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 44AB 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 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 14 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 18 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...
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**

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**

**Reporting for change in the method of valuation of stock:** 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.

This apart, the tax auditor in his report has to specifically refer to the method of valuation of stock under Clause 14 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 in 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 3**

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.

**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:
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 organisations 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 fail 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.

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 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 4

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 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 5

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

Answer

Method of accounting in Form No. 3CD of Tax Audit: Clause 13 of Form No. 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 6

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

Answer

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. 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. 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 7

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

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:

<table>
<thead>
<tr>
<th>Serial Number</th>
<th>Particulars</th>
<th>Previous year</th>
<th>Preceding Previous year</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Total turnover of the assesssee</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>Gross profit/turnover</td>
<td></td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>Net profit/turnover</td>
<td></td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>Stock-in-trade/turnover</td>
<td></td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>Material consumed/finished goods produced</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

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 assesses who are engaged in manufacturing or trading activities. This clause is not applicable to assesses carrying on profession. Moreover, the ratios have to be given for the business as a whole and need not be given product wise.

Question 8

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:

(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 9**

*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.

**Question 10**

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

**Answer**

**Revision of Tax Audit Report:**

(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 its 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 11


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 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 12

‘A’ Limited has paid minimum alternate tax under Section 115 JB of the Income-tax Act, 1961, for the year ended 31st March, 2016. 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’ as 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.

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.

**Question 13**

**Answer the following:**

(a) **ABC Printing Press, a proprietary concern, made a turnover of above ₹ 1.03 crore for the year ended 31.03.2016. 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 ₹ 1 crore 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 44AB of the Income-tax Act, 1961?**

**Answer**

(a) **Non-maintenance of stock register:** 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 clause 35(b) and clause 11(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) **Furnishing Audit Report of a Co-operative Society**: As per Section 44AB read with Explanation to Section 288(2) of the Income Tax Act, 1961, “accountant” means a chartered accountant within the meaning of the Chartered Accountants Act, 1949, and includes, in relation to any State, any person who by virtue of the provisions of section 141 of the Companies Act, 2013, 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 44AB of the Income-tax Act, 1961.

**Question 14**

**Discuss briefly Income Computation and Disclosure Standards (ICDS) to be followed by assesses under the Income-tax Law.**

**Answer**


**Under section 145(1), income chargeable under the heads “Profits and gains of business or profession” or “Income from other sources” shall be computed in accordance with either the cash or mercantile system of accounting regularly employed by the assessee.**

**Section 145(2)** empowers the Central Government to notify in the Official Gazette from time to time, income computation and disclosure standards to be followed by any class of assesses or in respect of any class of income.

Accordingly, the Central Government has, in exercise of the powers conferred under section 145(2), notified ten income computation and disclosure standards (ICDSs) to be followed by all assesses (other than an individual or a HUF who is not required to get his accounts of one previous year audited in accordance with the provisions of section 44(AB)), following the mercantile system of accounting, for the purposes of
computation of income chargeable to income-tax under the head “Profit and gains of business or profession” or “Income from other sources”. from the A.Y. 2017-18.

All the notified ICDSs are applicable for computation of income chargeable under the head “Profits and gains of business or profession” or “Income from other sources” and not for the purpose of maintenance of books of accounts. In the case of conflict between the provisions of the Income-tax Act, 1961 and the notified ICDSs, the provisions of the Act shall prevail to that extent.

The Central Government 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 assesses (other than an individual or a HUF who is not required to get his accounts of one previous year audited in accordance with the provisions of section 44(AB)) following mercantile system of accounting. Therefore, it is clear that those assesses who are following cash system of accounting need not follow the ICDSs notified above.

Question 15

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 31.3.2016, 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 16**

*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.*

**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 17**

*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?*
15.14 Advanced Auditing and Professional Ethics

Answer

Clause 16(c) of Form 3CD: 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 18

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/-.

Answer

(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.

Question 19

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

(ii) Expenditure incurred at clubs.

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.
15.16 Advanced Auditing and Professional Ethics

Question 20

While writing the audit program for tax audit in respect of A Ltd., you wish to include possible instances of capital receipt if not credited to Profit & Loss Account which needs to be reported under clause 16(e) of form 3CD. Please elucidate possible instances.

Answer

The following is an illustrative list of capital receipts which, if not credited to the profit and loss account, are to be stated under clause 16(e) of Form 3CD-

(a) Capital subsidy received in the form of Government grants, which are in the nature of promoters’ contribution i.e., they are given with reference to the total investment of the undertaking or by way of contribution to its total capital outlay. For e.g., Capital Investment Subsidy Scheme.

(b) Government grant in relation to a specific fixed asset where such grant is shown as a deduction from the gross value of the asset by the concern in arriving at its book value.

(c) Compensation for surrendering certain rights.

(d) Profit on sale of fixed assets/investments to the extent not credited to the profit and loss account.

Question 21

Mr. A engaged in business as a sole proprietor presented the following information to you for the FY 15-16. Turnover made during the year ₹ 124 lacs. Goods returned in respect of sales made during FY 13-14 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.

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 ₹ one crore, therefore, he would not be required to get his accounts

Question 22

Concession Ltd. is engaged in the business of manufacturing of threads. The company
recorded the turnover of ₹ 1.13 crore during the financial year 2015-16 before adjusting the
following:

- Discount allowed in the Sales Invoice ₹ 8,20,000
- Cash discount (other than allowed in
  Cash memo/ sales invoice) ₹ 9,20,000
- Trade discount ₹ 2,90,000
- Commission on Sales ₹ 6,00,000
- Sales Return (F.Y. 2014-15) ₹ 1,60,000
- Sale of Investment ₹ 6,60,000

You are required to ascertain the effective turnover to be considered for the prescribed limit of
tax audit under the relevant Act and guide the company whether the provisions relating to tax
audit applies.

Answer

The provisions relating to tax audit under section 44AB of the Income Tax Act, 1961 applies to
every person carrying on business, if his total sales, turnover or gross receipts in business
exceed the prescribed limit of ₹ 1 crore and to a person carrying on a profession, if his gross
receipts from profession exceed the prescribed limit of ₹ 50 lakhs (w.e.f. A.Y. 2017-18) in any
previous year. However, the term “sales”, “turnover” or “gross receipts” are not defined in the
Act, and therefore the meaning of the aforesaid terms has to be considered for the
applicability of the section.

Some of the points for merit consideration in this regard as discussed in the Guidance Note
issued by the Institute are given below-

(i) Discount allowed in the sales invoice will reduce the sale price and, therefore, the same
can be deducted from the turnover.

(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. Therefore, should not be deducted
from the turnover.

(iii) Turnover discount is normally allowed to a customer if the sales made to him exceed a
particular quantity. As per trade practice, it is in the nature of trade discount and should
be deducted from the figure.
(iv) Special rebate allowed to a customer can be deducted from the sales if it is in the nature of trade discount. If it is in the nature of commission on sales, the same cannot be deducted from the figure of turnover.

(v) Price of goods returned should be deducted from the turnover even if the returns are from the sales made in the earlier year/s.

(vi) Sale proceeds of any shares, securities, debentures, etc., held as investment will not form part of turnover. However, if the shares, securities, debentures etc., are held as stock-in-trade, the sale proceeds thereof will form part of turnover.

In the given case, Concession Ltd. is engaged in manufacturing business. Therefore, the tax audit would be applicable if the turnover exceeds ₹ 1 crore during the financial year 2015-16. The calculation of effective turnover for the prescribed limit purpose, in accordance with abovementioned conditions, is given below:

Recorded turnover during the year ₹ 1,13,00,000
Less: (i) Discount allowed in the Sales Invoice (₹ 8,20,000)
(ii) Trade discount (₹ 2,90,000)
(iii) Sales Return (₹ 1,60,000)
Effective turnover ₹ 1,00,30,000

The effective turnover of Concession Ltd. is Rupees one crore and thirty thousand only which is over and above the prescribed limit for tax audit under section 44AB of the Income Tax Act, 1961. Thus, the provisions related to tax audit are applicable to the company and is therefore liable for tax audit.

Question 23

XYZ Ltd. pays ₹ 90,000 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 ₹ 15,000. 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 2016-17?

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 24

Comment with respect to computation of total sales, turnover or gross receipts in business exceeding the prescribed limit under Section 44 AB of Income Tax Act, 1961 and VAT law.

(i) Discount allowed in the sales invoice
(ii) Cash discount
(iii) Price of goods returned related to earlier year
(iv) Sale proceeds of fixed assets.

Answer

Computation of Sales, Turnover or Gross Receipts:

I. In the context of section 44AB of the Income Tax Act, 1961: Following considerations are required with regard to computation of sales, turnover or gross receipts in business exceeding the prescribed limit under section 44AB of the Income Tax Act, 1961-

(i) Discount allowed in the sales invoice will reduce the sale price and, therefore, the same can be deducted from the turnover.

(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. Therefore, should not be deducted from the turnover.

(iii) Price of goods returned should be deducted from the turnover even if the returns are from the sales made in the earlier year/s.

(iv) Sale proceeds of fixed assets would not form part of turnover since these are not held for resale.

II. In the context of VAT Law: Following considerations are required with regard to computation of sales or turnover in business exceeding the prescribed limit as per VAT Law-

(i) Discount allowed in the sales invoice should be deducted from the sales or turnover.

(ii) Cash discount should not be deducted from the sales or turnover.
(iii) Price of goods returned is to be deducted only if they are made within the prescribed time.
(iv) Sale proceeds of a fixed asset will form a part of turnover or sales for the purpose of VAT law.

**Question 25**

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

(a) Mr. Bhupesh, is a renowned criminal lawyer, practising in Meerut. During the previous year, he collected service tax of ₹ 25 lakhs but utilized it for his personal use. The Commissioner of Central Excise issued a show cause notice to him as to why the tax, collected by him, is not deposited to the government account. He appeared before the Commissioner and stated his inability to pay the sum due to financial crisis. The proceedings are still pending before the Commissioner.

Mr. Bhupesh instructed his tax auditor not to disclose his service tax registration details, while filling particulars to be furnished in Form No. 3CD, believing that the income tax department might trace his scrutiny proceedings details pending before Commissioner of Central Excise which would bring disrepute to his profession.

(b) BB Ltd., a non-resident company, is engaged in the business of extraction of mineral oils, having turnover of ₹ 20 lakhs during the financial year 2016-17. The company claims that its profits and gains chargeable to tax under the head “Profits and gains of business or profession” is lower than the deemed income chargeable under section 44BB of the Income Tax Act, 1961. Therefore, it decided to get its accounts audited under section 44AB of the Income Tax Act, 1961.

(c) M/s. N.S. Enterprises, a manufacturing concern, sold a house property in Mumbai for a consideration of ₹ 48 lakh, to Mr. Gunaj on 1.8.2016. M/s. N. S. Enterprises had purchased the house property in the year 2014 for ₹ 40 lakh. The stamp duty value on the date of transfer, i.e., 1.8.2016, is ₹ 85 lakh for the house property.

(d) SL Pvt. Ltd. is a company engaged in the production of wool. Along with its production business, the company is also engaged in buying and selling of securities with the expectation of a favourable price change. It reports the following data for the current financial year:

<table>
<thead>
<tr>
<th>S. No.</th>
<th>Particulars</th>
<th>Amount (in ₹)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Paid up Share Capital</td>
<td>100 lakhs</td>
</tr>
<tr>
<td>2</td>
<td>Capital Reserve</td>
<td>33 lakhs</td>
</tr>
<tr>
<td>3</td>
<td>Capital Redemption Reserve</td>
<td>45 lakhs</td>
</tr>
<tr>
<td>4</td>
<td>Revaluation Reserve</td>
<td>32 lakhs</td>
</tr>
<tr>
<td>5</td>
<td>Speculation Loss on account of Purchase and Sales of Securities</td>
<td>12 lakhs</td>
</tr>
</tbody>
</table>

(e) Saurabh International Ltd. (SIL) was engaged in providing certain services on which it did not pay any service tax. As per SIL, said services were not liable to service tax. However, Department issued a show cause notice to SIL demanding service tax
along with interest worth ₹ 5,45,000 on the same and such demand was also confirmed. An appeal was filed to the Commissioner of Central Excise (Appeals) which passed an order which upheld the demand on SIL. SIL, being aggrieved by the order of the Commissioner of Central Excise (Appeals), decided to file an appeal to the CESTAT against such order. SIL has also requested the tax auditor not to report as those services were not liable for service tax and it has also filed an appeal for the same.

Answer

(a) Reporting Requirement Under Clause (4) of Form 3CD: Mr. Bhupesh has defaulted in payment of service tax for the previous year. Consequently, the Commissioner of Central Excise issued a show cause notice for such non-payment of tax. The arguments are still going on between the department and assessee. He also restrained his tax auditor from disclosing service tax registration details in tax audit report.

Provisions and Explanations: A tax auditor is required to report under Clause (4) of Form 3CD, which requires him to mention the registration number or any other identification number, if any, allotted, in case the assessee is liable to pay indirect taxes like excise duty, service tax, sales tax, customs duty, etc.

Part A of Form No. 3CD generally requires the auditor to give the factual details of the assessee. Thus, the auditor is primarily required to furnish the details of registration numbers as provided to him by the assessee.

The reporting is however, to be done in the manner or format specified by the e-filing utility in this context. The information may be obtained and maintained in the following format:-

<table>
<thead>
<tr>
<th>Sr. No</th>
<th>Relevant Indirect tax law which requires registration</th>
<th>Place of Business / profession / service unit for which registration is in place / or has been applied for:</th>
<th>Registration/Identification number</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td></td>
<td></td>
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<td>2</td>
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<tr>
<td>4</td>
<td></td>
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</tr>
</tbody>
</table>

Furthermore, the auditor has to keep in mind the provisions of Standard on Auditing 580 “Written Representation”. In case the auditor prima facie is of the opinion that any indirect tax laws is applicable on the business or profession of the assessee but the assessee is not registered under the said law, the auditor should report the same appropriately.

Conclusion: Therefore, the tax auditor of Mr. Bhupesh is required to furnish service tax registration number under Clause (4) of the Form 3CD. Thus, contention of Mr. Bhupesh not to disclose the service tax details is not tenable.

(b) Reporting Requirement Under Clause (8) and (12) of Form 3CD: BB Ltd., is a non-resident company which is engaged in the business of extraction of mineral oils, hence, its income is chargeable in accordance with the provisions of section 44BB of the Income Tax Act, 1961. But it has turnover of ₹ 20 lakhs during the financial year 2016-17. Therefore, the company does not need to get its accounts audited under section 44AB of the Income Tax Act, 1961 as it is below the prescribed limit applicable for auditing of
accounts. However, company is claiming lower income in comparison to deemed income under section 44BB of the said Act, thus, the company needs to get its accounts audited.

Provisions and Explanations: Under Clause (8) of Form 3CD, the tax auditor is required to mention the relevant clause of section 44AB under which the audit has been conducted. In case the assessee is carrying on business and his total sales, turnover or gross receipts as the case may be, exceeds one crore in the relevant previous year, the auditor is required to mention clause (a) under this head. If the assessee is carrying on profession and his gross receipts exceed fifty lakh rupees in the relevant previous year, the auditor is required to mention clause (b) under this head. Likewise, if the audit under section 44AB is being conducted by virtue of provisions of section 44AE, 44BB and 44BBB, the auditor is required to mention clause (c). For audit being conducted by virtue of provisions of section 44ADA, clause (d) is to be mentioned under this head. For audit being conducted by virtue of provisions of section 44AD, clause (e) is to be mentioned under this head.

Further, as per Clause (12) of Form 3CD, if the profit and loss account of the assessee includes any profits and gains assessable on presumptive basis, the tax auditor has to indicate the amount and the relevant sections (44AD, 44AE, 44AF, 44B, 44BB, 44BBA, 44BBB, Chapter XII-G, First Schedule or any other relevant section).
Conclusion: As per the facts of the case, provisions and explanations given above, the tax auditor of BB Ltd. is required to mention clause (c) of section 44AB, under clause (8) of Form no. 3CD.

In addition to above, the tax auditor has to indicate, under Clause (12) of Form No. 3CD, the amount of profits and gains assessable on presumptive basis under section 44BB of the Income Tax Act i.e. the amount of profits and gains credited/debited to the Profit & Loss Account.

(c) Reporting Requirement Under Clause (17) of Form 3CD: In this case, M/s N.S. Enterprises is a manufacturing concern and sold the house property in Mumbai for a consideration of ₹ 48 Lakh which is less than value assessed by Government i.e. Stamp Duty value of ₹ 85 Lakh.

Provisions and Explanations: As per Clause 17 of Form 3CD, the tax auditor is required to furnish detailed information in case if any land or building or both is transferred during the previous year for a consideration less than value adopted or assessed or assessable by any authority of a State Government referred to in section 43CA or 50C, as under:

<table>
<thead>
<tr>
<th>Details of property</th>
<th>Consideration received or accrued</th>
<th>Value adopted or assessed or assessable</th>
</tr>
</thead>
</table>

The auditor should obtain a list of all properties transferred by the assessee during the previous year. He may also verify the same from the statement of profit and loss or balance sheet, as the case may be. Further, the auditor has to furnish the amount of consideration received or accrued, during the relevant previous year of audit, in respect of land/building transferred during the year as disclosed in the books of account of the assessee.

For reporting the value adopted or assessed or assessable, the auditor should obtain from the assessee a copy of the registered sale deed in case, the property is registered. In case the property is not registered, the auditor may verify relevant documents from relevant authorities or obtain third party expert like lawyer, solicitor representation to satisfy the compliance of section 43CA / section 50C of the Act. In exceptional cases where the auditor is not able to obtain relevant documents, he may state the same through an observation in his report 3CA/CB.

Conclusion: As already discussed in fact of the cases, M/s. N. S. Enterprises, has sold the house property to Mr. Gunaj which is less than stamp duty value. Hence, tax auditor is required to report on the same under Clause 17 of Form 3CD.

(d) Reporting Requirement Under Clause (32)(e) of Form 3CD: SL Pvt. Ltd. is engaged in production business and side by side dealing in buying and selling of securities with the intention of speculation. During the current financial year, the company has made Speculation Loss of ₹ 12 lakhs.

Provisions and Explanations: A tax auditor has to furnish the details of speculation loss incurred during the previous year, under Clause 32(e) of Form 3CD, regarding whether
the company is deemed to be carrying on a speculation business as referred in explanation to section 73.

The Explanation to section 73 provides that where any part of the business of a company (other than a company whose gross total income consists mainly of income which is chargeable under the heads "Interest on securities", "Income from house property", "Capital gains" and "Income from other sources" or a company the principal business of which is the business of trading in shares or banking or the granting of loans and advances) consists in the purchase and sale of shares of other companies, such company shall, for the purposes of this section, be deemed to be carrying on a speculation business to the extent to which the business consists of the purchase and sale of such shares.

Conclusion: Therefore, the tax auditor of SL Pvt. Ltd. is required to furnish the details under Clause 32(e) of Form 3CD with respect to the speculation loss of `12 lakhs made during the year.

(e) Reporting Requirement Under Clause (41) of Form 3CD: In the instant case, Saurabh International Ltd. (SIL) is engaged in providing certain services on which it did not pay any service tax. Therefore, Department issued a show cause notice and demand for Service Tax along with interest thereon. SIL has also filed an appeal mentioning that said services are not liable to service tax, but Central Excise (Appeals) has passed an order confirming the demand and SIL being aggrieved by the order of Commissioner of Central Excise (Appeals) decided to file an appeal against the same. SIL also requested the tax auditor not to report on the same as the concerned services were not liable for any service tax and they have also decided to file an appeal to CESTAT against the order of Commissioner of Central Excise (Appeals).

Provisions and Explanations: As per Clause 41 of Form 3CD, the tax auditor should furnish the details of demand raised or refund issued during the previous year under any tax laws other than Income Tax Act, 1961 and Wealth tax Act, 1957 along with details of relevant proceedings.

Therefore, the tax auditor should obtain a copy of all the demand/ refund orders issued by the governmental authorities during the previous year under any tax laws other than Income Tax Act and Wealth Tax Act along with its proceeding. It may be noted that even though the demand/refund order is issued during the previous year, it may pertain to a period other than the relevant previous year. In such cases also, reporting has to be done under this clause.

Conclusion: In the instant case, reporting of the demand raised by Department and proceeding relating to it including appeal filed by SIL and decision thereon is required to be made by tax auditor as per Clause 41 of Form 3CD. Hence request of SIL, not to report on the same is not acceptable.
Question 26

(a) Ploy Ltd., engaged in the leasing of goods carriage, appointed you as the tax auditor for the financial year 2016-17. How would you deal with the following payments relating to the leasing transactions in your tax audit report:

(i) Payments of 6 invoices of ₹5,000 each made in cash to Mr. X on 4th July, 2016.

(ii) Payments of 2 invoices of ₹18,000 each made in cash to Mr. Y on 5th July, 2016 and 6th July, 2016 respectively.

(iii) Payment of ₹40,000 made in cash to Mr. Z on 7th July, 2016 against an invoice for expenses booked in 2015-16.

(b) Beam Ltd., having principal place of business in Gujarat, is engaged in the generation, transmission, distribution and supply of electricity throughout the India. The management of the company came to know that the provisions related to maintenance of cost records and cost audit are applicable to the company. The company, therefore, appointed a cost auditor for the financial year 2016-17.

The cost auditor reported certain disqualifications in Form CRA-3 of the cost audit report to which the management of the company disagreed.

The management of Beam Ltd. ingeniously instructed its tax auditor not to reveal any of the disqualifications related to the cost audit while filling particulars to be furnished in Form No. 3CD contending that the disqualifications are not relevant and there is no correlation between tax audit and cost audit as well.

As a tax auditor, how would you deal with the matter?

(c) Nadir India (P) Ltd. appointed a tax auditor under the value added tax system to conduct its VAT audit for the financial year 2016-17. You are required to state the approach to be adopted and the major areas to be tested by the tax auditor while conducting the tax audit under VAT laws.

Answer

(a) Reporting of Payments Exceeding ₹35,000 in Cash: 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, in case of payment made for plying, hiring or leasing of goods carriage, limit is ₹35,000 instead of ₹20,000.

Further, as per section 40A(3A) of the Income Tax Act, 1961, 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 ₹
20,000 (₹ 35,000 in case of plying, hiring or leasing of goods carriages).

However, exemption is provided under Rule 6DD having regard to nature and extent of banking facilities available and other relevant factors.

Subsequently, under clause 21(d)(A) and 21(d)(B) 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) and 40A(3A) respectively 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 clauses.

Therefore, as per the provisions and explanations discussed above, the given cases are dealt as under-

(i) Payments of 6 invoices of ₹ 5,000 each aggregating ₹ 30,000 made in cash on 4th July, 2016 need not be reported as the aggregate of payments do not exceed ₹ 35,000.

(ii) Payments of 2 invoices of ₹ 18,000 each made in cash on 5th July, 2016 and 6th July, 2016 respectively aggregating ₹ 36,000 need not be reported as the payment do not exceed ₹ 35,000 in a day.

(iii) Payment of ₹ 40,000 made in cash against an invoice for expenses booked in 2015-16 is likely to be deemed to be the profits and gains of business or profession under section 40A(3A) of the Income Tax Act, 1961. Thus, the details of such amount needs to be furnished under clause 21(d)(B) of Form 3CD.

(b) Reporting Requirement for Disqualifications in Cost Audit Report: A tax auditor is required to ascertain under Clause (37) of Form 3CD whether cost audit was carried out and if yes, provide the details of disqualification or disagreement on any matter/item/value/quantity as may be reported/identified by the cost auditor.

The tax auditor should obtain the copy of cost audit from the assessee. Even though the tax auditor is not required to make any detailed study of such report, he has to take note of the details of disqualification or disagreement on any matter/item/value/quantity as may be reported/identified by the cost auditor. The tax auditor need not express any opinion in a case where such audit has been ordered but the same has not been carried out.

In the given case, the cost auditor of Beam Ltd. has reported certain disqualifications in Form CRA-3 of the cost audit report.

Therefore, the tax auditor of Beam Ltd. is required to provide the details of disqualifications reported by the cost auditor under Clause (37) of the Form 3CD. Thus, the contention of the management of Beam Ltd. not to reveal any of the disqualifications related to the cost audit on the belief that there is no correlation between tax audit and cost audit is not acceptable.

(c) Approach to Tax Audit under VAT Law: The audit approach of the tax auditor under the value added tax system will be more or less similar to the approach, which is adopted
by the auditor while conducting the tax audit under the provisions of section 44AB of the
Income-tax Act, 1961. However, the reporting requirements vary to a considerable
extent.

While the auditor has to apply the basic principles of audit he has to keep in mind that
the requirements of VAT audit are different and accordingly he should design his audit
programme.

While designing the audit program the auditor has to ensure that the program includes
the performance of such audit checks as would generate the information which would
enable him to ensure the following and also to draw his audit reports.

The auditor has to take a judgement of his own regarding the adequacy and
appropriateness of the audit checks to be applied and the areas where the tests are to be
applied, so as to give him all the information needed to form a view not only on the
authenticity of the books of account, correctness of the returns filed but also in the
quantification of tax liability.

**Major areas to be tested:** The following are only the major areas which are to be tested
by the auditor while conducting the tax audit under VAT laws-

(i) The turnover of sales/purchases of goods has been properly determined keeping in
view not only the generally accepted accounting policies but the definition of
turnover of sales in the relevant VAT law. The sales turnover arrived at by applying
the generally accepted accounting policies may not be the same as required under
the VAT law. To take an example, the sale proceeds of a fixed asset will not form a
part of turnover or sales as per the generally accepted accounting policies but will
form a part of turnover or sales for the purpose of VAT law. Similarly, the price of
goods returned is deducted from the turnover or sales even if the returns are from
the sales effected in the previous years, while under VAT law, the goods returned
are to be deducted only if they are made within the prescribed time, say six months
from the date of sale. Thus, the results of the audit procedure adopted by the
auditor should be such as will give him a reasonable assurance regarding the
figures of sales reported in the returns. Not only that, he should also be able to get
the exact quantum of the sales under reported or over reported duly classified for
different tax rates and its impact on overall tax liability. The sales as per the
financial statements may include the turnover or sales effected by all the branches,
but for the purposes of VAT law the turnover or sales of only those branches will be
included which are included in one registration certificate.

(ii) The turnover of purchases should be tested by applying audit checks as will enable
the auditor to get the purchases eligible for grant of input tax credit segregated from
other purchases. Further, the purchases on which the input tax credit is available in
full and the purchases on which it is available partially should also be ascertained
correctly. Thereafter, the auditor should get the exact amount of input tax credit
available; compare the same with the credit claimed in the returns and report on the
excess/short claim of the credit in the returns filed.
(iii) The auditor is also required to comment on the timely filing of the returns under the VAT law. For this purpose the auditor is expected to list out the due dates of filing of returns and find out the reasons for delay in filing the returns if any.

(iv) The auditor is also required to give his report on the composition scheme. He should apply such compliance tests as will be enable him to ascertain that the auditee is eligible for composition, it has paid the requisite composition fee and all the procedural formalities in relation thereto have been complied with.

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

(vi) The auditor is also expected to check the consolidation of the returns filed for all the periods covered in the year under audit, both under the State-Level VAT law and the Central Sales-tax Act. These returns are to be compared with the books of account and the documentary evidences available. The auditor is expected to apply such substantive steps as would enable him to judge whether all the transactions relating to sale and purchase are entered in the books of account and have been taken into consideration while filing the returns. In case of any inconsistency, a proper reconciliation of book figures and the returned figures should be made and also the correct quantification of tax liability is to be done.

**Question 27**

AB Ltd. is a company in which public are not substantially interested. During the previous year 2015-16, the company issued shares to residents of India and provides you the following data related to such issue:

- No. of shares issued: 1,00,000
- Face Value: ₹10 per share
- Fair Market Value (FMV): ₹60 per share
- Consideration received: ₹80 per share

The management of the company contends that, it is a normal issue of shares, thus, needs not to be reported. As the tax auditor of AB Ltd., how would you deal with the matter in your tax audit report?

**Answer**

**Reporting for issue of shares for value exceeding fair market value:** In this case, AB Ltd. is a company, other than a company in which the public are substantially interested. During the previous year 2015-16, it receives consideration for issue of shares (i.e. ₹80 per share) which exceeds the face value (i.e. ₹10 per share) and fair market value of the shares (i.e. ₹60 per share).

Provisions and Explanations: A tax auditor has to furnish the details of shares issued during the previous year, under clause 29 of Form 3CD, in case, the assessee received any
consideration for issue of shares which exceeds the fair market value of the shares as referred to in section 56(2)(viib) of the Income Tax Act, 1961.

Section 56(2)(viib) provides that where a company, not being a company in which the public are substantially interested, receives, in any previous year, from any person being a resident, any consideration for issue of shares that exceeds the face value of such shares, the aggregate consideration received for such shares as exceeds the fair market value of the shares shall be chargeable to income-tax under the head “Income from other sources”.

Since section 56(2)(viib) is applicable to companies in which public is not substantially interested, reporting under this clause is to be done only for corporate assesses. The auditor should obtain from the auditee, a list containing the details of shares issued, if any, by him to any person being a resident and verify the same from the books of accounts and other relevant documents.

Conclusion: As per the facts of the case, provisions and explanations given above, the income generated by AB Ltd., due to differences in consideration received and fair market value of shares issued, is chargeable to income-tax under the head “Income from other sources” as per section 56(2)(viib) of the Income Tax Act, 1961.

Therefore, the tax auditor of AB Ltd. is required to furnish the details of shares issued under clause 29 of Form 3CD. The contention of the management of the company, behind non-reporting, that it is a normal issue of shares, is not acceptable.

**Question 28**

ABC Pvt. Ltd. and XYZ Pvt. Ltd. are the companies in which public are not substantially interested. During the previous year 2015-16, ABC Pvt. Ltd. received some property, being shares of XYZ Pvt. Ltd., the details of which are provided below:

| No. of Shares: | 1,000 |
| Aggregate fair market value of shares: | ₹ 75,000 |
| Consideration value: | Nil |

The management of the company contends that the shares need not to be furnished in Form No. 3CD. As the tax auditor of ABC Pvt. Ltd., how would you deal with the matter?

**Answer**

**Reporting for Receipt of Shares, the Aggregate Fair Market Value of Which Exceeds ₹ 50,000:** In this case, ABC Pvt. Ltd. is a company, other than a company in which the public are substantially interested. During the previous year 2015-16, the company received property, being shares, for no consideration, the aggregate fair market value of which is ₹ 75,000.

Provisions and Explanations: A tax auditor has to furnish the details of shares received during the previous year, under clause 28 of Form 3CD, in case, the assessee has received any property, being share of a company not being a company in which public are substantially interested, without consideration or for inadequate consideration as referred to in section 56(2)(viia) of the Income Tax Act, 1961.
Section 56(2)(viia) provides that where a firm or a company not being a company in which the public are substantially interested, receives, in any previous year any property being shares of a company not being a company in which the public is substantially interested,

(i) without consideration, the aggregate fair market value of which exceeds ₹ 50,000, the whole of the aggregate fair market value of such property;

(ii) for a consideration which is less than the aggregate fair market value of the property by an amount exceeding ₹ 50,000, the aggregate fair market value of such property as exceeds such consideration,

shall be chargeable to income-tax under the head “Income from other sources”.

The fair market value of shares means the value as determined in accordance with the method prescribed in Income Tax Rules, 1962.

Conclusion: As per the facts of the case, provisions and explanations given above, the income generated by ABC Pvt. Ltd., being whole of the aggregate fair market value of shares received (i.e. ₹ 75,000), is chargeable to income-tax under the head “Income from other sources” as per section 56(2)(viia) of the Income Tax Act, 1961.

Therefore, the tax auditor of ABC Pvt. Ltd. is required to furnish the details of such shares received under clause 28 of Form 3CD. The contention of the management of the company, for not reporting such receipt of shares, is not acceptable.