-TPL, dated 31st March, 2015, has prescribed 10 Income Computation and Disclosure Standards (ICDSs) as under:

A. ICDS I relating to Accounting Policies.

B. ICDS II relating to Valuation of Inventories.

C. ICDS III relating to Construction Contracts.

D. ICDS IV relating to Revenue Recognition.

E. ICDS V relating to Tangible Fixed Assets.

F. ICDS VI relating to the Effects of Changes in Foreign Exchange Rates.

G. ICDS VII relating to Government Grants.

H. ICDS VIII relating to Securities.

I. ICDS IX relating to Borrowing Costs.

J. ICDS X relating to Provisions, Contingent Liabilities and Contingent Assets.

The above ICDSs 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 ICDSs notified above.

Question 13

Draft an Audit programme for conducting the audit of a Public Trust registered under section 12A of the Income Tax Act, 1961. *(8 Marks, June, 2009)*

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' duty certified by the trustee;

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

Question 14

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? (8 Marks, June, 2009)

Answer

Compliance of Section 145 of the Income Tax Act, 1961: 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 Income Computation and Disclosure Standards (ICDSs) to be followed by any class of assesses or in respect of any class of income. In this context, the following Income Computation and Disclosure Standards have been notified by Notification No. 32/2015, F.No.134/48/2010-TPL, dated 31st March, 2015-

A. ICDS I relating to Accounting Policies.

B. ICDS II relating to Valuation of Inventories.

C. ICDS III relating to Construction Contracts.

D. ICDS IV relating to Revenue Recognition.

E. ICDS V relating to Tangible Fixed Assets.

F. ICDS VI relating to the Effects of Changes in Foreign Exchange Rates.

G. ICDS VII relating to Government Grants.

H. ICDS VIII relating to Securities.

I. ICDS IX relating to Borrowing Costs.

J. ICDS X relating to Provisions, Contingent Liabilities and Contingent Assets.

As per Section 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 completeness of the accounts of the assessee.

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

(iii) Where the (ICDSs) 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 13(a) of form 3CD. Further, Form 3CD *vide* clause 13(d) requires reporting of

the details of deviation, if any, in the method of accounting employed in the previous year from accounting standards (now Income Computation and Disclosure Standards) prescribed under section 145 and the effect thereof on the profit or loss.

(b) Provisions of all the (ICDSs) notified have been complied with.

Question 15

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

(4 Marks, November, 2008)

Answer

Revision of Tax Audit:

(a) Normally, the report of the tax auditor cannot be revised later.

(b) 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.

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

As the tax auditor of a Company, how would you report on payments exceeding ₹ 20,000 made in cash to a supplier against an invoice for expenses booked in an earlier year?

(5 Marks, May, 2008)

Answer

Reporting of Payments Exceeding ₹ 20000 in Cash: Such reporting is required to be done while conducting the tax audit u/s 44AB of the Income Tax Act, 1961 in Form 3CD. The tax auditor shall have to report under clause 21(d)(B) for the above as per the section 40A(3A) of the Income Tax Act, 1961 i.e. where an allowance has been made in the assessment for any year in respect of any liability incurred by the assessee for any expenditure and subsequently during any previous year the assessee makes payment in respect thereof, otherwise than by an account payee cheque drawn on a bank or account payee bank draft, the payment so made shall be deemed to be the profits and gains of business or profession and accordingly chargeable to income-tax as income of the subsequent year if the payments made to a person in a day, exceeds twenty thousand rupees.

In the instant case, the invoice for expenses has been booked in an earlier year. However, since payment for the same is made during the current year by cash exceeding ₹ 20000, the reporting thereof would be necessary in clause 21(d)(B) of Form 3CD. The sub-clause (d)(B) required furnishing of the amount inadmissible under section 40A(3A) read with rule 6DD along with computation.

The entire amount paid as above, is likely to be disallowed under section 40A(3A) of the Income Tax Act, 1961.

Question 17

Write a short note on Accounting ratios in Form 3 CD of Tax Audit. (4 Marks, November, 2007)

Answer

Accounting Ratios in Form 3CD of Tax Audit: Details regarding turnover, gross profit, etc., for the previous year and preceding previous year should be provided as follows:

Serial Number	Particulars	Previous year	Preceding Previous year
1.	Total turnover of the assessee		
2.	Gross profit/turnover		
3.	Net profit/turnover		
4.	Stock-in-trade/turnover		
5.	Material consumed/finished goods produced		

The details required to be furnished for principal items of goods traded or manufactured or services rendered. 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.

Question 18

Write a short note on Method of accounting in Form No. 3CD of Tax Audit. (4 Marks, May, 2007)

Answer

Method of Accounting in Form 3CD of Tax Audit: Clause 13 of Form 3CD of the tax audit requires to state method of accounting employed in the previous year. It also requires to state the change in method of accounting vis-à-vis the preceding year. If so, details of change and the effect on the profit or loss are to be stated. Also details of deviation thereof if any, from accounting standards prescribed under section 145 and the effect thereof on the profit or loss are stated.

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

Question 19

Labour charges paid on which tax is deducted at source at an inappropriate rate. As a tax auditor, how would you report? (4 Marks, May, 2006)

Answer

Reporting in Form 3CD: Section 40(a)(ia) 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 of 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, shall not be deducted in computing the income. Therefore, if tax is deducted at an inappropriate rate, the amount is disallowable under section 40(a)(ia) of the Income-tax Act. This fact needs to be reported in Clause 21(b)(ii) of Form 3CD where details of payment on which tax not deducted and details of payment on which tax has been deducted but not paid on or before the due date specified in sub- section (1) of section 139 needs 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 21(b)(ii) of Form 3CD.

Question 20

Enumerate some of the areas of concern in an audit of indirect taxes. (6 Marks, November, 2005)

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 control or expert 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 control 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.

Question 21

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 the tax auditor in his analytical review. (8 Marks, November, 2005)

Answer

Accounting Ratios in Form 3CD of Tax Audit: A tax auditor is required to provide details regarding turnover, gross profit, etc., for the previous year as well as for the preceding

previous year in Form 3CD. 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 would reflect that there is definitely something wrong with the 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.