PART-III
GUIDANCE NOTE ON INDEPENDENCE OF AUDITORS
(REVISED)*

1. INTRODUCTION

1.1 This Guidance Note aims to clarify the meaning of independence while performing their duties as Auditors. Professional integrity and independence is an essential characteristic of all the professions but is more so in the case of accountancy profession. Independence implies that the judgement of a person is not subordinate to the wishes or direction of another person who might have engaged him, or to his own self-interest. This document shall provide guidance to members about the specific circumstances and relationships that may create threats to independence. The Guidance Note also provides safeguards that should be employed by the auditors to mitigate the risk arising from such circumstances and relationship leading to the threats to independence.

1.2 It is not possible to define “independence” precisely. Rules of professional conduct dealing with independence are framed primarily with a certain objective. The rules themselves cannot create or ensure the existence of independence. Independence is a condition of mind as well as personal character and should not be confused with the superficial and visible standards of independence which are sometimes imposed by law. These legal standards may be relaxed or strengthened but the quality of independence remains unaltered.

1.3 There are two interlinked perspectives of independence of auditors, one, independence of mind; and two, independence in appearance.

The Code of Ethics for Professional Accountants, issued by International Federation of Accountants (IFAC) defines the term ‘Independence’ as follows:

*Independence is:

(a) Independence of mind – the state of mind that permits the provision of an opinion without being affected by influences that compromise professional judgment, allowing an individual to act with integrity, and exercise objectivity and professional skepticism; and

(b) Independence in appearance – the avoidance of facts and circumstances that are so significant a reasonable and informed third party, having knowledge of all relevant information, including any safeguards applied, would reasonably
III.2 Auditing Pronouncements

conclude a firm’s, or a member of the assurance team’s, integrity, objectivity or professional skepticism had been compromised.”

1.4 Independence of the auditor has not only to exist in fact, but also appear to so exist to all reasonable persons. The relationship between the auditor and his client should be such that firstly, he is himself satisfied about his independence and secondly, no unbiased person would be forced to the conclusion that, on an objective assessment of the circumstances, there is likely to be an abridgement of the auditors’ independence.

1.5 In all phases of a Chartered Accountant’s work, he is expected to be independent, but in particular in his work as auditor, independence has a special meaning and significance. Not only the client but also the stakeholders, prospective investors, bankers and government agencies rely upon the accounts of an enterprise when they are audited by a Chartered Accountant. As statutory auditor of a limited company, for example, the Chartered Accountant would cease to perform any useful function if the persons who rely upon the accounts of the company do not have any faith in the independence and integrity of the Chartered Accountant. In such cases he is expected to be objective in his approach, fearless, and capable of expressing an honest opinion based upon the performance of work such as his training and experience enables him to do so.

1.6 The objective of an audit of financial statements, prepared within a framework of recognized accounting policies and practices and relevant statutory requirements, if any, is to enable an auditor to express an opinion on such financial statements. The auditor’s opinion helps determination of the true and fair view of the financial position and operating results of an enterprise. The user, however, should not assume that the auditor’s opinion is an assurance as to the future viability of the enterprise or the efficiency or effectiveness with which management has conducted the affairs of the enterprise.

1.7 The idea of independence is instilled in the minds of Chartered Accountants from the commencement of their training under articles or audit service. It has to be applied in their day-to-day work and their success is dependent entirely upon their integrity, competence and independence of approach.

1.8 Dependent as it is on the state of mind and character of a person, independence, is a very subjective matter. One person might be independent in a particular set of circumstances, while another person might feel he is not independent in similar circumstances. It is therefore the duty of every Chartered Accountant to determine for himself whether or not he can act independently in the given circumstances of a case and quite apart from legal rules, in no case to place himself in a position which would compromise his independence.

1.9 The auditor should be straightforward, honest and sincere in his approach to his professional work. He must be fair and must not allow prejudice or bias to override his objectivity. He should maintain an impartial attitude and both be and appear to be free of any interest which might be regarded, whatever its actual effect, as being incompatible with integrity and objectivity. This is not self evident in the exercise of the reporting function but also applies to all other professional work. In determining whether a member in practice is or is not seen to be free of any interest which is incompatible with objectivity, the criterion should
be whether a reasonable person, having knowledge of relevant facts and taking into account
the conduct of the member and the member’s behaviour under the circumstances, could
conclude that the member has placed himself in a position where his objectivity would or could
be impaired.

1.10 While performing audit functions, maintaining quality control is the objectives of the
quality control and policies to be adopted by an Auditor shall ordinarily incorporate the
following:

(a) **Professional Requirements**: Personnel in the firm are to adhere to the principles of
Independence, Integrity, Objectivity, Confidentiality and Professional Behaviours.

(b) **Skills and Competence**: The firm is to be staffed by personnel who have attained and
maintained the Technical Standards and Professional Competence required to enable
them to fulfill their responsibilities with Due Care.

(c) **Assignment**: Audit work is to be assigned to personnel who have the degree of technical
training and proficiency required in the circumstances.

(d) **Delegation**: There is to be sufficient direction, supervision and review of work at all
levels to provide reasonable assurance that the work performed meets appropriate
standards of quality.

(e) **Consultation**: Whenever necessary, consultation within or outside the firm is to occur
with those who have appropriate expertise.

(f) **Acceptance and Retention of Clients**: An evaluation of prospective clients and a
review, on an ongoing basis, of existing clients is to be conducted. In making a decision
to accept or retain a client, the firm’s independence and ability to serve the client properly
are to be considered.

(g) **Monitoring**: The continued adequacy and operational effectiveness of quality control
policies and procedures is to be monitored.

1.11 A member not in practice has a duty to be objective in carrying out his or her
professional work whether or not the appearance of professional independence is attainable.
Thus a member performing professional work must recognize the problems created by
personal relationships or financial involvement, which by reason of their nature or degree
might threaten his independence.

1.12 Standing alone, the word “Independence” may lead observers to suppose that a person
exercising professional judgment ought to be free from all economic, financial and other
relationships. This is impossible, as every member of society has relationships with others.
Therefore, the significance of economic, financial and other relationships should also be
evaluated in the light of what a reasonable and informed third party having knowledge of all
relevant information would reasonably conclude to be unacceptable.

1.13 Many different circumstances, or combination of circumstances, may be relevant and
accordingly it is impossible to define every situation that creates threats to independence and
specify the appropriate mitigating action that should be taken. In addition, the nature of
assurance engagements may differ and consequently different threats may exist, requiring the application of different safeguards. A conceptual framework that requires chartered accountants to identify, evaluate and address threats to independence, rather than merely comply with a set of specific rules in the public interest.

2. THREATS TO INDEPENDENCE

2.1 The Code of Ethics for Professional Accountants, prepared by the International Federation of Accountants (IFAC) identifies five types of threats. These are:

1. **Self-interest threats**, which occur when an auditing firm, its partner or associate could benefit from a financial interest in an audit client. Examples include (i) direct financial interest or materially significant indirect financial interest in a client, (ii) loan or guarantee to or from the concerned client, (iii) undue dependence on a client's fees and, hence, concerns about losing the engagement, (iv) close business relationship with an audit client, (v) potential employment with the client, and (vi) contingent fees for the audit engagement.

2. **Self-review threats**, which occur when during a review of any judgement or conclusion reached in a previous audit or non-audit engagement, or when a member of the audit team was previously a director or senior employee of the client. Instances where such threats come into play are (i) when an auditor having recently been a director or senior officer of the company, and (ii) when auditors perform services that are themselves subject matters of audit.

3. **Advocacy threats**, which occur when the auditor promotes, or is perceived to promote, a client’s opinion to a point where people may believe that objectivity is getting compromised, e.g. when an auditor deals with shares or securities of the audited company, or becomes the client’s advocate in litigation and third party disputes.

4. **Familiarity threats are self-evident**, and occur when auditors form relationships with the client where they end up being too sympathetic to the client’s interests. This can occur in many ways: (i) close relative of the audit team working in a senior position in the client company, (ii) former partner of the audit firm being a director or senior employee of the client, (iii) long association between specific auditors and their specific client counterparts, and (iv) acceptance of significant gifts or hospitality from the client company, its directors or employees.

5. **Intimidation threats**, which occur when auditors are deterred from acting objectively with an adequate degree of professional skepticism. Basically, these could happen because of threat of replacement over disagreements with the application of accounting principles, or pressure to disproportionately reduce work in response to reduced audit fees.
3. **SAFEGUARDS TO INDEPENDENCE**

3.1 The Chartered Accountant has a responsibility to remain independent by taking into account the context in which they practice, the threats to independence and the safeguards available to eliminate the threats.

3.2 To address the issue, Members are advised to apply the following guiding principles:

- For the public to have confidence in the quality of audit, it is essential that auditors should always be and appear to be independent of the entities that they are auditing.

- In the case of audit, the key fundamental principles are integrity, objectivity and professional skepticism, which necessarily require the auditor to be independent.

- Before taking on any work, an auditor must conscientiously consider whether it involves threats to his independence.

- When such threats exist, the auditor should either desist from the task or, at the very least, put in place safeguards that eliminate them. All such safeguards measure needs to be recorded in a form that can serve as evidence of compliance with due process.

- If the auditor is unable to fully implement credible and adequate safeguards, then he must not accept the work.

3.3 **Provisions contained under the Companies Act, 1956**

3.3.1 In order to ensure independence, the law has made certain provisions which either prohibit the appointment of a person as auditor in certain circumstances or place certain restrictions on his appointment as auditor or put third parties on guard against the possibility of an abridgement of independence by requiring certain disclosures to be made. These provisions are briefly outlined below:

3.3.2 Section 226 of the Companies Act, 1956 prohibits the appointment of a Chartered Accountant as auditor of a Company if he is:

(i) an officer or employee of the Company;

(ii) a partner of a person in the employment of an officer or of an employee of the Company;

(iii) a person who is indebted to the company for an amount exceeding ₹ 1000;

(iv) a person who has given any guarantee or provided any security in connection with the indebtedness of any third person to the company for an amount exceeding ₹ 1000;

(v) a person holding any security of that company.

3.3.3 A person who is disqualified from becoming auditor of any body corporate under the above rules is also disqualified from appointment as auditor of such body’s subsidiary, co-subsidiary or holding company.

3.3.4 Section 314 of the Companies Act, 1956 makes separate provision for the case where an auditor of a Company (whether public or private) is a relative of a director, or manager of a private company of which the director of the company is a director or member. In the case of
such a person he may be appointed as auditor of a company only if such appointment if approved with the consent of the company in general meeting obtained by a special resolution.

3.3.5 It will be observed from the above that the Act has specifically provided for cases where the independence of an auditor may be affected by his connection with the company and prohibited or restricted him from acting as auditor under those circumstances.

3.3.6 A question often arises as to whether an indebtedness (as referred in para (iii) above) arises in cases where in accordance with the terms of his engagement by a client (e.g. resolution passed at the general meeting) the auditor recovers his fees on a progressive basis as and when a part of the work is done without waiting for the completion of the whole job. In these circumstances, where in accordance with such terms the auditor recovers his fees on a progressive basis he cannot be said to be indebted to the company at any stage.

3.3.7 A question of indebtedness may also be raised where an auditor of a company purchases goods or services from a company audited by him. In such a case, if the amount outstanding exceeds ₹ 1000/- irrespective of the nature of the purchase or period of credit allowed to other customers the provisions concerning disqualification of auditor as contained in Section 226 (3)(d) of the Companies Act, 1956 will be attracted.

3.3.8 Another question which arises for consideration is whether a partner is disqualified from appointment as auditor when the firm of which he is a partner is indebted to the company in excess of the limit prescribed and whether the firm is disqualified from appointment as auditor when a partner of the firm is indebted in excess of the prescribed limit. In both cases, the disqualification will apply, because when a firm is appointed as auditor, each partner is deemed to be so appointed and when a firm is indebted, each partner is deemed to be indebted.

3.3.9 There may also be situations in which, though the appointment is in the individual name of a partner, the work, is, in fact, carried out by the firm and the fees are credited to the account of the firm. In such situations, the firm will be deemed to be acting as auditor and the disqualification will be attracted.

3.4 Provisions contained under the Chartered Accountants Act, 1949, Chartered Accountants Regulations, 1988 and under Code of Ethics to ensure Independence of Auditors

3.4.1 Clause (10) of Part I of the First Schedule to the Chartered Accountants Act, 1949 prohibits acceptance of, what have been described as contingent fees, i.e., fees, which are either based on percentage of profits or otherwise dependent on the finding or the results of employment.

3.4.2 What distinguishes a profession from a business is that professional service is not rendered with the sole purpose of a profit motive. Personal gain is one but not the main or the only objective. Professional opinion, therefore, frowns upon methods where payment is made to depend on the basis of results. It is obvious that a person who is to receive payment in direct proportion to the benefit received by his client, may be tempted to exaggerate the
advantage of his service or may adopt means which are not ethical. It will have the effect of undermining his integrity and impairing his independence. Therefore, the members are prohibited from charging or accepting any remuneration based on a percentage of the profits or on the happening of a particular contingency such as, the successful outcome of an appeal in revenue proceedings.

3.4.3 Professional services should not be offered or rendered under an arrangement whereby no fee will be charged unless a specified finding or result is obtained or where the fee is otherwise contingent upon the findings or results of such services. However, fee should not be regarded as being contingent if fixed by a Court or other public authority.

3.4.4 The Council of the Institute has framed Regulation 192 which exempts members from the operation of this Clause in certain professional services. The said Regulation 192 is reproduced below:

“192. Restriction on fees

No chartered accountant in practice shall charge or offer to charge, accept or offer to accept, in respect of any professional work, fees which are based on a percentage of profits, or which are contingent upon the findings, or results of such work:

Provided that:

(a) in the case of a receiver or a liquidator, the fees may be based on a percentage of the realisation or disbursement of the assets;

(b) in the case of an auditor of a co-operative society, the fees may be based on a percentage of the paid up capital or the working capital or the gross or net income or profits; and

(c) in the case of a valuer for the purposes of direct taxes and duties, the fees may be based on a percentage of the value of the property valued.”

3.4.5 Attention of the members is invited to the provisions of Clause (4) of Part I of the Second Schedule to the Chartered Accountants Act, 1949 which provides that a Chartered Accountant in practice shall be deemed to be guilty of professional misconduct if he expresses his opinion on financial statements of any business or any enterprise in which he, his firm or a partner in his firm has a substantial interest, unless he discloses his interest also in his report.

3.4.6 If the opinion of auditors are to command respect and the confidence of the public, it is essential that they must disclose every factor which is likely to affect their independence. Since financial interest in the business can be one of the important factors, which may disturb independence, the clause provides that the existence of such an interest direct or indirect should be disclosed. This is intended to assure the public as regards the faith and confidences that could be reposed on the independent opinion expressed by the auditors.

3.4.7 The words “financial statements” used in this clause would cover both reports and certificates usually given after an examination of the accounts or the financial statement or any attest function under any statutory enactment or for purposes of income-tax assessments. This would not however, apply to cases where such statements are prepared by members in
III  Auditing Pronouncements

employment purely for the information of their respective employers in the normal course of their duties and not meant to be submitted to any outside authority.

3.4.8 Public conscience is expected to be ahead of the law. Members, therefore, are expected to interpret the requirement as regards independence much more strictly than what the law requires and should not place themselves in positions which would either compromise or jeopardise their independence.

3.4.9 A Member must take care to see that he does not get into situations where there could be a conflict of interest and duty. For example, where a Chartered Accountant is appointed the liquidator of a company, he should not himself audit the Statement of Account to be filed under Section 551 (1) of the Companies Act, 1956. The audit in such circumstances should be done by a Chartered Accountant other than the one who is the liquidator of the company. Attention of the members is drawn to the audit assignments where appointment is done by the Comptroller & Auditor General of India (C&AG), Reserve Bank of India (RBI) and such other authorities. In addition to ensuring independence during the assignment, it is also essential to avoid any situation in near future which may be interpreted as a threat to independence, as for example, he or any other partner of his firm should not accept any other assignment such as internal audit, system audit and management consultancy services within one year from the completion of audit assignment.

3.4.10 A Chartered Accountant in employment should not certify the financial statements of the concern in which he is employed, or of a concern under the same management as the concern in which he is employed, even though he holds certificate of practice and that such certification can be done by any chartered accountant in practice. This restriction would not however apply where the certification is permitted by any law, e.g. Section 228 (iv) of the Companies Act, 1956 and the Companies (Branch Audit Exemption) Rules made thereunder. The Council has decided that a chartered accountant should not by himself or in his firm name:-

(i) accept the auditorship of a college, if he is working as a part-time lecturer in the college.

(ii) accept the auditorship of a trust where his partner is either an employee or a trustee of the trust.

3.4.11 Many new areas of professional work have been added, e.g., Special Audit under the Statutes, Tax Audit, Concurrent Audit of Banks, Concurrent Audit of Borrowers of Financial institutions, Audit of non-corporate borrowers of banks and financial institutions, audit of stock exchange, brokers etc. The Council wishes to emphasis that the requirement of Clause (4) of Part I of the Second Schedule to the Chartered Accountants Act, 1949 is equally applicable while performing all types of attest functions by the members.

3.4.12 Some of the situations which may arise in the applicability of Clause (4) of Part I of the Second Schedule to the Chartered Accountants Act, 1949 are discussed below for the guidance of members:-
1. **Where the member, his firm or his partner or his relative has substantial interest in the business or enterprise.**

The independence of mind is a fundamental concept of audit and/or expression of opinion on the financial statements in any form and, therefore, must always be maintained. Nothing can substitute for the essential and fundamental requirements of independence. Therefore, the Council’s views are clarified in the following circumstances.

   (i) **An enterprise/concern of which a member is either an owner or a partner**

   The holding of interest in the business or enterprise by a member himself whether as sole-proprietor or partner in a firm, in the opinion of the Council, would affect his independence of mind in the performance of professional duties in conducting the audit and/or expressing an opinion on financial statements of such enterprise. Therefore, a member should not audit financial statements of such business or enterprise.

   (ii) **Where the partner or relative of a member has substantial interest**

   The holding of substantial interest by the partner or relative of the member in the business or enterprise of which the audit is to be carried out and opinion is to be expressed on the financial statement, may also affect the independence of mind of the member, in the opinion of Council, in the performance of professional duties. Therefore, the member may, for the same reasons as not to compromise his independence, desist from undertaking the audit of financial statements of such business or enterprise. However, where a member undertakes the audit of such business or enterprise, he should disclose such interest in his report while expressing his opinion on the financial statements of such business or enterprise.

2. **Where the member or his partner or relative is a director or in the employment of an officer or an employee of the company**

   Section 226 of the Companies Act, 1956 specifically prohibits a member from auditing the accounts of a company in which he is a director or in the employment of an officer or an employee of the company. Although the provisions of the aforesaid section are not specifically applicable in the context of audits performed under other statutes, e.g. tax audit, yet the underlying principle of independence of mind is equally applicable in those situations also. Therefore, the Council’s views are clarified in the following situations.

   (i) **Where a member is a director**

   In cases where the member is a director of a company the financial statements of which are to be audited and/or opinion is to be expressed, he should not undertake such job and/or express opinion on the financial statements of that company.

   (ii) **Where a partner or relative of the member is a director in the company who has a substantial interest.**
In such cases for the reason as not to compromise with the independence of mind, the member may desist from undertaking the audit of financial statements and/or expression of opinion thereon. However, if a member feels that his independence is not affected and undertakes the audit of such company, he should disclose such interest in his report while expressing his opinion on the financial statements of such company.

The meaning of the words “relative” and “substantial interest” shall be the same as are contained in the Resolution passed by the Council in pursuance to Regulation 190A of Chartered Accountants Regulations, 1988 (Appendix 9 of 2002 edition).

3.4.13 An accountant is expected to be no less independent in the discharge of his duties as a tax consultant or as a financial adviser than as auditor. In fact, it is necessary that he should bear the same degree of integrity and independence of mind in all spheres of his work. Unless this is done, the accounts of companies audited by Chartered Accountants or statements made by them during the course of assessment proceedings would not be relied upon as correct by the authorities.

3.4.14 The Members are not permitted to write the books of accounts of their auditee clients.

3.4.15 A statutory auditor of a company cannot also be its internal auditor, as it will not be possible for him to give independent and objective report issued under sub-Section 4A of Section 227 of the Companies Act, 1956 read with the Companies (Auditors’ Report) Order, 2003.

3.4.16 The Council has issued a Notification No.1-CA(37)/70 dated 23rd May, 1970 whereby a member of the Institute in practice shall be deemed to be guilty of professional misconduct, if–

I. he accepts appointment as Cost auditor of Company under Section 233B of the Companies Act, 1956 while he -

(a) is an auditor of the company appointed under Section 224 of the Companies Act; or
(b) is an officer or employee of the company; or
(c) is a partner, or is in the employment of an officer or employee of the company; or
(d) is a partner or is in the employment of the Company’s auditor appointed under Section 224 of the Companies Act, 1956; or
(e) is indebted to the company for an amount exceeding one thousand rupees, or has given any guarantee or provided any security in connection with the indebtedness of any third person to the company for an amount exceeding one thousand rupees;

OR

II. after his appointment as Cost Auditor, he becomes subject to any of the disabilities stated in items I (a) to (e) above and continues to function as a cost auditor thereafter.
3.4.17 The Council has issued a Notification No.1-CA(39)/70 dated 16th October, 1970 whereby a member of the Institute in practice shall be deemed to be guilty of professional misconduct, if he accepts the appointment as auditor of a company under Section 224 of the Companies Act, 1956, while he is an employee of the cost auditor of the Company appointed under Section 233B of the Companies Act, 1956.

3.4.18 The Council has issued a Notification No.1-CA(7)/60/2002 dated 8th March, 2002 whereby a member of the Institute in practice shall be deemed to be guilty of professional misconduct, if he accepts the appointment as statutory auditor of Public Sector Undertaking(s)/Government Company(ies)/Listed Company(ies) and other Public Company(ies) having turnover of ₹ 50 crores or more in a year and accepts any other work(s) or assignment(s) or service(s) in regard to the same Undertaking(s)/ Company(ies) on a remuneration which in total exceeds the fee payable for carrying out the statutory audit of the same Undertaking/company.

3.4.19 The Council has issued a Notification No.1-CA(7)/63/2002 dated 2nd August, 2002 whereby a member of the Institute in practice shall be deemed to be guilty of professional misconduct, if he accepts appointment as auditor of a concern while he is indebted to the concern or has given any guarantee or provided any security in connection with the indebtedness of any third person to the concern, for limits fixed in the statute and in other cases for amount exceeding ₹ 10,000/-.

3.4.20 To ensure that the professional independence of a member doing attest function does not appear to be jeopardized he should, as far as possible, take care to see that the professional fees for audit and other services received by the firm in which he is a partner, by him and his partners individually and by firm or firms in which he or his partner are partners from one or more clients or companies under the same management does not exceed 40% of the gross annual fees of the firm, firms and partners referred to above. 'Companies under the same management' here would refer to the definition of this expression as provided in section 370(1-B) of the Companies Act, 1956.

Provided that no such ceiling on the gross annual professional fees of a member would be applicable where such fees do not exceed two lakhs of rupees in respect of a member or firm including fees received by the member or firm for other services rendered through the medium of a different firm or firms in which such member or firm may be a partner or proprietor.

Provided further that no such ceiling on the gross annual professional fees of a member would be applicable in the case of audit of government companies, public undertakings, nationalized banks, public financial institutions or where appointments of auditors are made by the Government.

3.4.21 Members’ attention is also drawn to Clauses (8) & (9) of Part I of the First Schedule to the Chartered Accountants Act, 1949:

“A Member shall be deemed to be guilty of professional misconduct, if he:

X XX XXX XXXX
(8) accepts a position as auditor previously held by another chartered accountant or a restricted state auditor without first communicating with him in writing;

(9) accepts an appointment as auditor of a company without first ascertaining from it whether the requirements of Section 225 of the Companies Act, 1956 in respect of such appointment have been duly complied with."

3.4.22 Clause (8) of Part I of First Schedule to the Chartered Accountants Act, 1949 emphasized the requirement of mandatory communication with the previous auditor in all types of audit viz., statutory audit, tax audit, internal audit, concurrent audit or any kind of audit and it is equally applicable to audits of both government and non-government entities.

3.4.23 Clause (9) of Part I of First Schedule to the Chartered Accountants Act, 1949 provided that an auditor of the company before accepting the appointment, should ascertain from the auditor whether the requirements of Section 225 of the Companies Act, 1956 in respect of such appointment have been duly complied with. Section 224 of the Companies Act, 1956 contains several provisions in the matter of appointment of auditors in different circumstances and situations whereas Section 225 laid down the procedure which must be followed whenever a company desires to change its auditor. Also that the validity of the appointment of an auditor is not challenged or objected to by shareholders or the retiring auditors at a later date, it has been made obligatory to ascertain from the company that the appropriate procedure in the matter of appointment has been faithfully followed. Independence of auditor is a concept to be addressed through its all the possible aspects and the message of Clause (8) & (9) is to ensure that an auditor should be conscious about this aspect from the very point of accepting the position of an auditor.

4. CONCLUSION

4.1 The Council feels that there are adequate safeguards provided in the Companies Act, 1956 as well as in the Chartered Accountants Act, 1949. The Council is of the view that independence, being a state of the mind, is not necessarily affected by the fact of mere relationship any more than it should be existence if the relationship did not exist. In any case, lest there may be any feeling in the public mind that relationship would affect the independence of auditors, the Council suggests that where, due to near relationship of an auditor, with a Managing or a Whole-Time Director the independence of an auditor is likely to be jeopardized, he should use his good sense, and acting in the best traditions of the profession, refrain from accepting the appointment.

4.2 If the opinion of chartered accountant is to command respect and the confidence of the public, it is essential that they must ensure their independence to assure the public as regards the faith and confidence that could be reposed on them. The Chartered Accountant should ensure his independence in all assurance services including concurrent audit, tax audit and internal audit. The chartered accountant should make it certain that his independence is not jeopardized. Where he feels that his independence is jeopardized, he should refrain from accepting the assignment.
GUIDANCE NOTE ON AUDIT OF INVENTORIES*

The following is the text of the Guidance Note on Audit of Inventories, issued by the Auditing Practices Committee (APC)** of the Council of the Institute of Chartered Accountants of India. This Guidance Note should be read in conjunction with the Statements on Standard Auditing Practices (SAPs)¹ issued by the Institute.

1. Para 2.1 of the “Preface to the Statements on Standard Auditing Practices”¹ issued by the Institute of Chartered Accountants of India states that the “main function of the APC is to review the existing auditing practices in India and to develop Statements on Standard Auditing Practices (SAPs) so that these may be issued by the Council of the Institute.” Para 2.4 of the Preface states that the “APC will issue Guidance Notes on the issues arising from the SAPs wherever necessary.”

2. The Auditing Practices Committee has also taken up the task of reviewing the Statements on auditing matters issued prior to the formation of the Committee. It is intended to issue, in due course of time, Engagement Standards or Guidance Notes, as appropriate, on the matters covered by such Statements which would then stand withdrawn. Accordingly, with the issuance of this Guidance Note on Audit of Inventories, Chapter 5 of the Statement on Auditing Practices, titled “Inventories”, shall stand withdrawn. In due course of time, the entire Statement on Auditing Practices shall be withdrawn.³

INTRODUCTION

3. Inventories are tangible property held for sale in the ordinary course of business, or in the process of production for such sale, or for consumption in the production of goods or services for sale, including maintenance supplies and consumable stores and spare parts meant for replacement in the normal course.⁴ Inventories normally comprise raw materials including components, work-in-process, finished goods including by-products, maintenance supplies, stores and spare parts, and loose tools.⁵

¹ Issued in November, 1994.
² Now known as the Auditing and Assurance Standards Board (AASB).
³ Now known as Engagement Standards.
⁴ The said Preface has been withdrawn pursuant to issuance of the Revised “Preface to Standards on Quality Control, Auditing, Review, Other Assurance and Related Service”, by the Institute of Chartered Accountants of India. The Revised Preface is effective from April 1, 2008. The text of the revised Preface is reproduced in the Vol.1 of this Handbook.
⁵ Since the Statement was withdrawn in March, 2005, the entire paragraph is redundant.
⁶ Servicing equipment, stand-by equipment and specialised spares of machinery (which are in the nature of ‘insurance spares’) are normally capitalised.
⁷ The audit procedures, relating to shares debentures and other securities held as stock-in-trade (i.e., for sale in the ordinary course of business) are similar to those followed for audit of investments. Accordingly, this Guidance Note does not apply in respect of audit of shares, debentures and other securities held as stock-in-trade.
4. Inventories normally constitute a significant portion of the total assets, particularly in the case of manufacturing and trading entities as well as some service rendering entities. Audit of inventories, therefore, assumes special importance.

5. The following features of inventories have an impact on the related audit procedures:

(i) By their very nature, inventories normally turn over rapidly.

(ii) Inventories are susceptible to obsolescence and spoilage. Further, some of the items of inventory may be slow-moving while others may follow a seasonal pattern of movement.

(iii) Inventories are normally movable in nature, although there may be some instances of immovable inventories also, e.g., in the case of an entity dealing in real-estate.

(iv) All the items of inventory may not be located at one place but may be held at different locations such as factories and warehouses, or with third parties such as selling agents.

(v) The individual items of inventory may not be significant in value, but taken together, they normally constitute a significant proportion of total assets and current assets of manufacturing, trading and certain service entities.

(vi) Physical condition (e.g., stage of completion of work-in-process in certain industries) and existence of certain items of inventories may be difficult to determine.

(vii) Valuation of inventories may involve varying degrees of estimation, including expert opinions, e.g., in the case of jewelry.

INTERNAL CONTROL EVALUATION

6. The auditor should study and evaluate the system of internal control relating to inventories, to determine the nature, timing and extent of his other audit procedures. He should particularly review the following aspects of internal control relating to inventories:

(a) The control procedures should provide for segregation of such functions whose combination may permit the commitment or concealment of fraud or error; for example, persons undertaking the physical verification of stocks should be different from those responsible for store-keeping in respect of those stocks.

(b) The stores procedures should provide for the use of pre-numbered standardized forms.

(c) There should be a system of cross-checking the data generated by different operating departments.

7. The auditor should also review specific controls over receipts, issues, physical inventories, and inventory records.

VERIFICATION

8. As in the case of other assets, the responsibility for properly determining the quantity and

---

6 The extent of review of controls would depend upon the facts and circumstances of each case. Reference may be made in this regard to the “Internal Control Questionnaire”, issued by the Institute of Chartered Accountants of India in 1976 which contains, inter alia, an illustrative discussion on internal controls in relation to inventories.
value of inventories rests with the management of the entity. It is, therefore, the responsibility of the management of the entity to ensure that the inventories included in the financial information are physically in existence and represent all inventories owned by the entity. The management satisfies this responsibility by carrying out appropriate procedures which will normally include verification of all items of inventory at least once in every financial year. This responsibility is not reduced even where the auditor attends any physical count of inventories in order to obtain audit evidence.

9. In any auditing situation, the auditor employs appropriate procedures to obtain reasonable assurance about various assertions (Standard on Auditing (SA) 500, Audit Evidence). In carrying out an audit of inventories, the auditor is particularly concerned with obtaining sufficient appropriate audit evidence to corroborate the management's assertions regarding the following:

- **Existence** - that all recorded inventories exist as at the year-end.
- **Ownership** - that all inventories owned by the entity are recorded and that all recorded inventories are owned by the entity.
- **Valuation** - that the stated basis of valuation of inventories is appropriate and properly applied, and that the condition of inventories is recognised in their valuation.

Verification of inventories may be carried out by employing the following procedures:

(a) examination of records;
(b) attendance at stock-taking;
(c) obtaining confirmations from third parties;
(d) examination of valuation and disclosure; and
(e) analytical review procedures.

The nature, timing and extent of audit procedures to be performed is, however, a matter of professional judgement of the auditor.

**EXAMINATION OF RECORDS**

10. The entities usually maintain detailed stock records in the form of stores/stock ledgers showing in respect of each major item, the receipts, issues and balances. The extent of examination of these records by an auditor with reference to the relevant basic documents (e.g., goods received notes, inspection reports, material issue notes, bin cards, etc.) depends upon the facts and circumstances of each case.

11. The auditor may come across cases where the entity does not maintain detailed stock records other than the basic records relating to purchases and sales. In such situations, the auditor would have to suitably extend the extent of application of the audit procedures discussed in paragraphs 12-22 and 30.
ATTENDANCE AT STOCK-TAKING

12. Physical verification of inventories is the responsibility of the management of the entity. However, where the inventories are material and the auditor is placing reliance upon the physical count by the management, it may be appropriate for the auditor to attend the stock-taking. The extent of auditor's attendance at stock-taking would depend upon his assessment of the efficacy of relevant internal control procedures, and the results of his examination of the stock records maintained by the entity and of the analytical review procedures.

13. The procedures concerning the auditor's attendance at stock-taking depend upon the method of stock-taking followed by the entity.

14. There are two principal methods of stock-taking: periodic stocktaking and continuous stock-taking. Under the first method, physical verification of inventories is carried out at a single point of time, usually at the year-end or at a selected date before or shortly after the year-end. Under the second method, physical verification is carried out throughout the year, with different items of inventory being physically verified at different points of time. However, the verification programme is normally so designed that each material item is physically verified at least once in a year and more often in appropriate cases. The continuous stock-taking method is effective when a perpetual inventory system of record-keeping is also in existence. Some entities use continuous stock-taking methods for certain stocks and carry out a full count of other stocks at a selected date.

15. The auditor is expected to examine the adequacy of the methods and procedures of physical verification followed by the entity. Before commencement of verification, the management should issue appropriate instructions to stock-taking personnel. Such instructions should cover all phases of physical verification and preferably be in writing. It would be useful if the instructions are formulated by the entity in consultation with the auditor. The auditor should examine these instructions to assess their efficacy. An illustrative set of instructions which may be useful in most cases is given in Appendix I to this Guidance Note.

16. Where the auditor is present at the time of stock-taking, he should observe the procedure of physical verification adopted by the stock-taking personnel to ensure that the instructions issued in this behalf are being actually followed. The auditor should also perform test-counts to satisfy himself about the effectiveness of the count procedures. In carrying out the test counts, the auditor should give particular consideration to those stocks which have a high value either individually or as a category of stocks. Proper attention should also be paid to the physical condition of inventories.

17. Ideally, there should be no movement of stocks when the physical verification is being carried out. On occasions, however, it may be necessary for the entity to continue the production, receiving, or dispatch operations during physical verification. In such circumstances, it is essential that the entity has the procedures to identify and record such movements. The auditor should review the procedures adopted by the entity to account for the movement of inventories from one location to another within the entity during stock-taking (e.g., issues from stores to production departments).

18. The auditor should also examine whether the entity has instituted appropriate cut-off procedures to ensure that –
(a) goods purchased but not received have been included in the inventories and the liability has been provided for;

(b) goods sold but not despatched have been excluded from the inventories and credit has been taken for the sales.

The auditor may examine a sample of documents evidencing the movement of stocks into and out of stores, including documents pertaining to periods shortly before and shortly after the cut-off date, and check whether the stocks represented by those documents were included or excluded, as appropriate, during the stock-taking.

19. The auditor should review the original physical verification sheets and trace selected items including the more valuable ones into the final inventories. He should also compare the final inventories with stock records and other corroborative evidence, e.g., stock statements submitted to banks.

20. The auditor should examine whether the discrepancies noticed on physical verification have been investigated and properly accounted for.

21. Where continuous stock-taking methods are being used by the entity, the auditor should, in addition to performing the audit procedures discussed in paragraphs 16-20 above, pay greater attention to ascertaining whether the management:

(a) maintains adequate stock records that are kept up-to-date;

(b) has satisfactory procedures for physical verification of inventories, so that in the normal circumstances the programme of physical verification will cover all material items of inventories at least once during the year; and

(c) investigates and corrects all material differences between the book records and the physical counts.

22. The auditor should determine whether the procedures for identifying defective, damaged, obsolete, excess and slow-moving items of inventory are well-designed and operate properly.

CONFIRMATIONS FROM THIRD PARTIES

23. Where significant stocks of the entity are held by third parties, the auditor should examine that the third parties are not such with whom it is not proper that the stocks of the entity are held. The auditor should also directly obtain from the third parties written confirmation of the stocks held. Arrangements should be made with the entity for sending requests for confirmation to such third parties. A proforma letter of request for confirmation to be used in such cases is given in Appendix II to this Guidance Note. Similarly, the auditor should also obtain confirmation from such third parties for whom the entity is holding significant amount of stocks. Appendix-III to this Guidance Note gives a proforma letter of request for confirmation to be used for this purpose.

EXAMINATION OF VALUATION AND DISCLOSURE

24. The auditor's objective concerning valuation is to obtain evidence that the amount at which inventories have been valued is computed on an appropriate basis.
25. The auditor should satisfy himself that the valuation of inventories is in accordance with the normally accepted accounting principles and is on the same basis as in the preceding year. The generally accepted accounting principles involved in the valuation of most types of inventories are dealt with in Accounting Standard (AS) 2, “Valuation of Inventories”, issued by the Council of the Institute of Chartered Accountants of India.

26. The auditor should examine the methods of applying the basis of inventory valuation. Thus, with regard to determination of cost, the auditor should examine, *inter alia*, the stock sheets, records of physical verification, invoices, costing records and other relevant documents and also examine and test the treatment of overhead expenses as a part of cost of inventories.

27. Wherever feasible, and particularly where only a single or a few major products are produced, the auditor may call for a reconciliation of the total cost of production for the year as determined by the cost records with the total expenses as per the financial books and review this reconciliation. Where standard costs are used or where overheads are charged at standard rates or percentages, he may examine the variances from actuals and, where these are significant, ensure that appropriate adjustment is made to the inventories.

28. The auditor should examine the evidence supporting the assessment of net realizable value. In this regard, the auditor should particularly examine whether appropriate allowance has been made for defective, damaged and obsolete and slow-moving inventories in determining the net realizable value.

29. The auditor should satisfy himself that the inventories have been disclosed properly in the financial statements. Where the relevant statute lays down any disclosure requirements in this behalf, the auditor should examine whether the same have been complied with.

**ANALYTICAL REVIEW PROCEDURES**

30. In addition to the audit procedures discussed above, the following analytical review procedures may often be helpful as a means of obtaining audit evidence regarding the various assertions relating to inventories:

(i) reconciliation of quantities of opening stocks, purchases, production, sales and closing stocks;

(ii) comparison of closing stock quantities and amounts with those of the previous year;

(iii) comparison of the relationship of current year stock quantities and amounts with the current year sales and purchases, with the corresponding figures for the previous year;

(iv) comparison of the composition of the closing stock (e.g., raw materials as a percentage of total stocks, work-in-process as a percentage of total stocks) with the corresponding figures for the previous year;

(v) comparison of current year gross profit ratio with the gross profit ratio for the previous year;

---

7 It may be mentioned that the Manufacturing and Other Companies (Auditor's Report) Order, 1988 uses the words “normally accepted accounting principles”.

---

© The Institute of Chartered Accountants of India
(vi) comparison of actual stock, purchase and sales figures with the corresponding budgeted figures, if available;

(vii) comparison of yield with the corresponding figure for the previous year;

(viii) comparison of significant ratios relating to inventories with the similar ratios for other firms in the same industry, if available;

(ix) comparison of significant ratios relating to inventories with the industry norms, if available.

It may be clarified that the foregoing is only an illustrative list of analytical review procedures which an auditor may employ in carrying out audit of inventories. The exact nature of analytical review procedures to be applied in a specific situation is a matter of professional judgement of the auditor.

SPECIAL CONSIDERATIONS IN CASE OF WORK-IN-PROCESS

31. In general, the audit procedures regarding work-in-process are similar to those used for raw materials and finished goods. However, the auditor has to carefully assess the stage of completion of the work-in-process for assessing the appropriateness of its valuation. For this purpose, the auditor may examine the production/costing records (e.g., cost sheets), hold discussions with the personnel concerned, and obtain expert opinion, where necessary.

32. In certain cases, due to the nature of the product and the manufacturing process involved, physical verification of work-in-process may be impracticable. In such cases, the auditor should lay greater emphasis on ascertaining whether the system, from which the work-in-process is ascertained, is reliable. It may also be useful for the auditor to examine the subsequent records of production/sales.

MANAGEMENT REPRESENTATIONS

33. The auditor should obtain from the management of the entity, a written statement describing in detail, the location of inventories, methods and procedures of physical verification and valuation of inventories. While such a representation letter serves as a formal acknowledgment of the management’s responsibilities with regard to inventories, it does not relieve the auditor of his responsibility for performing audit procedures to obtain sufficient appropriate audit evidence to form the basis for the expression of his opinion on the financial information. A sample management representation letter regarding inventories is given in Appendix IV to this Guidance Note. It may be mentioned that the representations made in the letter can alternatively be included in a composite representation letter usually issued by the management to the auditor.

DOCUMENTATION

34. The auditor should maintain adequate working papers regarding audit of inventories. He should maintain on his audit file a summary of each inventory as also the details regarding the extent of his verification. The management representation letter concerning inventories should also be maintained on the audit file.
Appendix I

Illustrative Set of Instructions to be Issued by the Client to its Staff Responsible for Stock-Taking
(Ref. Paragraph 15)

This Appendix contains an illustrative set of instructions which may be issued by the client to the staff responsible for stock-taking. The Appendix also lists special instructions in respect of stocks held by others and work-in process.

The annual physical examination of inventories of the entity is to be carried out on 31st March. The work will commence at 8.00 A.M. on 31st March, and there will be no movement of inventories during their physical examination.

1. Mr. AB will be in overall charge of the physical counting.

2. Messrs............., Auditors, will depute their staff to observe the work performed by us. It should be remembered that they are not responsible for any part of the stock-taking.

3. You are responsible for the physical counting of all stocks in (state here the exact area for which the person is responsible e.g., Block B of Godown No. 2, or in the open yard on south of factory, etc.). You are not concerned with similar items of stock which may be stored at other locations.

How to proceed with the work

4. At 8 A.M. you should present yourself in the office of Mr. AB where you will be handed over a bunch of inventory tags. You should ensure that you have in your possession a sufficient number for your needs. You should also have in your possession a pen, blank papers, a measuring tape, ............ (state here any other instrument which is required for measurement, counting, weighing etc.). Please ensure that for all items in your area for which weighing or measuring is required, the necessary apparatus is available.

Procedure for tagging

5.1 You should place a tag on each pile, box, bin, etc., which is counted by you after recording the quantity, description, part number, condition of the stocks to the extent known (e.g., damaged stocks), etc., on the tag. You should proceed in proper order so as to ensure that no items are omitted. When the work of counting is completed you should hand over the remaining tags including soiled and damaged tags to Mr. PQ.

5.2 All items are required to be measured, weighed or counted in order to ascertain the exact quantity on hand. However, in respect of small items of in significant value, such as bolts, nuts (state here any other items which are known to be of small value), the quantities on hand may be estimated without actual counting etc. In the latter case, please state "estimated" on the tag.

5.3 Please ensure that proper identification is made by part number, description, etc., and that in the case of work-in-process, the last operation performed is clearly specified in accordance with the schedule attached to this Memorandum. No movement of any stock from one location to another should take place during the period of stock checking.
5.4 Where bin cards are kept on the bins or job tickets are attached to items in process, you should not merely copy the quantities shown on those documents to the tag without verification. All alterations made on the tags should be initialled and quantities should be recorded in ink.

5.5 Mr. PQ is responsible for the control over tags in use. For this purpose, he should prepare a schedule in the attached Form.

5.6 After obtaining the permission of the auditors\(^8\), instructions will be issued for the removal of the tags and a suitable person should be sent around in each department to detach the detachable portion of the tags, leaving the counterpart in the proper position. When they are collected, all such tags should be brought back to a central location, placed in serial order and tallied with the schedule prepared by Mr. PQ. After this has been done, the tags will be released to the Accounts Department which is concerned with the preparation of the inventory. Later on, when the inventory has been prepared, a check should be possible to see whether all the tags have been listed.

5.7 After the work of counting has been completed, Mr. AB, who is in overall charge of stock-taking, will make a visit to each area in order to ascertain that all bins, boxes, etc., bear a tag and make a check of the quantities shown therein. At this point, the auditors will carry out further observation and make such test checks as they consider necessary.

5.8 The counterparts of the tags should be left on the relevant bins or piles for a period of at least one month and the quantity shown on the counterparts of the tag should be used as the opening balance of the bin card for the subsequent period.

**Procedure for preparing stock sheets**

6.1 Separate listings under the following broad heads should be prepared:

(i) Raw materials, including components
(ii) Work-in-process
(iii) Finished goods, including by-products
(iv) Maintenance supplies and stores and spare parts
(v) Loose tools

Defective, damaged, obsolete, excess or slow-moving stocks should be listed separately under each of the above categories.

6.2 It should be examined that the stock cards, bin cards, tags or other stock records are posted up-to-date so that items can be traced and verified in these records, simultaneously with the physical checking of stocks.

6.3 A list of excesses and shortages should be drawn up at the time of physical stock-taking.

---

\(^8\) It is presumed that the auditors or their representatives are present at the time of stock-taking.
6.4 Stocks belonging to third parties and remaining in custody of the entity should be separately identified from the entity's own stock. A separate listing should be prepared for all such items of stocks.

6.5 Defective, damaged, obsolete, excess or slow-moving stocks should be kept separate from other items.

6.6 Counters and checkers should sign or initial the stock sheets for the work done by them.

**Stocks held by others**

7.1 The following steps be taken for stocks belonging to the entity but held by others:

(i) A separate listing for such stocks be prepared.

(ii) A letter should be sent to such persons to confirm the stocks held by them directly to the auditor.

(iii) An authority to inspect stocks held by third parties should be given to the auditor where the same is considered necessary by the auditor.

(iv) An independent record for such goods be kept by the entity.

7.2 The above steps should also be taken for stocks given on loan or received on loan.

**Work-in-Process**

8.1 With regard to work-in-process, the following instructions be given to the staff members concerned:

(i) A separate listing for work-in-process be prepared.

(ii) The internal records kept by the entity be written up-to-date.

(iii) If the amount of work-in-process is determinable from production records, the same be kept up-to-date.

(iv) A list of opening work-in-process be kept ready at the time of stock-taking.

---

**Appendix II**

**Illustrative Letter of Confirmation of Inventories Held by Others**

[Ref. Paragraph 23]

(Letterhead of Entity)

[Date]

[Name and address of holder of inventories]

Dear Sir,

For audit purposes, kindly furnish directly to our auditors (name and address of the auditors) details concerning our inventories held by you for [state here the purpose of holding of inventories by the third party] as of the close of business on .................
According to our records, you held the following inventories as of that date:

<table>
<thead>
<tr>
<th>Description</th>
<th>Quantity</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
</tbody>
</table>

In case you identify certain items of inventories as defective or damaged, the details thereof may be furnished separately, indicating the quantities and giving a general description of the condition of such items. Also, please confirm that our inventories held by you are free of any charge or encumbrance.

A stamped envelope addressed to our auditors is enclosed for your convenience.

Yours faithfully,

(Signature of responsible official of the entity)

Appendix III

Illustrative Letter of Confirmation – Inventories Held by the Entity on Behalf of Others

[Ref. Paragraph 23]

[Letterhead of Entity]

[Date]

[Name and address of owner of inventories]

Dear Sir,

For audit purposes, kindly furnish directly to our auditors (name and address of the auditors) details concerning your inventories held by us for [state here the purpose of holding of inventories by the entity as of the close of business on ____________].

According to our records, we held the following inventories as of that date:

<table>
<thead>
<tr>
<th>Description</th>
<th>Quantity</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
</tbody>
</table>

A stamped envelope addressed to our auditors is enclosed for your convenience.

Yours faithfully,

(Signature of responsible official of the entity)
Appendix IV

Representation Letter for Inventories
[Ref. Paragraph 33]

The following is a sample representation letter for inventories. It might be used to supplement the general letter of representation or included therein. The letter should be modified where appropriate.

[Letterhead of Entity]

[Date]

[Name and Address of the Auditor]

Dear Sir,

In connection with your audit of the financial statements of X limited as of ..... 19..., and for the year then ended, we make, to the best of our knowledge and belief, the following representations concerning inventories.

1. Inventories at the year-end consisted of the following:

   Raw Materials (including components) ₹ ________

   Work-in-Process ₹ ________

   Finished Goods (including by-products) ₹ ________

   Maintenance supplies and Stores and Spare Parts ₹ ________

   Loose Tools ₹ ________

   Others (specify each major head separately) ₹ ________

   Total ₹ ________

2. All quantities were determined by actual physical count or weight or measurement that was taken under our supervision and in accordance with written instructions, on ........... (date/dates of physical verification), except as follows:

   9

   Where physical verification of inventories is carried out at a date other than the closing date, this paragraph may be modified as below:

   Inventories recorded in the books as at ...........(date of balance sheet) aggregating to ₹ ........ are based upon the physical inventories taken as at .......... (date of physical verification) by actual count weight or measurement. The material discrepancies noticed on physical verification of stocks as compared to book records have been properly dealt with in the books of account and subsequent transactions recorded in the accounts fairly reflect the changes in the inventories up to .......... (balance sheet date).
3. Except as set out below, all goods included in the inventory are the property of the entity and are not subject to any charge, and none of the goods are held as consignee for others or as bailee:

..........................................................  ..........................................................

4. All inventories owned by the entity, wherever located, have been recorded, including goods sent on consignment.

5. Inventories do not include goods sold to customers for which delivery is yet to be made.

6. Inventories have been valued on the following basis/bases:
   Raw Materials (including components)
   Work-in-Process
   Finished Goods (including by-products)
   Maintenance supplies and Stores and Spare Parts
   Loose Tools
   Others (specify each major head separately)

   (In describing the basis/bases of valuation, the method of ascertaining the cost (e.g. FIFO, Average Cost or LIFO) should also be stated. Similarly, the extent to which overheads have been included in the cost should also be stated.)

7. The following provisions have been made in respect of excess, slow moving, damaged, or obsolete inventories and these, in our view, are adequate.

..........................................................  ..........................................................

8. No item of inventories has a net realizable value in the ordinary course of business which is less than the amount at which it is included in inventories.

9. The basis/bases of valuation is/are the same as that/those used in the previous year, except as set out below:

<table>
<thead>
<tr>
<th>Class of Inventory</th>
<th>Basis of valuation</th>
<th>Effect of change in Basis of Valuation</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>This year</td>
<td>Last year</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

..........................................................  ..........................................................

Yours faithfully,

(Signature of responsible official of the entity)
Clarification***

Auditor's Duties where Inventories are Stated to be “As Valued and Certified by the Management” in Financial Statements

(Refer Paragraph 33)

It has been observed that in some cases, inventories are described in the financial statements as “Stocks (as valued and certified by the management)”. The use of such an expression may lead the users of the financial statements to believe that the auditor merely relies on the management’s certificate without carrying out any other appropriate audit procedures to satisfy himself about the existence and valuation of inventories.

The Institute of Chartered Accountants of India has issued a Guidance Note on Audit of Inventories, which recommends the procedures to be followed by the auditors in conducting the audit of inventories. Para 33 of the Guidance Note, inter alia, recommends as below:

“The auditor should obtain from the management of the entity, a written statement describing in detail the location of inventories, methods and procedures of physical verification and valuation of inventories. While such a representation letter serves as a formal acknowledgment of the management’s responsibilities with regard to inventories, it does not relieve the auditor of his responsibility for performing audit procedures to obtain sufficient appropriate audit evidence to form the basis for the expression of his opinion on the financial information.”

In view of the above, the Council of the Institute hereby clarifies that despite the expression “as valued and certified by the management”， the duties and responsibilities of the auditors with regard to audit of inventories are not diminished. Thus, in order that the auditor’s role with regard to inventories is properly appreciated by the users of the financial statements, the auditor may advise his clients to omit the words “as valued and certified by the management”, when describing inventories in the financial statements.

*** Published in September, 1999 issue of “The Chartered Accountant”, p.66.
GUIDANCE NOTE ON
AUDIT OF DEBTORS, LOANS AND ADVANCES*

The following is the text of the Guidance Note on Audit of Debtors, Loans and Advances issued by the Auditing Practices Committee (APC)† of the Council of the Institute of Chartered Accountants of India. This Guidance Note should be read in conjunction with the Statements on Standard Auditing Practices (SAPs)¹ issued by the Institute.

1. Paragraph 2.1 of the “Preface to the Statements on Standard Auditing Practices”² issued by the Institute of Chartered Accountants of India states that the “main function of the APC is to review the existing auditing practices in India and to develop Statements on Standard Auditing Practices (SAPs) so that these may be issued by the Council of the Institute.” Paragraph 2.4 of the Preface states that the “APC will issue Guidance Notes on the issues arising from the SAPs wherever necessary.”

2. The Auditing Practices Committee has also taken up the task of reviewing the Statements on auditing matters issued prior to the formation of the Committee. It is intended to issue, in due course of time, Engagement Standards or Guidance Notes, as appropriate, on the matters covered by such Statements which would then stand withdrawn. Accordingly, with the issuance of this Guidance Note on Audit of Debtors, Loans and Advances, Chapter-7 of the Statement on Auditing Practices, titled ‘Debtors, Loans and Advances’, shall stand withdrawn. In due course of time, the entire Statement of Auditing Practices shall be withdrawn. ³

INTRODUCTION

3. Debtors, loans and advances may constitute a significant proportion of the total assets of an entity. Debtors represent the amounts due to an entity for goods sold or services rendered or in respect of other similar contractual obligations, but do not include the amounts which are in the nature of loans or advances. Loans represent the claims of an entity in respect of such contractual obligations as moneys lent. Advances represent payments made on account of, but before completion of, a contract or before acquisition of goods or receipt of services. For purposes of this Guidance Note, debtors, loans and advances include instruments such as bills of exchange, promissory notes and similar other instruments, evidencing debtors, loans

* Published in June, 1994 issue of ‘The Chartered Accountant’.
† Now known as the Auditing and Assurance Standards Board (AASB).
¹ Now known as Engagement Standards.
² The said Preface has been withdrawn pursuant to issuance of the Revised “Preface to Standards on Quality Control, Auditing, Review, Other Assurance and Related Service”, by the Institute of Chartered Accountants of India. The Revised Preface is effective from April 1, 2008. The text of the revised Preface is reproduced in the Vol.I of this Handbook.
³ Since the Statement was withdrawn in March, 2005, the entire paragraph is redundant.
and advances.

4. An important feature of debtors, loans and advances which has a significant effect on the related audit procedures is that these assets are represented only by documentary evidence; they have no physical existence. Moreover, the documentary evidence is generally in the form of invoices, loan documents, etc., prepared by the entity itself. The auditor should take these factors into account in designing his audit procedures.

INTERNAL CONTROL EVALUATION

5. The auditor should study and evaluate the system of internal control relating to debtors, loans and advances, to determine the nature, timing and extent of his other audit procedures. He should particularly review the following aspects of internal control relating to debtors, loans and advances.4

(a) In respect of debtors

(i) The basis on which credit limits for customers are to be determined should be clearly laid down. The credit limits fixed in respect of individual customers should be approved by an official independent of the sales department. These limits should be checked before orders are accepted from the customers. There should also be a system of periodic review of the credit limits.

(ii) The procedure should ensure prompt recording of debts and realisations and of linking receipts with outstandings.

(iii) There should be a procedure for preparation of aging schedule of debtors at regular intervals. The schedules should be reviewed by a responsible official and necessary action initiated in respect of overdue accounts.

(iv) Statements of account should be sent to all debtors at periodic intervals. They should be prepared and despatched by a person independent of the ledger-keeper. The debtors should be requested to confirm the balances as per the statements with reference to their own records. The confirmations received should be reviewed by a person independent of the ledger-keeper and the person responsible for preparing the statements of account, and necessary action taken in case of discrepancies.

(v) All material adjustments in debtors’ accounts, particularly those relating to rebates, allowances, commissions etc., should require approval of the competent authority. Similarly, any write-off of bad debts should require approval of the competent authority.

(vi) There should be a system of periodic reconciliation of various debtor balances with related control accounts.

4 The extent of review of internal controls would depend upon the facts and circumstances of each case. Reference may be made in this regard to the "Internal Control Questionnaire", issued by the Institute of Chattered Accountants of India in 1976, which contains an illustrative discussion on internal controls in relation to debtors and loans and advances.
(b) In respect of loans and advances

(i) As far as possible, the system should specify the following:
- total amount up to which loans may be made;
- the purposes for which loans may be made;
- maximum amount of loans which may be made for each such purpose in individual cases;
- the terms on which such loans may be made;
- the persons who are authorized to make loans;
- procedure for ensuring compliance with relevant legal requirements.

(ii) All variations in the terms of loans and advances should be duly approved in writing by the competent authority.

(iii) Where security is taken against the loans, the form and adequacy of security should be reviewed by a responsible official.

(iv) The loan and security documents should be kept in safe custody of a responsible official. A record of all such documents should be maintained and the documents should be periodically verified with reference to such records.

(v) The system should provide for identification of cases where principal and/or interest have become overdue or where any other terms are not being complied with.

(vi) Confirmation of balances should be obtained at periodic intervals in the same manner as in the case of debtors.

VERIFICATION

6. In any auditing situation, the auditor employs appropriate procedures to obtain reasonable assurance about various assertions (see Standard on Auditing (SA) 500, Audit Evidence). In carrying out an audit of debtors, loans and advances, the auditor is particularly concerned with obtaining sufficient appropriate audit evidence to corroborate the management's assertions regarding the following:

Existence - that all amounts recorded in respect of debtors, loans and advances are outstanding as at the date of the balance sheet.

Completeness - that there are no unrecorded debtors, loans and advances.

Valuation - that the stated basis of valuation of debtors, loans and advances is appropriate and properly applied, and that the recoverability of debtors, loans and advances is recognised in their valuation.

Disclosure - that the debtors, loans and advances are disclosed, classified, and described in accordance with recognised accounting policies and
Verification of debtors may be carried out by employing the following procedures:

(a) examination of records;
(b) direct confirmation procedure (also known as ‘circularisation procedure’);
(c) analytical review procedures.

The nature, timing and extent of audit procedures to be performed is, however, a matter of professional judgement of the auditor.

EXAMINATION OF RECORDS

7. The auditor should carry out an examination of the relevant records to satisfy himself about the validity, accuracy and recoverability of the debtor balances. The extent of such examination would depend on the auditor’s evaluation of the efficacy of internal controls.

8. The auditor should check the agreement of balances as shown in the schedules of debtors with those in the ledger accounts. He should also check the agreement of the total of debtor balances with the related control accounts. Any differences in this regard should be examined.

9. Verification of subsequent realizations is a widely used procedure, even in cases where direct confirmation procedure is followed. In the case of significant debtors, the auditor should also examine the correspondence or other documentary evidence to satisfy himself about their validity and accuracy.

10. While examining the schedules of debtors with reference to the debtors’ ledger accounts, the auditor should pay special attention to the following aspects:

(a) Where the schedules show the age of the debts, the auditor should examine whether the age of the debts has been properly determined.

(b) Whether the amounts outstanding are made up of items which are not overdue, having regard to the credit terms of the entity.

(c) Whether transfers from one account to another are properly evidenced.

(d) Whether provisions for allowances, discounts and doubtful debts are required. In this regard, the auditor should recognise that even though a debtor may have confirmed the balance due by him, he may still not pay the same.

11. The following are some of the indications of doubtful and uncollectible debts, loans and advances:

(a) The terms of credit have been repeatedly ignored.

(b) There is stagnation, or lack of healthy turnover, in the account.

(c) Payments are being received but the balance is continuously increasing.

(d) Payments, though being received regularly, are quite small in relation to the total
outstanding balance.

(e) An old bill has been partly paid (or not paid), while later bills have been fully settled.

(f) The cheques received from the debtor have been repeatedly dishonoured.

(g) The debt is under litigation, arbitration, or dispute.

(h) The auditor becomes aware of unwillingness or inability of the debtor to pay the dues e.g., a debtor has either become insolvent, or has closed down his business, or is not traceable.

(i) Amounts due from employees, which have not been repaid on termination of employment.

(j) Collection is barred by statute of limitation.

12. Bad debts written off or excessive discounts or unusual allowances should be verified with the relevant correspondence. Proper authorisation should be inspected.

13. In the case of claims made against insurance companies, shipping companies, railways, etc., the auditor should examine the correspondence or other available evidence to ascertain whether the claims have been acknowledged as debts and there is a reasonable possibility of their being realized. If it appears that they are not collectible, they should be shown as doubtful. Similar considerations apply in respect of claims for export incentives, claims for price escalation in case of construction contracts, claims for interest on delayed payments, etc.

14. The auditor should examine whether the contingent liability, if any, in respect of bills accepted by customers and discounted with the banks is properly disclosed. He should also examine whether adequate provision on this account has been made, where required.\(^5\)

Special Considerations in Case of Loans and Advances

15. In general, the procedure outlined above in regard to debtors is also applicable in the case of loans and advances. However, in the case of loans and advances, the auditor may find greater documentary evidence (in the form of loan and security documents and related correspondence) on which he can place reliance.

16. In the case of loans and advances, an important aspect to be examined by the auditor is whether the entity is empowered to make loans. In many cases, the statute governing the entity may contain restrictions or conditions about the amount of loans, purposes for which loans may be granted, parties to which loans may be granted etc. Similarly, the internal regulations of the entity may also prescribe the procedure to be followed for making the loans. For instance, in the case of companies, sections 292, 295 and 370 place restrictions on the making of loans by companies.\(^6\) The competence of the borrower to receive the loan may also

\(^5\) Reference may be made in this regard to Accounting Standard (AS) 4, Contingencies and Events Occurring after the Balance Sheet Date, issued by the Institute of Chartered Accountants of India.

\(^6\) For a detailed study of this aspect, reference may be made to the Institute’s publication titled A Guide to Company Audit. Similarly, in the case of entities like banks, insurance companies, etc., reference may be made to
affect the legality and, hence, the recoverability of the loan. The auditor should examine the loan documents and other evidence with reference to the above while determining the legality and recoverability of the loans made by the entity.

17. The auditor should ascertain whether the parties to whom loans and advances have been made have complied with the terms and conditions relating to payment of interest, repayment of loans or adjustment of advances, etc. In the case of defaults, e.g., where the repayment of loans or advances or the payment of interest are overdue, the auditor should consider whether such defaults are indicative of unwillingness or inability of the parties concerned to make the payment.

18. The auditor should pay particular attention to loans and advances given to parties in whom directors or persons who are substantial owners of the entity are interested. He should ascertain the purpose of such loans and advances, the terms and conditions on which they have been made as also their recoverability.

19. The auditor should also examine any other aspects required to be examined or reported upon by the relevant statute. For example, the auditor of a company covered by the Manufacturing and Other Companies (Auditor's Report) Order, 1988, is required to state in his report whether the terms and conditions on which loans and advances have been made are prima facie prejudicial to the interests of the company. Similarly, clause (a) of sub-section (1A) of section 227 of the Companies Act, 1956, requires the auditor to inquire "whether loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are not prejudicial to the interests of the company or its members".

DIRECT CONFIRMATION PROCEDURE

20. The verification of balances by direct communication with debtors is theoretically the best method of ascertaining whether the balances are genuine, accurately stated and undisputed, particularly where the internal control system is weak. It must be recognised, however, that mere confirmation of balance by a debtor does not by itself ensure ultimate recovery. Moreover, the utility of this procedure depends to a large extent on receiving adequate response to confirmation requests. Therefore, in situations where the auditor has reasons to believe, based on his past experience or other factors, that it is unlikely that adequate response would be received from the debtors, he may limit his reliance on direct confirmation procedure and place greater reliance on the other auditing procedures.

21. The auditor employs direct confirmation procedure with the consent of the entity under audit. There may be situations where the management of the entity requests the auditor not to seek confirmation from certain debtors. In such cases, the auditor should consider whether there are valid grounds for such a request. For example, the management may explain the

---

7 The Department of Company Affairs has notified the Companies (Auditor’s Report) Order, 2003 in June 2003 in terms of the powers given to it under section 227(4A) of the Companies Act, 1956.
reason as being the fact that there is a dispute with the particular debtor and the request for confirmation may aggravate sensitive negotiations between the entity and the debtor. Before accepting a refusal as justified, the auditor should examine any available evidence to support the management's explanations, e.g., correspondence between the entity and the debtor. In such a case, alternative procedures should be applied to debtors not subjected to confirmation. In appropriate cases, the auditor may also need to re-consider the nature, timing and extent of his audit procedures including the degree of planned reliance on management's representations.

22. The confirmation date, the method of requesting confirmations, and the particular debtors from whom confirmation of balances is to be obtained are to be determined by the auditor. While determining the information to be obtained, the form of confirmation, as well as the extent and timing of application of the confirmation procedure, the auditor should consider all relevant factors such as the effectiveness of internal control, the apparent possibility of disputes, inaccuracies or irregularities in the accounts, the probability that requests will receive consideration, and the materiality of the amounts involved.

23. The debtors may be requested to confirm the balances either (a) as at the date of the balance sheet, or (b) as at any other selected date which is reasonably close to the date of the balance sheet. The date should be settled by the auditor in consultation with the entity. Where the auditor decides to confirm the debtors at a date other than the balance sheet date, he should examine the movements in debtor balances which occur between the confirmation date and the balance sheet date and obtain sufficient evidence to satisfy himself that debtor balances stated in the balance sheet are not materially misstated.

24. The form of requesting confirmation from the debtors may be either (a) the 'positive' form of request, wherein the debtor is requested to respond whether or not he is in agreement with the balance shown, or (b) the 'negative' form of request, wherein the debtor is requested to respond only if he disagrees with the balance shown.

25. The use of the positive form is preferable when individual account balances are relatively large, or where the internal controls are weak, or where the auditor has reason to believe that there may be a substantial number of accounts in dispute or with inaccuracies or irregularities. An illustrative positive form of request letter is given in Appendix I to this Guidance Note.

26. The negative form is useful when internal controls are considered to be effective, or when a large number of small balances are involved, or when the auditor has no reason to believe that the debtors are unlikely to respond. If the negative rather than the positive form of confirmation is used, the number of requests sent and the extent of the other auditing procedures to be performed should normally be greater so as to enable the auditor to obtain the same degree of assurance with respect to the debtor balances. An illustrative negative form of request letter is given in Appendix II to this Guidance Note.

27. In many situations, it may be appropriate to use the positive form for debtors with large balances and the negative form for debtors with small balances.

28. Where the number of debtors is small, all of them may be circularized, but if the debtors are numerous, this may be done on a sample basis. The sample list of debtors to be
circularized, in order to be meaningful, should be based on a complete list of all debtor accounts. While selecting the debtors to be circularized, special attention should be paid to accounts with large balances, accounts with old outstanding balances, and customer accounts with credit balances. In addition, the auditor should select accounts in respect of which provisions have been made or balances have been written off during the period under audit or earlier years and request confirmation of the balance without considering the provision or write-off. The auditor may also consider including in his sample some of the accounts with nil balances. The nature of the entity’s business (e.g., the type of sales made or services rendered) and the type of third parties with whom the entity deals, should also be considered in selecting the sample, so that the auditor can reach appropriate conclusions about the debtors as a whole.

29. In appropriate cases, the debtor may be sent a copy of his complete ledger account for a specific period as shown in the entity's books. This procedure is more likely to reveal errors and fraud and may be particularly useful in the case of large accounts involving many entries, or where there is evidence that accounts are in dispute or are not being settled in accordance with the entity's usual trade terms.

30. The method of selection of the debtors to be circularised should not be revealed to the entity until the trial balance of the debtors' ledger is handed over to the auditor. A list of debtors selected for confirmation should be given to the entity for preparing requests for confirmation which should be properly addressed and duly stamped. The auditor should maintain strict control to ensure the correctness and proper dispatch of request letters. In the alternative, the auditor may request the client to furnish duly authorised confirmation letters and the auditor may fill in the names, addresses and the amounts relating to debtors selected by him and mail the letters directly. It should be ensured that confirmations as well as any undelivered letters are returned to the auditor and not to the client.

31. Where positive form of request is used, the auditor may, in appropriate cases, request the entity to follow up with a reminder to those debtors from whom he receives no replies. In exceptional circumstances, the auditor may also correspond directly with those significant debtors from whom he receives no replies despite reminders. In the event of inadequacy of responses received, the auditor will have to increase the extent of examination of records and analytical review procedures beyond that planned originally.

32. Any discrepancies revealed by the confirmations received or by the additional tests carried out by the auditor may have a bearing on other accounts not included in the original sample. The entity should be asked to investigate and reconcile the discrepancies. In addition, the auditor should also consider what further tests he can carry out in order to satisfy himself as to the correctness of the amount of debtors taken as a whole.

ANALYTICAL REVIEW PROCEDURES

33. In addition to the audit procedures discussed above, the following analytical review procedures may often be helpful as a means of obtaining audit evidence regarding the various assertions relating to debtors, loans and advances:
(a) comparison of closing balances of debtors, loans and advances with the corresponding figures for the previous year;

(b) comparison of the relationship between current year debtor balances and the current year sales with the corresponding figures for the previous year;

(c) comparison of actual closing balances of debtors, loans and advances with the corresponding budgeted figures, if available;

(d) comparison of current year's aging schedule with the corresponding figures for the previous year;

(e) comparison of significant ratios relating to debtors, loans and advances with the similar ratios for other firms in the same industry, if available;

(f) comparison of significant ratios relating to debtors, loans and advances with the industry norms, if available.

It may be clarified that the foregoing is only an illustrative list of analytical review procedures which an auditor may employ in carrying out an audit of debtors, loans and advances. The exact nature of analytical review procedures to be applied in a specific situation is a matter of professional judgement of the auditor.

DISCLOSURE

34. The auditor should satisfy himself that the debtors, loans and advances have been disclosed properly in the financial statements. Where the relevant statute lays down any disclosure requirements in this behalf, the auditor should examine whether the same have been complied with.

MANAGEMENT REPRESENTATIONS

35. The auditor should obtain from the management of the entity, a written statement regarding recoverability of debtors and loans and advances and their classification for balance sheet purposes. While such a representation letter serves as a formal acknowledgment of the management's responsibilities with regard to debtors, loans and advances, it does not relieve the auditor of his responsibility for performing audit procedures to obtain sufficient appropriate audit evidence to form the basis for the expression of his opinion on the financial information. A sample management representation letter regarding debtors, loans and advances is given in Appendix III to this Guidance Note. It may be mentioned that the representations made in the letter can alternatively be included in the composite representation letter usually issued by the management to the auditor.

DOCUMENTATION

36. The auditor should maintain adequate working papers regarding audit of debtors, loans and advances. Among others, he should maintain on his audit file, the confirmations received as well as any undelivered letters of request for confirmation. The management representation letter concerning debtors, loans and advances should also be maintained on the audit file.
Appendix I

Illustrative Letter of Confirmation to be Sent to Debtors-Positive Form

[Ref. Paragraph 25]
[Letterhead of Entity]

[Date]

[Name and address of debtor]

Dear Sir,

For audit purposes, kindly confirm directly to our auditors (name and address of the auditors) that the balance of Rs. ................. due by you as on ..........., as shown by our books, is correct. The details of the balance are as under:

<table>
<thead>
<tr>
<th>Invoice No.</th>
<th>Date</th>
<th>Order Reference or Acceptance or Tender No. etc. (To be used Particularly for Government Customers)</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Total

Less : Advance received

Net Amount due by you (Rs.)

A stamped envelope addressed to our auditors is enclosed for your convenience.

If the amount shown is in agreement with your books, kindly strike-out the paragraph marked (B) below. If the amount shown is not in agreement with your books, kindly furnish the details in the proforma given in the paragraph marked (B) below and strike-out paragraph (A). In either case, kindly sign at the place provided below and return this entire letter directly to our auditors in the enclosed envelope. Your prompt compliance with this request will be appreciated.

Kindly return this form in its entirety.

Yours Faithfully,

(Signature of responsible official of the entity)

© The Institute of Chartered Accountants of India

---

8 In case the list of invoices forming the balance is too large, these details may not be given.
(Do not perforate the form at this point)

(Name and Address of entity)

(A) We confirm that the above stated amount is correct as at ______

OR

(B) We state that the above-stated amount is not correct as per our records. The details of the balance as at ______ as per our records are as below:

<table>
<thead>
<tr>
<th>Invoice No.</th>
<th>Date</th>
<th>Order Reference</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Less: Advanced paid</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net Amount due from us (Rs.)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net Amount due from us (Rs.)</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Date        (Signature of debtor/responsible official)

Appendix II

Illustrative Letter of Confirmation to be Sent to Debtors-Negative Form

[Ref. Paragraph 26]

[Letterhead of Entity]

[Date]

[Name and address of debtor]

Dear Sir,

For audit purposes, kindly write directly to our auditors (name and address of the auditors) if the balance of Rs. due by you as on ______ as shown by our books, is not correct, giving details of the differences. The details of the balance are as under:9

<table>
<thead>
<tr>
<th>Invoice No.</th>
<th>Date</th>
<th>Order Reference or Acceptance or Tender No. etc. (To be used particularly for Government Customers)</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Less: Advanced paid</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net Amount due by you (Rs.)</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

9 In case the list of invoices forming the balance is too large, these details may not be given.
If you do not notify our auditors of any difference within ten days of the date of this letter, it will be presumed that the balance stated above is correct.

A stamped envelope addressed to our auditors is enclosed for your convenience.

Yours faithfully,

(Signature of responsible official of the entity)

Appendix III

Representation Letter for Debtors, Loans and Advances

[Ref. Paragraph 35]

The following is a sample representation letter for debtors, loans and advances. It might be used to supplement the general letter of representation or included therein. The letter should be modified where appropriate.

[Letterhead of Entity]  

[Date]

[Name and Address of the Auditor]

Dear Sir,

In connection with your audit of the financial statements of X Ltd. as of ......, 19.., and for the year then ended, we certify that the following items appearing in the books as at ........(date of the Balance Sheet) are considered good and fully recoverable with the exception of those specifically shown as “doubtful” in the Balance Sheet.

Sundry Debtors      Rs.
Loans and Advances  Rs.

Yours faithfully,

(Signature of responsible official of the entity)

---

10 It may be pointed out that a similar certificate regarding deposits made by the entity may also be obtained by the auditor in appropriate cases.
GUIDANCE NOTE ON AUDIT OF INVESTMENTS*

The following is the text of the Guidance Note on Audit of Investments issued by the Auditing Practices Committee (APC) of the Council of the Institute of Chartered Accountants of India. This Guidance Note should be read in conjunction with the Statements on Standard Auditing Practices (SAPs) issued by the Institute.

1. Para 2.1 of the "Preface to the Statements on Standard Auditing Practices" issued by the Institute of Chartered Accountants of India states that the "main function of the APC is to review the existing auditing practices in India and to develop Statements on Standard Auditing Practices (SAPs) so that these may be issued by the Council of the Institute." Para 2.4 of the Preface states that the "APC will issue Guidance Notes on the issues arising from the SAPs wherever necessary.

2. The Auditing Practices Committee has also taken up the task of reviewing the Statements on auditing matters issued prior to the formation of the Committee. It is intended to issue, in due course of time, Engagement Standards or Guidance Notes, as appropriate, on the matters covered by such Statements which would then stand withdrawn. With the issuance of this Guidance Note on Audit of Investments, Chapter 4 of the Statement on Auditing Practices, titled “Investments”, shall stand withdrawn. In due course of time, the entire Statement on Auditing Practices shall be withdrawn.5

1 Now known as the Auditing and Assurance Standards Board (AASB).
2 Now known as Engagement Standards.
3 The said Preface has been withdrawn pursuant to issuance of the Revised “Preface to Standards on Quality Control, Auditing, Review, Other Assurance and Related Service”, by the Institute of Chartered Accountants of India. The Revised Preface is effective from April 1, 2008. The text of the revised Preface is reproduced in Vol.I of this Handbook.
4 This Guidance Note does not deal with special aspects of audit of investments of retirement benefit plans, life insurance enterprises, mutual funds and/or the related asset management companies, banks and public financial institutions formed under a Central or State Government Act or so declared under the Companies Act, 1956. The special aspects of audit of investments of some of these institutions have been dealt with in other publications of the Institute, e.g., Guidance Note on Audit of Banks, Guidance Note on Audit of Companies Carrying on General Insurance Business, Guidance Note on Companies Carrying on Life Insurance Business. It may also be noted that in the case of certain types of entities, e.g., companies, banks, insurance companies, co-operative societies, etc., the question of compliance with the legal requirements assumes special importance. Appendix I to this Guidance Note contains a brief description of the main provisions of the statutes governing these types of entities in so far as they relate to investments. It may be emphasised that the Appendix is only illustrative and not exhaustive. Moreover, the legal requirements may change from time to time and, therefore, this Appendix should not be construed as representing the correct legal position at all points of time.
5 Since the Statement was withdrawn in March, 2005, the entire paragraph is redundant.
INTRODUCTION

3. Investments are assets held by an entity for earning income by way of dividends, interest and rentals, for capital appreciation, or for other benefits to the investing entity. Investments are classified as 'current investments' and 'long term investments'. A current investment is an investment that is by its nature readily realisable and is intended to be held for not more than one year from the date on which such investment is made. A long term investment is an investment other than a current investment.

4. The following features of investments have an impact on the related auditing procedures:
   (a) Investments constitute a significant portion of the total assets of certain entities like banks, insurance companies, investment companies, trusts, etc. In other cases, the nature, quantum and type of investments may vary from case to case.
   (b) Documentary evidence is generally available for audit verification. A detailed record of acquisition, disposal, etc., of the investments is usually maintained.
   (c) The market values of investments may keep on fluctuating. While in the case of some investments, such fluctuations may not be wide, in the case of others, they may be significant.
   (d) Physical location of documents of title to investments may be different from the one where the acquisition, disposal and recording thereof take place.
   (e) Many investments are readily marketable or can be converted into cash.

INTERNAL CONTROL EVALUATION

5. The auditor should study and evaluate the system of internal control relating to investments to determine the nature, timing and extent of his other audit procedures. He should particularly review the following aspects of internal control relating to investments.
   (a) Control over acquisition, accretion and disposal of investments: There should be proper authority for sanction, acquisition and disposal of investments (including renunciation of rights). It should also be ensured that investments are made in accordance with the legal requirements governing the entity as also with its internal regulations, e.g., the provisions of the articles of association, rules and regulations, trust deed, etc.
   (b) Safeguarding of investments: The investments should be in the name of the entity as far as possible. The legal requirements in this behalf, if any, should be complied with.

---

6. It may be clarified that the term 'investments' covers only such securities as are beneficially owned by the entity and not those held by it on behalf of others.
7. It may be clarified that inventories, as defined in Accounting Standard (AS) 2, "Valuation of Inventories", issued by the Institute of Chartered Accountants of India are not investments. However, the recommendations of this Guidance Note also apply, to the extent relevant to shares, debentures and other securities held as stock-in-trade. Fixed assets (other than investment properties), as defined in Accounting Standard (AS) 10, "Accounting for Fixed Assets", issued by the Institute, are also not investments.
8. The extent of review of controls would depend upon the facts and circumstances of each case. Reference may be made in this regard to the Internal Control Questionnaire, issued by the Institute of Chartered Accountants of India in 1976 which contains, inter alia, an illustrative list of internal controls in relation to investments.
should exist a proper system for the safe custody of all scrips or other documents of title to the investments belonging to the entity.

(c) Controls relating to title to investments: It should be ensured that in cases where the title does not pass on to the entity immediately on acquisition, the same is transferred to the entity in due course of time, along with the benefits that might have accrued since the acquisition of the investments. It should be ensured that there is no undue time-lag in the execution of various stages of the transactions.

(d) Information controls: These controls should ensure that reliable information is available for recording acquisitions (including by way of conversion of securities, right issues or other entitlements, under schemes of amalgamation, acquisition, etc.), accretions and disposals, and for ascertaining the market values etc. Detailed records regarding acquisition, disposal etc. of the investments should be maintained along with proper documentation.

VERIFICATION

6. The auditor's primary objective in audit of investments is to satisfy himself as to their existence and valuation. Verification of investments may be carried out by employing the following procedures:

(a) verification of transactions;
(b) physical inspection;
(c) examination of valuation and disclosure; and
(d) analytical review procedures.

The nature, timing and extent of audit procedures to be performed is, however, a matter of professional judgment of the auditor.

7. The investments of an entity may take various forms, e.g., they may be in the form of Government securities, shares and debentures, immovable properties, etc. The following paragraphs discuss the audit steps for verifying investments, with special reference to investments in the form of shares, debentures and other securities.

VERIFICATION OF TRANSACTIONS

8. The auditor should ascertain whether the investments made by the entity are within its authority. In this regard, the auditor should examine whether the legal requirements governing the entity, insofar as they relate to investments, have been complied with and the investments made by the entity are not ultra vires the entity. Apart from the above, the auditor should also ensure that any other covenants or conditions which restrict, qualify or abridge the right of ownership and/or disposal of investments, have been complied with by the entity.

9. The auditor should satisfy himself that the transactions for the purchase/sale of investments are supported by due authority and documentation. The acquisition/disposal of investments should be verified with reference to the broker's contract note, bill of costs,
receipts and other similar evidence. The auditor should pay special attention to ascertaining whether the investments have been purchased or sold cum-dividend/ex-dividend, cum-interest/ex-interest, cum-right/ex-right or cum-bonus/ex-bonus. He should check whether proper adjustments in this regard have been made in the cost/sales value of securities purchased or sold.

10. In the case of a rights issue, the offer to the entity contained in the letter of rights should be examined. Where the rights have been renounced or otherwise disposed of or not exercised, the auditor should examine the relevant decision of the appropriate authority in this behalf, as also that the sale proceeds, if any, have been duly accounted for.

11. As regards bonus shares, the intimation to the entity regarding such issue should be examined with a view to ascertaining the receipt and recording of the requisite number of shares by the entity.

12. Where the amounts of purchases or sales of investments are substantial, the auditor may check the prices paid/received with reference to the stock exchange quotations, where available, on or about the date of purchase or sale.

PHYSICAL INSPECTION

13. The auditor should carry out a physical inspection of investments in the form of shares, debentures and other securities. (Special considerations apply in the case of investments in the form of immovable properties, as discussed in paragraph 24.) In the case of certain entities (e.g., insurance companies), physical inspection of investments is a statutory requirement.

14. The depository services and scripless trading are becoming increasingly popular in India. Depository services involve custody of documents of title to investments such as certificates, scrips and deeds and thus avoid their physical handling by the investor. The Public Debt Office of the Reserve Bank of India offers such services to facilitate trading in Government Securities. Authorised institutions such as banks, financial institutions etc., which have individual ledger accounts with the Public Debt Office can trade in government securities between themselves by issuing and accepting Bankers' Receipts. In case of such transactions, the auditor should verify the periodic reconciliation of balances as per the records of the entity and those as per the Public Debt Office.

15. Apart from the Public Debt Office, there are now a number of other custodial organisations whose services are being utilised by banks, large investors, institutional investors, mutual funds etc. The concept of the National Depository System (NDS) is also under development. This system is aimed at eliminating physical movement of securities for purchases and sales. Wherever the services of any of these custodial or depository organisations are being used by the entity under audit, the auditor should redesign his audit procedures to ensure that there is an effective system of periodic reconciliation of balances as per the records of the entity and those as per the records of the custodial or depository organisation. The auditor should also examine the certificates issued by such organisations confirming the holdings of the entity. The concept of scripless trading being introduced by the
National Stock Exchange and the OTC Exchange of India also envisage elimination of movement of title deeds of securities. In such cases, the auditor should verify the interim and other acknowledgments issued by dealers as well as the year-end confirmation certificates of the depository organisations.

16. The investments held by the entity in its own custody should normally be examined at the close of business on the last day of the year. In case this is not possible, the auditor should carry out the inspection on a date as near to the balance sheet date as possible. In such a case, he should take into consideration any adjustments for subsequent transactions of purchase, sale, etc. Where a substantial number of investments are kept by the entity in its custody, the auditor should carry out a surprise inspection of the investments on hand at least once in the year in addition to his year-end examination. He should take particular care to see that only the investments belonging to the entity are produced to him. This aspect assumes special importance in the case of entities like banks which hold investments on their own account, in the form of securities lodged by the customers against loans and advances, and on behalf of the PMS clients.

17. Where investments are held by any other person on behalf of the entity, e.g., by banks, the auditor should examine the certificates received from them. Such certificates should preferably be received directly by the auditor. A suggested form of bank confirmation certificate is given in Appendix II to this Guidance Note.

18. In case investments are held by persons other than banks, the auditor should ensure that there is justification for it, e.g., securities in the custody of brokers or with the company concerned for transfer, consolidation, splitting up conversion, etc. Evidence of securities held with others should be examined and, in appropriate cases, physical inspection of the relevant documents may be made, to the extent possible, in the course of audit. Where the investments are recorded at an office other than the one where the documents of title thereto are physically located, the local auditor may be requested to verify the same.

19. If the investments are held otherwise than in the name of the entity (e.g., in the name of nominees/trustees), the auditor should ascertain the reasons for the same and examine the relevant documentary evidence (e.g., written confirmations from the nominees, trustees, etc.) supporting the real/beneficial interest of the entity in the investments.

20. The auditor should also examine any other aspects required to be examined or reported upon by the relevant statute. For example, in the case of a company, the auditor should also carry out the procedures outlined in paragraphs 21-23 below.

21. Where shares are held not in the name of the company but in the name of a director, officer, etc., the auditor should examine whether the declaration referred to in section 187-C of the Companies Act, 1956 has been properly made.

22. The auditor should keep in mind the provisions of section 227(1A)(c) which requires that
the auditor of a company, not being an investment company within the meaning of section 372 of the Companies Act, 1956 or a banking company, should enquire whether so much of the assets of the company as consist of shares, debentures and other securities have been sold at a price less than that at which they are purchased by the company.⁹

23. In case the entity is a finance, investment, chit fund, nidhi or mutual benefit company and is dealing or trading in shares, securities, debentures or other investments, the auditor has to state in his report (by virtue of the requirements of the Manufacturing and Other Companies (Auditor's Report) Order, 1988**, issued under section 227(4A) of the Companies Act, 1956) whether proper records have been maintained of the transactions and contracts and whether timely entries have been made therein as also whether the shares, securities, debentures and other investments have been held by the company in its own name except to the extent of exemptions granted under section 49 of the Companies Act, 1956.¹⁰

**IMMOVABLE PROPERTIES**

24. Where immovable properties are held as investments, the auditor should verify them in the same manner as in the case of immovable properties held as fixed assets.¹¹

**EXAMINATION OF VALUATION AND DISCLOSURE**

25. The auditor should satisfy himself that the investments have been valued and disclosed in the financial statements in accordance with recognised accounting policies and practices and relevant statutory requirements, if any.¹² Appendix III to this Guidance Note discusses, by way of illustration, the disclosure requirements of some of the Acts. The auditor should also examine whether the method of valuation followed by the entity is consistently applied.

26. The auditor should examine whether, in computing the cost of investments, the expenditure incurred on account of transfer fees, stamp duty, brokerage, etc., is included in the cost of investments.

27. The auditor may ascertain the market value of the quoted securities from official quotations of the stock exchange. In case of unquoted securities, the auditor should ascertain the method adopted by the entity for determining the market value of such securities. He

---

⁹ For a detailed discussion on this aspect reference may be made to the “Statement on Qualification in Auditor’s Report”, issued by the Institute of Chartered Accountants of India (ICAI).

(The readers may note that the Council, at 269th meeting, held from July 18 to 20, 2007, decided to withdraw the “Statement on Qualification in Auditor’s Report” except paragraphs 2.1 to 2.30 dealing with reporting under section 227(1A) of the Companies Act, 1956 and to rename the Statement as “Statement on Reporting under section 227(1A) of the Companies Act, 1956”.)

** Currently, the Companies (Auditor’s Report) Order, 2003 (Revised 2005) is in force in terms of section 227(4A) of the Companies Act, 1956.

¹⁰ For a detailed discussion on this aspect, reference may be made to the Statement on the Companies (Auditor’s Report) Order, 2003, issued by the Institute of Chartered Accountants of India.

¹¹ Reference may be made in this regard to the Guidance Note on Audit of Fixed Assets, issued by the Institute of Chartered Accountants of India.

¹² Reference may be made in this regard to Accounting Standard 13, Accounting for Investments, issued by the Institute of Chartered Accountants of India.
should examine whether the method adopted by the entity is one of the recognised methods of valuation of securities such as break-up value method, capitalisation of yield method, yield to maturity method, etc. In the case of investments other than in the form of securities (e.g., rare paintings), the auditor should examine that the market value has been ascertained on the basis of authentic market reports.

ANALYTICAL REVIEW PROCEDURES

28. As a measure of judging the overall reasonableness of the amounts attributed to investments, the auditor may relate the amount of income received from investments with the corresponding figures of investments and compare this ratio with the similar ratio for the previous years. For this purpose, investments may be classified into appropriate categories. Thus, in the case of fixed interest-bearing securities, the auditor may relate the amount of interest earned with the face value of the related securities. In the case of other securities, the auditor may review the schedule of dividend and other returns and the schedule of investments prepared by the entity and judge their reasonableness.

MANAGEMENT REPRESENTATIONS

29. The auditor should obtain from the management of the entity a written statement regarding classification and valuation of investments for Balance Sheet purposes. While such a representation letter serves as a formal acknowledgment of the management's responsibilities with regard to investments, it does not relieve the auditor of his responsibility for performing audit procedures to obtain sufficient appropriate audit evidence to form the basis for the expression of his opinion on the financial information. A sample management representation letter regarding investments is given in Appendix IV to this Guidance Note. It may be mentioned that the representations made in the letter can alternatively be included in the composite representation letter usually issued by the management to the auditor.

DOCUMENTATION

30. The auditor should maintain adequate working papers regarding audit of investments. Among others, he should maintain on his audit file, the management representation letter concerning investments.

Appendix I

Legal Requirements Relating to Investments

(Ref. Paragraph 2)

This Appendix contains an illustrative description of the legal provisions regarding investments as contained in the Companies Act, 1956, Banking Regulation Act, 1949, Insurance Act, 1938, and the Cooperative Societies Act, 1912. It may be emphasised that this Appendix is only illustrative in nature and is not intended to give an exhaustive description of all the relevant legal requirements applicable to different types of entities. Moreover, the legal requirements
may change from time to time and therefore, this Appendix should not be construed as representing the correct legal position at all points of time.

**Provisions of the Companies Act, 1956**

The main relevant sections are section 49, section 108, section 292, section 293(1)(c) and section 372, besides requirements of inquiry/reporting under sections 227(1A) and 227(4A).

Section 49 provides that, subject to certain exceptions, investments made by a company on its own behalf shall be made and held by it in its own name.

Section 108 lays down the mode of transfer of shares and debentures and prescribes the period of validity of blank transfers. Sections 108A-108I lay down certain restrictions on acquisition and transfer of shares.

Section 292 provides that the power to invest the funds of a company shall be exercised by its Board of Directors on behalf of the company only by means of resolutions passed at meetings of the Board. However, the Board may, by a resolution passed at a meeting, delegate this power to any of its committees, the managing director, the manager or any other principal officer of the company. In such case, every resolution delegating the power to invest the funds of the company shall specify the total amount upto which the funds may be invested and the nature of the investments which may be made, by the committee or the person to whom the power to invest is so delegated.

Section 293(1)(c) provides that the Board of Directors of a public company, or of a private company which is a subsidiary of a public company, shall not invest otherwise than in trust securities, the amount of compensation received by it in respect of the compulsory acquisition of any undertaking or of any premises or properties used for any such undertaking except with the consent of the company in a general meeting.

Section 372 provides that a company, whether by itself or together with its subsidiaries, shall not be entitled to acquire, by way of subscription, purchase or otherwise, the shares of any other body corporate except to the extent and except in accordance with the restrictions and conditions, specified in the section.

**Provisions of the Banking Regulation Act, 1949**

Section 19 of the Act provides that no banking company shall hold shares in any company, whether as pledgee, mortgagee or absolute owner, of an amount exceeding 30% of the paid-up share capital of that company or 30% of its own paid-up share capital and reserves, whichever is less. The above restriction, however, does not apply to the holding by a banking company of shares in its subsidiary. A banking company is also prohibited from holding shares, whether as pledgee, mortgagee or absolute owner, in any company in the management of which, any managing director or manager of the banking company is in any manner concerned or interested.

Section 24 of the Banking Regulation Act provides that every banking company shall maintain in India in cash, gold or unencumbered approved securities, an amount which shall not, at the close of business on any day, be less than twenty-five per cent or such other percentage not
exceeding forty, as the Reserve Bank of India may from time to time specify, of the total of its
demand and time liabilities in India as on the last Friday of the second preceding fortnight.

The above provisions also apply to the State Bank of India and its subsidiaries and the
nationalised banks.

Provisions of the Insurance Act, 1938

Section 27(B) of the Insurance Act, 1938 provides that no insurer carrying on general
insurance business can invest or keep invested any part of his assets otherwise than in any of
the approved investments or in other investments which satisfy certain conditions or in certain
prescribed assets which are deemed to be approved investments for the purposes of this
section.

A general insurance company can invest any part of its assets in investments other than the
investments mentioned above, provided that (i) the total amount of all such investments does
not exceed 25 per cent of its assets and (ii) the making or the continuance of the investment is
with the consent of all the directors, present and eligible to vote, at a meeting, special notice
of which, has been given to all directors, then in India. All such investments including
investments in which any director is interested must be reported without delay to the Controller
of Insurance with full details of the investments and the extent of any director's interest in any
such investment.

An insurer cannot invest or keep invested any part of his assets in the shares of any one
banking company or investment company more than (a) ten per cent of his assets, or (b) two
per cent of the subscribed share capital and debentures of the banking company or
investment company concerned, whichever is less.

Further, an insurer cannot invest or keep invested any part of his assets in the shares or
debentures of any one company other than a banking company or investment company more
than (a) ten per cent of his assets, or (b) ten per cent of the subscribed share capital and
debentures of the company, whichever is less.

Where an investment is in partly paid-up shares, the uncalled liability on such shares shall be
added to the amount invested, for the purpose of determining whether such investment
exceeds the limits referred to above. However, an insurer can subscribe to the right shares
notwithstanding the limits specified above.

These limits do not apply to an investment made by an insurer in the shares of any other
insurance company carrying on insurance or re-insurance business in India.

The Controller of Insurance can waive for a specified period and with certain conditions, the
limits specified above if, on an application from the insurer, he is satisfied that special grounds
exist warranting such waiver.

An insurer cannot invest or keep invested any part of his assets in the shares or debentures of
any private company.
III.48 Auditing Pronouncements

Provisions of the Cooperative Societies Act, 1912

Section 32 of the Cooperative Societies Act, 1912 provides that a registered society can invest or deposit its funds only:

(a) in Government Savings Banks;
(b) in any of the securities specified in section 20 of the Indian Trusts Act, 1882;
(c) in the shares or on the security of any other registered society;
(d) with any bank or person carrying on the business of banking, approved for this purpose by the Registrar; or
(e) in any other mode permitted by the rules.

Appendix II

Illustrative Letter of Confirmation – Investments Held by Banks
(Ref. Paragraph 17)

[Letterhead of entity]

.................(Bank)

Dear Sirs,

For audit purpose, kindly send directly to our auditors (name and address of the auditors) a certificate regarding all the shares, debentures and other securities belonging to us but lying with you as (i) security against loans and advances to us, or (ii) in safe custody account at the close of business on ..........

For your convenience, we enclose in duplicate a form in which the certificate may be sent. Please send one copy to our auditors, retaining the other for your records. Should you find the space on the form insufficient to contain all the relevant information, please attach a separate statement.

We would request you to state NIL wherever applicable.

Yours faithfully,

(to be signed by person authorised to operate accounts)
Disclosure Requirements Relating to Investments

(Ref. Paragraph 25)

To illustrate the manner of disclosure of investments in the financial statements, this Appendix discusses the requirements of the Companies Act, 1956, the Banking Regulation Act, 1949, and the Insurance Act, 1938, insofar as they relate to disclosure of information regarding investments in the financial statements prepared and presented in accordance with the provisions of these statutes. As regards the co-operative societies, the form and content of their financial statements are governed by the rules framed by the State Government concerned. It may be emphasised that, in every case, there should be an adequate disclosure of all relevant information to facilitate proper understanding of the financial statements by the users.

Requirements of the Companies Act, 1956

Schedule VI to the Companies Act, 1956 requires the disclosure of investments in the balance sheet as below:

1. Investments in Government or Trust Securities.
2. Investments in shares, debentures or bonds (showing separately shares fully paid up and partly paid up and also distinguishing the different classes of shares and showing also in similar details investments in shares, debentures or bonds of subsidiary companies).
3. Immovable properties.
4. Investments in the capital of partnership firms.

The above particulars have to be given showing the nature of investments and mode of valuation, for example, cost or market value. Further, the aggregate amount of the company's quoted investments and the market value thereof have to be shown. The aggregate amount of the company's unquoted investments is also required to be shown.

A statement of investments (whether shown under "Investments" or under "Current Assets" as stock-in-trade, separately classifying trade investments and other investments) is required to be annexed to the balance sheet, showing the names of the bodies corporate (indicating separately the names of the bodies corporate under the same management) in whose shares or debentures investments have been made (including all investments whether existing on the balance sheet date or not, made subsequent to the date as at which the previous balance sheet was made out) and the nature and extent of the investments so made in each such body corporate. In the case of an investment company, i.e., a company whose principal business is the acquisition of shares, stocks, debentures or other securities, it shall be sufficient if the statement shows only the investments existing on the date as at which the balance sheet has been made out. In regard to the investments in the capital of partnership firms, the names of the firms (with the names of all their partners, total capital and the share of each partner) are required to be given in the statement.
Requirements of the Banking Regulation Act, 1949

The Third Schedule to the Banking Regulation Act, 1949, requires the investments to be classified under the following heads for the purpose of balance sheet presentation:

I. Investments in India in
   (i) Government securities
   (ii) Other approved Securities
   (iii) Shares
   (iv) Debentures and Bonds
   (v) Subsidiaries and/or joint ventures
   (vi) Others (to be specified)
       Total:

II. Investments outside India in
   (i) Government securities (including local authorities)
   (ii) Subsidiaries and/or joint ventures abroad
   (iii) Other investments (to be specified)
       Total:
       Grand Total: (I &II)

Requirements of the Insurance Act, 1938

The First Schedule to the Insurance Act, 1938 requires the disclosure of investments of an insurer as below:

- Deposit with the Reserve Bank of India (Securities to be specified)
- Indian Government Securities
- State Government Securities
- British, British Colonial and British Dominion Government Securities
- Foreign Government Securities
- Indian Municipal Securities
- British and Colonial Securities
- Foreign Securities
- Bonds, Debentures, Stocks and other securities whereon interest is guaranteed by the Indian Government or a State Government
- Bonds, Debentures, Stocks and other securities whereon interest is guaranteed by the
Part-III: Guidance Notes

British or any Colonial Government

♦ Bonds, Debentures, stocks and other securities whereon interest is guaranteed by any Foreign Government

♦ Debentures of any railway in India

♦ Debentures of any railway out of India

♦ Preference or guaranteed shares of any railway in India

♦ Preference or guaranteed shares of any railway out of India

♦ Railway Ordinary Stocks (i) in India (ii) out of India

♦ Other Debentures and Debenture stock of companies incorporated (i) in India (ii) out of India

♦ Other guaranteed and preference stocks and shares of companies incorporated (i) in India (ii) out of India

♦ Other ordinary stocks and shares of companies incorporated (i) in India (ii) out of India

♦ Holdings in Subsidiary companies

The book value and the market value have to be shown in respect of the investments. Where the market value is ascertained on a basis other than the published quotations, the manner in which such value has been arrived at, is also required to be disclosed.

Appendix IV

Representation Letter for Investments
(Ref. Paragraph 29)

The following is a sample representation letter for investments. It might be used to supplement the general letter of representation or included therein. The letter should be modified where appropriate.

(Letterhead of Entity)

[Date]

[Name and Address of the Auditor]

Dear Sir,

In connection with your audit of the financial statements of X Limited as of ....... 19....., and for the year then ended, we confirm to the best of our knowledge and belief, the following representations concerning investments.

1. The current investments as appearing in the balance sheet consist of only such investments as are by their nature readily realisable and intended to be held for not more than one year from the respective dates on which they were made. All other investments have been shown in the balance sheet as ‘long-term investments’.
2. Current investments have been valued at the lower of cost and fair value. Long-term investments have been valued at cost, except that any permanent diminution in their value has been provided for in ascertaining their carrying amount.

3. In respect of offers of right issues received during the year, the rights have been either been subscribed to, or renunciated or allowed to lapse. In no case have they been renunciated in favour of third parties without consideration which has been properly accounted for in the books of account.

4. All the investments produced to you for physical verification belong to the entity and they do not include any investments held on behalf of any other person.

5. The entity has clear title to all its investments including such investments which are in the process of being registered in the name of the entity or which are not held in the name of the entity. There are no charges against the investments of the entity except those appearing in the records of the entity.

Yours faithfully,

(Signature of responsible official of the entity)
GUIDANCE NOTE ON AUDIT OF CASH AND BANK BALANCES*

The following is the text of the Guidance Note on Audit of Cash and Bank Balances issued by the Auditing Practices Committee (APC)¹ of the Council of the Institute of Chartered Accountants of India. This Guidance Note should be read in conjunction with the Statements on Standard Auditing Practices (SAPs)² issued by the Institute.

1. Para 2.1 of the Preface to the Statements on Standard Auditing Practices³, issued by the Institute of Chartered Accountants of India, states that the “main function of the APC is to review the existing auditing practices in India and to develop Statements on Standard Auditing Practices (SAPs) so that these may be issued by the Council of the Institute.” Para 2.4 of the Preface states that the “APC will issue Guidance Notes on the issues arising from the SAPs wherever necessary.”

2. The Auditing Practices Committee has also taken up the task of reviewing the Statements on auditing matters issued prior to the formation of the Committee. It is intended to issue, in due course of time, SAPs or Guidance Notes, as appropriate, on the matters covered by such Statements which would then stand withdrawn. With the issuance of this Guidance Note on Audit of Cash and Bank Balances, Chapter 6 of the Statement on Auditing Practices, titled ‘Cash and Bank Balances’, shall stand withdrawn.⁴ In due course of time, the entire Statement on Auditing Practices shall be withdrawn.⁵

INTRODUCTION

3. Cash and bank balances may constitute a significant proportion of the total assets of an entity. An important feature of cash and bank balances which has a significant impact on the related audit procedures is that these assets are highly prone to misappropriation, misapplication and other forms of fraud.

4. In any auditing situation, the auditor employs appropriate procedures to obtain reasonable assurance about various assertions (see Standard on Auditing (SA) 500, Audit

---

* Published in November, 1995 issue of 'The Chartered Accountant.
1 Now known as the Auditing and Assurance Standards Board (AASB).
2 Now known as Engagement Standards.
3 The said Preface has been withdrawn pursuant to issuance of the Revised “Preface to Standards on Quality Control, Auditing, Review, Other Assurance and Related Service”, by the Institute of Chartered Accountants of India. The Revised Preface is effective from April 1, 2008. The text of the revised Preface is reproduced in the Vol-I of this Handbook.
4 The special aspects of audit of cash and bank balances in the case of banks are dealt with in the Guidance Note on Audit of Banks (edn. 2008).
5 Since the Statement was withdrawn in March, 2005, the entire paragraph is redundant.
In carrying out an audit of cash and bank balances, the auditor is particularly concerned with obtaining sufficient appropriate audit evidence to corroborate the management’s assertions regarding the following:

- **Existence**: that recorded cash and bank balances exist as at the year-end.
- **Rights and obligations**: that recorded cash and bank balances represent the assets of the entity.
- **Completeness**: that there are no unrecorded cash and bank balances.

Besides the above, in certain situations, the auditor may also be particularly concerned with the valuation of cash and bank balances, e.g., in the case of foreign currency held by the entity or in the case of bank accounts designated in foreign currencies.

### INTERNAL CONTROL EVALUATION

5. The auditor should study and evaluate the system of internal control relating to cash and bank balances to determine the nature, timing and extent of his other audit procedures. He should particularly review the following aspects of internal control relating to cash and bank balances:

   - segregation of duties relating to authorisation of transactions, handling of cash/issuance of cheques and writing of books of account, and rotation of the duties periodically;
   - proper authorisation of cash and banking transactions;
   - daily recording of cash transactions;
   - safeguards such as restrictive crossing of cheques, use of pre-printed, pre-numbered forms;
   - periodic reconciliation of bank balances;
   - reconciliation of cash-on-hand with book balance on a daily basis or at other appropriate intervals, including surprise checks by higher authorities;
   - safe custody of cash, cheque books, receipt books etc.; and
   - cash/fidelity insurance.

### VERIFICATION

6. Verification of cash and bank balances may be carried out by employing the procedures described in paragraphs 7-27. It may, however, be emphasised that the nature, timing and extent of substantive procedures to be performed is a matter of professional judgement of the auditor which is based, *inter alia*, on the auditor's evaluation of the effectiveness of the related internal controls.

---

6 The extent of review of controls would depend upon the facts and circumstances of each case. Reference may be made in this regard to the *Internal Control Questionnaire*, issued by the Institute of Chartered Accountants of India in 1976 which contains, *inter alia*, an illustrative list of internal controls in relation to cash and bank balances.
VERIFICATION OF CASH BALANCES

7. The auditor should carry out physical verification of cash at the date of the balance sheet. However, if this is not feasible, physical verification may be carried out, on a surprise basis, at any time shortly before or after the date of the balance sheet. In the latter case, the auditor should examine whether the cash balance shown in the financial statements reconciles with the results of the physical verification after taking into account the cash receipts and cash payments between the date of the physical verification and the date of the balance sheet. Besides physical verification at or around the date of the balance sheet, the auditor should also carry out surprise verification of cash during the year.

8. All cash balances in the same location should be verified simultaneously. Where petty cash is maintained by one or more officials, the auditor should advise the entity to require the officials concerned to deposit the entire petty cash on hand on the last day with the cashier. The auditor should enquire whether the cashier also handles cash of sister concerns, staff societies, etc. In such a case, cash pertaining to them should also be verified at the same time so as to avoid chances of cash balances of one entity being presented as those of another.

9. If IOUs (‘I owe you’) or other similar documents are found during physical verification, the auditor should obtain explanations from a senior official of the entity as to the reasons for such IOUs/other similar documents remaining pending. It should also be ensured that such IOUs/other similar documents are not shown as cash-on-hand.

10. The quantum of torn or mutilated currency notes should be examined in the context of the size and nature of business of the entity. The auditor should also examine whether such currency notes are exchanged within a reasonable time.

11. If, during the course of the audit, it comes to the attention of the auditor that the entity is consistently maintaining an unduly large balance of cash-on-hand, he should carry out surprise verification of cash more frequently to ascertain whether the actual cash-on-hand agrees with the balances as shown by the books. If the cash-on-hand is not in agreement with the balance as shown in the books, he should seek explanations from a senior official of the entity. In case any material difference is not satisfactorily explained, the auditor should state this fact appropriately in his audit report. In any case, he should satisfy himself regarding the necessity for such large balances having regard to the normal working requirements of the entity. The entity may also be advised to deposit the whole or the major part of the cash balance in the bank at reasonable intervals.

12. Where postdated cheques are on hand on the balance sheet date, the auditor should verify that they have not been accounted for as collections during the period under audit.

VERIFICATION OF BANK BALANCES

13. The auditor should advise the entity to send a letter to all its bankers to, directly confirm the balances to the auditor. The Appendix to this Guidance Note gives an illustrative proforma letter of request for confirmation to be used for this purpose. The request for confirmation should also cover dormant accounts as well as accounts closed during the year.
14. The auditor should examine the bank reconciliation statement prepared as on the last
day of the year. He may also examine the reconciliation statements as at other dates during
the year. It should be examined whether (i) cheques issued by the entity but not presented for
payment, and (ii) cheques deposited for collection by the entity but not credited in the bank
account, have been duly debited/credited in the subsequent period. For this purpose, the bank
statements of the relevant period should be examined. If the cheques issued before the end of
the year have not been presented within a reasonable time, it is possible that the entity might
have prepared the cheques before the end of the year but not delivered them to the parties
concerned. In such a case, the auditor should examine that the entity has reversed the
relevant entries.

15. Where the auditor finds that post-dated cheques are issued by the entity, he should verify
that any cheques pertaining to the subsequent period have not been accounted for as
payments during the period under audit.

16. The auditor should pay special attention to those items in the reconciliation statements
which are outstanding for an unduly long period. The auditor should ascertain the reasons for
such outstanding items from the management. He should also examine whether any such
items require an adjustment/write-off.

17. The auditor should be alert to the possibility that even though the balance in an
apparently inoperative account may have remained stagnant, transactions may have taken
place in that account during the year.

18. Where a large number of cheques has been issued/deposited in the last few days of the
year, and a sizeable proportion of such cheques has subsequently remained
unpaid/uncleared, this may indicate an intention of understating creditors/debtors or
understating/overstating bank balances. In such a case, it may be appropriate for the auditor
to obtain confirmations from the parties concerned, especially in respect of cheques involving
large amounts. The auditor should also examine whether a reversal of the relevant entries
would be appropriate under the circumstances.

19. The procedures discussed in paragraph 18 should also be considered by the auditor in
cases where a large number of cheques is on hand at the date of the balance sheet and a
sizeable proportion of such cheques has subsequently remained undeposited/uncleared.

20. In relation to balances/deposits with specific charge on them, or those held under the
requirements of any law, the auditor should examine that suitable disclosures are made in the
financial statements.

21. In respect of fixed deposits or any other type of deposits with banks, the relevant
receipts/certificates, duly supported by bank advices, should be examined.

22. Remittances shown as being in transit should be examined with reference to their credit
in the bank in the subsequent period. Where the auditor finds that such remittances have not
been credited in the subsequent period, he should ascertain the reasons for the same. He
should also examine whether the entity has reversed the relevant entries in appropriate cases.

23. The auditor should examine that suitable adjustments are made in respect of cheques
which have become stale as at the close of the year.
24. Where material amounts are held in bank accounts which are blocked, e.g., in foreign banks with exchange control restrictions or any banks which are under moratorium or liquidation, the auditor should examine whether the relevant facts have been suitably disclosed in the financial statements. He should also examine whether suitable adjustments on this account have been made in the financial statements in appropriate cases.

25. Where the auditor finds that the number of bank accounts maintained by the entity is disproportionately large in relation to its size, the auditor should exercise greater care in satisfying himself about the genuineness of banking transactions and balances.

EXAMINATION OF VALUATION AND DISCLOSURE

26. The auditor should satisfy himself that cash and bank balances have been valued and disclosed in the financial statements in accordance with recognised accounting policies and practices and relevant statutory requirements, if any.\(^7\) In this regard, the auditor should examine that following items are not included in cash and bank balances:

(a) Temporary advances.
(b) Stale or dishonoured cheques.

Postage and revenue stamps, if material in amount, may be shown separately instead of being included under cash and bank balances.

27. The auditor should also examine that suitable disclosures as mentioned in paragraphs 20 and 24 above are made in relevant cases.

Appendix

Illustrative Letter of Confirmation – Bank Balances

(Ref. Paragraph 13)

[Letterhead of Entity]

[Name and Address of Bank] [Date]

Dear Sirs,

Please send directly to our auditors ......................... (name and address of the auditors) details of balances as at the close of business on [date] ....................... of all our accounts with you as well as details of charges held against such balances, with a copy to us. For your convenience, we enclose in duplicate a form in which details of our balances with you can be filled in. If you find the spaces on the form insufficient to contain all the relevant information, please attach a separate statement.

\(^7\) For valuation of foreign currency held as cash-in-hand and bank balances designated in foreign currencies, reference may be made to Accounting Standard 11, “Accounting for the Effects of Changes in Foreign Exchange Rates”, issued by the Institute of Chartered Accountants of India.
Please note that this request covers all our accounts with you as at the above-mentioned date, including any dormant accounts. We would also request you to give particulars of any of our accounts closed during the year. We would request you to state “Nil”, wherever applicable.

Yours faithfully,

(Signature of person authorised to operate accounts)

Reply from
(Bank)

[Name and Address of Auditors]

Dear Sirs,

Date: _______

Re: (Name of Client)

At the request of our clients, we submit below particulars of their accounts, Investments, bills, etc., as at the close of business on ....... as shown by our records.

1. **Current Accounts in Credit**
   - Designation of Account
   - Amount

2. **Overdrawn Current Accounts, Overdraft Accounts or Cash Credit Accounts.**
   - Designation of Account
   - Amount
   - Security held (give brief description. In the case of securities please list fully)

3. **Loan Accounts**
   - Designation of Account
   - Amount
   - Security held (give brief description. In the case of securities please list fully)

4. **Fixed, Call and Short Deposit Accounts**
   - Amount
   - Interest Accrued
   - Due Date
   - Particulars of any charges of liens to the closing date

5. **Investments and Other Documents of Title Held in Safe Custody**
   - Designation.
   - Face value or number of shares held.

6. **Margin against letters of credit Guarantees issued, etc.**
   - Designation of Account
   - Amount

7. **Bills for Collection**
   - Designation of Account
   - Amount
   - Due date

8. **Bills Discounted or Purchased.**
   - Name of Drawee
   - Amount
   - Due date
9. **Letters of Credit Open and Outstanding**
   
   In favour of  
   Amount not utilised  
   Valid upto  

10. **Guarantees given on behalf of clients**
   
   In favour of  
   Amount.  
   Date of expiry  

We certify that the above particulars are full and correct and do not exclude any other obligations of the entity to us.

Yours faithfully,

Name of Bank  
Designation of Signatory
GUIDANCE NOTE ON AUDIT OF LIABILITIES

The following is the text of the Guidance Note on Audit of Liabilities issued by the Auditing Practices Committee (APC) of the Council of the Institute of Chartered Accountants of India. This Guidance Note should be read in conjunction with the Statements on Standard Auditing Practices (SAPs) issued by the Institute.

1. Para 2.1 of the Preface to the Standards on Auditing issued by the Institute of Chartered Accountants of India states that the “main function of the APC is to review the existing auditing practices in India and to develop Statements on Standard Auditing Practices (SAPs) so that these may be issued by the Council of the Institute.” Para 2.4 of the Preface states that the “APC will issue Guidance Notes on the issues arising from the SAPs wherever necessary.”

2. The Auditing Practices Committee has also taken up the task of reviewing the Statements on auditing matters issued prior to the formation of the Committee. It is intended to issue, in due course of time, SAPs or Guidance Notes as appropriate, on the matters covered by such Statements which would then stand withdrawn. With the issuance of this Guidance Note on Audit of Liabilities, Chapter 9 of the Statement on Auditing Practices, titled ‘Liabilities’, shall stand withdrawn. In due course of time, the entire Statement on Auditing Practices shall be withdrawn.

INTRODUCTION

3. Liabilities are the financial obligations of an enterprise other than owners’ funds.

4. Liabilities include loans and borrowings, trade creditors and other current liabilities, deferred payment credits, instalments payable under hire purchase agreements, and provisions. Besides liabilities, this Guidance Note also deals with contingent liabilities, i.e., obligations relating to past transactions or other events or conditions that may arise in consequence of one or more future events which are presently deemed possible but not probable.

5. Special considerations may apply in the case of audit of liabilities of specialised entities like banks, financial institutions and venture capital funds.

6. Liabilities generally constitute a significant proportion of the total sources of funds of an

---

1 Published in December, 1995 issue of ‘The Chartered Accountant’.
2 Now known as the Auditing and Assurance Standards Board (AASB).
3 Now known as Engagement Standards.
4 The said Preface has been withdrawn pursuant to issuance of the Revised “Preface to Standards on Quality Control, Auditing, Review, Other Assurance and Related Service”, by the Institute of Chartered Accountants of India. The Revised Preface is effective from April 1, 2008. The text of the revised Preface is reproduced in the Vol-I of this Handbook.
5 Since the Statement was withdrawn in March, 2005, the entire paragraph is redundant.

© The Institute of Chartered Accountants of India
entity. The audit of liabilities is primarily directed at ensuring that all known liabilities have been properly accounted for, since material omission or misstatement of liabilities vitiates the true and fair view of the financial statements.

7. An important feature of liabilities which has a significant effect on the related audit procedures is that these are represented only by documentary evidence which originates mostly from third parties in their dealings with the entity.

8. In any auditing situation, the auditor employs appropriate procedures to obtain reasonable assurance about various assertions [Standard on Auditing (SA) 500, Audit Evidence]. In carrying out an audit of liabilities, the auditor is particularly concerned with obtaining sufficient appropriate audit evidence to satisfy himself that all known liabilities are recorded and stated at fair and reasonable amounts.

INTERNAL CONTROL EVALUATION

9. The auditor should study and evaluate the system of internal control relating to liabilities to determine the nature, timing and extent of his other audit procedures. He should particularly review the following aspects of internal control relating to liabilities.5

(a) In respect of loans and borrowings (including advances and deposits)

(i) As far as possible, the following should be clearly specified:

♦ the borrowing powers and limits;
♦ persons authorised and competent to borrow;
♦ terms of borrowings;
♦ procedure for ensuring compliance with relevant legal requirements/internal regulations.

(ii) Any variations in the terms of loans and borrowings should be truly approved/ratified in writing by competent authority.

(iii) Security offered against loans and borrowings should be properly recorded and periodically reviewed.

(iv) The records and documents should be kept in proper custody and reviewed periodically.

(v) The system should bring out all cases of non-compliance with terms and conditions including amounts of principal and/or interest which have become overdue.

(vi) Confirmation of balances should be obtained at periodic intervals and the discrepancies, if any, should be duly investigated and reconciled.

(vii) There should be a proper procedure for year-end valuation of loans and borrowings,

5 The extent of review of controls would depend upon the facts and circumstances of each case. Reference may be made in this regard to the Internal Control Questionnaire, issued by the Institute of Chartered Accountants of India, which contains, inter alia, an illustrative list of internal controls in relation to creditors and borrowings.
especially for those designated in foreign currencies.\footnote{Reference may be made in this regard to Accounting Standard 11 (revised 2003), \textit{Effects of Changes in Foreign Exchange Rates}, issued by the Institute of Chartered Accountants of India.}

(b) \textit{In respect of Trade Creditors}

(i) The procedure should ensure proper recording of transactions and facilitate the linking of payments with outstandings.

(ii) The payments made to creditors should be in line with the approved policies of the entity.

(iii) There should be specific procedures for payments against duplicate invoices or other duplicate records as well as for payments against accounts which have remained unclaimed for quite some time.

(iv) There should be procedures for preparation of schedules of trade creditors at periodic intervals; this should be reviewed by a responsible person and necessary action initiated on overdue accounts.

(v) Statements of account should be called for creditors at periodic intervals and the discrepancies, if any, should be duly investigated and reconciled.

(vi) All adjustments in the creditors’ accounts such as those relating to claims for returns, defectives, short receipts of goods, rebates, allowances and commissions etc., should require approval of competent authority. Similarly, any write-back of creditors’ balances and escalation claims should be approved by competent authority.

(vii) There should be appropriate cut-off procedures in relation to transactions affecting the creditor accounts.

(c) \textit{In respect of other current liabilities, trade deposits and provisions}

The internal control procedures as spelt out above for loans and borrowings and creditors broadly apply in relation to these items.

10. In respect of contingent liabilities, the auditor should examine whether the internal control system of the entity provides for a procedure for identifying and estimating such liabilities and for periodic review of the same.

\textbf{VERIFICATION}

11. Verification of liabilities may be carried out by employing the following procedures:

(a) examination of records;

(b) direct confirmation procedure;

(c) examination of disclosure;

(d) analytical review procedures,

(e) obtaining management representations.
The nature, timing and extent of substantive procedures to be performed is, however, a matter of professional judgement of the auditor which is based, *inter alia*, on the auditor’s evaluation of the effectiveness of the related internal controls.

EXAMINATION OF RECORDS

**Loans and Borrowings**

12. The auditor should satisfy himself that the loans obtained are within the borrowing powers of the entity.

13. The auditor should carry out an examination of the relevant records to judge the validity and accuracy of the loans.

14. In respect of loans and advances from banks, financial institutions and others, the auditor should examine that the book balances agree with the statements of the lenders. He should also examine the reconciliation statements, if any, prepared by the entity in this regard.

15. The auditor should examine the important terms in the loan agreements and the documents, if any, evidencing charge in respect of such loans and advances. He should particularly examine whether the requirements of the applicable statute regarding creation and registration of charges have been complied with.

16. Where the entity has accepted deposits, the auditor should examine whether the directives issued by the Reserve Bank of India or other appropriate authority are complied with.

17. In case the value of the security falls below the amount of the loan outstanding, the auditor should examine whether the loan is classified as secured only to the extent of the market value of the security.

18. Where short-term secured loans have been disclosed separately from other secured loans, the auditor should verify the correctness of the amount of such short-term loans.

19. Where instalments of long-term loans falling due within the next twelve months have been disclosed in the financial statements (e.g., in parentheses or by way of a footnote), the auditor should verify the correctness of the amount of such instalments.

20. The auditor should examine the hire purchase agreements for the purchase of assets by the entity and ensure the correctness of the amounts shown as outstanding in the accounts and also examine the security aspect. Future instalments under hire purchase agreements for the purchase of assets may be shown as secured loans.

21. The deferred payment credits should be verified with reference to the important terms in the agreement, including due dates of payments and guarantees furnished by banks. The auditor should also verify the copies of hundies/bills accepted separately.

**Trade Creditors and Other Current Liabilities**

22. The auditor should check the adequacy of cut-off procedures adopted by the entity in relation to transactions affecting the creditor accounts. For example, the auditor may examine the documents relating to receipt of goods from suppliers during a few days immediately
before the year-end and verify that the related invoices have been recorded as purchases of
the current year.

23. The auditor should check that the total of the creditors' balances agrees with the related
control account, if any; the difference, if any, should be examined.

24. The auditor should examine the correspondence and other relevant documentary
evidence to satisfy himself about the validity, accuracy and completeness of
creditors/acceptances.

25. The auditor should verify that in cases where income is collected in advance for services
to be rendered in future, the unearned portion, not applicable to the period under audit, is not
recognised as income of the period under audit but is shown in the balance sheet as a part of
current liabilities.

26. While examining schedule of creditors and other schedules such as those relating to
advance payments, unclaimed dividends and other liabilities, the auditor should pay special
attention to the following aspects:

(a) long outstanding items;
(b) unadjusted claims for short supplies, poor quality, discount, commission, etc.;
(c) liabilities not correlated/adjusted against related advances;
(d) authorisation and correctness of transfers from one account to another.

Based on his examination as aforesaid, the auditor should determine whether any adjustments
in accounts are required.

27. In case there are any unusual payments around the year-end, the auditor should
examine them thoroughly. In particular, the auditor should examine if the entries relating to
any such payments have been reversed in the subsequent period.

28. The auditor should review subsequent transactions to identify/confirm material liabilities
outstanding at the balance sheet date.

Provisions

29. The term ‘provision’ means amounts retained by way of providing for depreciation or
diminution in value of assets or retained by way of providing for any known liability the amount
of which cannot be determined with substantial accuracy. Provisions include those in respect
of depreciation or diminution in the value of assets, product warranties, service contracts and
guarantees, taxes and levies, gratuity, proposed dividend etc. This Guidance Note, however,
does not deal with provisions for depreciation or diminution in the value of assets.

30. The audit of provisions primarily involves examining the reasonableness and adequacy of
the amounts provided for. The auditor should also examine that the provisions made are not in
excess of what is reasonably required.

31. Provisions for Taxes and Duties: The adequacy of the provision for taxation for the year
should be examined. The position regarding the overall outstanding liability of the entity as at
the date of balance sheet should be reviewed. In respect of assessments completed, revised or rectified during the year, the auditor should examine whether suitable adjustments have been made in respect of additional demands or refunds, as the case may be. Similarly, he should examine whether excess provisions or refunds have been properly adjusted. The relevant orders received up to the time of audit should be considered and, on this basis, it should be examined whether any short provisions have been made good. If there is a material tax liability for which no provision is made in the accounts, the auditor should qualify his report in this respect even if the reserves are adequate to cover the liability.

32. If the entity disputes its liability in regard to demands raised, the auditor should examine whether there is a positive evidence or action on the part of the entity to show that it has not accepted the demand for payment of tax or duty, e.g., where it has gone into appeal under section 246 of the Income-tax Act, 1961. Where an application for rectification of mistake (e.g., under section 154 of the Income tax Act, 1961) has been made by the entity, the amount should be regarded as disputed. Where the demand notice/intimation for the payment of tax is for a certain amount and the dispute relates to only a part and not the whole of the amount, only such amount should be treated as disputed. A disputed tax liability may require a provision or suitable disclosure (see Accounting Standard (AS) 4, Contingencies and Events Occurring After the Balance Sheet Date issued by the Institute of Chartered Accountants of India). In determining whether a provision is required, the auditor should, among other procedures, make appropriate inquiries of management, review minutes of the meetings of the board of directors and correspondence with the entity's lawyers, and obtain appropriate management representations.

33. In case the entity has made the provision for taxation on the basis of the tax-effect accounting method, the auditor should examine whether the method has been applied properly.7

34. **Provision for Gratuity**: The auditor should examine whether the entity is required to pay gratuity to its employees by virtue of the provisions of the Payment of Gratuity Act, 1972 and/or in terms of agreement with employees and, if so, whether provision for accruing gratuity liability has been made by the entity.8 The auditor should examine the adequacy of the gratuity provision with reference to the actuarial certificate obtained by the entity. In case the entity has not obtained such an actuarial certificate, the auditor should examine whether the method followed by it for calculating the accruing liability for gratuity is rational.

35. **Provision for Bonus**: In the case of provision for bonus, the auditor should examine whether the liability is provided for in accordance with the Payment of Bonus Act, 1965 and/or agreement with the employees or award of competent authority. Where the bonus actually paid is in excess of the amount required to be paid as per the provisions of the applicable law/agreement/award, the auditor should specifically examine the authority for the same (e.g., resolution of the board of directors in the case of a company).

---

7 Reference may be made in this regard to the Accounting Standard (AS) 22, “Accounting for Taxes on Income” issued by the Institute of Chartered Accountants of India.

8 Reference may be made in this regard to Accounting Standard (AS) 15 (Revised in 2005), “Accounting for Employee Benefits”, issued by the Institute of Chartered Accountants of India.
36. **Provision for Dividends**: The auditor should examine that dividends are provided for as per applicable provisions of the relevant laws and rules framed thereunder, relevant agreements and resolutions.

37. **Other Provisions**: Where provisions are made for liabilities that may arise on account of product warranties, service contracts, performance warranties etc., the auditor should examine whether the provisions made are in accordance with Accounting Standard (AS) 4, “Contingencies and Events Occurring After the Balance Sheet Date”, issued by the Institute of Chartered Accountants of India. The auditor should also examine the reasonableness of the basis adopted for quantifying the provision with reference to the relevant agreements.

### Contingent Liabilities

38. The term ‘contingent liabilities’ refers to obligations relating to past transactions or other events or conditions that may arise in consequence of one or more future events which are presently deemed possible but not probable. Contingent liabilities may or may not crystallize into actual liabilities. If they do become actual liabilities, they give rise to a loss or an expense. The uncertainty as to whether there will be any legal obligation differentiates a contingent liability from a liability that has crystallized. Contingent liabilities should also be distinguished from those contingencies which are likely to result in a loss (i.e., a loss is not merely possible but probable) and which, therefore, require an adjustment of relevant assets or liabilities. Some of the instances giving rise to contingent liabilities are:

(a) law suits, disputes and claims against the entity not acknowledged as debts:

(b) membership of a company limited by guarantee.

39. The following general procedures may be useful in verifying contingent liabilities.

(a) Review of minutes of the meetings of board of directors, committees of board of directors/other similar body.

(b) Review of contracts, agreements and arrangements.

(c) Review of list of pending legal cases, correspondence relating to taxes, duties, etc.

(d) Review of terms and conditions of grants and subsidies availed under various schemes.

(e) Review of records relating to contingent liabilities maintained by the entity.

(f) Enquiry of, and discussions with, the management and senior officials of the entity.

(g) Representations from the management.

40. The auditor should verify that contingent liabilities do not include any items which require an adjustment of relevant assets or liabilities.

### DIRECT CONFIRMATION PROCEDURE

41. The verification of balances by direct communication with creditors is theoretically the best...
method of ascertaining whether the balances are genuine, accurately stated and undisputed, particularly where the internal control system is weak. However, the utility of this procedure depends to a large extent on receiving adequate response to confirmation requests. Therefore, in situations where the auditor has reasons to believe, based on his past experience or other factors, that it is unlikely that adequate response would be received from the creditors, he may limit his reliance on direct confirmation procedure and place greater reliance on the other auditing procedures.

42. The auditor employs direct confirmation procedure with the consent of the entity under audit. There may be situations where the management of the entity requests the auditor not to seek confirmation from certain creditors. In such cases, the auditor should consider whether there are valid grounds for such a request. For example, the management may explain the reason as being the fact that there is a dispute with the particular creditor and the request for confirmation may aggravate sensitive negotiations between the entity and the creditor. Before accepting a refusal as justified, the auditor should examine any available evidence to support the management's explanations, e.g., correspondence between the entity and the creditor. In such a case, alternative procedures should be applied to creditors not subjected to confirmation. In appropriate cases, the auditor may also need to re-consider the nature, timing and extent of his audit procedures including the degree of planned reliance on management's representations.

43. The confirmation date, the method of requesting confirmations, and the particular creditors from whom confirmation of balances is to be obtained are to be determined by the auditor. While determining the information to be obtained, the form of confirmation, as well as the extent and timing of application of the confirmation procedure, the auditor should consider all relevant factors such as the effectiveness of internal control, the apparent possibility of disputes, inaccuracies or irregularities in the accounts, the probability that requests will receive consideration, and the materiality of the amounts involved.

44. The creditors may be requested to confirm the balances either (a) as at the date of the balance sheet, or (b) as at any other selected date which is reasonably close to the date of the balance sheet. The date should be settled by the auditor in consultation with the entity. Where the auditor decides to seek confirmation from the creditors at a date other than the balance sheet date, he should examine the movements in creditor balances which occur between the confirmation date and the balance sheet date and obtain sufficient evidence to satisfy himself that creditor balances stated in the balance sheet are not materially misstated.

45. The form of requesting confirmation from the creditors may be either (a) the 'positive' form of request, wherein the creditor is requested to respond whether or not he is in agreement with the balance shown, or(b) the 'negative' form of request, wherein the creditor is requested to respond only if he disagrees with the balance shown.

46. The use of the positive form is preferable when individual account balances are relatively large, or where the internal controls are weak, or where the auditor has reason to believe that there may be a substantial number of accounts in dispute or with inaccuracies or irregularities. An illustrative positive form of request letter is given in Appendix I to this Guidance Note.
47. The negative form is useful when internal controls are considered to be effective, or when a large number of small balances are involved, or when the auditor has no reason to believe that the creditors are unlikely to respond. If the negative rather than the positive form of confirmation is used, the number of requests sent and the extent of the other auditing procedures to be performed should normally be greater so as to enable the auditor to obtain the same degree of assurance with respect to the creditor balances. An illustrative negative form of request letter is given in Appendix II to this Guidance Note.

48. In many situations, it may be appropriate to use the positive form for creditors with large balances and the negative form for creditors with small balances.

49. Where the number of creditors is small, all of them may be circularised, but if the creditors are numerous, this may be done on a sample basis. The sample list of creditors to be circularised, in order to be meaningful, should be based on a complete list of all creditor accounts. While selecting the creditors to be circularised, special attention should be paid to accounts with large balances, accounts with old outstanding balances, and supplier accounts with debit balances. In addition, the auditor should select accounts in respect of which balances have been written back to the profit and loss account. In such cases, the auditor may decide that the balance as per the books of the entity may not be stated in the request letter sent to the creditors concerned; instead, the creditors may be asked to intimate the balance as per their records. The auditor may also consider including in his sample some of the accounts which have been fully squared up. The nature of the entity’s business and the type of third parties with whom the entity deals, should also be considered in selecting the sample, so that the auditor can reach appropriate conclusions about the creditors as a whole.

50. In appropriate cases, the creditor may be sent a copy of his complete ledger account for a specific period as shown in the entity’s books. This procedure is more likely to reveal errors and fraud and may be particularly useful in the case of large accounts involving many entries, or where there is evidence that accounts are in dispute or are not being settled in accordance with the usual trade terms.

51. The method of selection of the creditors to be circularised should not be revealed to the entity until the trial balance of the creditors’ ledger is handed over to the auditor. A list of creditors selected for confirmation should be given to the entity for preparing requests for confirmation which should be properly addressed and duly stamped. The auditor should maintain strict control to ensure the correctness and proper dispatch of request letters. In the alternative, the auditor may request the client to furnish duly authorised confirmation letters and the auditor may fill in the names, addresses and the amounts relating to creditors selected by him and mail the letters directly. It should be ensured that confirmations as well as any undelivered letters are returned to the auditor and not to the client.

52. Where positive form of request is used, the auditor may, in appropriate cases, request the entity to follow up with a reminder to those creditors from whom he receives no replies. In exceptional circumstances, the auditor may also correspond directly with those significant creditors from whom he receives no replies despite reminders, with intimation to the entity. In the event of inadequacy of responses received, the auditor will have to increase the extent of examination of records and analytical review procedures beyond that planned originally.
53. Any discrepancies revealed by the confirmations received or by the additional tests carried out by the auditor may have a bearing on other accounts not included in the original sample. The entity should be asked to investigate reconcile the discrepancies. In addition, the auditor should also consider what further tests he can carry out in order to satisfy himself as to the correctness of the amount of creditors taken as a whole.

EXAMINATION OF DISCLOSURE

54. The auditor should satisfy himself that the liabilities have been disclosed properly in the financial statements. Where the relevant statute lays down any disclosure requirements in this behalf, the auditor should examine whether the same have been complied with.

55. In some cases loans are guaranteed by third parties in whose favour the assets of the entity are charged. The auditor should examine whether the disclosures concerning such loans are appropriate, e.g., they may be classified as secured with disclosure of the fact that the assets of the entity have been charged in favour of third parties which, in turn, have given guarantees to parties from whom loans have been obtained.

56. The auditor should recommend to the entity to disclose, in parentheses or in footnotes, the installments of term loans, if any, falling due for repayment within the next twelve months.

57. The auditor should examine that the following have been disclosed in respect of contingent liabilities:

(a) nature of each contingent liability;
(b) the uncertainties which may affect the future outcome;
(c) an estimate of the financial effect or a statement that such estimate cannot be made.

ANALYTICAL REVIEW PROCEDURES

58. In addition to the audit procedures discussed above, the following analytical review procedures may often be helpful as a means of obtaining audit evidence regarding the various assertions:

(a) comparison of closing balances of loans and borrowings, creditors, etc., with the corresponding figures for the previous year;
(b) comparison of the relationship between current year creditor balances and the current year purchases with the corresponding figures for the previous year;
(c) comparison of actual closing balances of loans and borrowings, creditors, etc., with the corresponding budgeted figures, if available;
(d) comparison of current year’s aging schedule of creditors with the corresponding figures for the previous year;
(e) comparison of significant ratios relating to loans and borrowings, creditors, etc., with the similar ratios for other firms in the same industry, if available;
(f) comparison of significant ratios relating to loans and borrowings, creditors, etc. with the
It may be clarified that the foregoing is only an illustrative list of analytical review procedures which an auditor may employ in carrying out an audit of liabilities. The exact nature of analytical review procedures to be applied in a specific situation is a matter of professional judgement of the auditor.

**Special Considerations in the Case of a Company**

59. In addition to the procedures described above, the auditor should also employ the following procedures in the case of audit of a company.

(a) In determining whether the loans obtained by the company are within its powers, the auditor should scrutinise its memorandum and articles of association and also examine whether the provisions of sections 292 and 293(1)(d) of the Companies Act, 1956 are complied with.

(b) The auditor should examine the register of charges to ensure that charges created have been duly registered. He should also ensure that the description of such charges disclosed in the balance sheet agrees in substance with that stated in the documents creating the charges.

(c) The auditor should examine all loans taken from bodies corporate under the same management or from a company, firm or other party in which any director is interested and determine whether, in his opinion, the rate of interest and other terms and conditions of the loans are prime facie prejudicial to the interest of the company.\(^\text{10}\)

(d) Where the company has accepted deposits, the auditor should examine compliance with the relevant legal provisions, e.g., section 58A of the Companies Act, 1956 and the rules framed thereunder/directions issued by the Reserve Bank of India.

(e) In respect of unclaimed dividends, the auditor should examine whether the company has complied with the provisions of section 205A of the Companies Act, 1956 and the rules framed thereunder regarding transfer of certain unpaid or unclaimed dividends to a special bank account/general revenue account of the Central Government.

(f) The auditor should examine whether any undisputed amounts payable in respect of income-tax, wealth tax, sales tax, customs duty and excise duty are outstanding as at the balance sheet date for a period of more than six months from the date they became payable. If so, the auditor should report the amounts of such outstanding dues.\(^\text{11}\)

(g) The verification procedure to be adopted by the auditor for audit of debentures would vary from year to year, depending upon whether fresh debentures are issued and/or they

---

\(^{10}\) Reference may also be made in this regard to the *Statement on the Companies (Auditor’s Report) Order, 2003* issued by the Institute of Chartered Accountants of India.

\(^{11}\) Reference may also be made in this regard to the *Statement on the Companies (Auditor’s Report) Order, 2003 (Revised 2005)* issued by the Institute of Chartered Accountants of India.
are redeemed or converted into shares during the year. In case of fresh issue of debentures, the auditor should examine the memorandum and articles of association of the company and resolutions authorising the issue. He should also examine compliance with the requirements of the terms of issue and any variations thereof and necessary approvals/clearances for the issue from authorities concerned such as SEBI, RBI etc. The auditor should also examine that proper accounts are maintained with regard to amounts received towards application, allotment and calls and that the Payments by way of refunds/interest and all other relevant accounts are duly reconciled. Where debentures are issued at a premium/discount, the auditor should ensure that such sums are accounted for distinctly. In case of buy-back, conversion, re-issue or redemption of debentures, the auditor should examine that these are in accordance with the terms of the issue. The auditor should examine that the requirements relating to creation of debenture redemption reserve and, where applicable, sinking fund and its Investment; and other related requirements are complied with.

MANAGEMENT REPRESENTATIONS

60. The auditor should obtain from the management of the entity a written statement that all known liabilities have been recorded in the books and that all contingent liabilities have been properly disclosed. While such a representation letter serves as a formal acknowledgment of the management’s responsibilities for proper accounting and disclosure of the relevant items, it does not relieve the auditor of his responsibility for performing audit procedures to obtain sufficient appropriate audit evidence to form the basis for the expression of his opinion on the financial statement. A sample management representation letter regarding liabilities and contingent liabilities is given in Appendix III to this Guidance Note. It may be mentioned that the representations made in the letter can alternatively be included in the composite representation letter usually issued by the management to the auditor.

DOCUMENTATION

61. The auditor should maintain adequate working papers regarding audit of liabilities and contingent liabilities. Among others, he should maintain on his audit file, confirmations received as well as any undelivered letters of request for confirmation. The management representation letter contingent liabilities and contingent liabilities should also be maintained on the audit file.

Appendix I

Illustrative Letter of Confirmation to be Sent to Creditors - Positive Form

[Ref. paragraph 46]

[Letterhead of Entity]

[Name and Address of Creditor] [Date]

Dear Sir,
For audit purposes, kindly confirm directly to our auditors (name and address of the auditors) that the balance of Rs. ______ due by us to you as on ______ as shown by our books, is correct. The details of the balance are as under:

<table>
<thead>
<tr>
<th>Invoice No.</th>
<th>Date</th>
<th>Order Reference</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Total
Less: Payments made/other debits
Net amount due to us (Rs.)

A stamped envelope addressed to our auditors is enclosed for your convenience.

If the amount shown is in agreement with your books, kindly strike-out the paragraph marked (B) below. If the amount shown is not in agreement with your books, kindly furnish the details in the proforma given in the paragraph marked (B) below and strike-out paragraph (A). In either case, kindly sign at the place provided below and return this entire letter directly to our auditors in the enclosed envelope. Your prompt compliance with this request will be appreciated.

Kindly return this form in its entirety.

Yours faithfully,

(Signature of responsible official of the entity)

[Name and Address of Entity]

(A) We confirm that the above stated amount is correct as at ______

OR

(B) We state that the above-stated amount is not correct as per our records. The details of the balance as at _____ as per our records are as below:

<table>
<thead>
<tr>
<th>Invoice No.</th>
<th>Date</th>
<th>Order Reference</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Total

12 In case the list of invoices forming the balance is too large, these details may not be given.
Part-III: Guidance Notes

Illustrative Letter of Confirmation to be Sent to Creditors - Negative Form

[Ref. paragraph 47]

[Letterhead of Entity]

[Date]

[Name and Address of Creditor]

Dear Sir,

For audit purposes, kindly write directly to our auditors (name and address of the auditors) if the balance of Rs. ________ due by us to you as on ________ as shown by our books, is not correct, giving details of the differences. The details of the balance are as under: 13

<table>
<thead>
<tr>
<th>Invoice No.</th>
<th>Date</th>
<th>Order Reference</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Total</th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Less: Payments made/other debits</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net amount due by us (Rs.)</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

If you do not notify our auditors of any difference within ten days of the date of this letter, it will be presumed that the balance stated above is correct.

A stamped envelope addressed to our auditors is enclosed for your convenience.

Yours faithfully,

(Signature of responsible official of the entity)

13 In case the list of invoices forming the balance is too large, these details may not be given
Illustrative Representation Letter for Liabilities and Contingent Liabilities

[Ref. paragraph 60]

The following is a sample representation letter for liabilities and contingent liabilities. It might be used to supplement the general letter of representation or included therein. The letter should be modified where appropriate.

[Letterhead of Entity]

[Date]

[Name and Address of the Auditor]

Dear Sir,

In connection with your audit of the financial statements of X Ltd. as of ………, 19……, and for the year then ended, we confirm, to the best of our knowledge and belief, the following representations:

1. We have recorded all known liabilities in the financial statements.
2. We have disclosed in notes to the financial statements all guarantees that we have given to third parties and all other contingent liabilities.
3. Contingent liabilities disclosed in the notes to the financial statements do not include any contingencies which are likely to result in a loss and which, therefore, require adjustment of assets or liabilities.
4. Provisions have been made in the accounts for all known losses and claims of material amounts.

Yours faithfully,

(Signature of responsible official of the entity)
GUIDANCE NOTE ON AUDIT OF REVENUE*

The following is the text of the Guidance Note on Audit of Revenue issued by the Auditing Practices Committee (APC)** of the Council of the Institute of Chartered Accountants of India. This Guidance Note should be read in conjunction with the Statements on Standard Auditing Practices (SAPs)+ issued by the Institute.

1. Para 2.1 of the ‘Preface to the Statements on Standard Auditing Practices’¹, issued by the Institute of Chartered Accountants of India, states that the "main function of the APC is to review the existing auditing practices in India and to develop Statements on Standard Auditing Practices (SAPs) so that these may be issued by the Council of the Institute." Para 2.4 of the Preface states that the “APC will issue Guidance Notes on the issues arising from the SAPs wherever necessary.”

2. The Auditing Practices Committee has also taken up the task of reviewing the Statements on auditing matters issued prior to the formation of the Committee. It is intended to issue, in due course of time, Engagement Standards or Guidance Notes, as appropriate, on the matters covered by such Statements which would then stand withdrawn. Accordingly, with the issuance of this Guidance Note on Audit of Revenue, paragraph 11.1 of Chapter 11 of the Statement on Auditing Practices, titled 'Profit and Loss Account', shall stand withdrawn. In due course of time, the entire Statement of Auditing Practices shall be withdrawn.²

INTRODUCTION

3. Revenue is the gross inflow of cash, receivables or other consideration arising in the course of the ordinary activities of an entity from the sale of goods, from the rendering of services, and from the use by others of entity resources yielding interest, royalties and dividends. Revenue is measured by the charges made to customers for goods supplied and services rendered to them and by the charges and rewards arising from the use of resources by them. The term ‘revenue’ covers only the gross inflow of cash, receivables or other consideration, as aforesaid, received or receivable by the entity on its own account. Amounts collected on behalf of third parties are excluded from revenue. For example, in an agency relationship, revenue from the viewpoint of the agent is the amount of commission receivable by him and not the gross amount of cash, receivables or other consideration collected by him on behalf of the principal.

* Published in May, 1997 issue of 'The Chartered Accountant'.  
** Now known as the Auditing and Assurance Standards Board (AASB).  
+ Now known as the Engagement Standards.  
¹ The said Preface has been withdrawn pursuant to issuance of the Revised "Preface to Standards on Quality Control, Auditing, Review, Other Assurance and Related Service", by the Institute of Chartered Accountants of India. The Revised Preface is effective from April 1, 2008. The text of the revised Preface is reproduced in the Vol-I of this Handbook.  
² Since the Statement was withdrawn in March, 2005, the entire paragraph is redundant.
4. This Guidance Note deals with the audit of the following types of revenue (dealt with in Accounting Standard (AS) 9, Revenue Recognition, issued by the Institute of Chartered Accountants of India) arising in the course of the ordinary activities of an entity:

- Sale of goods.
- Rendering of services.
- Use by others of entity resources yielding interest, royalties and dividends.

5. In any auditing situation, the auditor employs appropriate procedures to obtain reasonable assurance about various assertions (see Statement on Standard on Auditing (SA) 500, Audit Evidence). In carrying out an audit of revenue, the auditor is particularly concerned with obtaining sufficient appropriate audit evidence to corroborate the management’s assertions regarding the following:

- **Occurrence** – that recorded revenue arose from transactions which took place during the relevant period and pertain to the entity.
- **Completeness** – that there is no unrecorded revenue.
- **Measurement** – that revenue is recorded in the proper amounts and is allocated to the proper period.
- **Presentation and Disclosure** – that revenue is disclosed, classified, and described in accordance with recognised accounting policies and practices and relevant statutory requirements, if any.

**INTERNAL CONTROL EVALUATION**

6. The auditor should study and evaluate the system of internal control relating to revenue, to determine the nature, timing and extent of his other audit procedures. He should particularly review the following aspects of internal control relating to revenue: ³

   (a) The systems and procedures relating to generation of revenue including authority to fix prices, offer discounts and other terms of sale.

   (b) Accounting procedures relating to recognition of revenue.

   (c) Existence of periodic reports on actual performance vis-à-vis budgets.

**VERIFICATION**

7. Verification of revenue may be carried out by employing the following procedures:

   (a) examination of records;

   (b) analytical review procedures.

³ The extent of review of internal controls would depend upon the facts and circumstances of each case. Reference may be made in this regard to the "Internal Control Questionnaire" issued by the Institute of Chartered Accountants of India in 1976, which contains an illustrative list of internal controls in relation to sales.
The nature, timing and extent of substantive procedures to be performed is, however, a matter of professional judgment of the auditor which is based, *inter alia*, on the auditor's evaluation of the effectiveness of the related internal controls.

**EXAMINATION OF RECORDS**

8. The auditor should examine whether the basis of recognition of revenue by the entity is in accordance with the recognised accounting principles as laid down in Accounting Standard (AS) 9, *Revenue Recognition*, issued by the Institute of Chartered Accountants of India.

9. The auditor should examine whether the entity has instituted adequate cut-off procedures in relation to sales and sale returns. The objective of cut-off procedures is to ensure that the transactions pertaining to a period are recorded in that period and not in a preceding or subsequent period. The auditor should examine the efficacy of such procedures. The auditor can examine the despatch documents (such as railway receipts) pertaining to a few days immediately before the year-end and verify that the related sale invoices have been recorded as sales of the current year.

10. The auditor should examine selected entries in the sales journal with reference to the related sale invoices, dispatch documents and other supporting documents such as the customers' orders, credit approval notes, etc. He should compare the actual price charged with the authorised price lists or with the authorisation by the appropriate official of the entity, as the case may be. The auditor should also trace the selected entries to the customers' account.

11. The auditor should also examine selected despatch documents with reference to related sale invoices and the sales journal.

12. The auditor should examine selected entries in the sales return journal with reference to the receiving reports in respect of goods returned, credit notes and entries in the customers' accounts. Similarly, the auditor should examine selected credit notes with reference to entries in the sales return journal, receiving reports in respect of goods returned, and entries in the customers' accounts.

13. In respect of goods sent on approval, the auditor should particularly examine that revenue in respect of such goods is not recognised until (a) the goods have been formally accepted by the buyer, or (b) the buyer has done an act adopting the transaction, or (c) the time period for rejection has elapsed or where no time has been fixed, a reasonable time has elapsed.

14. In respect of sales to intermediate parties (i.e., where goods are sold to distributors, dealers or others for resale), the auditor should examine that revenue from such sales is not recognised until the significant risks and rewards of ownership have passed. However, in situations where an intermediate party is in substance an agent (e.g., a consignee), revenue
should not be recognised until the related goods are sold to a third party.\textsuperscript{4}

15. Where the consideration is receivable in installments and includes an element of interest, the auditor should examine that the revenue attributable to the sale excludes the interest element.

16. In respect of export sales, the auditor should carry out the following procedures in addition to the usual audit procedures applicable in respect of domestic sales.

(a) The auditor should examine that revenue from export sales in which consideration is receivable in a foreign currency is recorded at an appropriate amount in accordance with Accounting Standard (AS) 11, *Accounting for the Effects of Changes in Foreign Exchange Rates*\textsuperscript{5}.

(b) The auditor should obtain a written representation from the management to the effect that the entity has complied with the legal and regulatory requirements relating to exports.\textsuperscript{6}

17. In respect of revenue arising from services rendered (i.e., in the form of fees, commission, brokerage, etc.), the auditor should examine the related agreements and other documents. Similarly, in respect of revenue in the form of interest, dividends and royalties, the auditor should examine the related documents such as loan documents, lease agreements, etc. The auditor may also seek confirmatory certificates from the parties concerned.

18. The auditor should also verify realisations subsequent to the date of the balance sheet to identify items of unrecorded revenue.

**EXAMINATION OF PRESENTATION AND DISCLOSURE**

19. The auditor should satisfy himself that the revenue has been disclosed properly in the financial statements. Where the relevant statute lays down any disclosure requirements in this behalf, the auditor should examine whether the same have been complied with.

**ANALYTICAL PROCEDURES**

20. In addition to the audit procedures discussed above, the following analytical procedures may often be helpful as a means of obtaining audit evidence regarding the various assertions relating to revenue:

(a) Comparison, product-wise and location-wise, of revenue for the current year with the corresponding figures for previous years.

(b) Comparison of ratio of gross margin to sales for the current year with the corresponding figures for previous years.

(c) Comparison of ratio of sales returns to sales for the current year with the corresponding figures for previous years.

\textsuperscript{4} Reference may be made to AS 1, *Disclosure of Accounting Policies*, for discussion on the concept of “substance over form”.

\textsuperscript{5} This Accounting Standard has been revised in 2003. The title of the revised Accounting Standard is “Effects of Changes in Foreign Exchange Rates”.

\textsuperscript{6} Reference may be made in this regard to SA 580, “Representations by Management”.

© The Institute of Chartered Accountants of India
(d) Comparison of ratio of trade discount to sales for the current year with the corresponding figures for previous years.

(e) Comparison of ratio of excise duty/sales tax/export incentives to sales for the current year with the corresponding figures for previous years.

(f) Comparison, product-wise and location-wise, of quantity sold during the year with the corresponding figures for previous years.

(g) Product-wise reconciliation of quantity sold during the year with opening stock, purchases/production and closing stock.

(h) Comparison of dividend/interest/royalty for the current year with the corresponding figures for previous years.

(i) Comparison of ratio of income on investments to average investments for the current year (separately for each major type of investment) with the corresponding figures for previous years.

Apart from the above, the auditor may also work out quantitative ratios and reconciliations, e.g., he may relate the quantum of output to the quantum of input to judge its reasonableness. Similarly, he may relate the wage payments to the quantum of output, and so on.

It may be clarified that the foregoing is only an illustrative list of analytical procedures, which an auditor may employ in carrying out an audit of revenue. The exact nature of analytical procedures to be applied in a specific situation is a matter of professional judgment of the auditor.

SPECIAL CONSIDERATIONS IN THE CASE OF A COMPANY

21. In the case of audit of a company, in addition to the procedures described above, the auditor should also carry out appropriate audit procedures in respect of matters which are specifically required to be examined under the provisions of the Companies Act, 1956. For example, as required by the [Manufacturing and Other Companies (Auditor's Report) Order, 1988, issued under section 227(4A) of the Act, the auditor should examine whether the transactions of sale of goods, materials and services and purchase of goods and materials, made in pursuance of contracts or arrangements entered in the register(s) maintained under section 301 of the Act, and exceeding the limits specified in the Order, have been made at prices which are reasonable having regard to prevailing market prices for such goods, materials or services or the price at which transactions for similar goods or services have been made with other parties.]

DOCUMENTATION

22. The auditor should maintain adequate working papers regarding audit of revenue.

7 Reference may be made in this regard to Statement on Companies (Auditor's Report) Order, 2003 (Revised 2005).
GUIDANCE NOTE ON AUDIT OF EXPENSES*

Para 2.1 of the "Preface to the Statements on Standard Auditing Practices" issued by the Institute of Chartered Accountants of India states that the "main function of the APC is to review the existing auditing practices in India and to develop Statements on Standard Auditing Practices (SAPs)" so that these may be issued by the Council of the Institute. Para 2.4 of the Preface states that the "APC will issue Guidance Notes on the issues arising from the SAPs wherever necessary."

The Auditing Practices Committee*** has also taken up the task of reviewing the Statements on auditing matters issued prior to the formation of the Committee. It is intended to issue, in due course of time, SAPs or Guidance Notes, as appropriate, on the matters covered by such Statements which would then stand withdrawn. Accordingly, with the issuance of this Guidance Note on Audit of Expenses, paragraphs 11.2-11.8 of Chapter 11 of the Statement on Auditing Practices, titled 'Profit and Loss Account', shall stand withdrawn. In due course of time, the entire Statement on Auditing Practices shall be withdrawn.2

The following is the text of the Guidance Note on "Audit of Expenses" issued by the Auditing Practices Committee of the Council of the Institute of Chartered Accountants of India. This Guidance Note should be read in conjunction with the Statements on Standard Auditing Practices issued by the Institute.

INTRODUCTION

1. An expense is a cost relating to the operations of an accounting period or to the revenue earned during the period or the benefits of which do not extend beyond that period. The expression "cost" means the amount of expenditure incurred on or attributable to a specified article, product or activity.

2. Expenses are recognised by the following approaches:

(a) Identification with revenue transactions

---

* Published in November, 2001 issue of ‘The Chartered Accountant’.

1 The said Preface has been withdrawn pursuant to issuance of the Revised “Preface to Standards on Quality Control, Auditing, Review, Other Assurance and Related Service”, by the Institute of Chartered Accountants of India. The Revised Preface is effective from April 1, 2008. The text of the revised Preface is reproduced in the Vol.I of this Handbook.

** Now known as Engagement Standards.

*** Now known as Auditing and Assurance Standards Board.

2 Since the Statement was withdrawn in March, 2005, the entire paragraph is redundant.
Costs directly associated with the revenue recognised during the relevant period are considered as expenses and are charged to income for the period.

(b) Identification with a period of time

In many cases, although some costs may have connection with the revenue for the period, the relationship is so indirect that it is impracticable to attempt to establish it. However, there is a clear identification with a period of time. Such costs are regarded as ‘period costs’ and are expensed in the relevant period, e.g., salaries, telephone, travelling, depreciation on office building, normal interest, etc. Similarly, the costs, the benefits of which, do not clearly extend beyond the accounting period are also charged as expenses.

3. The following features of expenses affect the nature, timing and extent of the related audit procedures:

(a) In the case of most items of expenses, documentary evidence originating from third parties is available.

(b) The nature and relative significance of various items of expenses usually differ from one enterprise to another, depending primarily on the nature of operations carried out by them. For example, in the case of most manufacturing enterprises, the principal items of expenses would include the cost of raw materials consumed, labour cost and other conversion costs. On the other hand, in the case of a trading enterprise, the principal items of expenses would generally be the cost of goods sold. In the case of an enterprise supplying, providing, maintaining and operating any services, the principal items of expense would include personnel and professional expenses, office maintenance, etc.

(c) The amount of some expenses has a logical relationship with certain other financial statement items while the amount of some other expenses does not have such a relationship. For example, in an enterprise where the production process is standardised, the consumption of raw materials (and, therefore, the cost of raw materials consumed) has a logical relationship with the quantum of output. Similarly, the proportion of various constituents of cost of production is expected to remain more or less constant in the absence of known conditions to the contrary. Likewise, proportion of the amount of interest for a period to the amount of loans outstanding during the period is expected to vary within certain specific limits. On the other hand, the expenditure on research and development often has little relationship with other items in the financial statements.

(d) The amount of some items of expenses (e.g., gratuity, taxes, bonus, etc.) is significantly affected by applicable laws.

4. In an audit, the auditor employs appropriate procedures to obtain reasonable assurance about various assertions (see SA 500, Audit Evidence). In carrying out an audit of expenses, the auditor is particularly concerned with obtaining sufficient appropriate audit evidence to corroborate the management’s assertions regarding the following:

---

3 Reference may be made in this regard to Guidance Note on Accrual Basis of Accounting.
III.82 Auditing Pronouncements

Occurrence that recorded expenses arose from transactions or events placed during the relevant period and pertain to the entity.

Completeness that there are no unrecorded expenses.

Measurement that expenses are recorded in the proper amounts and are allocated to the proper period.

Presentation and Disclosure that expenses are disclosed, classified, and described in accordance with recognised accounting policies and practices and relevant statutory requirements, if any.

5. In view of the divergence in the nature of expenses incurred by different enterprises, it is not possible to describe the audit procedures applicable in carrying out an audit of expenses in all situations. This Guidance Note provides guidance on procedures to be employed in carrying out an audit of expenses which would be applicable in the case of most enterprises. It is recognised, however, that audit procedures different from or additional to those described in this Guidance Note may be necessary in a particular case, depending upon its specific facts and circumstances.

INTERNAL CONTROL EVALUATION

6. The auditor should study and evaluate the system of internal control relating to expenses, to determine the nature, timing and extent of his other audit procedures. He should particularly review the following aspects of internal control relating to expenses:

(a) The systems and procedures relating to incurring of expenses including authorisation procedures.

(b) Accounting procedures relating to recognition of expenses.

(c) Existence of periodic reports on actual performance vis a vis budgets and internal management reports, if any.

VERIFICATION

7. Verification of expenses may be carried out by employing the procedures, viz.,

(a) examination of records; and (b) analytical procedures. The nature, timing and extent of substantive procedures to be performed is, however, a matter of professional judgment of the auditor which is based, inter alia, on the auditor's evaluation of the effectiveness of the related internal controls. The auditor should examine whether the basis of recognition of expenses by the entity is in accordance with the recognised accounting principles.

---

4The extent of review of internal controls would depend upon the facts and circumstances of each case. Reference may be made in this regard to the "Internal Control Questionnaire", issued by the Institute of Chartered Accountants of India in 1976 which contains, inter alia, an illustrative list of internal controls in relation to petty cash, cash and bank payments, salaries and wages and purchases.
(a) **Examination of Records**

8. Examination of records and documents is one of the most important techniques of auditing. An auditor has to examine a large number of documents in the course of an audit since most transactions are supported only by documentary evidence. The accounting systems of business enterprises are so designed that documentary evidence is created in respect of each transaction. The auditor should carry out an examination of the relevant records to satisfy himself about the validity, accuracy and other assertions with regard to various expenses incurred by the entity. The extent of such examination would depend on the auditor’s evaluation of the efficacy of internal controls.

(b) **Analytical Procedures**

9. The auditor should conduct analytical procedures which involve analysis of significant ratios and trends, including the resulting investigation of fluctuations and relationships that are inconsistent with other relevant information or which deviate from predicted amounts.\(^5\)

10. The following paragraphs describe the audit procedures applicable in respect of various items of expenses.

**GOODS AND RAW MATERIALS CONSUMED**

11. The auditor's examination of the cost of goods, stores and materials consumed during the year would involve, *inter alia*, examination of purchases of goods and materials made during the year as well as of purchase returns and of opening and closing inventories.

**PURCHASES AND PURCHASE RETURNS**

12. The auditor should examine whether the entity has instituted adequate cut-off procedures in relation to purchases and purchase returns. The objective of cut-off procedures is to ensure that the transactions pertaining to a period are recorded in that period and not in a preceding or subsequent period. The auditor should examine the efficacy of such procedures. The auditor can examine the selected receipt documents (such as goods received notes) pertaining to a few days immediately before the year-end and verify that the related purchase invoices have been recorded as purchases of the current year. The auditor should pay particular attention to the cut-off procedures relating to purchases, both indigenous and imported, to determine whether these procedures ensure recognition of purchases at the time the significant risks and rewards of ownership of the related goods pass on to the entity.

13. The auditor should examine selected entries in the purchase journal with reference to the related purchase invoices, receipt records and other supporting documents such as the purchase orders. The auditor should also trace the selected entries to the suppliers' account.

14. While examining purchase invoices, the auditor should examine whether subsidies, rebates, duty drawbacks or other similar items have been properly accounted for. As per AS 2, costs of purchase consist of the purchase price including duties and taxes (other than those

\(^5\) Refer to Standard on Auditing (SA) 520, “Analytical Procedures”.

© The Institute of Chartered Accountants of India
subsequently recoverable by the enterprise from the taxing authorities), freight inwards and other expenditure directly attributable to the acquisition. Trade discounts, rebates, duty drawbacks and other similar items are deducted in determining the costs of purchase.

15. The auditor should also examine selected receipt records with reference to related purchase invoices and the purchase journal.

16. The auditor should examine selected entries of purchase returns with reference to the goods returned notes, debit notes and entries in the suppliers' accounts. Similarly, the auditor should examine selected debit notes with reference to purchase returns, goods returned notes, and entries in the suppliers' accounts.

17. In case of transactions between related parties, the auditor should pay special attention to nature and description of such transactions. \(^6\)

18. The auditor should obtain a representation from the management to the effect that the entity has complied with the legal and regulatory requirements, if any. When the auditor becomes aware of non-compliance, the auditor should obtain sufficient information to evaluate the possible effect in the financial statements. The auditor should also consider communication/reporting of non-compliance with the management including audit committee, users of financial statements and to regulatory authorities, as may be appropriate. \(^7\)

19. In respect of imports, the auditor should carry out the following procedures in addition to the usual audit procedures applicable in respect of domestic purchases.

(a) Besides examining the usual documents relating to purchases, the auditor should also examine such documents as bill of lading, custom documents, etc., which are specific to import transactions.

(b) The auditor should pay special attention to the terms of import relating to the incidence of charges like insurance and freight, i.e., whether the imports are on C.I.F. basis, or F.O.B. basis, or some other basis.

(c) The auditor should examine that imports for which consideration is payable in a foreign currency are recorded at an appropriate amount in accordance with Accounting Standard (AS) 11, Accounting for the Effects of Changes in Foreign Exchange Rates.

20. In addition to the audit procedures discussed above, the following analytical procedures may often be helpful as a means of obtaining audit evidence regarding the various assertions relating to purchases.

(a) Comparison, item-wise and location-wise, both quantity and value, of purchases for the current year/period with the corresponding figures for previous years/periods.

(b) Comparison of ratio of gross margin to sales for the current year/period with the corresponding figures for previous years/periods.

\(^6\) Refer to Accounting Standard (AS) 18, “Related Party Disclosures”.

\(^7\) Refer to Standard on Auditing (SA) 250, “Consideration of Laws and Regulations in an Audit of Financial Statements”.
Part-III: Guidance Notes

(c) Comparison of ratio of purchase returns to purchases for the current year/period with the corresponding figures for previous years/periods.

(d) Product-wise reconciliation of quantity sold during the year/period with opening stock, purchases/production and closing stock.

Apart from the above, the auditor may also work out quantitative ratios and reconciliations, e.g., he may relate the quantum of output to the quantum of input to judge its reasonableness. In case segment information is available, the above procedures may be carried out for each segment.

21. The auditor should also verify payments subsequent to the date of the balance sheet to identify any purchases which have not been recorded in the books of account.

Wages and Salaries

22. The auditor should examine the entries in the payroll/wage sheets with reference to relevant records, e.g., employee’s records maintained by the personnel department showing details of pay such as basic pay, allowances, annual increments, leaves availed, etc. Special attention may also be paid by auditor in respect of new employees joining the entity during the year. Similarly, the payroll may also be examined with reference to the time records/attendance records and leave records maintained by the personnel department. The deductions made in respect of income-tax, provident fund, Employees’ State Insurance (ESI), welfare schemes, health schemes, etc., may be examined with reference to the returns submitted to the authorities concerned and the receipts/acknowledgments issued by such authorities.

23. The auditor should examine whether any legal, regulatory or contractual requirements having a bearing on the rate or amount of wages and salaries have been complied with. Similar considerations would also apply to payments made to a contractor for hire of labour. Such requirements would include, inter alia, the provisions of the Minimum Wages Act, 1948, agreement with the employees, award of competent authority and judicial rulings.

24. In the case of senior management officials, the auditor should pay particular attention to determining whether the salaries payable are as per the terms of contract with the employees concerned. Special requirements of terms of contract such as granting stock options (as per schemes formulated by SEBI), availing leave encashment, total amount payable annually including ex-gratia, etc., should be specifically looked into.

25. In the case of casual labour, besides carrying out the other audit procedures, the auditor should specifically examine the sanction of the competent authority for employment of such labour and ascertain whether such employees are retained as per the time rate or piece-rate basis. In appropriate cases, the auditor may pay a surprise visit to the sites where the casual labour is employed to assess the correctness of the attendance records maintained in respect of such labour. In cases where complete outsourcing of labour has been given to an outside agency, the terms of agreement and compliance thereof would be examined.
26. The auditor should obtain a list of employees who have retired or otherwise left the services of the entity during the period under audit and examine that they have not been included in the payroll.

27. In addition to the audit procedures discussed above, the following analytical procedures may often be helpful as a means of obtaining audit evidence regarding the various assertions relating to wages and salaries:

(a) comparison of wage bill for the year/period with the wage bill of previous years/periods;
(b) comparison of the monthly wages and salaries of a month with other months during the year/period and with the corresponding month of the previous years/periods;
(c) comparison of the wage bill for each department/unit for the current year/period with the corresponding figures for previous years/periods;
(d) comparison of the ratios of wages and salaries to sales for the current year/period with the corresponding figures for the previous years/periods;
(e) comparison of the ratio of wages and salaries to cost of production for the current year/period with the corresponding figures for previous years/periods;
(f) comparison of the ratio of contribution towards provident fund to wages and salaries for the current year/period with the corresponding figures for previous years/periods;
(g) comparison of the ratio of contribution towards provident fund to wages and salaries for the current year/period with the rate(s) of contribution specified under the law governing provident fund;
(h) comparison of the ratio of contribution towards ESI to wages and salaries for the current year/period with the corresponding figure for previous years/periods;
(i) comparison of the ratio of contribution towards ESI to wages and salaries for the current year/period with the rate(s) of contribution specified under the law governing the ESI.

Bonus

28. In the case of provision for bonus, the auditor should examine whether the liability is provided for in accordance with the Payment of Bonus Act, 1965, and/or agreement with the employees or award of competent authority. Where the bonus actually paid is in excess of the amount required to be paid as per the provisions of the applicable law/agreement/award, the auditor should specifically examine the authority for the same (e.g., resolution of the board of directors in the case of a company).

Retirement Benefits

29. The auditor should examine whether the entity is liable to pay any retirement benefits to its employees such as provident fund, superannuation/pension, gratuity, etc., whether in pursuance of requirements of any law and/or in terms of agreement with the employees. If so, the auditor should examine whether the amount payable has been computed in accordance

---

8 Attention is invited in this regard to Accounting Standard (AS) 15, "Accounting for Employees Benefits".
with the relevant legal and/or contractual requirements. In respect of gratuity/pension, the auditor should specifically examine whether the provision for accruing gratuity/pension liability has been made by the entity. The auditor should examine the adequacy of provision with reference to the actuarial certificate obtained by the entity. In case the entity has not obtained such an actuarial certificate, the auditor should examine that the method followed by it, say, group gratuity insurance scheme taken by the entity, for calculating the accrued liability for gratuity is rational.

**Other Conversion Costs**

30. The auditor should verify the other conversion costs (such as power and fuel, processing charges, etc.) with reference to the supporting documents and related agreements. In case the material is sent outside to third parties for processing, necessary charges including existence of materials, wastage, etc., need to be ascertained and accounted for. In addition, the auditor may also compare the amount of expense on a particular item with the corresponding figure for previous years. Similarly, he may work out the ratios of different items of conversion costs to total cost of production for the current year and compare the same with the corresponding figures for previous years.

**Establishment and General Administrative Expenses**

31. The auditor should verify establishment expenses and general administrative expenses such as insurance, rent, rates, conveyance, travelling, telephone, entertainment, printing and stationery, general expenses, etc., with reference to the sanction of the competent authority, the supporting documents, related agreements and the rules and regulations followed by the entity. The auditor may also compare the amounts of these expenses with the corresponding figures for previous years. Similarly, he may work out the ratios of different items of expenses to sales for the current year and compare the same with the corresponding figures for previous years.

**Interest and Financial charges**

32. The auditor should verify the amount of interest expense for the year with reference to the terms and conditions of relevant agreements. The auditor may also work out the ratio of interest expense for the year to average interest-bearing loans and advances outstanding during the year and compare it with the corresponding figure for previous years and reconcile the same. The auditor should particularly examine that interest as well as other financing costs such as commitment fees on funds borrowed for a qualifying asset included in the gross book value of the asset to which they relate and have not been charged to the Profit and Loss Account of the period in which they are incurred. If the entity has paid any penal interest, it should also be examined. Such interest should be disclosed as part of normal interest. The auditor should consider, having regard to the materiality, whether it requires separate disclosure.

---

9 Attention is also invited in this regard to Standard on Auditing (SA) 620, “Using the Work of an Expert”.
10 Attention is invited in this regard to Accounting Standard (AS) 16, “Borrowing Costs”.

© The Institute of Chartered Accountants of India
DEPRECIATION

33. The auditor should check the calculation of depreciation. The total depreciation arrived at should be compared with that of previous years to identify reasons for variations. The auditor should particularly examine whether the depreciation charge having regard to rate of depreciation and method of depreciation followed consistently is adequate keeping in view the generally accepted bases of accounting for depreciation\(^\text{11}\). Alternatively, the auditor may consider qualifying his report. In case, assets have been revalued by entity during the year, the auditor should ensure that the depreciation has been computed properly.

RESEARCH AND DEVELOPMENT EXPENSES

34. The auditor should verify various items of expenses incurred on research and development with reference to supporting documents and related agreements. For example, the cost of materials consumed for research and development may be verified with reference to such documents as purchase invoices, goods received notes, records relating to issue of materials, etc. The auditor should particularly examine whether the accounting policy followed by the entity regarding treatment of research and development costs is in accordance with Accounting Standard (AS) 8, “Accounting for Research and Development”.

35. The auditor should examine whether the deferral meets the appropriate legal requirements, if any. If an accounting policy for deferral of research and developments is adopted, it should be applied to all such projects which meet the criteria laid down for deferral under AS 8. The auditor should examine whether the criteria laid down in AS 8 which previously justified the deferral of certain research and development costs no longer apply, the unamortised balance has been charged as an expense of the year. Similarly, the auditor should examine that where the criteria for deferral continue to be met but the amount of unamortised balance of the deferred research and development costs and other relevant costs exceed the expected future revenues/benefits related thereto, such excess has been charged as an expense immediately.

REPAIRS AND MAINTENANCE

36. The auditor should scrutinise the repairs and maintenance account to ascertain that new fixed assets and substantial improvements to existing assets have not been included in repairs and maintenance. The auditor should exercise special care particularly in case large amounts charged to the Profit and Loss Account.

CONTINGENCIES

37. In respect of product warranties, service contracts, performance warranties, etc., the auditor should examine whether provisions have been made in accordance with Accounting Standard (AS) 4, “Contingencies and Events Occurring After the Balance Sheet Date”. The auditor should also examine the reasonableness of the basis adopted for quantifying the provision with reference to the relevant agreements and the assessment based on his past experience.

\(^{11}\) Attention is also drawn to Accounting Standard (AS) 6, “Depreciation Accounting”.

© The Institute of Chartered Accountants of India
TAXES ON INCOME

38. The auditor should examine that tax expense or tax saving has been properly computed and disclosed in the financial statements. The tax expense for the period which comprises current tax and deferred tax is to be included in the determination of net profit or loss for the period under audit. In case of companies attracting minimum alternate tax, it has to be ensured that proper provision has been considered in the accounts. The auditor should examine that the deferred taxes have been recognised for all timing differences subject to consideration of prudence in respect of deferred tax assets as set out in Accounting Standard (AS) 22, *Accounting for Taxes on Income*. If there is a material departure from the provisions of AS 22, the auditor should qualify his report.

39. In respect of assessments completed, revised or rectified during the year, the auditor should examine whether suitable adjustments have been made in respect of additional demands or refunds, as the case may be. The relevant orders received up to the time of audit should be considered and, on this basis, it should be examined whether adjustment is required in the financial statements.

40. If the entity disputes its liability in regard to demands raised, the auditor should examine whether there is a positive evidence or action on the part of the entity to show that it has not accepted the demand for payment of tax or duty, e.g., where it has gone into appeal under relevant provisions of the Income-tax Act, 1961. Where an application for rectification of mistake has been made by the entity, the amount should be regarded as disputed. Where the demand notice/intimation for the payment of tax is for a certain amount and the dispute relates to only a part and not the whole of the amount, only such amount should be treated as disputed. A disputed tax liability may require a provision or suitable disclosure (see Accounting Standard 4, *Contingencies and Events Occurring After the Balance Sheet Date*). In determining whether a provision is required, the auditor should, among other procedures, make appropriate inquiries of management, review minutes of the meetings of the board of directors and correspondence with the entity's lawyers, and obtain appropriate management representations.

41. The auditor should obtain from the management, a statement showing the status of pending tax matters. He should examine the statements to assess the adequacy of provisions made in respect of those matters in the context of their current status.

SPECIAL CONSIDERATIONS IN THE CASE OF A COMPANY

42. In the case of audit of a company, in addition to the procedures described above, the auditor should also carry out appropriate audit procedures in respect of matters which are specifically required to be examined under the provisions of the Companies Act, 1956. Some of the illustrative procedures specifically applicable in the case of audit of a company are described below. It may be clarified that the following is not an exhaustive list of additional procedures to be carried out in the case of audit of expenses in the case of a company.

---

12 Attention is drawn to Accounting Standard (AS) 22, *Accounting for Taxes on Income*. © The Institute of Chartered Accountants of India
(a) The auditor should examine whether the managerial remuneration paid or payable by the company is within the limits laid down under section 198 and Schedule XIII to the Companies Act, 1956. The auditor should also examine whether the remuneration paid or payable to the directors of the company, including any managing or whole-time director, has been determined by the Articles of Association of the company or by a resolution of the company passed in a general meeting. The auditor should also examine whether the remuneration of directors complies with the provisions of section 309 of the Companies Act, 1956. The auditor should further examine whether the computation of net profit for purposes of managerial remuneration is in accordance with sections 349 and 350 of the Companies Act, 1956.

(b) The auditor should examine whether the contributions, if any, made by the company to charitable and other funds not directly relating to the business of the company or the welfare of its employees comply with the provisions of section 293 of the Companies Act, 1956. According to this section, the board of directors of a public company cannot, except with the consent of the company in general meeting, contribute to charitable and other funds not directly relating to the business of the company or the welfare of its employees, any amounts the aggregate of which will, in any financial year, exceed Rs.50,000 or 5 per cent of the average net profits of the company as determined in accordance with the provisions of section 349 and section 350 during the three financial years immediately preceding, whichever is greater. The auditor should examine whether the Memorandum of Association of the company empowers it to make contributions to charitable or other funds not directly relating to the business of the company or the welfare of its employees. If the objects clause in the Memorandum does not contain such authority, the company has no power to make such contributions.

The auditor should ask the management to prepare a schedule of contributions to various funds covered by section 293 made during the year, giving the names of the institutions to which contributions have been made, the amounts paid and the dates on which the contributions were approved by the board of directors. He should also ask the management to prepare a computation showing the limits of permissible contributions which can be made under this section.

(c) The auditor should examine whether political contributions made by the company are within the limit prescribed in section 293A of the Companies Act, 1956.\(^\text{13}\) Where the limit laid down under section 293A is adhered to and the facts are properly disclosed, the auditor has no further duty. Where, however, the facts regarding such contributions are not properly disclosed, the auditor should qualify his report and state the facts therein. Where the auditor has genuine doubt regarding the applicability of the Section, he should ensure that the fact is properly disclosed in his audit report.

Where the auditor is satisfied that political contributions have been made in excess of the limit prescribed in section 293A, he should bring this to the attention of the shareholders.

\(^{13}\) Reference may be made in this regard to the Guidance Note on Section 293A of the Companies Act, 1956 and the Auditor.
by qualifying his audit report and making a mention of the excess amount involved, if ascertainable.

The auditor should obtain a certificate from company's board of directors to the effect that all amounts of contributions to political parties or for any political purpose to any person falling under the provisions of section 293A have been brought into the books of account of the company and that no amounts of such nature other than those so included in the books have been paid/given, directly or indirectly.

(d) The auditor should examine whether the contribution, if any, to the National Defence Fund or any other fund approved by the Central Government for the purpose of national defence complies with the provisions of section 293B of the Companies Act, 1956. This section empowers the board of directors to make such contributions. It may be noted that unlike the contributions to charitable or other funds not directly relating to the business of the company or to the welfare of its employees, contributions to National Defence Fund (or other similar funds) can be made by a company even where the Memorandum of Association of the company does not specifically empower it in this regard. The auditor should examine whether the total amount or amounts contributed by the company to the National Defence Fund (or other similar funds) during the year have been suitably disclosed in the profit and loss account.

(e) In respect of payments to sole-selling agents, the auditor should examine whether the provisions of sections 294, 294A and 294AA have been complied with.

(f) The auditor should examine whether the provisions of section 297 have been complied with in appropriate cases. He should also examine compliance with the terms and conditions, if any, stipulated by the Central Government in its approval under the proviso to sub-section (1) of section 297.

(g) In case any partner or relative of a director of the company, any firm in which such director, or relative of such director, is a partner, any private company of which such director is a director or member, or any director, or manager of such a private company, holds any office or place of profit under the company or under any subsidiary of the company, the auditor should examine whether the provisions of section 314 have been complied with.

(h) The auditor should examine whether any personal expenses have been charged to revenue account.

(i) The auditor should examine whether the transaction of purchase of goods and materials and services, made in pursuance of contracts or arrangements entered in the register(s) maintained under section 301 of the Companies Act, 1956, as aggregating during the year to Rs. 50,000 (Rupees Fifty Thousand) or more in respect of each party, have been made at prices which are reasonable having regard to prevailing market prices for such

\* This limit has been enhanced to Rs. five lacs by the Companies (Auditor’s Report) Order, 2003.
goods, materials and services or the prices at which transaction for similar goods or service have been made with other parties.\textsuperscript{14}

(j) The auditor should examine whether any undisputed amounts payable in respect of income tax, wealth tax, sales tax, customs duty and excise duty were outstanding as at the last day of financial year concerned, for a period of more than six months from the date they became payable have been reported under MAOCARO, 1988\textsuperscript{@@}.

EXAMINATION OF PRESENTATION AND DISCLOSURE

43. The auditor should satisfy himself that the expenses have been properly classified and disclosed in the financial statements. Where the relevant statute lays down any disclosure requirements in this behalf, the auditor should examine whether the same have been complied with.

MANAGEMENT REPRESENTATION

44. The auditor should consider obtaining a management representation on expenses charged to the statement of profit or loss when other sufficient appropriate audit evidence cannot reasonably be expected to exist.\textsuperscript{15}

DOCUMENTATION

45. The auditor should maintain adequate working papers regarding audit of expenses.\textsuperscript{16}

\textsuperscript{14} Reference may be made in this regard to the Statement on the Companies (Auditor's Report) Order, 2003 (Revised in 2005).
\textsuperscript{@@} Replaced by the Companies (Auditor's Report) Order, 2003.
\textsuperscript{15} Reference may be made in this regard to Standard on Auditing (SA) 580, “Representation by Management”.
\textsuperscript{16} Reference may be made in this regard to Standard on Auditing (SA) 230, “Documentation”.

© The Institute of Chartered Accountants of India
GUIDANCE NOTE ON SECTION 227(3)(e) AND (f) OF THE COMPANIES ACT, 1956 [REVISED]*

INTRODUCTION

1. Section 227 of the Companies Act, 1956 (hereinafter referred to as the "Act") deals with the powers and duties of the auditors of companies. Section 227(1A) of the Act requires the auditor to make certain specific enquiries during the course of audit. Section 227(2) of the Act requires the auditor, inter alia, to give his report to the members of company on the accounts examined by him, and on every balance sheet and profit and loss account and every document declared to be a part of or annexed to such balance sheet or profit and loss account which are laid before the company in a general meeting during the tenure of the auditor's office. Sub-section (3) of section 227 of the Act also lays down certain matters necessarily required to be reported upon by the auditor in his report. The auditor is also required to include a statement on the matters specified in the Companies (Auditor's Report) Order, 2003 (Revised 2005) (hereinafter referred to as “CARO, 2003”), issued under section 227(4A) of the Act. Sub-section (3) of section 227 of Act provides as follows:

"(3) The auditor's report shall also state -

(a) whether he has obtained all the information and explanations, which to the best of his knowledge and belief, were necessary for the purposes of his audit;

(b) whether, in his opinion, proper books of account, as required by law, have been kept by the company so far as appears from his examination of those books, and proper returns adequate for the purposes of his audit have been received from branches not visited by him;

(bb) whether the report on the accounts of any branch office audited under section 228 by a person other than the company's auditor has been forwarded to him as required by clause (c) of sub-section (3) of that section and how he has dealt with the same in preparing the auditor's report;

(c) whether the company's balance sheet and profit and loss account dealt with by the report are in agreement with the books of account and returns;

(d) whether, in his opinion, the profit and loss account and balance sheet comply with the accounting standards referred to in sub-section (3C) of section 211;

(e) in thick type or in italics the observations or comments of the auditors which have any adverse effect on the functioning of the company;

(f) whether any director is disqualified from being appointed as director under clause (g) of sub-section (1) of section 274;

(g) whether the cess payable under section 441A has been paid and if not, the details of the amount of cess not paid.  

2. In terms of reporting requirements under sub-sections (2) and (3) of section 227 of the Act, matters on which the auditor has to report upon, can be broadly divided into two categories as under:

(i) statements of fact; and

(ii) opinions.

3. The statements of fact are:

(i) whether he has obtained all the information and explanations which to the best of his knowledge and belief were necessary for the purposes of his audit;

(ii) whether the report on the accounts of any branch office audited under section 228 by a person other than the company's auditors has been forwarded to him as required by section 228(3)(c) and how he has dealt with the same in preparing the auditor's report;

(iii) whether the company's balance sheet and profit and loss account dealt with by the report are in agreement with the books of account and returns;

(iv) whether any director is disqualified from being appointed as a director under clause (g) of sub-section (1) of section 274; and

(v) whether the cess payable under section 441A has been paid and if not, the details of the amount of cess not paid.

4. The opinions which the auditor is required to express are:

(i) whether proper books of account as required by law have been kept by the company so far as it appears from the examination of the books and proper returns adequate for the purposes of the audit have been received from branches not visited by him;

(ii) whether the profit and loss account and balance sheet comply with the accounting standards referred to in sub-section (3C) of section 211;

(iii) whether the accounts give the information required by the Act in the manner so required; and

(iv) whether the accounts give a true and fair view, in the case of the balance sheet of the state of the company's affairs, and in the case of the profit and loss account, of the profit or loss for the year.

SCOPE OF THE GUIDANCE NOTE

5. This Guidance Note is intended to assist the auditors in discharging their duties in respect of clauses (e) and (f) of sub-section (3) of section 227 of the Act. Clause (e) of the
said sub-section creates a requirement for the auditor to consider whether any matter leading to the modification of the auditor's report on financial statements is likely to have an adverse effect on the functioning of the company. It may be noted that the matters that lead to modification in the auditor's report on financial statements are an emphasis of matter paragraph, qualification, situation giving rise to limitation on scope and disagreement with the management. If the matter leading to the modification of the auditor's report on financial statements is likely to have an adverse effect on the functioning of the company, the auditor is required to highlight such matter in **thick** type or in *italics*. Under clause (f) of sub-section (3) of section 227 of the Act, the auditor is required to state whether any director of the company is disqualified from being appointed a director of a company in terms of clause (g) of sub-section (1) of section 274 of the Act.

**REPORTING UNDER SECTION 227(3)(E) OF THE ACT**

6. The relevant extracts of section 227(3)(e) of the Act are reproduced below:

   "3. The auditor's report shall also state –

   ..............................................

   (e) in thick type or in italics, the observations or comments of the auditors, which have any adverse effect on the functioning of the company".

7. Clause (e) requires the auditor to highlight "in thick type or in italics, the observations or comments which have any adverse effect on the functioning of the company". An auditor's report may contain matters leading to modifications in the auditor's report on financial statements. Such matters may be related to issues which may have an adverse effect on the functioning of the company. The words "observations" or "comments" as appearing in clause (e) of section 227(3) are construed to have the same meaning as referring to "emphasis of matter paragraphs, qualifications, situations giving rise to limitation on scope, disagreements with the management leading to modification in the auditors report". Therefore, only such "observations" or "comments" which have an adverse effect on the functioning of the company are required to be stated in thick type or in italics. For the sake of clarity, it may be noted that neither the auditor's observations nor the comments made by him have any adverse effect on the functioning of a company. Instead, these observations or comments made by the auditor might contain matters which might have an adverse effect on the functioning of a company.

8. The Act does not specify the meaning of the phrase 'adverse effect on the functioning of the company'. The expression may be interpreted to mean that any event affecting the functioning of the company, observed by the auditor, should be reported upon even though it does not affect the financial statements, e.g., revocation of a license to manufacture one out of the many products during the year to which the financial statements relate, etc. However, such an interpretation would not only be beyond the scope of the audit of financial statements of the company but would also not be in accordance with the objective and concept of audit stipulated under the Act. A more logical and harmonious interpretation is that the amendment

---

2 Reference may be made to paragraphs 31 through 47 of Standard on Auditing (SA) 700, "The Auditor's Report on Financial Statements."
Auditing Pronouncements

9. The scope of the audit and auditor’s role remains as contemplated under the Engagement Standards and other relevant pronouncements issued by the Institute of Chartered Accountants of India as well as laid down in the Act, i.e., to lend credibility to the financial statements by reporting whether they reflect a true and fair view. SA 200A, “Objective and Scope of the Audit of Financial Statements” specifies, “the auditor’s opinion helps determination of the true and fair view of the financial position and operating results of an enterprise. The user, however, should not assume that the auditor’s opinion is an assurance as to the future viability of the enterprise or the efficiency or effectiveness with which management has conducted the affairs of the enterprise”. It also states, “the auditor’s work involves exercise of judgement, for example, in deciding the extent of audit procedures and in assessing the reasonableness of the judgements and estimates made by management in preparing the financial statements. Furthermore, much of the evidence available to the auditor can enable him to draw only reasonable conclusions therefrom. Because of these factors, absolute certainty in auditing is rarely attainable”. Further, it also clarifies that “in forming his opinion on the financial statements, the auditor follows procedures designed to satisfy himself that the financial statements reflect a true and fair view of the financial position and operating results of the enterprise. The auditor recognises that because of the test nature and other inherent limitations of an audit, together with the inherent limitations of any system of internal control, there is an unavoidable risk that some material misstatement may remain undiscovered. While in many situations the discovery of a material misstatement by management may often arise during the conduct of the audit, such discovery is not the main objective of audit nor is the auditor’s programme of work specifically designed for such discovery”.

10. There is no change in the objective and scope of an audit of financial statements because of inclusion of clause (e) in sub-section (3) of section 227 of the Act. The auditor expresses his opinion on the true and fair view presented by the financial statements through his report which may be modified in certain circumstances. However, the auditor would now have to evaluate subject matters leading to modification of the audit report to make judgement as to which of them has an adverse effect on the functioning of the company within the overall context of audit of financial statements of the company. Only such matters, which in the opinion of the auditor, deal with matters that have an adverse effect on the functioning of the company should be given in thick type or in italics. Conversely, such qualifications or adverse remarks of the auditor, which do not deal with matters that have adverse effect on the functioning of the company, need not be given in thick type or in italics. Examples of qualifications or adverse comments which have an adverse effect on the functioning of the company include a situation where the going concern assumption is considered inappropriate or there exists any item having a significant impact on the current financial results of the company and which might also have a material effect on the future results of the entity, e.g., non-determination of obsolete stocks / bad debts, significant impairment of the assets, etc.
11. As far as inquiries under section 227(1A) are concerned, the auditor is not required to report on these matters unless he has any special comments to make on any of the items referred to therein. The auditor may also consider highlighting such comments in **thick** type or in *italics* which have any adverse effect on the functioning of the company. Another issue which arises is whether any observation or comment made by the auditor in respect of his statements on matters specified in CARO, 2003 issued under section 227(4A) of the Act, which has any adverse effect on the functioning of the company, should also be reported in terms of this clause. In this regard, it is noted that section 227(4A) of the Act treats the comments on the matters specified in CARO, 2003 as a part of the auditor’s report. Accordingly, any observation or comment made by the auditor in his report under CARO, 2003 contain such matters, which, in his opinion, will have any adverse effect on the functioning of the company, should also be reported in **thick** type or *italics* as required by this clause. An example in this regard may be where an auditor in respect of paragraph 4(i)(c) of CARO, 2003 reports that there exists a substantial doubt that without the replacement of significant part of fixed assets sold during the year, the company would be able to continue as a going concern for the foreseeable future.

**Reporting under Section 227(3)(f) of the Act**

12. Clause (f) of section 227(3) of the Companies Act, 1956, is reproduced below:

> “227(3) The auditor’s report shall also state –
> 
> .................................................................
> 
> (f) whether any director is disqualified from being appointed as a director under clause (g) of sub-section (1) of section 274.”

13. In order to report upon clause (f) of sub-section (3) of section 227 of the Act, it is essential that the auditor understands the requirements of clause (g) of sub-section (1) of section 274 of the Act. The relevant extracts of section 274(1)(g) referred to in clause (f) of section 227(3), are reproduced below:

> "274(1) A person shall not be capable of being appointed director of a company, if—
> 
> .................................................................
> 
> (g) such person is already a director of a public company which –
> 
> (A) has not filed the annual accounts and annual returns for any continuous three financial years commencing on and after the first day of April, 1999; or
> 
> (B) has failed to repay its deposit or interest thereon on due date or redeem its debentures on due date or pay dividend and such failure continues for one year or more;
> 
> Provided that such person shall not be eligible to be appointed as a director of any other public company for a period of five years from the date on which such public
company in which he is a director failed to file annual accounts and annual returns under sub-clause (a) or has failed to repay its deposit or interest or redeem its debentures on due date or pay dividend referred to in clause (B)."

14. On a perusal of section 227(3)(f), it is apparent that the auditor of a company, public or private, has to report on whether any of the directors of the company is disqualified from being appointed as a director in terms of clause (g) of sub-section (1) of section 274 of the Act. This is because while clause (f) of section 227(3) is the operating clause, clause (g) of sub-section (1) of section 274 is the defining clause. Thus, in order to be able to make a statement pursuant to clause (f) of sub-section (3) of section 227 of the Act in his report, the auditor would need to satisfy himself as to whether any of the directors of the company is disqualified under section 274(1)(g) from being appointed as a director in a company. It may also be noted that where none of the directors of a private company have been directors in a public company, the disqualification mentioned under section 274(1)(g) would not get attracted since the disqualification under the said section is defined in respect of a person who is director of a public company.

15. Disqualification of a director for being appointed as a director of a company under section 274(1)(g) should be determined with reference to a particular date only. This is so because a director can become disqualified under the said section at any point of time during the year. Further, a director can attract the disqualification if any of the defaults mentioned under section 274(1)(g) is either done by the company being audited (if the company being audited is a public company) or any other public company in which a director of the company being audited is a director or has been a director in a public company which incurred the defaults and the period of five years has not elapsed. These factors make it impracticable for an auditor to determine whether any of the directors of the company attracted the disqualification under section 274(1)(g) at any point of time during the period covered by the auditor’s report. It is, therefore, practicable that whether any of the directors of the company has attracted disqualification should be considered as on a particular date, namely, at the balance sheet date.

16. The Department of Company Affairs3 ("the Department") vide its Notification numbered GSR 830(E) dated October 21, 2003, has issued "The Companies (Disqualification of Directors under section 274(1)(g) of the Companies Act, 1956) Rules, 2003 (hereinafter referred to as the “Rules”) to carry out the purpose of clause (g) of sub-section (1) of section 274 of the Act. The text of the Rules is reproduced in Appendix I to this Guidance Note.

17. The Rules are applicable to all public limited companies. However, the question regarding the applicability of the Rules to a company, which has been granted license under section 25 of the Act, and a private company, which is a subsidiary of a body corporate incorporated outside India, is required to be examined.

18. Section 25 of the Act only contains conditions subject to which the Central Government may dispense with the requirement to use the word "limited" or "private limited" in the name of a company. Thus, a public company, which is granted a license under section 25 of the Act,

---

3 Now "Ministry of Company Affairs".
Part-III: Guidance Notes

continues to be a public limited company under the Act and therefore the Rules would be applicable to such a public limited company.

19. As far as a private company, which is a subsidiary of a body corporate incorporated outside India is concerned, it may be noted that section 4(7) of the Act provides that:

“(7) A private company, being a subsidiary of a body corporate incorporated outside India, which, if incorporated in India, would be a public company within the meaning of this Act, shall be deemed for the purposes of this Act to be a subsidiary of a public company if the entire share capital in that private company is not held by that body corporate whether alone or together with one or more other bodies corporate incorporated outside India.”

20. By virtue of section 3(iv)(c), a private company, if it is a subsidiary of a body corporate incorporated outside India, which if incorporated in India would have been a public company and some part of its share capital is held by a legal entity in India, would become a public company within the meaning of the Act. Therefore, the Rules would also be applicable to such a private company.

DISQUALIFICATION UNDER SECTION 274(1)(G)

21. The situation for disqualification of a director, as envisaged in sub-clause (A) of clause (g) of section 274 (1) of the Act is that the concerned public company has not filed the annual accounts and annual returns for any continuous three financial years commencing on or after the first day of April 1999. Further, sub-rule (a) of Rule 3 lays down that in such a case, persons who are directors on the last due date for filing the annual accounts and the annual returns shall be disqualified from being appointed as a director of another public company. In this context, it is also necessary to understand as to what is the “last due date” as envisaged by the Rules. The last due date would mean the due date with reference to the annual accounts and annual returns of the last of the three consecutive financial years for which the annual accounts and annual returns have not been filed. The proviso to clause (g) of sub-section (1) of section 274 provides that the period of five years would be reckoned from the date as specified in sub-clause (A), on which the public company failed to file its annual accounts and annual returns. From the above, it is clear that if the following conditions are satisfied in respect of a person, he would become disqualified under sub-clause (A) of clause (g) of sub-section (1) of section 274 of the Act:

(a) The person is a director in a public company as on the last due date for filing the annual accounts and annual return for three continuous financial years. Thus, even if the person concerned has been appointed as a director in the public company only a few days before the last due date, the person would attract disqualification under section 274(1)(g). Further, a person who ceased to be a director of the public company as on the last due date for filing the annual accounts and annual return for three continuous financial years would not be disqualified from being appointed as a director of a public company.
(b) The public company has not filed the annual accounts and annual return for three consecutive financial years. Thus, if the said failure is not for a period of three continuous financial years, the disqualification would not be attracted.

(c) The public company has failed to file both, the annual accounts and annual return. Thus, if the company has filed either the annual accounts or annual return within the due dates, the disqualification would not be attracted.

(d) The period of five years has not elapsed since the date of default made by the public company. Thus, if the period of five years has elapsed since the date of the default, the person concerned shall not remain disqualified under sub-clause (A) of section 274(1)(g).

22. The situation for disqualification of a director, as envisaged in sub-clause (B) of clause (g) of section 274 of the Act is that the concerned public company has failed to repay its deposit or interest thereon on due date or redeem its debentures on due date or pay dividend and such failure continues for a period of one year or more. Further, sub-rule (b) of Rule 3 provides that if a company has failed to repay any deposit, irrespective of the enactment, rules or regulations under which the deposits have been accepted by the companies, or interest thereon, or redeem its debentures, or pay any dividend declared on the respective due dates, and if such failure continues for one year, as described in sub-clause (B) of clause (g) of sub-section (1) of section 274, then the directors of that company would stand disqualified immediately on expiry of one year from the respective due dates. The proviso to the Rule further provides that that all the directors who have been directors in the relevant year, from the due date to the expiry of one year after the due date, will also be disqualified. It may also be noted that the disqualification on account of the reasons cited under sub-rule (b) of Rule 3 of the Rules is also applicable to the reappointment as a director.

23. The explanation to Rule 3, however, clarifies that a company would not be considered as having defaulted in payment of the dividend referred to in sub-clause (B) of clause (g) of section 274(1) in the following situations:

(i) The dividend in question has not been claimed; or

(ii) The dividend in question has been transferred to a separate bank account, i.e., the Unpaid Dividend Account of the company in accordance with the requirements of section 205A of the Act; or

(iii) The dividend in question has been paid into the Investor Education and Protection Fund as required under section 205C of the Act.

24. The Department has also issued certain Circulars/Notifications in respect of operation/applicability of clause (g) of section 274(1) of the Act. A gist of these Notifications/Circulars is as under:

(i) In respect of sub clause (B) of clause (g) of section 274(1) of the Act, the Department, vide its general circular numbered 5 of 2003 (F No. 25/2001-CLV) dated 14-1-2003 has clarified that default in repayment of privately placed bonds/ debentures/ debt instruments by public financial institutions will not be considered as default to disqualify directors under section 274(1)(g) of the Act.
(ii) The Department has, vide its notification numbered GSR 829(E), also clarified that the provisions of clause (g) of sub section (1) of section 274 of the Act shall not be applicable to a Government company.

(iii) Further, the Department has also clarified, vide its general circular numbered 8/2002, dated 22-3-2002, that the nominee directors appointed by the public financial institutions and companies established under the Act of Parliament having non obstante provisions over the Companies Act, 1956 like IDBI, LIC, UTI, IIBI, etc., in their respective statutes shall not be liable to be disqualified under section 274(1)(g) of the Act. The Department has also clarified that the nominee directors appointed on the boards of assisted concerns or other public companies by (a) public financial institutions within the meaning of section 4A of the Act; (b) Central or State Government; and (c) banking companies are also exempt from the provisions of section 274(1)(g) of the Act.

25. The proviso to sub-section (1) of section 252 of the Act requires that a public company having a paid-up capital of rupees five crores or more; or one thousand or more small shareholders may have a director elected by such small shareholders in the manner as may be prescribed. The Department had, vide its Notification No. GSR. 168(E), dated March 9, 2001, issued the “Companies (Appointment of the Small Shareholders’ Director) Rules, 2001. The said Rules define “small shareholders” as “a shareholder holding shares of nominal value of twenty thousand rupees or less in a public company to which section 252 of the Act applies. The said Rules deal with the manner of election of small shareholders’ director, disqualification of such directors and vacation of office by such directors. Rule 5 of the said Rules which deals with the disqualification of small shareholders’ directors lists out certain conditions wherein a person shall not be capable of being appointed as a small shareholders’ director of a company. The said Rule 5, however, does envisage the situations outlined in clause (g) of section 274(1) as a condition for disqualification. Thus, a logical interpretation of the situation would be that a person appointed as a small shareholders’ director pursuant to the above mentioned Rules would not be subject to any disqualification arising in terms of clause (g) of section 274(1) of the Act.

26. The Companies (Disqualification of Directors under section 274(1)(g) of the Companies Act, 1956) Rules, 2003 (the “Rules”) have also introduced the concepts of “Disqualifying” and “Appointing” companies. As per Rule 2, a “disqualifying” company is “the company in which the default has occurred on account of which a director stands disqualified”. Further, Rule 2 also defines an “appointing” company as “the company in which an individual is seeking an appointment as a director, including reappointment as a director”. However, this distinction between the “appointing company” and “disqualifying company” apparently has no significance to the auditor since he is required to state in his report on the financial statements of the company whether any of the directors of the company as on the balance sheet is disqualified from being appointed as a director of a company under section 274(1)(g) of the Act.

27. Under Rule 9, every director in a public company registered under the Companies Act, 1956, is required to file Form DD-A, as prescribed in the Rules, before he is appointed or reappointed in any company. Rule 5 also casts a duty on every company which has failed to file its annual accounts and returns and/or fails to repay any deposit, interest, dividend, or fails
to redeem its debentures, as described in clauses (A) and (B) of clause (g) of sub-section (1) of section 274 of the Act, to immediately file a return in duplicate in Form DD-B (prescribed in the said Rules) with the Registrar of Companies.

28. Another point to note is that the provisions of clause (g) of section 274(1) of the Act do not find a place in the provisions of section 283 of the Act, which deals with vacation of office by the director(s). Therefore, a director should not be construed as having vacated his office merely because of his having incurred a disqualification under clause (g) of section 274(1) of the Act. Another question that arises in this regard is whether in case all the directors of a company are disqualified under section 274(1)(g), whether such directors can approve the financial statements of the company. As mentioned, in case a director of a company becomes disqualified from being appointed as a director in a company in terms of section 274(1)(g) of the Act, he continues to be a director of the company until the expiry of his term. Therefore, even in a case where all the directors become disqualified from being appointed as a director in a company they can approve the financial statements and continue to discharge the duties and responsibilities assigned by the Act.

DUTIES OF THE AUDITOR UNDER THE RULES

29. Rule 4 of the Rules deals with the duties of the statutory auditors of both the disqualifying as well as the appointing companies. Sub-rule (a) of Rule 4 requires that the statutory auditors of both the appointing as well as the disqualifying company:

(i) report under section 227(3)(f) of the Act to the members of the respective companies as to whether any director is disqualified from being appointed as a director under clause (g) of section 274(1) of the Companies Act, 1956; and

(ii) furnish a certificate every year as to whether on the basis of his examination of the books and records of the company, any director of the company is disqualified as a director or not.

30. It is, therefore, clear that the statutory auditors of both the disqualifying as well as the appointing company would, in addition to their report in terms of section 227(3)(f) of the Act, would also have to, each financial year, furnish a certificate as required in Rule 4.

31. Sub Rule (b) of Rule 4 further casts a duty on the statutory auditors of the “disqualifying” company to report to the members of the company as required under section 227(3)(f) whether any director in the company has been disqualified during the year from being reappointed as director, or being appointed as a director in another company under clause (g) of section 274(1).

Auditor’s Procedures for Compliance with Section 227(3)(f) and the Rules

32. In order to comply with the requirements of section 227(3)(f) of the Act and the Rules, the auditor should obtain a written representation as to:

(a) Names of directors of the company during the period covered by the auditor’s report (including the directors at the balance sheet date), showing separately, the names of
nominee directors and directors appointed in accordance with the Companies (Appointment of the Small Shareholders' Director) Rules, 2001

(b) Particulars of appointment/reappointment, resignation/retirement etc., of each of the above directors.

(c) Whether in case of directors appointed on or after the date of the Companies (Disqualification of Directors under section 274(1)(g) of the Companies Act, 1956) Rules, 2003 coming into effect, each such director has submitted Form DD-A, as required under the said Rules.

(d) That the information contained in the register of directors maintained under section 303(1) is updated to show the position as on the balance sheet date.

(e) Whether the company has committed any default as envisaged in sub-clauses (A) and/or (B) of clause (g) of section 274(1) of the Act.

(f) In case the company has committed a default under sub-clauses (A) and/or (B) of clause (g) of section 274(1) of the Act, whether the company has furnished the Form DD-B, as required by the Rules.

33. The auditor should also obtain a written representation from the directors of the company as to whether they have attracted the disqualification in terms of clause (g) of sub-section (1) of section 274 of the Act. The auditor should require the directors to submit a written representation in respect of each public company in which they are directors as to whether as on the balance sheet date the public companies of which he is a director have defaulted in terms of the section 274(1)(g). There is a practice amongst many companies that the directors obtain a legal compliance report, periodically, to ensure that the companies have complied with all the legal requirements. Such compliance reports generally also contain the information regarding filing of annual accounts and annual return and compliance with clause (g) of sub-section (1) of section 274 can be a part of the said legal compliance report. Such a compliance report can, therefore, be submitted by the director as an evidence in this regard. In addition to written representation obtained from the director in respect of public companies of which he is a director, the auditor should also obtain written representation from the director in respect of each of those public companies in which he was a director in the past as to whether or not the director is disqualified to be appointed as a director in terms of proviso to Section 274(1)(g). The auditor should insist that written representations provided by the management as well as the directors appointed prior to the issuance of Rules or the legal compliance report, as the case may be, should be taken on record by the Board of Directors of the company being audited. However, in no case, is the auditor of either the appointing company or the disqualifying company expected to make any roving enquiries from such other companies in which the concerned director is also a director, as to whether or not they have committed any default in terms of sub clauses (A) and/or (B) of clause (g) of section 274(1) of the Act.

34. The auditor should verify the information provided by the management and the directors from the information contained in the register maintained under section 303(1) of the Act. The said register contains various particulars relating to all the directors of the company including
particulars in respect of the office of director, managing director, etc. The auditor can also examine the Form 32 filed by the company during the financial year under section 303(2) of the Act so as to know the changes, for example, appointment, retirement, resignation etc., of directors during the year. Form DD-A filed by the directors would also assist the auditor in assessing whether any director appointed during the year, at the time of appointed, was disqualified under section 274(1)(g) of the Act.

35. In case company being audited happens to be a public company which has not filed the annual accounts and annual returns for any continuous three financial years commencing on and after 1st April, 1999; or has failed to repay its deposit or interest thereon on due date or redeem its debentures on due date or pay dividend and such failure continues for one year or more; then the auditor must report that all the directors are disqualified from being appointed as director in terms of clause (g) of sub-section (1) of section 274 of the Act. The auditor, in such a case, should also examine the return in Form DD-B to be filed under the Rules. Form DD-B contains the particulars of directors during the relevant period.

36. Since the Rules are applicable to public limited companies only, Forms DD-A and DD-B would not be available to the auditor a private company. In such cases, the auditor’s employs the same procedures to comply with the requirements of section 227(3)(f) which are applied by an auditor of a public company except that the auditor is not required to examine Forms DD-A and DD-B because of their non-availability in a private company.

37. The reporting under clause (f) of sub-section (3) of section 227 of the Act may be as follows, keeping in view the situation concerned:

(a) Where all the directors of the company are able to produce the evidence as specified in paragraph 33 above that the public company/(ies) of which they are directors have not defaulted in terms of section 274(1)(g), the auditor may report as follows:

“On the basis of the written representations received from the directors, and taken on record by the Board of Directors, we report that none of the directors is disqualified as on 31st March, 2XXX from being appointed as a director in terms of clause (g) of sub-section (1) of section 274 of the Companies Act, 1956”.

(b) In a situation where a director is unable to produce the written representation as specified in paragraph 33 above, the auditor may report as follows:

“Mr. X, who is also a director of ABC Ltd., has not produced written representation as to whether ABC Ltd., in which Mr. X is a director as on 31st March, 2XXX, had not defaulted in terms of section 274(1)(g) of the Companies Act, 1956. In the absence of this representation, we are unable to comment whether Mr. X is disqualified from being appointed as a director under clause (g) of sub-section (1) of section 274 of the Companies Act, 1956. As far as other directors are concerned, on the basis of the written representations received from such directors, and taken on record by the Board of Directors, we report that none of the remaining directors is disqualified as on 31st March, 2XXX from being appointed as a director in terms of clause (g) of sub-section (1) of section 274 of the Companies Act, 1956.”
(c) Where on the basis of the written representation received from a director, it is noted that the director was disqualified from being appointed as a director under this clause, the auditor may report as follows:

"On the basis of the written representation received from Mr. Y, who is a director of ABC Ltd., as on 31st March 2XXX, and taken on record by the Board of Directors, we report that he is disqualified from being appointed as a director in terms of clause (g) of sub-section (1) of section 274 of the Companies Act, 1956.

As far as other directors are concerned, on the basis of the written representations received from such directors, and taken on record by the Board of Directors, we report that none of the remaining directors is disqualified as on 31st March 2XXX from being appointed as a director in terms of clause (g) of sub-section (1) of section 274 of the Companies Act, 1956."

Certificate under the Rules

38. As mentioned, sub-rule (a) of Rule 4 requires that it shall be the duty of the statutory auditor to furnish a certificate each year as to whether on the basis of his examination of the books and records of the company, any director of the company is disqualified for appointment as a director or not. The Rules, however, are silent as to whom the said certificate would be addressed. An interpretation could be that the auditor should furnish such a certificate to the shareholders of the company. However, this does not seem to be logical since the shareholders would get the same information from the auditor’s statement in respect of clause (f) of sub-section (3) of section 227 of the Act. Therefore, it would be appropriate that the certificate is addressed to the Board of Directors of the Company. It may also be noted that the Rules are also silent as to the format and contents of the certificate. An illustrative format of the said certificate is given in Appendix II, which may be used by the auditors.

Appendix I

PUBLISHED IN THE GAZETTE OF INDIA, PART II, SECTION 3(i), EXTRAORDINARY

Ministry of Finance

(Department of Company Affairs)

NOTIFICATION

New Delhi, the 21st October, 2003

G.S.R. 830 (E).- In exercise of the powers conferred by clause (b) of sub-section (1) of section 642 of the Companies Act, 1956 (1 of 1956), the Central Government hereby makes the following rules to carry out the purpose of clause (g) of sub-section (1) of section 274 of the said Act, namely :-

1. Short Title, Commencement and Extent

(1) These rules may be called the Companies (Disqualification of Directors under section 274(1)(g) of the Companies Act, 1956) Rules, 2003.
These rules shall come into force from the date of their notification in the Official Gazette.

These rules shall apply to all public limited companies registered under the Companies Act, 1956.

2. Definitions

In these Rules, unless the context otherwise requires,-

(a) “disqualifying company” is the company in which the default has occurred on account of which a director stands disqualified;

(b) “appointing company” is the company in which an individual is seeking appointment as a director, including re-appointment as director.

3. Disqualifications under clause (g) of sub-section (1) of section 274 of the Companies Act, 1956

(a) Whenever a company fails to file the annual accounts and annual returns, as described in sub-clause (A) of clause (g) of sub-section (1) of section 274, persons who are directors on the last due date for filing the annual accounts and the annual returns for any continuous three financial years commencing on and after the first day of April, 1999, shall be disqualified.

(b) If a company has failed to repay any deposit, irrespective of the enactment, rules or regulations under which the deposits have been accepted by the companies, or interest thereon, or redeem its debentures, or pay any dividend declared on the respective due dates, and if such failure continues for one year, as described in sub-clause (B) of clause (g) of sub-section (1) of section 274, then the directors of that company shall stand disqualified immediately on expiry of that one year from the respective due dates:

Provided that all the directors who have been directors in the relevant year, from the due date to the expiry of one year after the due date, will be disqualified:

Provided further that disqualification on account of the reasons cited under this Rule shall also apply to the reappointment as a director.

Explanation-For the purpose of this rule, it is clarified that non-payment of dividend referred to in sub-clause (B) of clause (g) of sub-section (1) of section 274 due to the reason of dividend not being claimed or kept in separate bank account as required under section 205A of Companies Act, 1956 or paid into Investors Education & Protection Fund as required under section 205C of that Act shall not be deemed to be a failure to make payment of dividend.

4. Duty of Statutory Auditor to Report on Disqualification

(a) It shall be the duty of statutory auditor of the appointing company as well as disqualifying company, as required under section 227(3)(f) to report to the members of the company whether any director is disqualified from being appointed as director under clause (g) of sub-section (1) of section 274 and to furnish a certificate each year as to whether on the
basis of his examination of the books and records of the company, any director of the company is disqualified for appointment as a director or not.

(b) It shall be the duty of the statutory auditors of the “disqualifying company” as required in section 227(3)(f) to report to the members of the company whether any director in the company has been disqualified during the year from being re-appointed as director, or being appointed as director in another company under clause (g), of sub-section (1) of section 274.

5. **Duty of Company to Intimate Disqualification**

Whenever a company fails to file the annual accounts and returns, or fails to repay any deposit, interest, dividend, or fails to redeem its debentures, as described in clauses (A) and (B) of clause (g) of sub-section (1) of section 274, the company shall immediately file a return in duplicate in Form ‘DD-B’, prescribed under these rules for this purpose, to the Registrar of Companies, furnishing therein the names and addresses of all the Directors of the company during the relevant financial years:

Provided that names of such directors who have been exempted from application of Section 274(1)(g) by the Central Government, from time to time, shall be excluded.

Provided further that no unusual abbreviations or short forms shall be used in filling up the Form ‘DD-B’, which shall give such details as may be necessary to distinguish and identify each director without any ambiguity.

6. **Failure to Intimate Disqualification Shall render Director as Officer in Default**

When a company fails to file the Form ‘DD-B’ as above within 30 days of the failure that would attract disqualification under Section 274(1)(g), officers of the company listed in section 5 of the Companies Act, 1956 shall be officers in default.

7. (a) Upon receipt of the Form ‘DD-B’ in duplicate under Rule 5, the Registrar of Companies shall immediately register the document and place one copy of it in the document file for public inspection.

(b) The Registrar of Companies shall forward the other copy to the Central Government.

8. **Names of the Disqualified Directors on the Website etc.**

(a) The Central Government shall place on the web site of the Department of Company Affairs the names and addresses and such other details including names and details of the companies concerned, as may be necessary, in respect of all the disqualified directors.

(b) The Central Government may also publicize the names of disqualified directors in such manner as it may consider appropriate.

(c) The Central Government shall take such steps as may be required to update its web-site to ensure that name of the person, in whose respect disqualification period has expired after 5 years, is deleted from the web-site.
9. **Duty of Every Director**

Every director in a public company registered under the Companies Act, 1956 shall file Form ‘DD-A’, prescribed under these Rules, before he is appointed or re-appointed.

10. If any question arises as to whether these rules are or are not applicable to a particular company, such question shall be decided by the Central Government.

11. **Punishment for Contravention of the Rules**

If a company or any other person contravenes any provision of these rules for which no punishment is provided in the Companies Act, 1956, the company and every officer of the company who is in default or such other person shall be punishable with fine which may extend to five thousand rupees and where the contravention is a continuing one, with a further fine which may extend to five hundred rupees for every day after the first, during which the contravention continues.

12. On the commencement of these rules, all rules, orders or directions in force in relation to any matter for which provision is made in these Rules shall stand repealed, except as respects things done or omitted to be done before such repeal.

[F. No.1/8/2002-CL.V]
Rajiv Mehrishi,
Joint Secretary

**FORM ‘DD-A’**

Companies (Disqualification of Directors under section 274(1)(g) of the Companies Act, 1956) Rules, 2003

Intimation by Director

[Pursuant to Section 274(1)(g)]

Registration No. of Company ______________
Nominal Capital Rs._____________
Paid-up Capital Rs. _____________
Name of Company__________________________
Address of its Registered Office___________________

To
The Board of Directors
of __________________________

I _______________ son/daughter/wife of _______________ resident of _______________ director/managing director/manager in the company hereby give notice that I am/was a director in the following companies during the last 3 years:
Part-III: Guidance Notes

<table>
<thead>
<tr>
<th>Name of the Company</th>
<th>Date of Appointment</th>
<th>Date of Cessation</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

I further confirm that I have not incurred disqualification under section 274(1)(g) of the Companies Act, 1956 in any of the above companies, in the previous financial year, and that I, at present, stand free from any disqualification from being a director.

or

I further confirm that I have incurred disqualifications under section 274(1)(g) of the Companies Act, 1956 in the following company(s) in the previous financial year, and that I, at present stand disqualified from being a director.

<table>
<thead>
<tr>
<th>Name of the Company</th>
<th>Date of Appointment</th>
<th>Date of Cessation</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Signature
(Full Name)
Dated this _________ day of _________

FORM ‘DD-B’
Report by a Public Company

[Pursuant to Section 274(1)(g) read with Rule 5 of Companies (Disqualification of Directors under section 274(1)(g) of the Companies Act, 1956) Rules, 2003]

Registration No. of Company:__________________________
Nominal Capital Rs.____________________________________
Paid-up Capital Rs. ____________________________________
Name of Company_____________________________________
Address of its Registered Office__________________________

To
The Registrar of Companies,

It is hereby reported under section 274(1)(g) of Companies Act, 1956, that M/s. ___________ have failed to (i) file the annual accounts and annual returns for the last three financial years, or (ii) repay deposits or interest thereon on due date being ___________ or redeem its debentures on due date being ___________ or pay dividend declared by the company since ___________ or both. The period of one year has expired on ___________.

© The Institute of Chartered Accountants of India
The name and address of directors at the relevant period are as under:

(a) Director’s name in full, without abbreviations

(b) Director’s name as per company’s records (abbreviations may be expanded and shown)

(c) Address of the Director
   (i) Permanent
   (ii) Present

(d) Positions held by the director in the last 5 years, prior to disqualification:

Signature
Designation*

Dated this ______ day of ______

*State whether Director, Managing Director, Manager or Secretary

Appendix II

FORMAT OF THE CERTIFICATE TO BE ISSUED UNDER RULE 4 (a) OF THE COMPANIES (DISQUALIFICATION OF DIRECTORS UNDER SECTION 274(1)(g) OF THE COMPANIES ACT, 1956) RULES, 2003

Auditor’s Certificate

Rule 4 (a) of the Companies (Disqualification of Directors under section 274(1)(g) of the Companies Act, 1956) Rules, 2003

To,
The Board of Directors of __________ (name of the company)

In terms of Rule 4(a) of the Companies (Disqualification of Directors under section 274(1)(g) of the Companies Act, 1956) Rules, 2003, l/we ………………………………………………………………………… (name of the chartered accountant/ firm, as the case may be), based on our examination of the books and records of the company, carried out in accordance with the requirements of the Guidance Note on Section 227(3)(e) and (f) of the Companies Act, 1956, issued by the Institute of Chartered Accountants of India, do hereby certify that none of the directors of the company, i.e., ………………………………………….. (name of the company) as on ______ (date of the balance sheet) is disqualified for appointment as a director in the aforementioned company in terms of clause (g) of sub section (1) of section 274 of the Companies Act, 1956.

Date:
Address:

For XYZ & Co.,
Chartered Accountants

……………………………………
(Signature)

(Name of the Member Signing the Certificate)

(Designation 

……………………………………
(Membership Number)

© The Institute of Chartered Accountants of India

4 Partner or proprietor, as the case may be.
GUIDANCE NOTE ON COMPUTER ASSISTED AUDIT TECHNIQUES (CAATs)*

INTRODUCTION
1. The overall objectives and scope of an audit do not change when an audit is conducted in a computer information systems (CIS) environment. The application of auditing procedures may, however, require the auditor to consider techniques known as Computer Assisted Audit Techniques (CAATs) that use the computer as an audit tool for enhancing the effectiveness and efficiency of audit procedures. CAATs are computer programs and data that the auditor uses as part of the audit procedures to process data of audit significance, contained in an entity’s information systems.

2. The purpose of this Guidance Note is to provide guidance in the use of CAATs. This Guidance Note describes computer assisted audit techniques including computer tools, collectively referred to as CAATs. This Guidance Note applies to all uses of CAATs when a computer of any type or size is involved whether that computer is operated by the entity or by a third party.

DESCRIPTION OF COMPUTER ASSISTED AUDIT TECHNIQUES (CAATs)
3. Computer Assisted Audit Techniques (CAATs) are important tools for the auditor in performing audits. CAATs may be used in performing various auditing procedures, including the following:
   ◆ tests of details of transactions and balances, for example, the use of audit software for recalculating interest or the extraction of invoices over a certain value from computer records;
   ◆ analytical procedures, for example, identifying inconsistencies or significant fluctuations;
   ◆ tests of general controls, for example, testing the set-up or configuration of the operating system or access procedures to the program libraries or by using code comparison software to check that the version of the program in use is the version approved by management;
   ◆ sampling programs to extract data for audit testing;
   ◆ tests of application controls, for example, testing the functioning of a programmed control; and
   ◆ reperforming calculations performed by the entity’s accounting systems.

* Issued in September, 2003
4. CAATs allow the auditor to give access to data without dependence on the client, test the reliability of client software, and perform audit tests more efficiently. CAATs are computer programs and data that the auditor uses as part of the audit procedures to process data of audit significance contained in an entity’s information systems. CAATs may consist of package programs, purpose-written programs, utility programs or system management program. Regardless of the origin of the programs, the auditor substantiates their appropriateness and validity for audit purposes before using them. A brief description of the programs commonly used is given below.

- **Package Programs** are generalized computer programs designed to perform data processing functions, such as reading data, selecting and analyzing information, performing calculations, creating data files and reporting in a format specified by the auditor.

- **Purpose-Written Programs** perform audit tasks in specific circumstances. These programs may be developed by the auditor, the entity being audited or an outside programmer hired by the auditor. In some cases, the auditor may use an entity’s existing programs in their original or modified state because it may be more efficient than developing independent programs.

- **Utility Programs** are used by an entity to perform common data processing functions, such as sorting, creating and printing files. These programs are generally not designed for audit purposes, and therefore may not contain features such as automatic record counts or control totals.

- **System Management Programs** are enhanced productivity tools that are typically part of a sophisticated operating systems environment, for example, data retrieval software or code comparison software. As with utility programs these tools are not specifically designed for auditing use and their use requires additional care.

Details of some of the techniques used are mentioned in the Appendix.

**CONSIDERATIONS IN THE USE OF CAATS**

5. When planning an audit, the auditor may consider an appropriate combination of manual and computer assisted audit techniques. In determining whether to use CAATs, the factors to consider include:

- the IT knowledge, expertise and experience of the audit team;
- the availability of CAATs and suitable computer facilities and data;
- the impracticability of manual tests;
- effectiveness and efficiency; and
- time constraints.
Before using CAATs the auditor considers the controls incorporated in the design of the entity’s computer systems to which CAAT would be applied in order to determine whether, and if so, how, CAATs should be used.

**IT KNOWLEDGE, EXPERTISE AND EXPERIENCE OF THE AUDIT TEAM**

6. Standard on Auditing (SA) 401, “Auditing in a Computer Information Systems Environment” deals with the level of skill and competence the audit team needs to conduct an audit in a CIS environment. It provides guidance when an auditor delegates work to assistants with CIS skills or when the auditor uses work performed by other auditors or experts with such skills. Specifically, the audit team should have sufficient knowledge to plan, execute and use the results of the particular CAAT adopted. The level of knowledge required depends on “availability of CAATs” and “suitable computer facilities”.

**AVAILABILITY OF CAATS AND SUITABLE COMPUTER FACILITIES**

7. The auditor considers the availability of CAATs, suitable computer facilities and the necessary computer-based information systems and data. The auditor may plan to use other computer facilities when the use of CAATs on an entity’s computer is uneconomical or impractical, for example, because of an incompatibility between the auditor’s package program and entity’s computer. Additionally, the auditor may elect to use their own facilities, such as PCs or laptops.

8. The cooperation of the entity’s personnel may be required to provide processing facilities at a convenient time, to assist with activities such as loading and running of CAAT on the entity’s system, and to provide copies of data files in the format required by the auditor.

**IMPRACTICABILITY OF MANUAL TESTS**

9. Some audit procedures may not be possible to perform manually because they rely on complex processing (for example, advanced statistical analysis) or involve amounts of data that would overwhelm any manual procedure. In addition, many computer information systems perform tasks for which no hard copy evidence is available and, therefore, it may be impracticable for the auditor to perform tests manually. The lack of hard copy evidence may occur at different stages in the business cycle.

- Source information may be initiated electronically, such as by voice activation, electronic data imaging, or point of sale electronic funds transfer. In addition, some transactions, such as discounts and interest calculations, may be generated directly by computer programs with no specific authorization of individual transactions.

- A system may not produce a visible audit trail providing assurance as to the completeness and accuracy of transactions processed. For example, a computer program might match delivery notes and suppliers’ invoices.

- In addition, programmed controlled procedures, such as checking customer credit limits, may provide hard copy evidence only on an exception basis.

- A system may not produce hard copy reports. In addition, a printed report may contain only summary totals while computer files retain the supporting details.
EFFECTIVENESS AND EFFICIENCY

10. The effectiveness and efficiency of auditing procedures may be improved by using CAATs to obtain and evaluate audit evidence. CAATs are often an efficient means of testing a large number of transactions or controls over large populations by:

♦ analyzing and selecting samples from a large volume of transactions;
♦ applying analytical procedures; and
♦ performing substantive procedures.

11. Matters relating to efficiency that an auditor might consider include:

♦ the time taken to plan, design, execute and evaluate CAAT;
♦ technical review and assistance hours;
♦ designing and printing of forms (for example, confirmations); and
♦ availability of computer resources

12. In evaluating the effectiveness and efficiency of CAAT, the auditor considers the continuing use of CAAT application. The initial planning, design and development of CAAT will usually benefit audits in subsequent periods.

TIME CONSTRAINTS

13. Certain data, such as transaction details, are often kept for a short time and may not be available in machine-readable form by the time auditor wants them. Thus, the auditor will need to make arrangements for the retention of data required, or may need to alter the timing of the work that requires such data.

14. Where the time available to perform an audit is limited, the auditor may plan to use CAAT because its use will meet the auditor’s time requirement better than other possible procedures.

USING CAATS

15. The major steps to be undertaken by the auditor in the application of CAAT are to:

(a) set the objective of CAAT application;
(b) determine the content and accessibility of the entity’s files;
(c) identify the specific files or databases to be examined;
(d) understand the relationship between the data tables where a database is to be examined;
(e) define the specific tests or procedures and related transactions and balances affected;
(f) define the output requirements;
(g) arrange with the user and IT departments, if appropriate, for copies of the relevant files or database tables to be made at the appropriate cut off date and time;
(h) identify the personnel who may participate in the design and application of CAAT;
(i) refine the estimates of costs and benefits;

(j) ensure that the use of CAAT is properly controlled;

(k) arrange the administrative activities, including the necessary skills and computer facilities;

(l) reconcile data to be used for CAAT with the accounting and other records;

(m) execute CAAT application;

(n) evaluate the results;

(o) document CAATs to be used including objectives, high level flowcharts and run instructions; and

(p) assess the effect of changes to the programs/system on the use of CAAT.

TESTING CAAT

16. The auditor should obtain reasonable assurance of the integrity, reliability, usefulness, and security of CAAT through appropriate planning, design, testing, processing and review of documentation. This should be done before reliance is placed upon CAAT. The nature, timing and extent of testing is dependent on the commercial availability and stability of CAAT.

CONTROLLING CAAT APPLICATION

17. The specific procedures necessary to control the use of CAAT depend on the particular application. In establishing control, the auditor considers the need to:

(a) approve specifications and conduct a review of the work to be performed by CAAT;

(b) review the entity’s general controls that may contribute to the integrity of CAAT, for example, controls over program changes and access to computer files. When such controls cannot be relied on to ensure the integrity of CAAT, the auditor may consider processing CAAT application at another suitable computer facility; and

(c) ensure appropriate integration of the output by the auditor into the audit process.

18. Procedures carried out by the auditor to control CAAT applications may include:

(a) participating in the design and testing of CAAT;

(b) checking, if applicable, the coding of the program to ensure that it conforms with the detailed program specifications;

(c) asking the entity’s staff to review the operating system instructions to ensure that the software will run in the entity’s computer installation;

(d) running the audit software on small test files before running it on the main data files;

(e) checking whether the correct files were used, for example, by checking external evidence, such as control totals maintained by the user, and that those files were complete;

(f) obtaining evidence that the audit software functioned as planned, for example, by reviewing output and control information; and
(g) establishing appropriate security measures to safeguard the integrity and confidentiality of the data.

When the auditor intends to perform audit procedures concurrently with online processing, the auditor reviews those procedures with appropriate client personnel and obtains approval before conducting the tests to help avoid the inadvertent corruption of client records.

19. To ensure appropriate control procedures, the presence of the auditor is not necessarily required at the computer facility during the running of CAAT. It may, however, provide practical advantages, such as being able to control distribution of the output and ensuring the timely correction of errors, for example, if the wrong input file were to be used.

20. Audit procedures to control test data applications may include:
   - controlling the sequence of submissions of test data where it spans several processing cycles;
   - performing test runs containing small amounts of test data before submitting the main audit test data;
   - predicting the results of the test data and comparing it with the actual test data output, for the individual transactions and in total;
   - confirming that the current version of the programs was used to process the test data; and
   - testing whether the programs used to process the test data were the programs the entity used throughout the applicable audit period.

21. When using CAAT, the auditor may require the cooperation of entity staff with extensive knowledge of the computer installation. In such circumstances, the auditor considers whether the staff improperly influenced the results of CAAT.

22. Audit procedures to control the use of audit-enabling software may include:
   - verifying the completeness, accuracy and availability of the relevant data, for example, historical data may be required to build a financial model;
   - reviewing the reasonableness of assumptions used in the application of the tool set, particularly, when using modeling software;
   - verifying availability of resources skilled in the use and control of the selected tools; and
   - confirming the appropriateness of the tool set to the audit objective, for example, the use of industry specific systems may be necessary for the design of audit programs for unique business cycles.

DOCUMENTATION

23. The various stages of application of CAATs should be sufficiently documented to provide adequate audit evidence.
24. The audit working papers should contain sufficient documentation to describe CAAT application, including the details set out in the sections below:

(a) Planning
   - CAAT objectives;
   - CAAT to be used;
   - Controls to be exercised; and
   - Staffing, timing and cost.

(b) Execution
   - CAAT preparation and testing procedures and controls;
   - Details of the tests performed by CAAT;
   - Details of inputs (e.g., data used, file layouts), processing (e.g., CAATs high-level flowcharts, logic) and outputs (e.g., log files, reports);
   - Listing of relevant parameters or source code; and
   - Relevant technical information about the entity’s accounting system, such as file layouts.

(c) Audit Evidence
   - Output provided;
   - Description of the audit work performed on the output;
   - Audit findings; and
   - Audit conclusions;

(d) Other
   - Recommendations to the entity management; and

In addition, it may be useful to document suggestions for using CAAT in future years.

ARRANGEMENTS WITH THE ENTITY

25. The auditor may make arrangements for the retention of the data files, such as detailed transaction files, covering the appropriate audit time frame.

26. In order to minimize the effect on the organisation’s production environment, access to the organisation’s information system facilities, programs/systems and data should be arranged well in advance of the needed time period.

27. The auditor should also consider the effect of these changes on the integrity and usefulness of CAAT, as well as the integrity of the programs/system and data used by the auditor.
USING CAATS IN SMALL ENTITIES

28. Although the general principles outlined in this Guidance Note apply in small entity IT environments, the following points need special consideration:

(a) The level of general controls may be such that the auditor will place less reliance on the system of internal control. This will result in greater emphasis on tests of details of transactions and balances and analytical review procedures, which may increase the effectiveness of certain CAATs, particularly, audit software.

(b) Where smaller volumes of data are processed, manual methods may be more cost effective.

(c) A small entity may not be able to provide adequate technical assistance to the auditor, making the use of CAATs impracticable.

(d) Certain audit package programs may not operate on small computers, thus restricting the auditor’s choice of CAATs. The entity’s data files may, however, be copied and processed on another suitable computer.

Appendix

Examples of Computer Assisted Audit Techniques

<table>
<thead>
<tr>
<th>Techniques</th>
<th>Description</th>
<th>Advantages</th>
<th>Disadvantages</th>
</tr>
</thead>
<tbody>
<tr>
<td>Audit Automation</td>
<td>♦ Expert Systems</td>
<td>♦ These techniques are more useful when auditors are using laptops which can be directly linked with the entity’s system.</td>
<td>♦ Not applicable in the case of mainframe computers.</td>
</tr>
<tr>
<td></td>
<td>♦ Tools to evaluate a client’s risk management procedures</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>♦ Electronic working papers, which provide for the direct extraction of data from clients computer records</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>♦ Corporate and financial modeling programs for use as predictive audit test</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Software Type</td>
<td>Descriptions</td>
<td>Additional Notes</td>
<td></td>
</tr>
<tr>
<td>-------------------------------</td>
<td>------------------------------------------------------------------------------</td>
<td>----------------------------------------------------------------------------------</td>
<td></td>
</tr>
<tr>
<td><strong>Audit Software</strong></td>
<td>◇ Software used by the auditor to read data on client’s files, to provide information for the audit and/or to re-perform procedures carried out by the client’s programs.</td>
<td>◇ Performs a wide variety of audit tasks ◇ Long term economies ◇ Reads actual records ◇ Capable of dealing with large volumes of transactions ◇ Requires a reasonable degree of skill to use ◇ Initial set up costs can be high ◇ Adaptation often needed from machine to machine</td>
<td></td>
</tr>
<tr>
<td><strong>Core Image Comparison</strong></td>
<td>Software used by the auditor to compare the executable version of a program with a secure master copy.</td>
<td>◇ Provides a high degree of comfort concerning the executable version of the program ◇ Particularly useful where only executable versions are distributed ◇ Requires a high degree of skill to set up and to interpret the results. ◇ Where programs have been recompiled the comparison may be invalidated as the program records everything as a difference ◇ Printouts are hard to interpret and the actual changes made are difficult to establish ◇ Availability restricted to certain machine types</td>
<td></td>
</tr>
<tr>
<td><strong>Database Analysers</strong></td>
<td>Software used by the auditor to examine the rights associated with terminals and the ability of users to access information on a database.</td>
<td>◇ Provides detailed information concerning the operation of the database ◇ Enhances the auditor’s understanding of the database management system ◇ Requires a high degree of skill to set up and to interpret the results. ◇ Restricted availability both as regards machine types and database management systems ◇ Specific and limited audit applicability</td>
<td></td>
</tr>
<tr>
<td><strong>Embedded Code</strong></td>
<td>Software used by the auditor to examine.</td>
<td>◇ Performs a wide variety of ◇ There is a processing overhead involved</td>
<td></td>
</tr>
</tbody>
</table>
transactions passing through the system by placing his own program in the suite of programs used for processing.

<table>
<thead>
<tr>
<th>Audit Tasks</th>
<th>Because of the extra programs</th>
</tr>
</thead>
<tbody>
<tr>
<td>♦ Examines each transaction as it passes through the system</td>
<td>♦ Definition of what constitutes an unusual transaction needs to be very precise</td>
</tr>
<tr>
<td>♦ Operates continuously</td>
<td>♦ Precautions need to be taken over the output from the programs to ensure is security</td>
</tr>
<tr>
<td>♦ Capable of identifying unusual transactions passing through the system.</td>
<td>♦ Precautions need to be taken to ensure that the program cannot be suppressed or tampered with</td>
</tr>
<tr>
<td></td>
<td>♦ Requires some degree of skill to use and to interpret the results</td>
</tr>
</tbody>
</table>

Log Analysers
Software used by the auditor to read and analyse records of machine activity

| Provides detailed information on machine usage.                         | Requires a high degree of skill to use and to interpret the results |
| Long term economies                                                    | Limited availability as regards machine types |
| Effective when testing integrity controls                               | High volume of records restricts extent of test |

Mapping
Software used by the auditor to list unused program instructions

| Identifies program code which may be there for fraudulent reasons.       | Very specific objective |
|                                                                        | Requires a high degree of skill to use and to interpret the results |
|                                                                        | Adaptation needed from machine to machine. |

Modelling
A variety of software, usually associated with a microcomputer, enabling the auditor to carry out analytical

<p>| Can be a very powerful analytical tool                                  | A high volume of data may need to be entered initially |
| Can enable the auditor to examine                                      | Results require careful interpretation |</p>
<table>
<thead>
<tr>
<th>Part-III: Guidance Notes</th>
<th>III.121</th>
</tr>
</thead>
</table>

<table>
<thead>
<tr>
<th><strong>On-line Testing</strong></th>
<th><strong>Program Code Analysis</strong></th>
<th><strong>Program Library Analysers</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Techniques whereby the auditor arranges or manipulates data either real or fictitious, in order to see that a specific program or screen edit test is doing its work.</td>
<td>An examination by the auditor of the source code of a particular program with a view to following the logic of the program so as to satisfy himself that it will perform according to his understanding.</td>
<td>Software used by the auditor to examine dates of changes made to the executable library and the use of utilities to amend programs.</td>
</tr>
<tr>
<td>♦ Very widely applicable</td>
<td>♦ Gives a reasonable degree of comfort about the program logic</td>
<td>♦ Provides the auditor with useful information concerning the program library</td>
</tr>
<tr>
<td>♦ Easy to use</td>
<td>♦ The auditor can examine every function of the program code</td>
<td>♦ Identifies abnormal changes to the library</td>
</tr>
<tr>
<td>♦ Can be targeted for specific functions carried out by programs</td>
<td></td>
<td>♦ Requires a high degree of skill to use and to interpret the results</td>
</tr>
<tr>
<td></td>
<td></td>
<td>♦ Availability restricted to certain machine types</td>
</tr>
<tr>
<td></td>
<td></td>
<td>♦ Only relevant when testing integrity controls</td>
</tr>
<tr>
<td></td>
<td></td>
<td>♦ Each use satisfies only one particular objective</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Care must be taken to ensure that “live” data does not impact actual results</td>
</tr>
<tr>
<td></td>
<td></td>
<td>♦ Requires a high degree of skill to use and to interpret the results</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Availability restricted to certain machine types</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Only relevant when testing integrity controls</td>
</tr>
</tbody>
</table>

reviews of client’s results, to alter conditions so as to identify amounts for provisions or claims, or to project results and compare actual results with those expected.

provisions on a number of different bases

- Very flexible in use
- Can provide the auditor with useful information on trends and patterns

© The Institute of Chartered Accountants of India
## Auditing Pronouncements

### Snapshots
- **Useful when testing program security**
- Permits the auditor to examine processing at a specific point in time or to confirm the way a particular aspect of the system operates.
- Can be expensive to set up.

### Source Comparison
- **Compared source code line by line and identifies all differences**
- Useful when testing integrity controls or particularly important program procedures.
- Other procedures are necessary to ensure that the executable version reflects the source code examined.
- Requires some degree of skill to use and to interpret the results.
- Availability restricted to certain machine types.

### Test Data - “Live”, “Dead”, Integrated Test Facility or Base Case System Evaluation
- **Performs a wide variety of tasks**
- Gives considerable comfort about the operation of programs.
- Can be precisely targeted for specific procedures within programs.
- “Dead” test data requires additional work for the auditor to satisfy himself the right programs were used.
- Care must be taken to ensure that “live” data does not impact actual results.
- Technique can be expensive to set up and cumbersome to use.
- Adequate for detection of major error but less likely to detect deep-
<table>
<thead>
<tr>
<th>Tracing</th>
<th>Long term economies</th>
<th>seated fraud</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Software used by the auditor to identify which instructions were used in a program and in what order</td>
<td>Helps to analyse the way in which a program operates</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
GUIDANCE NOTE ON
AUDIT OF CAPITAL AND RESERVES

The following is the text of the Guidance Note on Audit of Capital and Reserves, issued by the Council of the Institute of Chartered Accountants of India. The Guidance Note should be read in conjunction with the Standards on Auditing issued by the Institute.

INTRODUCTION

1. Capital and reserves constitute the owners’ funds. Capital comprises both the amounts contributed by the owners and the profits capitalised over a period of time (by way of issue of bonus shares in case of corporate entities or by way of crediting the retained earnings to the capital account in case of non-corporate entities).

2. Capital may consist of various classes of shares with varying voting rights in case of corporate entities.

3. Reserves are the portion of earnings, receipts or other surplus of an enterprise (whether capital or revenue) appropriated by the management for a general or a specific purpose other than a provision for depreciation or diminution in the value of assets or for a known liability. Reserves comprise both capital and revenue reserves. Ordinarily, revenue reserves are retained earnings, whereas the capital reserves may constitute both retained capital profits and owners’ contribution in the form of premium on issue of shares and surpluses resulting from re-issue of forfeited shares. Revaluation reserve arising from revaluation of fixed assets is also a capital reserve.

4. The auditor, in many audit engagements, particularly those relating to corporate entities, may find very few changes in the capital account and/or reserve accounts. However, the transactions in the capital and reserve accounts are normally material in amount in addition to being significant in nature and, therefore, each transaction in these accounts requires careful attention.

5. In any auditing situation, the auditor employs appropriate procedures to obtain reasonable assurance about various assertions (see Standard on Auditing (SA) 500, Audit Evidence). In carrying out the audit of capital and reserves, the auditor is particularly concerned with obtaining sufficient appropriate audit evidence to corroborate the management’s assertions regarding the following:

---

1 Issued in January, 2006. Attention of the readers is invited to the fact that prior to the issuance of this Guidance Note, the aspect of audit of Capital and Reserves was covered by paragraphs 8.1 to 8.18 of the Statement on Auditing Practices. The Statements was withdrawn pursuant to the issuance of the Guidance Note on Audit of Payment of Dividend in August 2005.
Existence: that the recorded amounts of capital and reserves exist at the given date
Occurrence: that the transactions recorded in the capital and reserve account(s) occurred during the period under audit
Obligation: that the amounts appearing in the capital and reserves account(s) are in fact a liability of the entity
Completeness: that there are no unrecorded transactions in respect of capital and reserves account(s)
Measurement: that the transactions in the capital and reserves account(s) have been recorded at the proper amount
Valuation: that the amounts recorded in the capital and reserve account(s) are recorded at appropriate carrying value
Presentation and disclosure: that the items of capital and reserves have been disclosed, classified, and described in the financial statements in accordance with recognised financial reporting framework applicable to the client.

6. The principal objectives of the auditor in the examination of capital and reserves, therefore, are:
   (a) to ascertain that amounts shown in capital and reserve account(s) as at the balance sheet date are correct;
   (b) to determine that all transactions during the year, affecting owners' funds were properly authorised and recorded;
   (c) to examine whether the applicable laws and regulations and terms of issue/ agreement, if any, have been complied with; and
   (d) to verify whether these amounts have been properly classified and disclosed in the financial statements.

**INTERNAL CONTROL EVALUATION**

7. Paragraph 2 of the Standard on Auditing (SA) 400, *Risk Assessments and Internal Control*, requires the auditor to obtain an understanding of the accounting and internal controls relating to capital and reserves sufficient to plan the audit and develop an effective audit approach. Paragraph 1 of the SA 500 requires the auditor to “obtain sufficient appropriate audit evidence through the performance of compliance and substantive procedures to enable him to draw reasonable conclusions therefrom on which to base his opinion on the financial information”. Paragraph 1 further states:

   “Compliance procedures are tests designed to obtain reasonable assurance that those internal controls on which audit reliance is to be placed are in effect.

   Substantive procedures are designed to obtain evidence as to the completeness, accuracy and validity of the data produced by the accounting system.”

In certain cases, the client may employ a third party to carry out any of its transactions in respect of capital and/or reserves. For example, it is quite common for listed companies to
outsource the administrative aspects related to allotment, issuance of share certificates, share transfer, maintenance of records of shareholders, etc. In such situations, the auditor, as required by Standard on Auditing (SA) 402, "Audit Considerations Relating to Entities Using Service Organisations", should also consider how such arrangements affect the client’s accounting and internal control system so as to plan and develop an effective audit approach.

8. In the case of non-corporate entities, the auditor needs to ascertain general terms and conditions regarding contribution of capital, interest payable on capital, interest chargeable on withdrawals, limits imposed on withdrawals, etc. In respect of corporate entities, the auditor should particularly review the following aspects of internal controls relating to capital and reserves:

(a) **Proper authorisation of transactions**: All transactions in the capital and reserves accounts such as issue of fresh shares and allotment, buy back of shares, forfeiture, making calls on the shares, should be properly authorised as required by the Companies Act, 1956. Outsourcing of any services, e.g., depository services should also be with the proper authorisation of a competent authority. The authority to sign the share certificates may be delegated to a person as per the laws applicable to the entity.

(b) **Proper control over issue and custody of share certificates**: In case where shares are in the physical form, the auditor is required to examine that proper internal control system exists to ensure that the share certificates are pre-numbered, proper accounts are maintained for certificates cancelled due to defacement, wear out, exhaustion of cages to record transfer particulars, dematerialisation. The auditor should examine whether blank share certificates are under the lock and control of the company secretary or some other responsible officer of the entity. He should also examine whether at least one officer of the entity personally signs the share certificates issued, though other signatures can be facsimile type and whether such a signing officer also verifies the register of share certificates, wherein the issue particulars are recorded. It may be noted that share certificates are generally issued for a fixed lot of shares (marketable lot, or some other predetermined denomination).

(c) **Allotment and call intimations etc.**: The auditor should examine whether allotment of shares and calls is done pursuant to a resolution of the Board and that proper internal controls exist for despatch of allotment advices and call letters.

(d) **Internal control on receipts and accounting of application, allotment and call money**: Internal controls applicable for receipt and accounting of money received on application, allotment and calls need to be evaluated. Proper records should be maintained for recording the said transactions. Periodical reconciliation of bank accounts opened specially for transactions in capital account have to be made.

(e) **Maintenance of adequate records**: The auditor should verify whether proper system of internal controls for documentation is in operation. It includes maintenance of proper and adequately detailed records in respect of the details of members, share certificate stock ledger, duplicate certificates, cancelled certificates, etc.
(f) **Proper control over issue of instructions to depository participants:** There should exist proper controls over issue of instructions to and for execution of requests received from the depository participants for the dematerialisation/re-materialisation of shares and proper records are required to be maintained for recording such transactions.

**INTERNAL CONTROLS RELATING TO OUTSOURCED ACTIVITIES**

9. For the efficient carrying out of the day to day transactions like issue of share certificates/instructions to depository participants for the credit of shares on allotment, either on public issue or rights issue, issue of call letters, etc., authority may be delegated, at the general meeting, to registrars and share transfer agents. In such cases, the auditor should follow the procedures described by the SA 402.

**VERIFICATION**

10. Verification of capital and reserves may be carried out employing the following procedures:

(i) examination of records;

(ii) examination of compliance with laws and regulations and terms of issue/contract, if any; and

(iii) examination of presentation and disclosure.

11. The nature, timing and extent of substantive procedures to be performed is, however, a matter of professional judgment of the auditor which is based, *inter alia*, on the auditor’s evaluation of the effectiveness of the related internal controls.

**ENTITIES OTHER THAN PARTNERSHIPS AND SOLE PROPRIETORSHIPS**

**Examination of Records**

**Capital**

**Authorised Capital**

12. The authorised capital shown in the balance sheet should be checked with the Memorandum of Association in case of a company, registered byelaws in case of a co-operative society, relevant statute or the Government Order in case of a statutory corporation or other body corporate. The auditor may also refer the audited balance sheet of the immediately preceding year.

13. The minutes of the general meeting and/ or Board should be examined to see, if any, change in the capital structure has taken place since the last balance sheet and whether it is properly authorised. A company, having a share capital, in terms of the provisions of section 94 of the Companies Act, 1956 may change its share capital as follows:

(i) increase its share capital by such amount as it thinks expedient by issuing new shares

(ii) consolidate or divide all or any of its share capital into shares of larger amount than its existing shares
(iii) convert all or any of its fully paid up shares into stock, and reconvert that stock into fully paid-up shares of any denomination

(iv) sub-divide its shares, or any of them, into shares of smaller amount than is fixed by the memorandum

(v) cancel shares which, at the date of passing of the resolution in that regard, have not been taken or agreed to be taken by any person, and diminish the amount of its share capital by the amount of the shares so cancelled

In such cases, the auditor should also examine the copy of the documents filed with the Registrar of Companies in relevant form along with the specified fee pursuant to the requirements of section 97 of the Companies Act, 1956. In addition to the situations envisaged in section 94 of the Companies Act, 1956, the auditor should also enquire whether the Central Government has, under Section 81(4) ordered or directed under Section 94A(2) of the Companies Act, 1956, the conversion of debentures or loans into share capital, resulting in an increase in the authorised capital of the company. The authorised capital may also undergo a change, as a consequence of a merger or a demerger. Similarly, in case of statutory corporations, amendments made to the statute governing the entity or the Government Order in case of other public sector bodies should be enquired into.

Issued and Subscribed Capital

14. Issued Capital: The following records/documents would ordinarily provide necessary evidence for issued capital:

(a) The minutes of the general and/ or board meetings for further issue of shares, e.g., under section 81 of the Companies Act, 1956;

(b) Offer documents, if any, filed with the Securities and Exchange Board of India (SEBI)/Registrar of Companies (ROCs) and Reserve Bank of India (RBI) in respect of permission in case of ADR/GDR issue.

(c) Return of allotment filed with the Registrar of Companies.

15. Subscribed Capital: Shares subscribed in response to the issue of capital can be verified by reviewing the applications received for the subscription of shares. The subscribed capital is the capital for which the application money is received. The subscribed share capital cannot exceed the issued capital.

Paid up capital

16. Periodical reconciliation of outstanding shares held in demat and physical form as on book closure/ record date should also be done.

17. The auditor should review the minutes books of Board of Directors and the members and also any amendments made to the statutory register to ascertain whether any changes have taken place in the capital of the entity, for example –
A. Increase in capital due to:
   (i) Fresh issue of shares/ADR/GDR.
   (ii) Allotment of shares pursuant to merger/amalgamation or acquisition of property or services.
   (iii) Part/full conversion of loans or debentures
   (iv) Allotment of shares pursuant to exercise of option either by the promoters or the employees or other option holders.
   (v) Allotment of Bonus shares
   (vi) Rights issue

B. Decrease in capital due to:
   (i) Forfeiture
   (ii) Buy-back of shares
   (iii) Redemption of redeemable preference shares
   (iv) Reduction of capital
   (v) Surrender of shares as in the case of Co-operative societies
   (vi) De-merger

18. A list of members, together with shares held by them and the amounts paid-up thereon, should be available with the company/entity as at the balance sheet date and the aggregate of these should agree, with the details of capital shown in the balance sheet. A copy of the annual return for the previous year filed under the Companies Act, 1956 or any other statute or a list of members prepared for issuing dividend warrants may also be examined. If the auditor chooses to verify the list of members as per the annual return or list of members prepared for issuing dividend warrants, he should also check the reconciliation with the amount as at the balance sheet date, with the changes occurred during the period from the date of balance sheet and record date/book closure date. Where the registration work is carried out by independent specialised agencies, a certificate, containing the list of members, the number of shares held, including those in the demat form and physical form and amount paid up on these shares and calls in arrears, if any, should be obtained and reconciliation of the particulars with the amount credited as paid up in the share capital account of the General Ledger be checked on a test basis.

19. If a change in the capital has taken place during the year under audit, inquiries should be made to ascertain that it is properly authorised in the manner prescribed by the Articles and appropriate resolutions have been passed with requisite majority.

20. The auditor should enquire whether the Central Government has passed any order under Section 108 or Section 250 of the Companies Act, 1956 freezing the voting rights of any shareholders. It may be noted that there are provisions in the Banking Regulation Act, 1949
limiting the voting rights of a person. Similarly, the Co-operative Societies Act, 1912 provides for issue of two types of shares, one having voting rights and other not having voting rights. The Companies Act, 1956 also provides for issue of shares with non voting rights. These matters have a bearing while examining the validity of the resolutions passed by the members of the entity. The auditor should, therefore, also check that the classes of shares have been appropriately disclosed.

Subscription in Cash and Kind

21. The law requires a distinction to be made between shares subscribed for in cash and shares subscribed for consideration other than in cash. Shares subscribed for in cash should include only the following kinds of subscription:

(a) where the subscription amount is received either in cash or by cheque;

(b) where the amount is adjusted against a bona fide debt payable in money at once by the company.

There might be situations where a company has taken a loan under a stipulation that in case of default in repayment of the loan, the loan would get converted into shares. In such a situation, on a default in repayment of the loan by the company, if the loan gets converted into shares in the company, such shares would be considered as having been allotted for cash. Where shares are allotted against credit balance in a person's account, inquiry should be made as to how the credit balance in that account has arisen, whether it was for a valid consideration and whether the amount was due for payment at the time of issue.

22. The Department of Company Affairs has clarified through its circular No. 8/32(75) 77-CL-V dated 13th March, 1978, that a genuine debt adjusted against the amount receivable towards share capital can be treated as amount paid in cash. The extracts from the advice received from an eminent Counsel in this regard are given as Appendix A to this Guidance Note.

23. Where the subscription for share capital is paid into a bank account in a foreign country, it should be verified that the amount deposited in the foreign currency is in accordance with the terms of issue and such an amount as, if remitted into India on the day on which the deposit is made in the foreign country, would have realised in Indian rupees a sum equal to the amount credited as paid up and premium, if any, on the shares. The auditor should verify that the guidelines issued by SEBI for inviting, collecting and recording of foreign capital have been complied with by the company. The foreign exchange fluctuations, if any, should be accounted for in the balance with bank in accordance with the provisions of Accounting Standard 11, Accounting for the Effects of Changes in Foreign Exchange Rates.

24. Issue of Shares for Consideration Other than Cash: Shares may also be issued for a consideration other than cash, e.g., for supply of machinery or technical know-how. The auditor should examine the underlying agreement in respect of the same and verify whether the agreement has been properly approved. The auditor should treat the shares issued for

---

2 Now known as the Ministry of Company Affairs.
consideration other than cash separate from those issued against cash in his audit approach. He needs to verify that the consideration for which shares are issued, viz., supply of machinery or technical know-how is *prima facie* fully received.

25. Further, as per the provisions of section 75 of the Companies Act, 1956, whenever company having a share capital makes any allotment of its shares, the company has to comply with the following conditions:

i. It has to file with the Registrar of Companies, a return of the allotment, stating the number and nominal amount of shares comprised in the allotment, the names, addresses and occupations of the allottees, and the amount if any, paid or due and payable on the shares.

ii. In case of shares allotted for other than cash, it has to produce before the Registrar, *inter alia*, a contract in writing, constituting the title of the allottee to the allotment together with any contract of sale, or a contract for services or other consideration in respect of which allotment was made.

26. The auditor may examine the following records to the extent they are applicable to the particular circumstances, in case of increase in paid-up capital:

(a) Final price determined in case of offer through book building process.

(b) Scheme of compromise or arrangement as referred to in section 394 of the Companies Act, 1956, approved by the Court.

(c) Compromise proposal with creditors and the consequential Order of the Court or an Order of Central Government under Section 397 of the Companies Act, 1956.

(d) Procedure and terms of reissue of forfeited shares.

27. In case the payment is allowed to be made on allotment and/or also in instalments of one or more calls, the auditor has to verify the resolution of the Board for making calls, amount received against the calls and the posting of the amount to the correct member’s account/folio. A schedule of allotment money and a schedule for each call have to be verified on test check basis and reconciled with total amount received and due on allotment and each call. If the accounting work relating to the share capital is outsourced to a Registrar and Share Transfer Agent, the auditor should follow the principles enunciated in SA 402. If the Articles of Association permit and the terms of issue state that in the event of delay in payment of either allotment money or calls, the investor has to pay interest, the auditor should verify whether such interest is collected and properly accounted for in the books of account. The auditor should review the schedules of calls in arrears and calls in advance, and ensure that interest has been correctly accounted for.

---

3. *Book Building Process:* Listed companies can also issue shares through Book Building Process. Book Building is a process wherein the issuer of securities asks investors to bid for his securities at different prices. These bids are within an indicative price-band, decided by the issuer. Here, investors bid for different quantity of shares, at different prices. Considering these bids, the issuer determines a cutoff price, which is the price at which the securities are allotted. SEBI has issued guidelines on issue of shares through Book Building Process. The auditor has to verify whether the company has complied with all the guidelines issued by SEBI in this regard and also that the basis of determination of the floor price and the final price by the company is consistent with the provisions in that regard.
is provided in accordance with the Articles of Association, Offer Documents/Terms of Issue. The auditor may verify the Board Resolution, if any, for waiver of interest on calls in arrears. Interest on calls in arrears may be accounted at the time of receipt, with proper disclosure in the balance sheet for deviating from the accrual principle. The schedule of calls in arrears should show separately the amounts, if any, due from the directors. Similarly, the auditor should also examine the payment of interest on calls received in advance, if any, made by the company. He should verify whether any such payment of interest on calls received in advance is permitted by the articles of association of the company. He should also examine the Board resolution in this regard.

28. In case shares are issued at discount, the auditor has to verify the compliance of Section 79 of the Companies Act, 1956.

29. Generally, employees are offered shares at a price lesser than the market rate. Sections 79 and 79A of the Companies Act, 1956 and SEBI (Employee Stock Option Scheme and Employees Stock Purchase Scheme) Guidelines, 1999 (ESOS and ESPS), Employee Stock Option Scheme for Public Sector Enterprises and others statutes governing the entity have to be complied with. Transactions relating to options are to be accounted as required by the said scheme or the Accounting Standards and provisions of any relevant statute, if any, in force, on treatment of discount etc., on ESOS/ESPS.

30. **Issue of Sweat Equity:** Section 79A of the Companies Act, 1956 deals with the issue of sweat equity by the company to its employees and directors, at a discount or for consideration other than cash for providing know-how or making available rights in the nature of intellectual property rights or value additions, by whatever name called. SEBI has also issued SEBI (Issue of Sweat Equity) Regulations, 2002 for issue of the sweat equity by the listed companies. The issue of sweat equity by unlisted companies is governed by Unlisted Companies (Issue of Sweat Equity Shares) Rules, 2003. The auditor must verify that if the company has issued any sweat equity, whether the provisions of Section 79A of the Companies Act, 1956 and the Rules applicable to the company, depending whether listed or not, have been complied with.

31. Companies are now allowed to buy-back their own shares. Sections 77A and 77B of the Companies Act, 1956 lay down the conditions and procedures for buy-back of the shares of a company. In case of private limited and unlisted companies, the Private Limited Company and Unlisted Public Limited Company (Buy-back of Securities) Rules 1999, and in case of listed companies, SEBI (Buy-back of Securities) Regulations, 1998 have to be complied with. The auditor should verify particularly that the funds employed for the buy-back are from the resources as permitted by the law. The reconciliation of entries in escrow account or the bank account separately opened for payment of purchase consideration have to be verified with the number of shares bought back and price paid. The auditor should also verify the entries made in the concerned booksregisters with regard to destruction of share certificates and extinguishments of dematerialised shares and a reconciliation of these two to arrive at the total number of securities purchased under buy-back process.

---

32. Registered Byelaws of the Co-operative Societies specify the terms and conditions for surrender of all or certain class of shares. Generally, surrender of shares is allowed only at par. The auditor has to verify the certificates surrendered vis-à-vis the payment made and the entries made in the Register of members, share certificate ledger etc.

33. In case of reduction of capital is by way of reduction of the nominal value of the shares, either by canceling unpaid portion of the partly paid shares, or extinguishing some part of the paid up capital, the auditor has to verify that the High Court Order under Section 100 of the Companies Act, 1956 for reduction of capital has been complied with. Further, he has to verify the share certificates surrendered and the statement of corresponding new share certificates issued. In case reduction is achieved by canceling fully paid shares proportionately, the auditor should also verify the surrendered shares/issue of stickers/intimation to the depositories vis-à-vis the amount reduced.

34. It may be noted that the buy-back of shares under Section 77A and redemption of redeemable preference shares under Section 80 do not attract the provisions of Section 100 of the Companies Act, 1956.

Application Money

35. Schedule VI to the Companies Act, 1956 does not prescribe the manner of disclosure of share application money. However, as a matter of prudence and better disclosure, share application money should be shown separately between “Share Capital” and “Reserves & Surpluses” in the Balance Sheet till the time share application money is transferred to the Share Capital Account. However, in the following situations, the share application money would be disclosed separately under the head “Current Liabilities” in the Balance Sheet:

- invalid or revoked applications;
- excess application money received due to over subscription; and
- when minimum subscription stated in the offer document is not received.

36. The auditor has to verify whether application money stated is fully backed by the share application forms/certificate from the Share Transfer Agent and applications are received pursuant to a resolution of the appropriate authority for issue of capital. Amount received without satisfying any of the above conditions should be refunded by the company.

37. Share application money accepted by the company, if not backed by the application form/Registrar’s certificate alongwith the resolution of the Board as stated above, should be treated as unsecured loan. The auditor should verify that the application money received in excess of capital offered for subscription, if any, has been stated under Current Liabilities. The auditor may examine the reasonableness of the period for which the share application money remains pending allotment.

38. In case of refund of excess application money/revoked applications, the auditor should verify the same and apply the similar audit procedures as applied for audit of any other liability. The auditor should also verify whether the company has complied with the Guidelines prescribed by SEBI with regard to time schedule and payment of interest in case of delay in such refunds.
Calls Received in Advance

39. The auditor should examine whether the calls received in advance and payment of interest, if any, thereon is in accordance with the provisions contained in the Articles of Association in this regard. Schedule of calls received in advance is to be reviewed with reference to the amounts deposited in the bank.

40. Interest, if any, paid on the amount received in advance of calls should be verified and the audit procedure to be employed is same as in case of payment of interest on borrowings.

General

41. The auditor should examine whether proper accounts have been maintained with regard to amounts received on application, allotment and calls and the payments by way of refunds/interest and all other relevant accounts are duly reconciled. Where shares are issued at a premium, the auditor should ensure that such sums are accounted for separately. In case of buy back, reissue or redemption of preference shares and reduction of capital by payment of money, the auditor should examine whether these have been properly accounted and duly reconciled with payments made for the same.

42. Proviso to section 383A of the Companies Act, 1956 requires certain companies to obtain a certificate of compliance with the provisions of the Companies Act, 1956 from a practicing company secretary. The auditor of such companies may review the same.

Reserves

43. Reserves should be distinguished from provisions. For this purpose, reference may be made to the definitions of the expressions, “provision” and “reserve”, etc., in the Guidance Note on Terms Used in Financial Statements issued by the Institute. The definition of the term “reserve” as given in the said Guidance Note is explained in paragraph 3. It is important to remember that any amount provided in excess of the requirements is in the nature of reserve and should be shown as such.

44. It is also necessary to make a distinction between capital reserves and revenue reserves in the accounts. A Revenue Reserve is ordinarily available for distribution as dividend.

45. Reserves may also contain amount received from the Government. These grants may be in the nature of promoters’ contribution or related to any specific fixed asset. The auditor should verify that the principles of Accounting Standard 12, Accounting for Government Grants for recognition, presentation, refund, if required, and disclosure of the grant have been appropriately complied with.

46. A reserve account is styled as Reserve Fund only when such reserves are represented by specifically earmarked assets or investments.

47. In case of amalgamations and mergers, reserves of the amalgamated /merged company have to be treated as prescribed in Accounting Standard 14, Accounting for Amalgamations issued by the Institute. However, the auditor, especially in cases of amalgamations/mergers, may come across a situation where the relevant Court/ Tribunal has made an order sanctioning an accounting treatment different from that prescribed by an Accounting Standard.
In such a situation, the attention of the members is drawn to the announcement of the Council of the Institute in this respect. The Council has recommended that the following disclosures be made in the financial statements for the year in which different treatment has been given:

(i) A description of the accounting treatment made alongwith the reason that the same has been adopted because of the Court/ Tribunal order.

(ii) Description of the difference between the accounting treatment prescribed in the Accounting Standard and that followed by the Company.

(iii) The final impact, if any, arising due to such a difference.

**Capital Reserves**

**Capital Redemption Reserve**

48. In terms of the provisions of sections 77A and 80 of the Companies Act, 1956, if the company redeems the preferential share capital or buys back its own shares, using the retained earnings, the amount equivalent to the nominal value of the shares redeemed/bought back have to be transferred to the capital redemption reserve, and such reserve can be utilised only for issue of bonus shares to the members of the company.

**Securities Premium Account**

49. Any premium realised on issue of securities should be transferred to Securities Premium Account and utilised only for the purposes laid down in section 78 of the Companies Act, 1956.

**Government Grants**

50. Grants, contributions and subsidies received from Government specifically for acquisition of assets have to be treated and disclosed in the financial statements as laid down in Accounting Standard 12, issued by the Institute.

**Revaluation Reserve**

51. Reserves arising out of revaluation of fixed assets are to be transferred to the Revaluation Reserve account. The treatment and utilisation of these reserves is governed by the “Guidance Note on Treatment of Reserve Created on Revaluation of Fixed Assets” and “Guidance Note on Availability of Revaluation Reserve for Issue of Bonus Shares” issued by the Institute.

**Statutory Reserves**

52. Section 17 of the Banking Regulation Act, 1949 and certain provisions in the Cooperative Societies Act, 1912 provide for creation and utilisation of certain specific reserves. Laws governing other entities may contain similar provisions as to the creation and utilisation of such reserves. The regulators may also direct the entities to create some specific reserves, for example, the Reserve Bank of India has directed all banking companies to create and transfer certain amount of profits earned on trading of investments to Investment Fluctuation Reserve and has also stipulated the purpose for which such reserve can be utilised. The
auditor should familiarise himself with such regulatory directions with respect to creation and utilization of such specific reserve and verify compliance therewith.

Revenue Reserves

53. A revenue reserve is a reserve, which is available for distribution as dividend. The auditor should examine the legal provisions governing the entity with regard to transfer of certain percentage of profits to reserves, for example, the requirements of section 205 (2A) of the Companies Act, 1956, the Reserve Bank of India Directions in case of Non Banking Financial Companies, etc.

54. Certain other statutes may require transfer of profits to reserves. For example, the Income-tax Act, 1961 may require creation of certain reserves and provide for rules for utilisation of such reserves to claim certain fiscal benefits. The auditor should examine the need for transfer of profits to reserves and utilisation of such transfers.

Examination of Compliance with Laws and Regulations

55. Standard on Auditing (SA) 250, Consideration of Laws and Regulations in an Audit of Financial Statements requires that “when planning and performing audit procedures and in evaluating and reporting the results thereof, the auditor should recognise that non compliance by the entity with laws and regulations may materially affect the financial statements.” The auditor should therefore acquire sufficient knowledge of the legal and regulatory framework within which the client operates. This assumes added importance in cases of audit of capital and reserves of companies since the matters relating to the share capital and reserves are governed by the provisions of the Companies Act, 1956, especially the provisions contained in sections 69 to 116, section 177C, section 205(2A) of the said Act. For example, sections 69 to 116 of the Companies Act, 1956 regulate the matters relating to issue and allotment of shares, section 205 (2A) and section 177C of the Companies Act, 1956 contain provisions relating to creation and utilisation of certain reserves and section 187C deals with the situation where the beneficial owner of the shares of the company is different from the person whose name is appearing in the shareholders’ register of the company. Guidelines issued by the Securities and Exchange Board of India from time to time also contain the matters relating to the issue and allotment of shares in case of public offer and substantial acquisition of shares in case of existing listed companies. Moreover, the Articles of Association of the entity may also have provisions relating to share capital and reserves. The Companies Act, 1956 requires compliance with the Articles of Association in so far as they are not contradictory to the provisions of the Act. Hence, it is very important to verify the compliance with the laws and regulations governing the entity.

56. The State Co-operative Societies Acts may have conditions as to minimum paid up capital and also minimum number of members for co-operative societies and with regard to creation and utilisation of various reserves. Statutes governing the entity may contain similar provisions with regard to the number of members and minimum amount of capital. The auditor should be familiar with the laws governing the entity. The auditor has to carefully examine the compliance of such legal requirements.
57. The auditor has to examine the compliance with the various rules and regulations, for example:

(a) Government Order, if any, the Memorandum and the Articles of Association of the company or the Rules and Regulations governing the entity.

(b) Terms of issue attached or subsequently approved in case of conversion of loans or convertible preference shares.

(c) Issue of Foreign Currency Convertible Bonds and Ordinary Shares (Through Depository Receipt Mechanism) Scheme, 1993 and Guidelines on Euro Issues.

(d) Rules and Regulations relating to issue and buy back of ADR/GDR.


(g) Unlisted Companies (Issue of Sweat Equity Shares) Rules, 2003.

(h) Any other Rules and Regulations prescribed by Government/SEBI from time to time.

Examination of Presentation and Disclosure

58. The laws governing the entity may prescribe the format for disclosure of information relating to the Capital and Reserves in its Balance Sheet. For example, the Companies Act, 1956, the Banking Regulation Act, 1949, the Electricity Act, 2003 and Insurance laws prescribe the format of Balance Sheet and the manner of disclosure of the capital and reserves in the financial statements. The auditor should examine compliance with such disclosure requirements and adequacy thereof. Where the relevant statute lays down any disclosure requirements in this behalf, the auditor should examine whether the same are complied with, for example, SEBI requires that in case of public issue and preferential issue of shares and/or partly/fully convertible debentures, purpose for which these monies are utilised and the manner in which the unutilised money is invested should be disclosed. Sometimes, it may be necessary to disclose the information either in the Significant Accounting Policies and Notes on Accounts to clarify the matters, for example, any employee options outstanding, etc. The auditor should examine such necessity and consider whether appropriate disclosures such as those listed below have been made:

- Aggregate number and class of shares allotted as fully paid up pursuant to contract(s) with or without payment being received in cash
- Aggregate number and class of shares allotted as fully paid by way of bonus shares
- Aggregate number and class of shares bought back
- Source of issuance of bonus shares during the year, if any
- Preference Share Capital, including terms of redemption or conversion
- Shares with differential rights
SPECIAL CONSIDERATIONS APPLICABLE TO PARTNERSHIP ENTITIES

59. The most significant document underlying the partnership form of organisation is the Partnership Deed.

60. The Partnership Deed generally provides the capital required to be contributed by the partners and their respective share in profits and losses and interest, if any, on the capital contributed or balances to their credit. The Partnership Deed may also provide for the treatment of excess capital contributed by any partner and their respective rights relating to the withdrawals from capital/drawing accounts.

61. It may be possible that one or more partners contributes the capital in kind rather than in cash. For example, the premises required for the business may be provided by a partner as his capital contribution. If such contributions are in kind at the time of admission of the partners, the value of such assets is generally mentioned in the Partnership Deed. If the value is not mentioned in the Partnership Deed, the auditor may request for a declaration of the value in writing by all the partners. He should also obtain necessary audit evidence for supporting the valuation.

62. The partnership deed may also provide for fixed capital contribution and timing of contribution by each partner. The auditor should examine whether the capital contributed by each of the partners is in accordance with the Partnership Deed and the capital is maintained at the level mentioned in the Partnership Deed throughout the period of audit.

63. If the Partnership Deed places any restrictions on the drawings of the partners, the auditor should examine whether the drawings have been within the permissible limit.

64. The auditor has to verify the correctness of the interest, if any, credited or debited to the partners’ capital or drawings account.

65. Generally, remuneration, interest on capital, interest on drawings, profits or losses are adjusted in the capital accounts or the drawing accounts of the partners, and Reserve accounts are not maintained in case of partnership accounts. However, if fiscal or any other law require any reserve has to be created for claiming any benefit, a reserve with appropriate title may be created out of the profits of the firm. The rules for utilisation of the reserve may be provided in the relevant laws. In such event, the auditor should examine the compliance with the same. Sometimes, the partners may decide to create and utilise certain reserves due the exigencies of the business, in which case the auditor has to verify the compliance of the decision of the partners. In case the entity has not complied with the prescribed reserve utilization requirements, he should consider the effect of the same on his audit report in terms of the principles laid down in the SA 250, Consideration of Laws and Regulations in an Audit of Financial Statements.

66. Special Reserves, created to meet the requirements of any law, may be credited to the Partners’ Capital Accounts on fulfillment of such statutory requirements or the terms of creation of such reserves.

67. Government grants and subsidies received shall have to be accounted for in accordance with Accounting Standard 12.
68. Where either investments or drawings have come from Non Resident Indians or foreign sources involving foreign currency, the auditor has to verify the compliance of RBI regulations as well as the provisions of the Foreign Exchange Management Act, 1999 in this regard.

69. All transactions in the partners’ capital account and drawings account have to be vouched for their correctness.

70. The auditor has to verify that the distribution of profit/loss is as per the terms of Partnership Deed. It may be noted that if any minor is admitted to the benefits of partnership, no loss should be apportioned to the share of minor.

71. If a partner dies/retires during the year, the partnership entity may prepare accounts up to the date of such death/retirement to ascertain the claim of heirs/retiring partner. In such event, the auditor has to verify the apportionment of the profit/loss for both the periods.

SPECIAL CONSIDERATIONS APPLICABLE TO A SOLE PROPRIETARY ENTITY

72. The audit of capital account of the sole proprietor poses considerable problems, as the capital account is generally maintained as a current account. Generally, the entries in the capital account are many, when compared with other forms of entities. The capital introduced by the proprietor in the entity may be in cash or in kind. The introduction of capital can take place at number of times, depending upon the need for the working capital in the entity. Similarly, the drawings are made for various personal expenses.

73. It may also be possible that the personal expenses of the proprietor are booked in the accounts of the business without appropriately reflecting them in those accounts.

74. Generally, internal control procedures are inadequate or absent in many sole proprietary entities. Hence, the auditor should be careful while examining the accounts of such entity. Though the auditor needs to obtain the same level of assurance in order to express an unqualified opinion on the financial statements of both small and large entities, however, many internal controls which would be relevant to large entities are not practical in the small business. For example, in small businesses, accounting procedures may be performed by a few persons who may have both operating and custodial responsibilities, and therefore segregation of duties may be missing or severely limited. Inadequate segregation of duties may, in some cases, be offset by a strong management control system in which owner/manager supervisory controls exist because of direct personal knowledge of the entity and involvement in transactions. In circumstances where segregation of duties is limited and audit evidence of supervisory controls is lacking, the audit evidence necessary to support the auditor’s opinion on the financial statements may have to be obtained entirely through the performance of substantive procedures. He should apply his professional judgment based on the knowledge of the business he has acquired to determine whether the expenditure recorded is in fact relevant and appropriate to the business and also all expenditures are recorded in the books of account.

75. The auditor should examine the nature of assets included in the balance sheet of the entity and verify whether such assets are relevant and appropriate to the nature of the business and recorded at fair value.
76. Generally profits or losses are adjusted in the capital account or the drawings account of the proprietor, and reserve accounts are not maintained in case of sole proprietorship accounts. However, if fiscal laws require any reserve to be created for claiming any fiscal benefit, a reserve account with appropriate title may be created out of the profits of the firm. The rules for utilisation of the reserve account may be provided in the same fiscal laws. In such event the auditor should examine the compliance with such laws.

77. Special Reserves created, if any, pursuant to fiscal laws, upon fulfillment of the terms of such reserves, have to be transferred to the capital account of the sole proprietor.

78. Government grants and subsidies received shall have to be accounted for in accordance with Accounting Standard 12.

MANAGEMENT REPRESENTATIONS

79. The auditor should obtain from the management of the entity, a written representation on significant aspects of capital and reserves accounts, viz., that all the transactions in the capital and reserves have been recorded and recorded at correct values; that there are no unrecorded transactions in the capital and reserves accounts; that the year end balances (including any notes to the accounts in respect thereof) of the capital and reserves accounts have been appropriately presented and disclosed in accordance with applicable financial reporting framework, in the financial statements, that the management has complied with all the applicable rules and regulations while undertaking transactions relating to capital and reserves.

DOCUMENTATION

80. The auditor should maintain adequate working papers documenting significant aspects of audit such as:

(a) the nature, timing, extent and results of the audit procedures performed to comply with Standards on Auditing and applicable legal and regulatory requirements;

(b) the audit evidence obtained;

(c) the conclusions reached on significant matters; and

(d) in relation to audit procedures designed to address identified risks of material misstatement, conclusions that are not otherwise readily determinable from the procedures performed or audit evidence obtained.

However, it may be noted that the extent of documentation is a matter of professional judgment since it is neither necessary nor practical that every observation, consideration or conclusion is documented by the auditor in his working papers.

Appendix A

Extracts from Counsel’s opinion referred to in Para 22 – “Subscription in Cash and Kind”

“The ratio of Spargo’s case is that if there is on the one side a bona-fide debt payable in money at once by the company (hereinafter called “debt”), and on the other side a bona-fide
liability to pay money on allotment of shares, so that if bank notes are handed from one side of the table to other in payment of calls, they may legitimately be handed back in payment of the debt. The law does not make it necessary that the formality should be gone through of the money being handed over be taken back again, and if the two demands are set off against each other the shares have been paid for in cash. This is still good law and on facts similar to those of Spargo's case it would be right for a company to show in its accounts the shares as having been allotted for cash.

It is the necessary implication of Section 227(1A)(f) that shares may be correctly stated to have been allotted for cash even though cash may not have been actually received in respect of such allotment …….. If the Auditors find that the case is covered by the ratio of the decision in Spargo's case, no comment would be required from the Auditors and the statement in the Balance Sheet and other accounts that the shares were allotted for cash must be accepted as correct, regular and not misleading, although no cash had been actually received by the company………..

The function of Section 75(1) is merely to impose an obligation on the company to file a Return of the Allotments with the Registrar. Now, the expression "share allotted for cash" is an ambiguous expression. It may mean shares allotted for cash actually received by the Company, or it may mean shares allotted for cash not actually received but adjusted against a debt. In order that this ambiguity may be removed and the Registrar may know the precise factual position, Section 75(1)(a) requires that in the Return of Allotments to be filed with the Registrar shares should not be shown as having been allotted for cash if cash has not been actually received. This, however, does not prevent the company from stating in the Return that shares not shown in the Return as having been allotted for cash were in fact allowed against adjustment of a debt, and consequently such shares would be shown in the company's accounts as having been allotted for cash."
GUIDANCE NOTE ON
AUDIT OF PAYMENT OF DIVIDEND*

The following is the text of the Guidance Note on Audit of Payment of Dividend issued by the Auditing and Assurance Standards Board of the Council of the Institute of Chartered Accountants of India. This Guidance Note should be read in conjunction with the Standards on Auditing issued by the Institute.

1. Paragraph 2.1 of the “Preface to the Statements on Standard Auditing Practices” issued by the Institute of Chartered Accountants of India states that the “main function of the Auditing Practices Committee (APC) is to review the existing auditing practices in India and to develop Statements on Standard Auditing Practices (SAPs) so that these may be issued by the Council of the Institute”. Paragraph 2.4 of the Preface states that the “APC will issue Guidance Notes on the issues arising from the SAPs wherever necessary”.

2. The Auditing and Assurance Standards Board has also taken up the task of reviewing the Statements on auditing matters issued prior to the formation of the Board. It is intended to issue, in due course of time, Engagement Standards or Guidance Notes, as appropriate, on the matters covered by such Statements which would then stand withdrawn. Accordingly, with the issuance of this Guidance Note on Audit of Payment of Dividends, paragraphs 8.19 to 8.24 of the “Capital and Reserve” section of “Statement on Auditing Practices” shall stand withdrawn.4

Introduction

3. Guidance Note on Terms Used in the Financial Statements, issued by the Institute, defines dividend as “A distribution to shareholders out of profits or reserves available for this purpose”.

4. Dividend means a return on shares held in an entity and payable out of distributable surplus. The dividends, which are paid on winding up, are in fact distribution of the entity’s assets and not of profits, even if those assets include some profit earned on winding up of the entity. However, the proviso to section 205(3) of the aforementioned Act permits a company to

---

* Issued in August, 2005.
1 The said Preface has been withdrawn pursuant to issuance of the Revised “Preface to Standards on Quality Control, Auditing, Review, Other Assurance and Related Service”, by the Institute of Chartered Accountants of India. The Revised Preface is effective from April 1, 2008. The text of the revised Preface is reproduced in the Vol-I.A of this Handbook.
2 Now known as the Auditing and assurance Standards Board (AASB).
3 Now known as Engagement Standards.
4 Since the Statement was withdrawn in March, 2005, the entire paragraph is redundant.
capitalise its profits by issuing fully paid bonus shares or paying up any amount being unpaid on shares held by its members. Further, under section 205(3) of the Companies Act, 1956, no dividend is payable otherwise than in cash.

5. Dividend includes any interim dividend. It may also be noted that in case of a company, provisions of section 205, 205A, 205C, 206, 206A and 207 of the Companies Act, 1956 apply to interim dividend as well.

6. In any auditing situation, the auditor employs appropriate procedures to obtain reasonable assurance about various assertions as laid down in paragraph 6 of the Standard on Auditing 500, “Audit Evidence”. In carrying out the audit of payment of dividends, the auditor’s primary objective is to obtain sufficient appropriate audit evidence to satisfy himself that dividend has been declared and paid in accordance with the applicable provisions, if any, of the relevant laws and regulations applicable to the entity and that all the transactions relating to declaration and payment of dividend have been properly accounted for and disclosed. The auditor’s scope of examination would, therefore, include:

(a) verifying whether dividend has been declared out of distributable surplus after proper authorisation, as required under law;

(b) evaluating the internal control system regarding procedure of preparation and issuance of dividend warrants /instructions for direct transfer of funds to the shareholders’ accounts and also check the timeliness of dispatch of warrants and deposition of the dividend amount in the separate bank account, if any, maintained for this purpose;

(c) examining compliance with the requirements of the relevant laws and regulations relating to payment of dividend, for example, mandatory transfer to a reserve fund or transfer to other funds, such as unclaimed dividend account, Investor Education and Protection Fund, etc., as applicable to the entity; and

(d) examining the system for recording and appropriate disclosure of transactions during the year relating to payment of dividend.

Internal Control Evaluation

7. The auditor should ascertain whether the governing charter, for example, Articles of Association in case of a company, or any similar document of the entity, permits payment of dividend to the members by the entity. For example, a company formed under section 25 of the Companies Act, 1956 is prohibited under the said section itself from paying any dividend to its members.

8. The auditor should study and evaluate the system of internal control relating to payment of dividend to determine the nature, timing and extent of his other audit procedures. He should particularly review the following aspects relating to payment of dividend:

(a) whether all transactions in the dividend account have been authorised by the competent
Auditing Pronouncements

III.144

authority;
(b) whether the registers containing the details of members and dividend have been properly maintained by the entity;
(c) whether there is an effective system of segregation of duties in place. Special attention should be given to the segregation of the duties towards maintenance of shareholders' register, preparation of dividend warrants and maintenance of warrant dispatch register;
(d) the internal control procedures with regard to preparation of dividend warrants and posting them to the members, or the instructions given for electronic transfer of funds or any other mode of payment of dividend to the members, and records maintained to record the details of unclaimed dividend. Separate records of unclaimed dividend should be maintained for each year's dividend/interim dividend;
(e) the procedures for payment of unclaimed dividend and should satisfy himself that they are not paid without adequate safeguards being taken as to identification of the payee, checking of the payee's claim, etc.

In case, the above activities are outsourced, the auditor should evaluate the activities of the service organisation and if finds them significant, he should obtain sufficient information to understand the accounting and internal control systems of the service organisation and assess control risk at either the maximum or a lower level, as appropriate, if tests of control are performed. For detailed guidance in this respect, reference may be made to Standard on Auditing 402, “Audit Considerations Relating to an Entity Using a Service Organisation.”

Verification

9. Verification of payment of dividend may be carried out by performing the following procedures:
(a) examination of compliance with laws and regulations and such other relevant information having a bearing on payment of dividend; and
(b) examination of the system of maintenance of records.

10. The auditor should verify the compliance with laws and regulations, provisions contained in the governing charter, e.g. Articles of Association in case of companies, bye-laws or rules and directions/instructions issued by any regulatory authority applicable to the entity and/or the terms of the banks/financial institutions which may lay down certain restrictions or conditions on declaration of dividend. For example:
(a) In case of companies, the following conditions have to be complied with before declaration of dividend:

   ♦ It has provided for depreciation for any previous financial year(s) which fall(s) after the commencement of the Companies (Amendment) Act, 1960 [section 205(1)] and
further that such depreciation has been computed in accordance with the requirements of section 350 and other provisions of section 205(2) of the Act

♦ It has provided for any losses incurred in any previous financial year(s) which fall(s) after the commencement of the Companies (Amendment) Act, 1960 [section 205(1)]

♦ Where the company has declared dividend for any financial year out of the profits for that year, it has also transferred to a reserve such percentage (or a higher percentage) of profits as may be prescribed in the Companies (Transfer of Profits to Reserves) Rules, 1975 [section 205(2A)]

♦ It has complied with the requirements of section 80A, dealing with redemption of irredeemable preference shares etc., of the Companies Act, 1956.

(b) Under the Banking Regulation Act, 1949, dividend can not be paid without first writing off intangible assets and transferring certain percentage of profits to statutory reserves unless permitted by the Central Government to do so. Section 17 of the Banking Regulation Act, 1949 requires that a banking company incorporated in India must transfer twenty per cent of its annual profits to a reserve fund before any dividend is distributed unless a specific exemption has been obtained from the Central Government.

(c) State Co-operative laws lay down that certain percentage of profits have to be transferred to various reserves and a minimum percentage of profit has to be paid as dividend.

11. The auditor has to verify that the dividend is declared only out of distributable surplus. For example, in case of a company, under section 205 of the Companies Act, 1956, dividends can be distributed out of profits for the year in which dividend is declared, accumulated profits of any preceding year or under any guarantee given by Central or any State Government.

12. The auditor should verify that a specific resolution for payment of dividend has been duly passed at the meeting of the Board or any similar authority. In case of interim dividend, the dividend declared by the Board of Directors or similar authority is final. In case of final dividend, the auditor should also verify that the recommendations of the Board have been approved by the members at the annual general meeting. It may, however, be noted that in case of companies, the members can reduce the amount of dividend or decide for non-payment of dividend but they can not increase the dividend recommended by the Board.

13. If the entity has non-voting shares and/or shares with variable rights and/or preference shares with various options like, cumulative, participatory, etc., the resolution declaring the dividend should also specify different rates of dividend on the shares having variable rights or preferential rights as to dividend. In such cases, the auditor has to verify that the dividend paid is in accordance with the terms of the resolution and also the resolution is in accordance with the terms attached to these shares.

14. Other laws and regulations, relating to payment of dividend, governing the entity may impose similar or other restrictions. The auditor has to be familiar with the laws and regulations.
governing the entity and verify whether these laws and regulations have been complied with. For example, the auditor has to examine the compliance with provisions of the Foreign Exchange Management Act, 1999 for the payment of dividend in foreign currency pursuant to issue of shares to non-residents and issue of ADR/GDR. Appendix to this Guidance Note contains relevant extracts of the provisions of various statutes having a bearing on the declaration and payment of dividend.

15. In case of a listed company, the auditor should also verify whether the provisions of the Listing Agreement as to declaration of dividend, e.g., prior intimation to the Stock Exchange about the Board meeting at which declaration/recommendation of dividend is to be considered, intimation to Stock Exchanges of all dividends and/or cash bonuses recommended or declared or the decision to pass any dividend or interest payment at the Board meeting, have been complied with or not.

16. The nature, timing and extent of substantive procedures to be performed by the auditor is, however, a matter of professional judgment of the auditor which is based, inter alia, on the auditor’s evaluation of the effectiveness of the related internal controls.

17. The auditor should examine that the mandatory transfer of the amount specified to a separate fund, where so required by the relevant laws and regulations, have been made before payment of dividend.

18. The auditor has to verify that the dividend is paid in accordance with the terms prescribed in resolution by the Board/members.

19. The auditor should verify that the dividend warrants have been dispatched to the members within the time limit prescribed.

20. If an interim dividend is declared, the auditor has to verify whether the same is approved in a general meeting of the members and the provisions contained in the Articles of Association or bye-laws or other statutes governing the body corporate permit it to pay interim dividend. In case of statutory corporations and nationalised banks, the Board may be empowered to declare and pay the dividend and resolution by the members may not be necessary. In case of companies, the auditor should verify that the financial statements have been prepared and presented before the Board and the Board while considering the interim dividend, has taken into account the depreciation to be provided for the full year, profit to be transferred to reserves under Companies (Transfer of Profits to Reserves) Rules, 1975 and the dividend payable to preference shareholders.

21. If the laws and regulations applicable to the entity require it to deposit the amount of dividend, interim and/or final, in a separate bank account, the auditor has to verify whether such transfer of funds to the separate account has been made within the prescribed time limit. The auditor should also verify the compliance of law with regard to unclaimed dividend. For example, in case of companies, the dividend declared has to be deposited within prescribed period in a
separate bank account and if dividend is not claimed within such number of days, of such
transfer, as may be specified by the Companies Act, 1956 or rules made thereunder and the
amount remaining in the separate bank account has to be transferred to unpaid dividend account
separately opened with any scheduled bank and the amount remaining in that account after the
expiry of such period of opening such unpaid dividend account, as may be prescribed together
with interest accrued thereon, if any, has to be transferred to Investor Education and Protection
Fund Account established under the Companies Act, 1956. It may be noted, that within specified
number of months prior to the transfer of unclaimed dividend to Investor Education & Protection
Fund, the company has to give notice to individuals who have not claimed such dividend. If the
auditor finds that the amounts required to be transferred as above have a material effect on the
financial statements, and have not been properly reflected in the financial statements, the
auditor should assess the impact of such non-compliance on his audit report.

22. The auditor should verify that adjustment, if any, made in the dividend payable, towards
calls in arrears or any other sums due from members is in accordance with the terms of issue,
laws and regulations applicable to the entity.

23. The auditor may verify the total amount of dividend transferred to a separate bank account
is in agreement with the statement prepared by the body corporate reconciling the total dividend
payable on shares in physical form, dematerialised form, and dividend withheld in respect of
shares pending for registration of transfer and adjustments, if any, made for the calls in arrears
and other dues from the members.

24. The listed companies are required to electronically transfer dividend to bank accounts of
the shareholders, wherever Electronic Clearing Services (ECS) facility is available and the
members/depositories furnish details of the respective bank accounts of the members and in
respect of others, distribute the dividend through dividend warrants. In such cases, in addition to
test checks for individual payments, the auditor should examine the overall reconciliation of the
total payment made through electronic transfer and payment made through dividend warrants.

25. The auditor should verify that the dividend is paid:

(a) (i) in respect of shares held in electronic form, to those persons whose details as on
record date/book closure date are furnished by the depositories; and/or

(ii) in respect of shares held in physical form, to the members whose names are
appearing on the record date/ immediately after effecting the transfers submitted till
the date of book closure; and

(b) in respect of share warrants to the holders of share warrants.

26. The auditor should apply the analytical procedures before forming any overall conclusion
so as to find out any material fluctuations and deviations from the relevant information that he
has gained during the course of audit. Such analytical procedures may be regarding the changes
in the shareholding pattern, dividend pay out ratio, ratio of gross dividend payable to the paid up

© The Institute of Chartered Accountants of India
share capital or ratio of net dividend payable with the gross dividend payable by the entity. In case of listed companies, the auditor may also review the minutes of the meetings of the Investors’ Grievances Committee, wherever such Committee exists, to have an overview of the nature and number of complaints related to dividends as the same would provide the auditor an additional evidence as to the efficacy of the internal control system in relation to payment of dividend.

27. The auditor should verify that the total amount remaining in the unclaimed dividend account, for example, because of dispute about ownership on account of court cases etc., or the amount not claimed by shareholders, tallies with the schedule of unclaimed dividend for each year for which dividend remains unclaimed.

28. The auditor has to verify that in case the entity proposes to pay dividend out of its accumulated reserves, whether the same has been paid after complying with the statutory requirements, if any. For example, a company can pay dividend out of its accumulated reserves only after complying with the provisions of sub-section (3) of Section 205A of the Companies Act, 1956 and the Companies (Declaration of Dividend out of Profits) Rules, 1975. These Rules provide for the maximum amount that can be paid as dividend. In cases where the company declares dividend that is not in accordance with these Rules, the auditor must verify that the company has obtained prior approval from the Central Government for the same. Similar provisions, if any, in the laws applicable to other entities have to be complied with.

29. The auditor should also verify that:

(a) If capital profits are distributed as dividend:
   (i) the Articles or the bye-laws or other rules and regulations applicable to the entity, permit such distribution; and
   (ii) it has been realised in cash; and
   (iii) the Board or similar authority is satisfied that net aggregate value of the assets remaining after distribution of that profit will not be less than the book values so that share capital and reserves remaining after the distribution will be fully represented by the remaining assets.

(b) Capital surplus arising on the revaluation of fixed assets is not directly or indirectly available for distribution as dividend.

(c) Any reserve in the nature of capital reserve arising on acquisition of a business as a going concern or on amalgamation in the nature of purchase and Securities premium collected on the issue of securities can not be utilised for declaration of dividend.

Disclosure

30. Proposed dividend should be shown as appropriation of profit in the Profit and Loss
Account and as provision under “Provisions” in the Balance Sheet.

31. Unclaimed dividends should be shown in Balance Sheet under the head “Current Liabilities”.

32. In respect of companies, all arrears of cumulative preference dividends should be shown as a contingent liability.

Management Representation

33. The auditor should obtain representation from the management of the entity about the amount retained in unclaimed dividend account by reason of disputes pending in various courts of law and also that it has complied with all laws and regulations applicable to the provisioning and payment of dividend including transfers to Unclaimed Dividend Fund or any other fund such as Investors Education and Protection Fund, where so required and that the dividend has been paid to the persons entitled to it.

Documentation

34. The auditor’s working papers should contain the plan devised for verification of payment of dividend. Among other papers, he should maintain in his audit file, the management representations and any other relevant document, such as copy of the Board resolution authorising payment of dividend, etc. He should ensure that all significant matters that require the exercise of his professional judgment, together with the auditor’s conclusion thereon have been properly included in his working papers.

Appendix

Provisions of Certain Acts and Rules With Regard to Declaration and Payment of Dividend

The Companies Act, 1956

205. Dividend to be Paid only out of Profits – (1) No dividend shall be declared or paid by a company for any financial year except out of the profits of the company for that year arrived at after providing for depreciation in accordance with the provisions of sub-section (2) or out of the profits of the company for any previous financial year or years arrived at after providing for depreciation in accordance with those provisions and remaining undistributed or out of both or out of moneys provided by the Central Government or a State Government for the payment of dividend in pursuance of a guarantee given by that Government:

Provided that –

5 The Acts and Rules specified in this Appendix are only illustrative in nature and are not meant to be exhaustive for the purposes of the laws dealing with the payment of dividend by different entities.
(a) if the company has not provided for depreciation for any previous financial year or years which falls or fall after the commencement of the Companies (Amendment) Act, 1960 (65 of 1960) it shall, before declaring or paying dividend for any financial year provide for such depreciation out of the profits of that financial year or out of the profits of any other previous financial year or years;

(b) if the company has incurred any loss in any previous financial year or years, which falls or fall after the commencement of the Companies (Amendment ) Act, 1960 (65 of 1960) then, the amount of the loss or an amount which is equal to the amount provided for depreciation for that year or those years whichever is less, shall be set off against the profits of the company for the year for which dividend is proposed to be declared or paid or against the profits of the company for any previous financial year or years, arrived at in both cases after providing for depreciation in accordance with the provisions of sub-section (2) or against both;

(c) the Central Government may, if it thinks necessary so to do in the public interest, allow any company to declare or pay dividend for any financial year out of the profits of the company for that year or any previous financial year or years without providing for depreciation:

Provided further that it shall not be necessary for a company to provide for depreciation as aforesaid where dividend for any financial year is declared or paid out of the profits of any previous financial year or years which falls or fall before the commencement of the Companies (Amendment) Act, 1960 (65 of 1960).

(1A) The Board of directors may declare interim dividend and the amount of dividend including interim dividend shall be deposited in a separate bank account within five days from the date of declaration of such dividend.

(1B) The amount of dividend including interim dividend so deposited under sub-section (1A) shall be used for payment of interim dividend.

(1C) The provisions contained in sections 205, 205A, 205C, 206, 206A and 207 shall, as far as may be, also apply to any interim dividend.

(2) For the purpose of sub-section (1), depreciation shall be provided either –

(a) to the extent specified in section 350; or

(b) in respect of each item of depreciable asset, for such an amount as is arrived at by dividing ninety-five per cent of the original cost thereof to the company by the specified period in respect of such asset; or

(c) on any other basis approved by the Central Government which has the effect of writing off by way of depreciation ninety-five per cent of the original cost to the company of each such depreciable asset on the expiry of the specified period; or
(d) as regards any other depreciable asset for which no rate of depreciation has been laid
down by this Act or any rules made there under, on such basis as may be approved by the
Central Government by any general order published in the Official Gazette or by any
special order in any particular case:

Provided that where depreciation is provided for in the manner laid down in clause (b) or clause
(c), then, in the event of the depreciable asset being sold, discarded, demolished or destroyed
the written down value thereof at the end of the financial year in which the asset is sold,
discarded, demolished or destroyed, shall be written off in accordance with the proviso to section
350.

(2A) Notwithstanding anything contained in sub-section (1), on and from the commencement of
the Companies (Amendment) Act, 1974 (41 of 1974), no dividend shall be declared or paid by a
company for any financial year out of the profits of the company for that year arrived at after
providing for depreciation in accordance with the provisions of sub-section (2), except after the
transfer to the reserves of the company of such percentage of its profits for that year, not
exceeding ten per cent, as may be prescribed:

Provided that nothing in this sub-section shall be deemed to prohibit the voluntary transfer by a
company of a higher percentage of its profits to the reserves in accordance with such rules as
may be made by the Central Government in this behalf.

(2B) A company which fails to comply with the provisions of section 80A shall not, so long as
such failure continues, declare any dividend on its equity shares.

(3) No dividend shall be payable except in cash:

Provided that nothing in this sub-section shall be deemed to prohibit the capitalization of profits
or reserves of a company for the purpose of issuing fully paid-up bonus shares or paying up any
amount, for the time being unpaid, on any shares held by the members of the company.

(4) Nothing in this section shall be deemed to affect in any manner the operation of the section
208.

(5) For the purposes of this section –

(a) “specified period” in respect of any depreciable asset shall mean the number of years at the
end of which at least ninety-five per cent of the original cost of that asset to the company
will have been provided for by way of depreciation if depreciation were to be calculated in
accordance with the Provisions of section 350;

(b) any dividend payable in cash may be paid by cheque or warrant sent through the post
directed to the registered address of the shareholder entitled to the payment of the
dividend, or in the case of joint shareholders, to the registered address of that one of the
joint shareholders which is first named on the register of members, or to such person and
to such address as the shareholder or the joint shareholders may in writing direct.
205A. Unpaid dividend to be transferred to special dividend account—

(1) Where, after the commencement of the Companies (Amendment) Act, 1974 (41 of 1974), a dividend has been declared by a company but has not been paid, or claimed, within thirty days from the date of the declaration, to any shareholder entitled to the payment of the dividend, the company shall, within seven days from the date of expiry of the said period of thirty days, transfer the total amount of dividend which remains unpaid or unclaimed within the said period of thirty days to a special account to be opened by the company in that behalf in any scheduled bank, to be called “Unpaid Dividend Account of …… Company Limited/ Company (Private) Limited”.

Explanation: In this sub-section, the expression “dividend which remains unpaid” means any dividend the warrant in respect thereof has not been encashed or which has otherwise not been paid or claimed.

(2) Where the whole or any part of any dividend, declared by a company before the commencement of the Companies (Amendment) Act, 1974 (41 of 1974), remains unpaid at such commencement, the company shall within a period of six months from such commencement, transfer such unpaid amount to the account referred to in sub-section (1).

(3) Where, owing to inadequacy or absence of profits in any year, any company proposes to declare dividend out of the accumulated profits earned by the company in previous years and transferred by it to the reserves, such declaration of dividend shall not be made except in accordance with such rules as may be made by the Central Government in this behalf, and, where any such declaration is not in accordance with such rules, such declaration shall not be made except with the previous approval of the Central Government.

(4) If the default is made in transferring the total amount referred to in sub-section (1) or any part thereof to the unpaid dividend account of the concerned company, the company shall pay, from the date of such default, interest on so much of the amount as has not been transferred to the said account, at the rate of twelve per cent per annum and the interest accruing on such amount shall ensure to the benefit of the members of the company, in proportion to the amount remaining unpaid to them.

(5) Any money transferred to the unpaid dividend account of a company in pursuance of this section which remains unpaid or unclaimed for a period of seven years from the date of such transfer shall be transferred by the company to the fund established under sub-section (1) of section 205C.

(6) The company shall, when making any transfer under sub-section (5) to the Fund established under section 205C any unpaid or unclaimed dividend, furnish to such authority or committee as the Central Government may appoint in this behalf a statement in the prescribed form setting forth in respect of all sums included in such transfer, the nature of the sums, the names and last known addresses of the persons entitled to receive the sum, the amount to
which each person is entitled and the nature of his claim thereto, and such other particulars as
may be prescribed.

(7) The company shall be entitled to a receipt from the authority or committee under sub-
section (4) of section 205C for any money transferred by it to the Fund and such a receipt shall
be an effectual discharge of the company in respect thereof.

(8) If a company fails to comply with any of the requirements of this section, the company and
every officer of the company who is in default, shall be punishable with fine which may extend to
five thousand rupees for every day during which the failure continues.

205B. Payment of unpaid or unclaimed dividend— Any person claiming to be entitled to any
money transferred under sub-section (5) of section 205A to the general revenue account of the
Central Government, may apply to the Central Government for an order for payment of the
money claimed; and the Central Government may, if satisfied, whether on a certificate by the
company or otherwise, that such person is entitled to the whole or any part of the money
claimed, make an order for the payment to that person of the sum due to him after taking such
security from him as it may think fit:

Provided that nothing contained in this section shall apply to any person claiming to be entitled
to any money transferred to the fund referred to in section 205C on and after the
commencement of the Companies (Amendment) Act, 1999.

205C. Establishment of Investor Education and Protection Fund— (1) The Central
Government shall establish a fund to be called the Investor Education and Protection Fund
(hereafter in this section referred to as the “Fund”).

(2) There shall be credited to the Fund the following amounts, namely:

(a) amounts in the unpaid dividend accounts of companies;

(b) the application moneys received by companies for allotment of any securities and due for
refund;

(c) matured deposits with companies;

(d) matured debentures with companies;

(e) the interest accrued on the amounts referred to in clauses (a) to (d);

(f) grants and donations given to the Fund by the Central Government, State Governments,
companies or any other institutions for the purposes of the Fund; and

(g) the interest or other income received out of the investments made from the Fund:

Provided that no such amounts referred to in clauses (a) to (d) shall form part of the Fund unless
such amounts have remained unclaimed and unpaid for a period of seven years from the date
they became due for payment.
Explanation: For the removal of doubts, it is hereby declared that no claims shall lie against the Fund or the company in respect of individual amounts which were unclaimed and unpaid for a period of seven years from the dates that they first became due for payment and no payment shall be made in respect of any such claims.

(3) The Fund shall be utilised for promotion of investor’s awareness and protection of the interests of investors in accordance with such rules as may be prescribed.

(4) The Central Government shall, by notification in the Official Gazette, specify an authority or committee, with such members as the Central Government may appoint, to administer the Fund, and maintain separate accounts and other relevant records in relation to the Fund in such form as may be prescribed in consultation with the Comptroller and Auditor General of India.

(5) It shall be competent for the authority or committee appointed under sub-section (4) to spend moneys out of the Fund for carrying out the objects for which the Fund has been established.

206. Dividend not to be paid except to registered shareholders or to their order or to their bankers—(1) No dividend shall be paid by a company in respect of any share therein, except—

(a) to the registered holder of such share or to his order or to his bankers; or

(b) in case a share warrant has been issued in respect of the share in pursuance of section 114, to the bearer of such warrant or to his bankers.

(2) Nothing contained in sub-section (1) shall be deemed to require the bankers of a registered shareholder to make a separate application to the company for the payment of the dividend.
206A. Right to dividend, right shares and bonus shares to be held in abeyance pending registration of transfer of shares— Where any instrument of transfer of shares has been delivered to any company for registration and the transfer of such shares has not been registered by the company, it shall, notwithstanding anything contained in any other provisions of this Act,—

(a) transfer the dividend in relation to such shares to the special account referred to in section 205A unless the company is authorised by the registered holder of such share in writing to pay such dividend to the transferee specified in such instrument of transfer; and

(b) keep in abeyance in relation to such shares any offer of rights shares under clause (a) of sub-section (1) of section 81 and any issue of fully paid-up bonus shares in pursuance of sub-section (3) of section 205.

207. Penalty for failure to distribute dividends within thirty days – Where a dividend has been declared by a company but has not been paid, or the warrant in respect thereof has not been posted, within thirty days from the date of declaration, to any shareholder entitled to the payment of the dividend, every director of the company shall, if he is knowingly a party to the default, be punishable with simple imprisonment for a term which may extend to three years and shall also be liable to a fine of one thousand rupees for every day during which such default continues and the company shall be liable to pay simple interest at the rate of eighteen per cent per annum during the period for which such default continues:

Provided that no offence shall be deemed to have been committed within the meaning of the foregoing provisions in the following cases, namely:

(a) where the dividend could not be paid by reason of the operation of any law;

(b) where a shareholder has given directions to the company regarding the payment of the dividend and those directions cannot be complied with;

(c) where there is a dispute regarding the right to receive the dividend;

(d) where the dividend has been lawfully adjusted by the company against any sum due to it from the shareholder; or

(e) where, for any other reason, the failure to pay the dividend or to post the warrant within the period aforesaid was not due to any default on the part of the company.
Companies (Transfer of Profits to Reserves) Rules, 1975

[GSR 426 (E), Dated 24-7-1975]

In exercise of the powers conferred by sub-section (2A) of section 205, read with clause (a) of subsection (1) of section 642, of the Companies Act, 1956 (1 of 1956), the Central Government hereby makes the following rules, namely:

Short title
1. These rules may be called the Companies (Transfer of Profits to Reserves) Rules, 1975.

Percentage of profits to be transferred to reserves
2. No dividend shall be declared or paid by a company for any financial year out of the profits of the company for that year arrived at after providing for depreciation in accordance with the provisions of sub-section (2) of section 205 of the Act, except after the transfer to the reserves of the company of a percentage of its profits for that year as specified below:

(i) where the dividend proposed exceeds 10 per cent but not 12.5 per cent of the paid-up capital, the amount to be transferred to the reserves shall not be less than 2.5 per cent of the current profits;

(ii) where the dividend proposed exceeds 12.5 per cent but does not exceed 15 per cent of the paid-up capital, the amount to be transferred to the reserves shall not be less than 5 per cent of the current profits;

(iii) where the dividend proposed exceeds 15 per cent but does not exceed 20 per cent of the paid-up capital, the amount to be transferred to the reserves shall not be less than 7.5 per cent of the current profits;

(iv) where the dividend proposed exceeds 20 per cent of the paid-up capital, the amount to be transferred to reserves shall not be less than 10 per cent of the current profits.

Conditions governing voluntary transfer of a higher percentage
3. Nothing in rule 2 shall be deemed to prohibit the voluntary transfer by a company of a percentage higher than 10 per cent of its profits to its reserves for any financial year, so however, that:

(i) Where a dividend is declared, -

(a) a minimum distribution sufficient for the maintenance of dividends to shareholders at a rate equal to the average of the rates at which dividends declared by it over the three years immediately preceding the financial year, or

(b) in a case where bonus shares have been issued in the financial year in which the dividend is declared or in the three years immediately preceding the financial year, a minimum distribution sufficient for the maintenance of dividends to shareholders at an
amount equal to the average amount (quantum) of dividend declared over the three years immediately preceding the financial year, is ensured:

Provided that in a case where the net profits after tax are lower by 20 per cent or more than the average net profits after tax of the two financial years immediately preceding, it shall not be necessary to ensure such minimum distribution,

(ii) where no dividend is declared, the amount proposed to be transferred to its reserves from the current profits shall be lower than the average amount of the dividends to the shareholders declared by it over the three years immediately preceding the financial year.

Penalty

4. If a company fails to comply with any of the provisions contained in these rules, the company and every officer of the company in default, shall be punishable with fine which may extend to five hundred rupees, and, where the contravention is a continuing one, with a further fine which may extend to fifty rupees for every day, after the first, during which such contravention continues.

Companies (Declaration of Dividend out of Reserves) Rules, 1975

[GSR No. 427 (E), Dated 24-7- 1975]

In exercise of the powers conferred by sub-section (3) of section 205A, read with clause (a) of sub-section (1) of section 642, of the Companies Act, 1956 (1 to 1956), the Central Government hereby makes the following rules, namely:

Short title

1. These rules may be called the Companies (Declaration of Dividend out of Reserves) Rules, 1975.

Declaration of dividend out of reserves

2. In the event of inadequacy or absence of profits in any year, dividend may be declared by a company for that year out of the accumulated profits earned by it in previous years and transferred by it to the reserves, subject to the conditions that -

   (i) the rate of the dividend declared shall not exceed the average of the rates at which dividend was declared by it in the five years immediately preceding that year or ten per cent of its paid up capital, whichever is less;

   (ii) the total amount to be drawn from the accumulated profits earned in previous years and transferred to the reserves shall not exceed an amount equal to one-tenth of the sum of its paid-up capital and free reserves and the amount so drawn shall first be utilised to set off the losses incurred in the financial year before any dividend in respect of preference or equity shares is declared; and
(iii) the balance of reserves after such drawal shall not fall below fifteen per cent of its paid-up share capital.

Explanation: For the purposes of this rule, “profits earned by a company in previous years and transferred by it to the reserves” shall mean the total amount of net profits after tax, transferred to reserves as at the beginning of the year for which the dividend is to be declared; and in computing the said amount, the appropriations out of the amount transferred from the Development Rebate Reserve [at the expiry of the period specified under the Income-tax Act, 1961 (43 of 1961) shall be included and all items of Capital Reserves including reserves created by revaluation of assets shall be excluded.

Insurance Act, 1938

Restriction on dividends and bonuses

49. (1) No insurer, being an insurer specified in sub-clause (a) (ii) or sub-clause (b) of clause (9) of section 2, who carries on the business of life insurance or any other class or sub-class of insurance business to which section 13 applies, shall, for the purpose of declaring or paying any dividend to shareholders or any bonus to policy-holders or of making any payment in service of any debentures, utilize directly or indirectly any portion of the life insurance fund or of the fund of such other class or sub class of insurance business, as the case may be, except a surplus shown in the valuation balance-sheet in such form as may be specified by the regulations made by the Authority submitted to the Authority as part of the abstract referred to in section 15, as a result of an actuarial valuation of the assets and liabilities of the insurer; nor shall he increase such surplus by contributions out of any reserve fund or otherwise unless such contributions have been brought in as revenue through the revenue account applicable to that class or sub-class of insurance business on or before the date of valuation aforesaid, except when the reserve fund is made up solely of transfers from similar surpluses disclosed by valuations in respect of which returns have been submitted to the Authority under section 15 of this Act or to the Central Government under section 11 of the Indian Life Assurance Companies Act, 1912 (6 of 1912):

Provided that payments made out of any such surplus in service of any debentures shall not exceed fifty per-cent of such surplus including any payment by way of interest on the debentures, and interest paid on the debentures shall not exceed ten per-cent of any such surplus except when the interest paid on the debentures is offset against the interest credited to the fund or funds concerned in deciding the interest basis adopted in the valuation disclosing the aforesaid surplus:

Provided further that the share of any such surplus allocated to or reserved for the shareholders (including any amount for the payment of dividends guaranteed to them, whether by way of first charge or otherwise), shall not exceed such sums as may be specified by the Authority and such share shall in no case exceed ten per-cent of such surplus in case of participating policies and in other cases the whole thereof.
(2) For the purposes of sub-section (1), the actual amount of income-tax deducted at source during the period following the date as at which the last preceding valuation was made and preceding the date as at which the valuation in question is made may be added to such surplus after deducing an estimated amount for income-tax on such surplus, such addition and deduction being shown in an abstract of the report of the actuary referred to in sub-section (1) of section 13:

Declaration of interim bonuses

112. Notwithstanding anything to the contrary contained in this Act, an insurer carrying on the business of life insurance shall be at liberty to declare an interim bonus or bonuses to policy-holders whose policies mature for payment by reason of death or otherwise during the interval valuation period on the recommendation of the investigating actuary made at the last preceding valuation.

The Banking Regulation Act, 1949

15. Restrictions as to Payment of Dividend

(1) No banking company shall pay any dividend on its shares until all its capitalised expenses (including preliminary expenses, organisation expenses, share-selling commission, brokerage, amounts of losses incurred and any other item of expenditure not represented by tangible assets) have been completely written off.

(2) Notwithstanding anything to the contrary contained in sub-section (1) or in the Companies Act, 1956 (1 of 1956), a banking company may pay dividends on its shares without writing off-

(i) the depreciation, if any, in the value of its investments in approved securities in any case where such depreciation has not actually been capitalised or otherwise accounted for as a loss;

(ii) the depreciation, if any, in the value of its investments in shares, debentures or bonds (other than approved securities) in any case where adequate provision for such depreciation has been made to the satisfaction of the auditor of the banking company;

(iii) the bad debts, if any, in any case where adequate provision for such debts has been made to the satisfaction of the auditor of the banking company.

17. Reserve Fund

(1) Every banking company incorporated in India shall create a reserve fund and shall, out of the balance of profit of each year, as disclosed to the profit and loss account prepared under Section 29 and before any dividend is declared, transfer to the reserve fund a sum equivalent to not less than twenty per cent of such profit.

(1A) Notwithstanding anything contained in sub-section (1), the Central Government may, on the recommendation of the Reserve Bank and having regard to the adequacy of the paid-up capital
III.160 Auditing Pronouncements

and reserves of a banking company in relation to its deposit liabilities, declare by order in writing that the provisions of sub-section (1) shall not apply to the banking company for such period as may be specified in the order:

Provided that no such order shall be made unless, at the time it is made, the amount in the reserve fund under sub-section (1), together with the amount in the share premium account is not less than the paid-up capital of the banking company.

(2) Where a banking company appropriates any sum or sums from the reserve fund or the share premium account, it shall, within twenty-one days from the date of such appropriation, report the fact to the Reserve Bank, explaining the circumstances relating to such appropriation:

Provided that the Reserve Bank may, in any particular case, extend the said period of twenty-one days by such period as it thinks fit or condone any delay in the making of such report.

The Regional Rural Banks Act, 1976

21. Disposal of profits— After making provisions for bad and doubtful debts, depreciation in assets, contributions to staff and superannuation funds and all other matters for which provision is, under law, necessary or which are usually provided for by banking companies, a Regional Rural Bank may, out of its net profits, declare a dividend.

The Multi-State Co-Operative Societies Act, 2002

62. Funds not to be divided by way of profit— (1) No part of the funds, other than net profits, of a multi-State co-operative society shall be divided by way of bonus or dividend or otherwise distributed among its members.

(2) The net profit of a multi-State co-operative society referred to in sub-section (1) in respect of a society earning profits shall be calculated by deducting from the gross profits for the year, all interest accrued and accruing in relation to amounts which are overdue, establishment charges, interest payable on loans and deposits, audit fees, working expenses including repairs, rent, taxes and depreciation, bonus payable to employees under the law relating to payment of bonus for the time being in force, and equalization fund for such bonus, provision for payment of income-tax and making approved donations under the Income-tax Act, 1961 (43 of 1961), development rebate, provision for development fund, bad debt fund, price fluctuation fund, dividend equalization fund, share capital redemption fund, investment fluctuation fund, provision for retirement benefits to employees, and after providing for or writing off bad debts and losses not adjusted against any fund created out of profit:

Provided that such society may add to the net profits for the year interest accrued in the preceding years, but actually recovered during the year:

Provided further that in the case of such multi-State co-operative societies, as do not have share capital, the surplus of income over expenditure shall not be treated as net profits and such surplus shall be dealt with in accordance with the bye-laws.
63. **Disposal of net profits**

(1) A multi-State co-operative society shall, out of its net profits in any year,

(a) transfer an amount not less than twenty-five per cent to the reserve fund;

(b) credit one per cent, to co-operative education fund maintained, by the National Co-operate Union of India Limited, New Delhi, in the manner as may be prescribed;

(c) transfer an amount not less than ten per cent, to a reserve fund for meeting unforeseen losses.

(2) Subject to such conditions as may be prescribed, the balance of the net profits may be utilised for all or any of the following purposes, namely: -

(a) payment of dividend to the members on their paid-up share capital at a rate not exceeding the prescribed limit;

(b) constitution of, or contribution to, such special funds including education funds, as may be specified in the bye-laws;

(c) donation of amounts not exceeding five per cent of the net profits for any purpose connected with the development of co-operative movement or charitable purpose as defined in Section 2 of the Charitable Endowments Act, 1890 (6 of 1890);

(d) payment of ex-gratia amount to employees of the multi-State co-operative society to the extent and in the manner specified in the bye-laws.

64. **Investment of funds**: A multi-State co-operative society may invest or deposit its funds—

(a) in a co-operative bank, State co-operative bank, co-operative land development bank or Central co-operative bank; or

(b) in any of the securities specified in Section 20 of the Indian Trusts Act, 1882 ; or

(c) in the shares or securities of any other multi-State co-operative society or any co-operative society; or

(d) in the shares, securities or assets of a subsidiary institution or any other institution; or

(e) with any other bank; or

(f) in such other mode as may be provided in the bye-laws.

*Explanation: For the purposes of clause (e), “bank” means any banking company as defined in clause (c) of Section 5 of the Banking Regulation Act, 1949, and includes-

(a) the State Bank of India constituted under the State Bank of India Act, 1955;

(b) a subsidiary bank as defined in clause (k) of Section 2 of the State Bank of India (Subsidiary Banks) Act, 1959;
(c) a corresponding new bank constituted under Section 3 of the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970 (5 of 1970) or a corresponding new bank constituted under Section 3 of the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980 (40 of 1980).

**Multi-State Co-operative Societies Rules, 2002**

24. **Distribution of profit to members.**

(1) No part of the funds, other than net profits of a multi-State co-operative society shall be distributed by way of bonus or dividend or otherwise among its members.

(2) Payment of dividend to the members on their paid-up share capital shall be as specified in the bye-laws.

(3) The bye-laws of a multi-State co-operative society may provide for distribution of patronage bonus to its members in consonance with the transactions of a member with the society.

(4) Every multi-State Co-operative society may also provide for in their bye-laws the subjects and purposes for which the reserve fund will be utilised.
## GUIDANCE NOTE ON TAX AUDIT UNDER SECTION 44AB OF THE INCOME-TAX ACT, 1961

### 1. Terms, abbreviations used in this Guidance Note.

In this Guidance Note the following terms and abbreviations occur often in the text. A brief explanation of such terms and abbreviations is given below. Further, reference to a section without reference to the relevant Act means that the section has reference to the Income-tax Act, 1961.

<table>
<thead>
<tr>
<th>Term</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>AS</td>
<td>Accounting Standards prescribed under the Companies Act, 2013 for company assesses and prescribed by the Institute of Chartered Accountants of India for non company assesses.</td>
</tr>
<tr>
<td>AS(IT)</td>
<td>Accounting Standards notified by the Central Government under section 145(2).</td>
</tr>
<tr>
<td>Assessee</td>
<td>As defined in section 2(7) of the Act.</td>
</tr>
<tr>
<td>Audit report</td>
<td>Any report submitted in Form No. 3CA/3CB along with the statement of particulars in Form No. 3CD.</td>
</tr>
<tr>
<td>Board</td>
<td>The Central Board of Direct Taxes constituted under the Central Boards of Revenue Act, 1963.</td>
</tr>
<tr>
<td>Circular</td>
<td>A circular or instructions issued by the Board under section 119(1) of the Act.</td>
</tr>
<tr>
<td>Form or Forms</td>
<td>Collectively refer to Forms 3CA, 3CB and 3CD.</td>
</tr>
<tr>
<td>ICAI/Institute</td>
<td>The Institute of Chartered Accountants of India.</td>
</tr>
<tr>
<td>Limited Liability Partnership (LLP)</td>
<td>As defined in the Limited Liability Partnership Act, 2008</td>
</tr>
<tr>
<td>Person</td>
<td>As defined in section 2(31) of the Act.</td>
</tr>
<tr>
<td>Previous year</td>
<td>As defined in section 3 of the Act.</td>
</tr>
</tbody>
</table>
III.164 Auditing Pronouncements

(m) Rules The Income-tax Rules, 1962.

(n) Specified date "Specified date", in relation to the accounts of the assessee of the previous year relevant to an assessment year, means the due date for furnishing the return of income under subsection (1) of section 139 of the Act.

(o) SA Standards on Auditing


(q) Tax audit The audit carried out under the provisions of section 44AB.

(r) Tax auditor Auditor appointed by an assessee to carry out tax audit.

2. Introduction

2.1 The Act provides for audit of accounts and/or report/certificate of a chartered accountant in the following cases in respect of AY 2014-15:

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Assessees carrying on the business of growing and manufacturing tea/coffee/rubber claiming deduction under section 33AB.</td>
<td>33AB (2)</td>
<td>5AC</td>
<td>3AC</td>
</tr>
<tr>
<td>2.</td>
<td>Assessees carrying on business consisting of the prospecting for, or extraction or production of, petroleum or natural gas or both in India and in relation to which the Central Government has entered into an agreement for the purpose of deposit in Special Account/ Site Restoration Account under section 33ABA.</td>
<td>33ABA (2)</td>
<td>5AD</td>
<td>3AD</td>
</tr>
</tbody>
</table>
### Part-III: Guidance Notes

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>3.</td>
<td>Assessees other than companies or co-operative societies claiming amortisation of certain preliminary expenses under section 35D and assessee being Indian company or a non-corporate resident claiming deduction for expenditure on prospecting etc. for certain minerals under section 35E.</td>
<td>35D (4) and 35E (6)</td>
<td>6AB</td>
<td>3AE</td>
</tr>
<tr>
<td>4.</td>
<td>Assessees carrying on business or profession whose sales, turnover or gross receipts exceed Rs.1 Crore (Rs.25 lakhs in the case of profession) as per the provisions of section 44AB, and assessees who claim their income to be lower than the profits or gains deemed to be the profits and gains of their business under sections 44AD, 44AE, 44BB or 44BBB.</td>
<td>44AB</td>
<td>6G</td>
<td>3CA/ 3CB/ and 3CD</td>
</tr>
<tr>
<td>5.</td>
<td>Assessee being a non-resident (not being a company) or a foreign company receiving income by way of royalty or fees for technical services from Government or India concern as per the provisions of section 44DA.</td>
<td>44DA (2)</td>
<td>6GA</td>
<td>3CE</td>
</tr>
<tr>
<td>-------</td>
<td>---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------</td>
<td>-----------------------------------------------</td>
<td>--------------------------------------------</td>
<td>---------</td>
</tr>
<tr>
<td>6.</td>
<td>Every assessee who has effected slump sale in the previous year as per the provisions of section 50B.</td>
<td>50B (3)</td>
<td>6H</td>
<td>3CEA</td>
</tr>
<tr>
<td>7.</td>
<td>Every person who has entered into an ‘International transaction or specified domestic transaction’ as per the requirement of section 92E of the Act.</td>
<td>92E</td>
<td>10E</td>
<td>3CEB</td>
</tr>
<tr>
<td>8.</td>
<td>Assessee being a trust or institution claiming deduction u/s 11 &amp; 12 as per the requirement of section 12A(b).</td>
<td>142(2A)</td>
<td>14A</td>
<td>6B</td>
</tr>
<tr>
<td>9.</td>
<td>Assessee being a trust or institution claiming deduction u/s 11 &amp; 12 as per the requirement of section 12A(b).</td>
<td>12A(1)(b)</td>
<td>17B</td>
<td>10B</td>
</tr>
<tr>
<td>-------</td>
<td>-----------------------------------------------------------------------------------------------------------------</td>
<td>------------------------------------------------</td>
<td>------------------------------------------</td>
<td>----------</td>
</tr>
<tr>
<td>10.</td>
<td>Assessees being any fund or trust or institution or any university or other educational institution or any hospital or other medical institution referred to in sub-clause (iv) or sub-clause (v) or sub-clause (vi) or sub-clause (via) of section 10(23C) claiming exemption under section 10(23C).</td>
<td>10(23C)(iv)/(v)/(vi)/(via)</td>
<td>16CC</td>
<td>10BB</td>
</tr>
<tr>
<td>11.</td>
<td>Assessees being electoral trust receiving voluntary contributions</td>
<td>13B</td>
<td>17CA(12)</td>
<td>10BC</td>
</tr>
<tr>
<td>12.</td>
<td>Assessees claiming deduction in respect of eligible businesses under sections 80 – IA or 80 – IB (except Multiplex Theatres/ Convention Centres/ hospitals in rural areas) and eligible undertakings/enterprises claiming deduction under section 80 – IC.</td>
<td>80-IA (7)/80-IB/80-IC and 80-IE</td>
<td>18BBB (1)</td>
<td>10CCB</td>
</tr>
<tr>
<td>13.</td>
<td>Assessees claiming deduction under section 80-ID in respect of the profits and gains derived from the business of hotels and convention centres in specified areas.</td>
<td>80-ID (3)(iv)</td>
<td>18DE(3)</td>
<td>10CCBBA</td>
</tr>
<tr>
<td>14.</td>
<td>Assessees claiming deduction under section 80-IB (11C) in respect of the profits and gains from the</td>
<td>80-IB(11C)</td>
<td>18DDA</td>
<td>10CCBD</td>
</tr>
</tbody>
</table>

© The Institute of Chartered Accountants of India
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>15.</td>
<td>Assessees claiming deduction under section 80-IA (6) in respect of profits and gains of business of housing or other activities which are an integral part of a highway project.</td>
<td>80-IA (6)</td>
<td>18BBE (3)</td>
<td>10CCC</td>
</tr>
<tr>
<td>16.</td>
<td>Assessees, being scheduled banks owning an offshore banking unit in a Special Economic Zone and International financial services centre, for claiming deduction under Section 80LA in respect of specified incomes.</td>
<td>80LA (3)</td>
<td>19AE</td>
<td>10CCF</td>
</tr>
<tr>
<td>17.</td>
<td>Assessees, being Indian companies, claiming deduction under section 80JJAA, in respect of employment of new workmen.</td>
<td>80JJAA(2)(b)</td>
<td>19AB</td>
<td>10DA</td>
</tr>
<tr>
<td>18.</td>
<td>Assessee responsible for making the payment to a non resident</td>
<td>195(6)</td>
<td>37BB(1)(ii)(a)</td>
<td>15CB</td>
</tr>
<tr>
<td>19.</td>
<td>Assessee who has failed to deduct tax at source in accordance with the provisions of the Act, not be deemed as an assessee in default provided certain conditions are fulfilled and</td>
<td>201(1)</td>
<td>31ACB (1)</td>
<td>26A</td>
</tr>
<tr>
<td>-------</td>
<td>---------------------------------------------------------------------------------------------------------------</td>
<td>-----------------------------------------------</td>
<td>------------------------------------------</td>
<td>---------</td>
</tr>
<tr>
<td>20.</td>
<td>Assessee who has failed to collect tax at source in accordance with the provisions of the Act, not be deemed as an assessee in default provided certain conditions are fulfilled and a certificate from an accountant to this effect is furnished in the format prescribed under section 206C(6A) of the Act.</td>
<td>206C (6A)</td>
<td>37J (1)</td>
<td>27BA</td>
</tr>
<tr>
<td>21.</td>
<td>Corporate assessees liable to pay Minimum Alternate tax under section 115JB of the Act, to furnish a report from an accountant certifying the computation of book profits.</td>
<td>115JB (4)</td>
<td>40B</td>
<td>29B</td>
</tr>
<tr>
<td>22.</td>
<td>Non-corporate assessees liable to pay Alternate Minimum tax under section 115JC of the Act, to furnish a report from an accountant certifying the computation of adjusted book profits.</td>
<td>115JC (3)</td>
<td>40BA</td>
<td>29C</td>
</tr>
<tr>
<td>23.</td>
<td>Assessee being a non-resident having a liaison office in India prepare and deliver a statement containing such particulars as may be prescribed.</td>
<td>285</td>
<td>114DA</td>
<td>49C</td>
</tr>
<tr>
<td>-------</td>
<td>------------------------------------------------</td>
<td>-----------------------------------------------</td>
<td>---------------------------------------------</td>
<td>----------</td>
</tr>
<tr>
<td>24.</td>
<td>Manufacturer assessee deriving Profits and gains from an undertaking by the export of articles or things or computer software</td>
<td>10A(5)</td>
<td>16D</td>
<td>56F</td>
</tr>
<tr>
<td>25.</td>
<td>Corporate assessee being an amalgamated company to furnish certificate from the principal officer, duly verified by an accountant regarding achievement of the prescribed level of production and continuance of such level of production in subsequent years.</td>
<td>72A(2)(b)(iii)</td>
<td>9C(b)</td>
<td>62</td>
</tr>
<tr>
<td>26.</td>
<td>Assessee being Unit Trust of India, distributing income to its unit holders to furnish a statement giving details of amount so distributed to be verified by an accountant as required by section 115R(3A).</td>
<td>115R(3A)</td>
<td>12B(2)</td>
<td>63</td>
</tr>
<tr>
<td>27.</td>
<td>Assessee being a mutual fund, distributing income to its unit holders to furnish a statement giving details of amount so distributed to be verified by an accountant as required by section 115R(3A).</td>
<td>115R(3A)</td>
<td>12B(3)</td>
<td>63A</td>
</tr>
<tr>
<td>28.</td>
<td>Assessee being a venture capital company or a venture capital fund to furnish a statement giving details of the nature of income paid or credited</td>
<td>115U (2)</td>
<td>12C (2)</td>
<td>64</td>
</tr>
<tr>
<td>--------</td>
<td>---------------------------------------------</td>
<td>-----------------------------------------------</td>
<td>-------------------------------------------</td>
<td>---------</td>
</tr>
<tr>
<td></td>
<td>during the previous year and other relevant details to be verified by an accountant as per section 115U.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>29.</td>
<td>Assessees engaged in the business of operating qualifying ships having opted for computation of income from such business under the tonnage tax scheme contained in chapter XII G of the Act to furnish a report under section 115VW of the Act.</td>
<td>115VW(ii)</td>
<td>11T</td>
<td>66</td>
</tr>
</tbody>
</table>

2.2 The first edition of this Guidance Note was published in the year 1985 immediately after the introduction of tax audit provision to help members in discharging their responsibility in an efficient manner. In order to incorporate changes made by the amendments to the Finance Act, as well as judicial pronouncements, circulars etc., the said Guidance Note has been revised in the years 1989, 1998, 1999, 2005 and 2013. The sequence of certain significant events is as follows:

(a) The Government had substituted revised Rule 6G and Forms 3CA, 3CB and 3CD in the Official Gazette on June 4, 1999, vide Notification No 10950/F.No. 153/74/98/TPL and omitted Forms No.3CC and 3CE.

(b) These forms have been subsequently revised vide CBDT’s Notification No. 280/2004 dated 16th November 2004.

(c) Significant changes in the Form No.3CD were made in the year 2006 through a Notification No. 208/2006 dated 10th August, 2006 which notified the Income tax (Ninth Amendment) Rules, 2006.

(d) Significant changes in the Form No.3CD were again made in the year 2014 through the Notification No. 33/2014 dated 25.07.2014 which notified the Income-tax (7th Amendment) Rules, 2014.

2.3 Form No. 3CD is quite comprehensive and covers generally all the items included in Form No. 6B prescribed for reporting under section 142(2A) and hence this Guidance Note...
would meet almost all the reporting requirements of audit under section 142(2A) also. However, if under section 142(2A), the Assessing Officer requires specific information, the same has to be given separately along with Form No. 6B. The Institute has published separate Guidance Notes for audit of Public Charitable Institutions under section 12A(b), Report under section 92E of the Act, Report under section 115JB of the Act and Report under section 115JC of the Act.

2.4 The tax audit was introduced by section 11 of the Finance Act, 1984, which inserted a new section 44AB with effect from 1st April, 1985 [Assessment Year 1985-86]. This section makes it obligatory for a person carrying on business to get his accounts audited by a chartered accountant, and to furnish by the ‘specified date’, the report in the prescribed form of such audit, if the total sales, turnover or gross receipts in business in the relevant previous year exceed or exceeds the prescribed limit (Rs. One Crore w.e.f. A.Y. 2013-14). For a professional, the provisions of tax audit become applicable, if his gross receipts in profession exceed the prescribed limit (Rs. Twenty five Lakhs w.e.f. A.Y. 2013-14) in the relevant previous year. As observed by the Finance Minister, while presenting the Union Budget for 1984-85, and as stated in the Memorandum explaining the provisions of the Finance Bill, 1984, the compulsory audit is intended to ensure proper maintenance of books of account and other records, in order to reflect the true income of the tax payer and to facilitate the administration of tax laws by a proper presentation of the accounts before the tax authorities. This would also save the time of the Assessing Officers considerably in carrying out the verification. The scope of section 44AB was enlarged to provide that audit under the section would be required in case of a person carrying on the business of the nature referred to in section 44AD or 44AE or 44AF (by the Finance Act 1997 w.e.f. assessment year 1998-99) or 44BB or 44BBB (by the Finance Act 2003 w.e.f. assessment year 2004-05), if such person claims that his income is lower than the amount of income deemed under these sections as presumptive income. Thereafter, Finance (No.2) Act, 2009 (w.e.f. AY 2011-12) enlarged the scope of section 44AD to encompass within its ambit the assessees covered by the provision of erstwhile section 44AF and hence, section 44AF has been omitted. While section 44AF dealt with assessees carrying on retail trade, the amended section 44AD covers all assessees carrying on eligible business except professionals as referred to in section 44AA(1), a person earning income in the nature of commission or brokerage, a person carrying on any agency business.

2.5 The vires of section 44AB has been upheld by Hon’ble Supreme Court in T.D. Venkata Rao v. Union of India [1999] 237 ITR 315 (SC). The Apex Court has made the following significant observations:

"Chartered Accountants, by reason of their training have special aptitude in the matter of audits. It is reasonable that they, who form a class by themselves, should be required to audit the accounts of businesses whose income (sic: turnover) exceeds Rs.40 lakhs* and professionals whose income (sic: gross
receipts) exceeds Rs.10 lakhs** in any given year. There is no material on record and indeed in our view, there cannot be that an income-tax practitioner has the same expertise as chartered accountants in the matter of accounts. For the same reasons the challenge under article 19 must fail, and it must be pointed out that these income-tax practitioners are still entitled to be authorised representatives of assessees.”

*(increased to Rs. One Crore w.e.f. A.Y. 2013-14)

**(increased to Rs. Twenty Five Lakhs w.e.f. A.Y. 2013-14)

3. Provisions of section 44AB

3.1 Section 44AB reads as under:

"Audit of accounts of certain persons carrying on business or profession".

44AB. Every person, --

(a) carrying on business shall, if his total sales, turnover or gross receipts, as the case may be, in business exceed one crore rupees* in any previous year; or

(b) carrying on profession shall, if his gross receipts in profession exceed twenty-five lakh rupees* in any previous year; or

(c) carrying on the business shall, if the profits and gains from the business are deemed to be the profits and gains of such person under section 44AE or section 44BB or section 44BBB, as the case may be, and he has claimed his income to be lower than the profits or gains so deemed to be the profits and gains of his business, as the case may be, in any previous year; or

(d) carrying on the business shall, if the profits and gains from the business are deemed to be the profits and gains of such person under section 44AD and he has claimed such income to be lower than the profits and gains so deemed to be the profits and gains of his business and his income exceeds the maximum amount which is not chargeable to income-tax in any previous year

get his accounts of such previous year audited by an accountant before the specified date and furnish by that date the report of such audit in the prescribed form duly signed and verified by such accountant and setting forth such particulars as may be prescribed.

Provided that this section shall not apply to the person, who derives income of the nature referred to in section 44B or section 44BBA, on and from the 1st day of April, 1985 or, as the case may be, the date on which the relevant section came into force, whichever is later.
Provided further that in a case where such person is required by or under any other law to get his accounts audited, it shall be sufficient compliance with the provisions of this section if such person gets the accounts of such business or profession audited under such law before the specified date and furnishes by that date the report of the audit as required under such other law and a further report by an accountant in the form prescribed under this section.

Explanation - For the purposes of this section, -

(i) "accountant" shall have the same meaning as in the Explanation below sub-section (2) of section 288;

(ii) "specified date", in relation to the accounts of the assessee of the previous year relevant to an assessment year, means the due date for furnishing the return of income under sub-section (1) of section 139

* w.e.f. A.Y. 2013-14

3.2 The Explanation below sub-section (2) of section 288 defines “accountant”. Accordingly, "accountant" means a chartered accountant within the meaning of the Chartered Accountants Act, 1949 (38 of 1949), and includes, in relation to any State, any person who by virtue of the provisions of sub-section (2) of section 226 of the Companies Act, 1956 (1 of 1956), is entitled to be appointed to act as an auditor of companies registered in that State. Section 226 of the Companies Act, 1956 has been replaced by section 141 in the Companies Act, 2013 w.e.f 1.4.2014.

3.3 The above section stipulates that every person carrying on business or profession is required to get his accounts audited by a chartered accountant before the "specified date" and furnish by that date the report of such audit, if the total sales, turnover or gross receipts exceed the prescribed limit (Presently Rs.1 crore w.e.f A.Y. 2013-14) in the case of business and gross receipts exceed the prescribed limit (Presently Rs.25 lakhs w.e.f A.Y. 2013-14) in the case of profession - vide clauses (a) and (b) of section 44AB.

3.4 Clause (c) of section 44AB, inserted by the Finance Act, 1997 and subsequently amended by the Finance Act, 2003 and Finance (No. 2) Act, 2009, provides that in the case of an assessee carrying on a business of the nature specified in sections 44AE, 44BB or 44BBB tax audit will be required, if he claims his income to be lower than the presumptive income deemed under the said sections even if his sales, turnover, or gross receipts does not exceed the prescribed limit (Presently Rs.1 crore w.e.f A.Y. 2013-14).

3.5 (1) Clause (d) of section 44AB, inserted by the Finance Act, 2009 w.e.f 1-4-2011 provides that in the case of an assessee carrying on a business of the nature specified in section 44AD, tax audit will be required, if he claims his income to be lower than the presumptive income deemed under the said section and such income exceeds the maximum amount not chargeable to income-tax (i.e. basic exemption limit). Section 44AD as amended by Finance Act, 2009 provides that notwithstanding anything to the contrary contained
in sections 28 to 43C, in the case of an eligible assessee engaged in an eligible business, a sum equal to eight per cent of the total turnover or gross receipts of the assessee in the previous year on account of such business or, as the case may be, a sum higher than the aforesaid sum claimed to have been earned by the eligible assessee, shall be deemed to be the profits and gains of such business chargeable to tax under the head "Profits and gains of business or profession".

(2) Any deduction allowable under the provisions of sections 30 to 38 shall, for the purposes of sub-section (1), be deemed to have been already given full effect to and no further deduction under those sections shall be allowed:

Provided that where the eligible assessee is a firm, the salary and interest paid to its partners shall be deducted from the income computed under sub-section (1) subject to the conditions and limits specified in clause (b) of section 40.

(3) The written down value of any asset of an eligible business shall be deemed to have been calculated as if the eligible assessee had claimed and had been actually allowed the deduction in respect of the depreciation for each of the relevant assessment years.

(4) The provisions of Chapter XVII-C shall not apply to an eligible assessee in so far as they relate to the eligible business.

(5) Notwithstanding anything contained in the foregoing provisions of this section, an eligible assessee who claims that his profits and gains from the eligible business are lower than the profits and gains specified in sub-section (1) and whose total income exceeds the maximum amount which is not chargeable to income-tax, shall be required to keep and maintain such books of account and other documents as required under sub-section (2) of section 44AA and get them audited and furnish a report of such audit as required under section 44AB.

(6) The provisions of this section, notwithstanding anything contained in the foregoing provisions, shall not apply to:

(i) a person carrying on profession as referred to in sub-section (1) of section 44AA;
(ii) a person earning income in the nature of commission or brokerage; or
(iii) a person carrying on any agency business.

Explanation.—For the purposes of this section,—

(a) "eligible assessee" means,—

(i) an individual, Hindu undivided family or a partnership firm, who is a resident, but not a limited liability partnership firm as defined under clause (n) of sub-section (1) of section 2 of the Limited Liability Partnership Act, 2008 (6 of 2009); and

(ii) who has not claimed deduction under any of the sections 10A, 10AA, 10B, 10BA or deduction under any provisions of Chapter VIA under the heading "C. - Deductions in respect of certain incomes" in the relevant assessment year.
III.176 Auditing Pronouncements

(b) "eligible business" means,—

(i) any business except the business of plying, hiring or leasing goods carriages referred to in section 44AE; and

(ii) whose total turnover or gross receipts in the previous year does not exceed an amount of one crore rupees.

3.6 Under the provisions of section 44AD, an eligible assessee can opt to be assessed on presumptive basis, so long as the sales, turnover or gross receipts from an eligible business do not exceed Rs.1 crore. Once the sales, turnover or gross receipts from any such eligible business(es) exceed the prescribed limit (Presently Rs.1 crore w.e.f A.Y. 2013-14), a tax audit will be required under clause (a) of section 44AB. The provisions of sections 44AA and 44AB shall not apply insofar as they relate to an eligible business as referred to in section 44AD and, the business of plying, hiring or leasing goods carriages as referred to in section 44AE. In computing the monetary limits under sections 44AA and 44AB, the sales, turnover or gross receipts, from the business in the said sections is to be excluded.

3.7 If a person is carrying on business(es), coming within the scope of sections 44AD, 44AE, 44BB or 44BBB but he exercises his option given under these sections to get his accounts audited under section 44AB, tax audit requirements would apply, in respect of such business(es) even if the turnover of such business(es) does not exceed the prescribed limit (Presently Rs.1 crore w.e.f A.Y. 2013-14). In the case of a person carrying on businesses covered by sections 44AD, 44AE, 44BB or 44BBB and opting for presumptive taxation, tax audit requirement would not apply in respect of such businesses. If such person is carrying on other business(es) not covered by presumptive taxation, tax audit requirements would apply in respect thereof, if the turnover of such business(es), other than the business(es) covered by presumptive taxation thereof, exceed the prescribed limit (Presently Rs.1 crore w.e.f. A.Y. 2013-14).

3.8 The first proviso to section 44AB stipulates that this section will not be applicable to a person who derives income of the nature referred to in sections 44B or 44BBA. Accordingly, where the assessee is carrying on any one or more of the businesses specified in section 44B or 44BBA referred to in the first proviso to section 44AB, the sales/turnover/gross receipts from such businesses shall not be included in the total sales/turnover/gross receipts for determining the applicability of section 44AB.

3.9 The report of such audit, duly signed and verified by the chartered accountant is required to be given in such form and setting forth such particulars as prescribed by the Board. Rule 6G provides that such audit report and particulars should be given in Forms No. 3CA/3CB as may be applicable and the statement of particulars should be given in Form No.3CD.

3.10 A question may arise in the case of an assessee who is eligible to claim deductions under various sections like sections 80-IA, 80-IB or 80-IC etc., as to whether it will be
necessary for him to get separate audit reports/certificates under these sections in addition to an audit report under section 44AB. The requirement of section 44AB is a general requirement covering the overall position of the accounts of the assessee. This applies to the consolidated accounts of the assessee for the relevant previous year covering the results of all the units owned by the assessee whether situated at one place or at different places. Therefore, when the turnover of all the units put together exceed the prescribed limits, the assessee will have to get the audit report under section 44AB in the prescribed form and separate audit reports in the forms prescribed for different purposes like sections 80-IA, 80-IB or 80-IC etc. will have to be further obtained by the assessee to meet the specific requirements of the relevant sections.

4. ‘Profession’ and ‘business’ explained

4.1 The term "business" is defined in section 2(13) of the Act, as under:

"Business" includes any trade, commerce, or manufacture or any adventure or concern in the nature of trade, commerce or manufacture.

The word 'business' is one of wide import and it means activity carried on continuously and systematically by a person by the application of his labour or skill with a view to earning an income. The expression "business" does not necessarily mean trade or manufacture only - Barendra Prasad Ray v ITO [1981] 129 ITR 295 (SC).

4.2 Section 2(36) of the Act defines profession to include vocation. Profession is a word of wide import and includes "vocation" which is only a way of living. – Additional CIT v. Ram Kripal Tripathi [1980] 125 ITR 408 (All).

4.3 Whether a particular activity can be classified as 'business' or 'profession' will depend on the facts and circumstances of each case. The expression "profession" involves the idea of an occupation requiring purely intellectual skill or manual skill controlled by the intellectual skill of the operator, as distinguished from an operation which is substantially the production or sale or arrangement for the production or sale of commodities. - CIT Vs. Mannmohan Das (Deceased) [1966] 59 ITR 699 (SC), CIT v. Ram Kripal Tripathi [1980] 125 ITR 408 (All).

4.4 The following have been listed out as professions in section 44AA read with Rule 6F and other professions notified thereunder (Notifications No. 1620 SO-18(E) dated 12.1.77, No. 9102SO 2675 dated 25.09.1992 and No.116 SO 385(E), dated 4.5.2001):

(i) Accountancy
(ii) Architectural
(iii) Authorised Representative
(iv) Company Secretary
(v) Engineering
III.178 Auditing Pronouncements

(vi) Film Artists/Actors, Cameraman, Director including an assistant director; a music director, including an assistant music director, an art director, including an assistant art director; a dance director, including an assistant dance director; Singer, Story-writer, a screen-play writer, a dialogue writer, editor, , lyricist and dress designer.

(vii) Interior Decoration

(viii) Legal

(ix) Medical

(x) Technical Consultancy


4.5. The following activities have been held to be business:

(i) Advertising agent


(iii) Couriers

(iv) Insurance agent

(v) Nursing home

(vi) Stock and share broking and dealing in shares and securities - CIT v. Lallubhai Nagardas & Sons [1993] 204 ITR 93 (Bom).

(vii) Travel agent.

5. Sales, turnover, gross receipts

5.1 It will be noted that the provision relating to tax audit applies to every person carrying on business, if his total sales, turnover or gross receipts in business exceed the prescribed limit (Rs.1 crore w.e.f. A.Y. 2013-14) and to a person carrying on a profession, if his gross receipts from profession exceed the prescribed limit (Rs.25 lakhs w.e.f A.Y. 2013-14) 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.

5.2 The Central Sales Tax Act, 1956 defines “Turnover” as follows:

"turnover used in relation to any dealer liable to tax under this Act means the aggregate of the sale prices received and receivable by him in respect of sales of any goods in the course of inter-State trade or commerce made during any prescribed period and determined in accordance with the provisions of the Act and rules made there under."
Further, section 8A(1) of the said Act provides that in determining turnover, deduction of sales tax should be made from the aggregate of sales price.

5.3 The term "Turnover" has been defined under Section 2(91) of the Companies Act, 2013 as follows:

"2(91) "turnover" means the aggregate value of the realisation of amount made from the sale, supply or distribution of goods or on account of services rendered, or both, by the company during a financial year;"

5.4 In the “Guidance Note on Terms Used in Financial Statements” published by the Institute, the expression “Sales Turnover” (Item 15.01) has been defined as under:-

“The aggregate amount for which sales are effected or services rendered by an enterprise. The term ‘gross turnover’ and ‘net turnover’ (or ‘gross sales’ and ‘net sales’) are sometimes used to distinguish the sales aggregate before and after deduction of returns and trade discounts”.

5.5 The Guide to Company Audit issued by the Institute in the year 1980, while discussing “sales”, stated as follows:

“Total turnover, that is, the aggregate amount for which sales are effected by the company, giving the amount of sales in respect of each class of goods dealt with by the company and indicating the quantities of such sales for each class separately.

Note (i) The term ‘turnover’ would mean the total sales after deducting therefrom goods returned, price adjustments, trade discount and cancellation of bills for the period of audit, if any. Adjustments which do not relate to turnover should not be made e.g. writing off bad debts, royalty etc. Where excise duty is included in turnover, the corresponding amount should be distinctly shown as a debit item in the profit and loss account.”

5.6 The “Statement on the Amendments to Schedule VI to the Companies Act, 1956” issued by the Institute (Page 14, 1976 edition)( replaced with Guidance Note on Revised Schedule VI of the Companies Act, 1956) while discussing the disclosure requirements relating to ‘turnover’ stated as follows:-

“As regards the value of turnover, a question which may arise is with reference to various extra and ancillary charges. The invoices may involve various extra and ancillary charges such as those relating to packing, freight, forwarding, interest, commission, etc. It is suggested that ordinarily the value of turnover should be disclosed exclusive of such ancillary and extra charges, except in those cases where because of the accounting system followed by the company, separate demarcation of such charges is not possible from the accounts or where the company’s billing procedure involves a composite charge inclusive of various services rather than a separate charge for each service.
In the case of invoices containing composite charges, it would not ordinarily be proper to attempt a demarcation of ancillary charges on a proportionate or estimated basis. For example, if a company makes a composite charge to its customer, inclusive of freight and despatch, the charge so made should accordingly be treated as part of the turnover for purpose of this section. It would not be proper to reduce the value of the turnover with reference to the approximate value of the service relating to freight and despatch. On the other hand, if the company makes a separate charge for freight and despatch and for other similar services, it would be quite proper to ignore such charges when computing the value of the turnover to be disclosed in the Profit and Loss Account. In other words, the disclosure may well be determined by reference to the company’s invoicing and accounting policy and may thereby vary from company to company. For reasons of consistency as far as possible, a company should adhere to the same basic policy from year to year and if there is any change in the policy the effect of that change may need to be disclosed if it is material, so that a comparison of the turnover figures from year to year does not become misleading."

5.7 The Statement on the Companies (Auditors' Report) Order, 2003 issued by the Institute in April 2004, while discussing the term 'turnover' in paragraph 23 states as follows:

The term, "turnover", has not been defined by the Order. Part II of Schedule VI to the Act, however, defines the term "turnover" as the aggregate amount for which sales are effected by the company. It may be noted that the "sales effected" would include sale of goods as well as services rendered by the company. In an agency relationship, turnover is the amount of commission earned by the agent and not the aggregate amount for which sales are effected or services are rendered. The term "turnover" is a commercial term and it should be construed in accordance with the method of accounting regularly employed by the company.

5.8 Although, Schedule III of the Companies Act, 2013 has replaced the Revised Schedule VI of the Companies Act, 1956 in the year 2014, guidance given herein above with respect to meaning of the term "turnover" is still relevant.

5.9 The term ‘turnover’ for the purposes of this clause may be interpreted to mean the aggregate amount for which sales are effected or services rendered by an enterprise. If sales tax and excise duty are included in the sale price, no adjustment in respect thereof should be made for considering the quantum of turnover. Trade discounts can be deducted from sales but not the commission allowed to third parties. If, however, the Excise duty an / or sales tax recovered are credited separately to Excise duty or Sales tax Account (being separate accounts) and payments to the authority are debited in the same account, they would not be included in the turnover. However, sales of scrap shown separately under the heading ‘miscellaneous income’ will have to be included in turnover.

5.10 Considering that the words "Sales", "Turnover" and "Gross receipts" are commercial terms, they should be construed in accordance with the method of accounting regularly
employed by the assessee. Section 145(1) provides that income chargeable under the head "Profits and gains of business or profession" or "Income from other sources" should be computed in accordance with either cash or mercantile system of accounting regularly employed by the assessee. The method of accounting followed by the assessee is also relevant for the determination of sales, turnover or gross receipts in the light of the above discussion.

5.11 Applying the above generally accepted accounting principles, a few typical cases may be considered:

(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. The same should not be deducted from the figure of turnover.

(iii) Turnover discount is normally allowed to a customer if the sales made to him exceed a particular quantity. This being dependent on the turnover, as per trade practice, it is in the nature of trade discount and should be deducted from the figure of turnover even if the same is allowed at periodical intervals by separate credit notes.

(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 figure of turnover even if the returns are from the sales made in the earlier year/s.

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

(vii) Sale proceeds of property held as investment property will not form part of turnover.

(viii) 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.

5.12 (a) A question may also arise as to whether the sales by a commission agent or by a person on consignment basis forms part of the turnover of the commission agent and/or consignee as the case may be. In such cases, it will be necessary to find out, whether the property in the goods or all significant risks, reward of ownership of goods belongs to the commission agent or the consignee immediately before the transfer by him to third person. If the property in the goods or all significant risks and rewards of ownership of goods continue to belong to the principal, the relevant sale price shall not form part of the sales/turnover of the commission agent and/or the consignee as the case may be. If, however, the property in the goods, significant risks and reward of ownership belongs to the commission agent and/or the
III.182 Auditing Pronouncements

consignee, as the case may be, the sale price received/receivable by him shall form part of his sales/turnover.

(b) In this context, it would be useful to refer to the CBDT Circular No.452 dated 17th March, 1986, where the Board has clarified the question of applicability of section 44AB in the cases of Commission Agents, Arhatias, etc. The Circular is published in Appendix I (Page no. 213).

5.13 Share brokers, on purchasing securities on behalf of their customers, do not get them transferred in their names but deliver them to the customers who get them transferred in their names. The same is true in case of sales also. The share broker holds the delivery merely on behalf of his customer. The property in goods does not get transferred to the share brokers. Only brokerage which is being accounted for in the books of account of share brokers should be taken into account for considering the limits for the purpose of section 44AB. However, in case of transactions entered into by share broker on his personal account, the sale value should also be taken into account for considering the limit for the purpose of section 44AB. The case of a sub-broker is not different from that of a share broker.

5.14 The turnover or gross receipts in respect of transactions in shares, securities and derivatives may be determined in the following manner.

(a) **Speculative transaction:** A speculative transaction means a transaction in which a contract for the purchase or sale of any commodity, including stocks and shares, is periodically or ultimately settled otherwise than by the actual delivery or transfer of the commodity or scrips. Thus, in a speculative transaction, the contract for sale or purchase which is entered into is not completed by giving or receiving delivery so as to result in the sale as per value of contract note. The contract is settled otherwise and squared up by paying out the difference which may be positive or negative. As such, in such transaction the difference amount is ‘turnover’. In the case of an assessee undertaking speculative transactions there can be both positive and negative differences arising by settlement of various such contracts during the year. Each transaction resulting into whether a positive or negative difference is an independent transaction. Further, amount paid on account of negative difference paid is not related to the amount received on account of positive difference. In such transactions though the contract notes are issued for full value of the purchased or sold asset the entries in the books of account are made only for the differences. Accordingly, the aggregate of both positive and negative differences is to be considered as the turnover of such transactions for determining the liability to audit vide section 44AB.

(b) **Derivatives, futures and options:** Such transactions are completed without the delivery of shares or securities. These are also squared up by payment of differences. The contract notes are issued for the full value of the asset purchased or sold but entries in the books of account are made only for the differences. The transactions may be squared up any time on or before the striking date. The buyer of the option pays the
premia. The turnover in such types of transactions is to be determined as follows:

(i) The total of favourable and unfavourable differences shall be taken as turnover.

(ii) Premium received on sale of options is also to be included in turnover.

(iii) In respect of any reverse trades entered, the difference thereon, should also form part of the turnover.

(c) **Delivery based transactions**: Where the transaction for the purchase or sale of any commodity including stocks and shares is delivery based whether intended or by default, the total value of the sales is to be considered as turnover.

5.15 (a) Further, an issue may arise whether such transactions of purchase or sale of stocks and shares undertaken by the assessee are in the course of business or as investment. The answer to this issue will depend on the facts and circumstances of each case taking into consideration the nature of the transaction, frequency and volume of transactions etc. For this, attention is invited to the following judgments where this issue has been considered.

(i) **CIT v. P.K.N. and Co Ltd (1966) 60 ITR 65 (SC)**

(ii) **Saroj Kumar Mazumdar v. CIT (1959) 37 ITR 242 (SC)**

(iii) **CIT v. Sutlej Cotton Mills Supply Agency Ltd. (1975) 100 ITR 706 (SC)**

(iv) **G. Venkataswami Naidu & Co. v. CIT (1959) 351TR 594 (SC)**

Further, CBDT Circular No.4/2007, dated: 15-6-2007-**Appendix II (Page no. 217)** may also be referred to.

(b) In case such transactions are for the purposes of investment and income/loss arising therefrom is to be computed under the head 'Capital Gains', then the value of such transaction is not to be included in sales or turnover for deciding the applicability of audit under section 44AB. However, in case such transactions are in the course of business, then the total of such sales are to be included in the sale, turnover or gross receipts as the case may be, of the assessee for determining the applicability of audit under section 44AB.

5.16 The term "gross receipts" is also not defined in the Act. It will include all receipts whether in cash or in kind arising from carrying on of the business which will normally be assessable as business income under the Act. Broadly speaking, the following items of income and/or receipts would be covered by the term "gross receipts in business":

(i) Cash assistance (by whatever name called) received or receivable by any person against exports under any scheme of the Government of India;

(ii) Any duty of customs or excise or service tax re-paid or repayable as drawback to any person against exports under the Customs and Central Excise Duties and Service tax Drawback Rules, 1995;

(iii) The aggregate of gross income by way of interest received by the money lender;

(iv) Commission, brokerage, service and other incidental charges received in the business
III.184 Auditing Pronouncements

of chit funds;

(v) Reimbursement of expenses incurred (e.g. packing, forwarding, freight, insurance, travelling etc.) and if the same is credited to a separate account in the books, only the net surplus on this account should be added to the turnover for the purposes of Section 44AB;

(vi) The net exchange rate difference on export sales during the year on the basis of the principle explained in (v) above will have to be added;

(vii) Hire charges of cold storage;

(viii) Liquidated damages;

(ix) Insurance claims - except for fixed assets;

(x) Sale proceeds of scrap, wastage etc. unless treated as part of sale or turnover, whether or not credited to miscellaneous income account;

(xi) Gross receipts including lease rent in the business of operating lease;

(xii) Finance income to reimburse and reward the lessor for his investment and services;

(xiii) Hire charges and instalments received in the course of hire purchase;

(xiv) Advance received and forfeited from customers.

(xv) the value of any benefit or perquisite, whether convertible into money or not, arising from business or the exercise of a profession

5.17 The following items would not form part of "gross receipts in business" for purposes of section 44AB.

(i) Sale proceeds of fixed assets including advance forfeited, if any;

(ii) Sale proceeds of assets held as investments;

(iii) Rental income unless the same is assessable as business income;

(iv) Dividends on shares except in the case of an assessee dealing in shares;

(v) Income by way of interest unless assessable as business income;

(vi) Reimbursement of customs duty and other charges collected by a clearing agent;

(vii) In the case of a recruiting agent, the advertisement charges received by him by way of reimbursement of expenses incurred by him;

(viii) In the case of a travelling agent, the amount received from the clients for payment to the airlines, railways etc. where such amounts are received by way of reimbursement of expenses incurred on behalf of the client. If, however, the travel agent is conducting a package tour and charges a consolidated sum for transportation, boarding and lodging and other facilities, then the amount received from the members of group tour should form part of gross receipts;
(ix) In the case of an advertising agent, the amount of advertising charges recovered by him from his clients provided these are by way of reimbursement. But if the advertising agent books the advertisement space in bulk and recovers the charges from different clients, the amount received by him from the clients will not be the same as the charges paid by him and in such a case the amount recovered by him will form part of his gross receipts;

(x) Share of profit of a partner of a firm in the total income of the firm excluded from his total income under section 10(2A) of the Income-tax Act;

(xi) Write back of amounts payable to creditors and/or provisions for expenses or taxes no longer required.

5.18 Thus, the principle to be applied is that if the assessee is merely reimbursed for certain expenses incurred, the same will not form part of his gross receipts. But in the case of charges recovered, which are not by way of reimbursement of the actual expenses incurred, they will form part of his gross receipts.

5.19 In the case of a professional, the expression "gross receipts" in profession would include all receipts arising from carrying on of the profession. A question may, however, arise as to whether the out of pocket expenses received by him should form part of his gross receipts for purposes of this section. Normally, in the case of solicitors, advocates or chartered accountants, such out of pocket expenses received in advance are credited in a separate client's account and utilised for making payments for stamp duties, registration fees, counsel's fees, travelling expenses etc. on behalf of the clients. These amounts, if collected separately either in advance or otherwise, should not form part of the "gross receipts". If, however, such out of pocket expenses are not specifically collected but are included/collected by way of a consolidated fee, the whole of the amount so collected shall form part of gross receipts and no adjustment should be made in respect of actual expenses paid by the professional person for and/or on behalf of his clients out of the gross fees so collected. However, the amount received by way of advance for which services are yet to be rendered will not form part of the receipts, as such advances are the liabilities of the assessee and cannot be treated as his receipts till the services are rendered.

5.20 A question may arise in the case of an assessee carrying on business and at the same time engaged in a profession as to what are the limits applicable to him under section 44AB for getting the accounts audited. In such a case if his professional receipts are, say, rupees twenty seven lakhs but his total sales, turnover or gross receipts in business are, say, rupees seventy two lakhs, it will be necessary for him to get his accounts of the profession and also the accounts of the business audited because the gross receipts from the profession exceed the limit of rupees twenty five lakhs. If however, the professional receipts are, say, rupees twenty one lakhs and total sales turnover or gross receipts from business are, say, rupees eighty six lakhs it will not be necessary for him to get his accounts audited under the above section, because his gross receipts from the profession as well as total sales, turnover or
gross receipts from the business are below the prescribed limits.

5.21 It may, however, be noted that in cases where the assessee carries on more than one business activity, the results of all business activities should be clubbed together. In other words, the aggregate sales, turnover and/or gross receipts of all businesses carried on by an assessee would be taken into consideration in determining whether the prescribed limit (Presently Rs. 1 crore w.e.f. A.Y. 2013-14) as laid down in section 44AB has been exceeded or not. However, where the business is covered by section 44B or 44BBA turnover of such business shall be excluded. Similarly, where the business is covered by section 44AD or 44AE and the assessee opts to be assessed under the respective sections on presumptive basis, the turnover thereof shall be excluded. So far as a partnership firm is concerned, each firm is an independent assessee for purposes of Income-tax Act. Therefore, the figures of sales of each firm will have to be considered separately for purposes of determining whether or not the accounts of such firm are required to be audited for purposes of section 44AB.

5.22 It must also be understood that the issue whether the turnover exceeds the prescribed limit (Presently Rs.1 crore w.e.f A.Y. 2013-14) in the case of business or the gross receipts exceed the prescribed limit (Presently Rs.25 lakhs w.e.f. A.Y. 2013-14) in the case of profession is to be determined in each year independent of the results obtained in the preceding year or years. Further, this section applies only if the turnover exceeds the prescribed limit according to the accounts maintained by the assessee. If the Assessing Officer wants the assessee to get his accounts audited in cases where the figures of turnover as appearing in the books of account of the assessee do not exceed the prescribed limits, he has no option but to pass an order under section 142(2A) directing the assessee to get his accounts audited from a chartered accountant as may be nominated by the Commissioner of Income-tax or the Chief Commissioner of Income-tax.

6. Liability to tax audit - Special cases

6.1 A question may arise in the case of an assessee whose income is not chargeable to income-tax by reason of a specific exemption contained in the law or otherwise, as to whether he is required to get his accounts audited and to furnish such report under section 44AB. Such cases may cover those assessee who are wholly outside the purview of income-tax law as well as those whose income is otherwise exempt under the Act. It is felt that neither section 44AB nor any other provisions of the Act stipulate exemption from the compulsory tax audit to any person whose income is exempt from tax. This section makes it mandatory for every person carrying on any business or profession to get his accounts audited where conditions laid down in the section are satisfied and to furnish the report of such audit in the prescribed form. A trust/association/institution carrying on business may enjoy exemptions as the case may be under sections 10(21), 10(23A), 10(23B) or section 10(23BB) or section 10(23C) or section 11. A co-operative society carrying on business may enjoy deduction under section 80P. Such institutions/associations of persons will have to get their accounts audited and to furnish such audit report for purposes of section 44AB if their turnover in business exceeds...
the prescribed limit (Presently Rs.1 crore w.e.f. A.Y. 2013-14). But an agriculturist, who does not have any income under the head "Profits and gains of business or profession" chargeable to tax under the Act and who is not required to file any return under the said Act, need not get his accounts audited for purposes of section 44AB even though his total sales of agricultural products may exceed the prescribed limit (Presently Rs.1 crore w.e.f. A.Y. 2013-14).

6.2 It may be appreciated that the object of audit under section 44AB is only to assist the Assessing Officer in computing the total income of an assessee in accordance with different provisions of the Act. Therefore, even if the income of a person is below the taxable limit laid down in the relevant Finance Act of a particular year, he will have to get his accounts audited and to furnish such report under section 44AB, if his turnover in business exceed the prescribed limit (Presently Rs.1 crore w.e.f. A.Y. 2013-14).

6.3 The case of non-residents may be considered separately. Section 44AB does not make any distinction between a resident or non-resident. Therefore, a non-resident assessee is also required to get his accounts audited and to furnish such report under section 44AB if his turnover/sales/gross receipts exceed the prescribed limits. This audit, however, would be confined only to the Indian operations carried out by the non-resident assessee since he is chargeable to income-tax in India only in respect of income accruing or arising or received in India.

7. Specified date and tax audit

7.1 As per the recent developments, the tax audit report is required to be uploaded using digital signature of the tax auditor. A question may arise whether a tax auditor appointed under section 44AB can be held responsible if he does not complete the audit and if the tax audit report is not uploaded before the specified date. Answer to this question will depend on the facts and circumstances of the case. Normally, it is the professional duty of the chartered accountant to ensure that the audit accepted by him is completed before the due date. If there is any unreasonable delay on his part, he is answerable to the Institute if a complaint is made by the client. However, if the delay in the completion of audit is attributable to his client, the tax auditor cannot be held responsible. It is, therefore, necessary that no chartered accountant should accept audit assignments which he cannot complete within the above time frame. In this regard, reference may also be made to paragraph 12 of this Guidance Note.

8. Penalty

8.1 In order to ensure proper compliance with section 44AB, section 271B has been enacted which reads as under:-

"Failure to get accounts audited

271B. If any person fails to get his accounts audited in respect of any previous year or years relevant to an assessment year or furnish a report of such audit as required under
section 44AB, the Assessing Officer may direct that such person shall pay, by way of penalty, a sum equal to one-half per cent of the total sales, turnover or gross receipts, as the case may be, in business, or of the gross receipts in profession, in such previous year or years or a sum of one hundred fifty thousand rupees, whichever is less."

8.2. As such, the failure of a person, to get his accounts audited in respect of any previous year or furnish a copy of such report as required under section 44AB may attract a penalty equal to 0.5% of the total sales, turnover or gross receipts, or Rs.1.5 lakh whichever is less. However, in view of the specific provisions contained in section 273B, no penalty is imposable under section 271B on the assessee for the above failure if he proves that there was reasonable cause for the said failure. The onus of proving reasonable cause is on the assessee.

8.3. Some of the instances where Tribunals/Courts have accepted as "reasonable cause" are as follows:

(a) Resignation of the tax auditor and consequent delay;
(b) Bona fide interpretation of the term 'turnover' based on expert advice;
(c) Death or physical inability of the partner in charge of the accounts;
(d) Labour problems such as strike, lock out for a long period, etc.;
(e) Loss of accounts because of fire, theft, etc. beyond the control of the assessee;
(f) Non-availability of accounts on account of seizure;
(g) Natural calamities, commotion, etc.

9. Tax auditor

9.1 The tax audit is to be carried out by an "accountant". The term "accountant" has been defined in sub-clause (i) of Explanation to section 44AB as under:

For the purposes of this section, -

(i) "accountant" shall have the same meaning as in the Explanation below sub-section (2) of section 288".

The above-mentioned Explanation reads as under:

"Accountant" means a chartered accountant within the meaning of Chartered Accountants Act, 1949 (38 of 1949) and includes, in relation to any State, any person, who by virtue of the provisions of sub-section (2) of section 226 of the Companies Act, 1956 (1 of 1956), is entitled to be appointed to act as an auditor of companies registered in that State."

As stated earlier, section 226 of the Companies Act, 1956 has been replaced with section 141 in the Companies Act, 2013 with effect from 1.04.2014.
9.2 The proviso to section 44AB lays down that where the accounts of an assessee are required to be audited by or under any other law, it shall be sufficient compliance with the provisions of this section, if such person gets the accounts of such business or profession audited under such other law before the specified date and furnishes by that date the report by an ‘accountant’ as required under section 44AB. It may be noted that after amendment by the Finance Act, 2001, tax audit can be carried out by an accountant only. Accordingly, in case of any assessee like a co-operative society where the accounts under the relevant law have been audited by a person other than a chartered accountant, the tax audit will have to be conducted by the ‘accountant’ as defined under section 44AB.

9.3 Though the section refers to the accounts being audited by an accountant which means a chartered accountant as defined above, the audit can also be done by a firm of chartered accountants. This has been a recognised practice under the Act. In such a case, it would be necessary to state the name of the partner who has signed the audit report on behalf of the firm. The member signing the report as a partner of a firm or in his individual capacity should give his membership number while registering himself in the e-filing portal.

9.4 Section 44AB stipulates that only Chartered Accountants should perform the tax audit. This section does not stipulate that only the statutory auditor appointed under the Companies Act or other similar Statute should perform the tax audit. As such the tax audit can be conducted either by the statutory auditor or by any other chartered accountant in full time practice.

9.5 It may be noted that the Council at its 242nd meeting has passed a resolution effective from 1st April 2005, that any member in part-time practice (namely, holding a certificate of practice and also engaging himself in any other business and/or occupation) is not entitled to perform attest functions including tax audit.

9.6 A question may arise in the case of a public sector company or any other company where the statutory auditor has not been appointed by the authorities concerned as to whether the tax auditor appointed under section 44AB can complete his audit without waiting for statutory audit report on the accounts audited by the statutory auditors. It may be noted that Form No. 3CA requires the tax auditor to enclose a copy of the audit report conducted by the statutory auditor or the auditor of the financial statements as the case may be. Where a statutory auditor has not been appointed by the authorities concerned or where the report of the statutory auditor is not available for whatever reasons, it will be possible for the tax auditor to give his report in Form No. 3CB and to certify the relevant particulars in Form No.3CD. This is particularly important in those cases where the assessee concerned has suffered losses in the relevant accounting year. It may, however, be noted that the tax auditor in such cases will have to conduct the financial audit as well in order to enable him to certify whether or not the accounts reported upon by him give a true and fair view of the state of affairs of the assessee whose accounts are audited by him under section 44AB.

9.7 Tax audit under section 44AB being a recurring audit assignment, for expressing professional opinion on the financial statements and the particulars, the member accepting the
assignment should communicate with the member who had done tax audit in the earlier year as provided in the Chartered Accountants Act. When making the enquiry from the retiring auditor, the member accepting the assignment should find out whether there is any professional or other reasons why he should not accept the appointment. The professional reasons for not accepting the appointment include:

- Non-compliance of the provisions of sections 224 and 225 of the Companies Act as mentioned in *Code of Ethics issued by ICAI under Clause (9) of Part I of First Schedule to Chartered Accountants Act, 1949. Sections 224 and 225 have been replaced with section 139/142 and section 140 respectively in Companies Act, 2013.

- Non-payment of undisputed audit fees by auditees other than in case of sick units for carrying out the statutory audit under the Companies Act, 1956/2013 or various other statutes.

- Issuance of qualified report

9.8 In the case of a person whose accounts of the business or profession have been audited under any other law (i.e. a company, a co-operative society, etc. which is required to get the accounts audited under a Statute) it is not necessary to communicate with the statutory auditor if he had not done tax audit in the earlier year. Attention of the members is invited to the detailed discussion in the publication of ICAI, **“Code of Ethics” – Appendix III (Page no. 220).** Further, attention of members is invited to the Chapter- VII “Appointment of an Auditor in case of non-payment of undisputed fees” of the Council Guidelines No.1-CA(7)/02/2008, dated 8th August, 2008- **Appendix IV (Page no. 226)**

"In view of the fact that with effect from 01.04.2014.the Companies Act, 1956 has been replaced with Companies Act, 2013, the “Code of Ethics” issued by ICAI is under revision. The members may refer the revised “Code of Ethics” as and when published for the above mentioned provisions.

9.9 A chartered accountant should not accept the tax audit of a person to whom he is indebted for more than rupees ten thousand. Reference should be made to Chapter- X “Appointment of an auditor when he is indebted to a concern” of the Council Guidelines No.1-CA(7)/02/2008, dated 8th August, 2008- **Appendix IV (Page no. 226)** whereby a member of the Institute shall be deemed to be guilty of professional misconduct if he accepts appointment as an auditor of a concern while he is indebted to the concern or has given any guarantee or provided any security in connection with the indebtedness of any third person to the concern, for limits fixed in the statute and in other cases for amount exceeding rupees ten thousand. For this purpose, the limit of Rs. 10,000/- shall be the aggregate amount in respect of the proprietor and/or the partner/s of the firm of chartered accountants.

9.10 The Council has issued a Guideline No.1-CA(7)/02/2008, dated 8th August, 2008 given in **Appendix IV (Page no. 226)** Chapter- IX “Appointment as Statutory auditor” states that a member of the Institute in practice shall be deemed to be guilty of professional misconduct, if he accepts the appointment as statutory auditor of Public Sector Undertaking/ Government
Company / Listed Company and other Public Company having turnover of Rs. 50 crores or more in a year and accepts any other work or assignment or service in regard to the same undertaking/company on a remuneration which in total exceeds the fee payable for carrying out the statutory audit of the same undertaking/company.

9.11 The above restrictions shall apply in respect of fees for other work or service or assignment payable to the statutory auditors and their associate concerns put together.

9.12 As per the said notification, the term “other work(s)” or “service(s)” or “assignment(s)” shall include Management Consultancy and all other professional services permitted by the Council pursuant to Section 2(2)(iv) of the Chartered Accountants Act, 1949 but shall not include:

(i) audit under any other statute;

(ii) certification work required to be done by the statutory auditors; and

(iii) any representation before an authority.

9.13 Since the obligation for tax audit has been specified in section 44AB of the Income-tax Act, 1961, it will be considered as an audit under any other statute for the purpose of this notification and thus the above restriction shall not apply in respect of tax audit fees.

9.14 The tax auditor should obtain from the assessee a letter of appointment for conducting the audit as mentioned in section 44AB. It is advisable that such an appointment letter should be signed by the person competent to sign the return of income in terms of the provisions of section 140 of the Act. It would also be useful if the letter affirms that no other auditor was appointed to conduct the tax audit for the year for which the appointment is being made. The letter may also give the name and address of the tax auditor for the previous year, wherever relevant. This would give the necessary information to the incoming tax auditor to enable him to communicate with the previous auditor. The letter of appointment should also specify the remuneration of the tax auditor. SA-210, Agreeing the Terms of Audit Engagement issued by the ICAI requires that the auditor to agree with the terms of audit engagement with management or those charged with governance as appropriate. The agreed terms would need to be recorded in an audit engagement letter or other suitable form of written agreement and shall include (a) The objective and scope of the audit of the financial statements; It should be specifically mentioned that the scope of audit is restricted to the provisions contained in section 44AB of the Income tax Act, 1961 and the Income-tax Rules, 1962. (b) The responsibilities of the auditor; (c) The responsibilities of management; (d) Identification of the applicable financial reporting framework for the preparation of the financial statements; and (e) Reference to the expected form and content of any reports to be issued by the auditor as per the provisions of Income-tax Act, 1961 and Income-tax Rule, 1962 along with a statement that there may be circumstances in which a report may differ from its expected form and content. In the interest of both client and auditor, the auditor should send an engagement letter, preferably before the commencement of the engagement, to help avoid any
III.192 Auditing Pronouncements

misunderstandings with respect to the engagement. The engagement letter documents and
confirms the auditor’s acceptance of the appointment, the objective and scope of the audit and
the extent of the auditor’s responsibilities to the client. However, it may be noted that
wherever an audit is to be conducted under a Statute, acknowledgement of the letter of the
auditor by the client is considered to be sufficient compliance of SA-210. The tax auditor
should get the statement of particulars, as required in the annexure to the audit report,
authenticated by the assessee before he does the same.

9.15 The tax auditor is required to upload the tax audit report directly in the e-filing portal.

9.16 The appointment of the auditor for tax audit in the case of a company need not be made
at the general meeting of the members. It can be made by the Board of Directors or even by
any officer, if so authorised by the Board in this behalf. The appointment in the case of a firm
or a proprietary concern can be made by a partner or the proprietor or a person authorised by
the assessee. It is possible for the assessee to appoint two or more chartered accountants as
joint auditors for carrying out the tax audit, in which case, the audit report will have to be
signed by all the chartered accountants. In case of disagreement, they can give their reports
separately. In this regard, attention is invited to Para 12 of the SA 299, Responsibility of Joint
Auditors issued by ICAI reproduced below:

"Normally, the joint auditors are able to arrive at an agreed report. However, where the
joint auditors are in disagreement with regard to any matters to be covered by the
report, each one of them should express his own opinion through a separate report. A
joint auditor is not bound by the views of the majority of the joint auditors regarding
matters to be covered in the report and should express his opinion in a separate report
in case of a disagreement."

The responsibility of joint tax auditors will be the same as in the case of other audits e.g. audit
under the Companies Act. For details relating to such responsibility, in the case of joint tax
audit, reference may be made to SA 299, Responsibility of Joint Auditors.

9.17 The position of a tax auditor for conducting audit under section 44AB will be considered
as an office of profit. Therefore, the provisions of section 314 of the Companies Act, 1956 will
be attracted when a relative of a director is appointed as a tax auditor of the company, if the
remuneration thereof exceeds the limits prescribed in the aforesaid section. The necessary
formalities will be required to be complied with as required under section 314. It may be noted
Section 314 of the Companies Act, 1956 has been replaced with section 188 of the
Companies Act, 2013, w.e.f. 1.4.2014.

9.18 The Act does not prohibit a relative or an employee of the assessee being appointed as
a tax auditor under section 44AB. It may, however, be noted that as per the decision of the
Council (reported in the Code of Ethics under clause (4) of Part I of Second Schedule), a
chartered accountant should not express his opinion on financial statements of any business
or enterprise in which he, his firm or a partner in his firm has a substantial interest. It may be
noted that the Council has decided not to permit a Chartered Accountant in employment to certify the financial statements of the concern in which he is employed, or of a concern under the same management as the concern in which he is employed, even though he holds certificate of practice and that such certification can be done by any Chartered Accountant in practice. This restriction would not however apply where the certification is permitted by any law, e.g. Section 228(4) of the Companies Act, 1956 and the Companies (Branch Audit Exemption) Rules, 1961 made thereunder. Therefore, an employee of an assessee or an employee of a concern under the same management cannot audit the accounts of an assessee under section 44AB. Relevant extracts from the *Code of Ethics published by ICAI are given in Appendix V (Page no. 237)

*In view of the fact that with effect from 01.04.2014, the Companies Act, 1956 has been replaced with Companies Act, 2013, the “Code of Ethics” issued by ICAI is under revision. The members may refer the revised “Code of Ethics” as and when published for the above mentioned provisions.

9.19 A chartered accountant who is responsible for writing or maintenance of the books of account of the assessee should not audit such accounts. This principle will apply to the partner of such a member as well as to the firm in which he is a partner. In view of this, a chartered accountant who is responsible for writing or maintenance of the books of account or his partner or the firm in which he is a partner should not accept tax audit assignment under section 44AB in the case of such an assessee.

9.20 The audit of accounts of a professional firm of chartered accountants, under section 44AB cannot be conducted by any partner or employee of such firm.

9.21 A chartered accountant/firm of chartered accountants, who is appointed as tax consultant of the assessee, can conduct tax audit under section 44AB. But an internal auditor of the assessee cannot conduct tax audit if he is an employee of the assessee. The Council of ICAI in its 281st meeting held from 3rd to 5th October, 2008 decided that an internal auditor of an assessee, whether working with the organisation or independently practicing chartered accountant or a firm of chartered accountants, cannot be appointed as his tax auditor. The decision was made effective from 12-12-2008.

9.22 A question may arise whether an assessee can remove a tax auditor appointed under section 44AB. The answer depends upon the facts and circumstances of the case. It is, however, possible for the management to remove a tax auditor where there are valid grounds for such removal. This may arise where the tax auditor has delayed the submission of audit report under section 44AB for an unreasonable period and if it is found that there is no possibility of getting the audit report uploaded before the specified date. In such cases, the management may be justified in removing the tax auditor. However, the tax auditor cannot be removed on the ground that he has given an adverse audit report or the assessee has an apprehension that the tax auditor is likely to give an adverse audit report. If there is any unjustified removal of tax auditors, the Ethical Standards Board constituted by the Institute
III.194 Auditing Pronouncements

can intervene in such cases. No other chartered accountant should accept the audit assignment if the removal of his predecessor is not on valid grounds.

9.23 Before accepting a tax audit, the chartered accountant should take into consideration the ceiling on tax audit assignments fixed under the Chapter VI- Tax Audit assignments under Section 44AB of the Income-tax Act, 1961 of the Council Guidelines No.1-CA(7)/02/2008, dated 8th August,2008 as amended by a decision of the Council taken in its 331st meeting held from 10.02.2014 to 12.02.2014 and its 333rd meeting held from 14.05.2014 to 16.05.2014.- Appendix-IV (Page no. 226).

9.24 In view of the said Guidelines a member of the Institute in practice, shall be deemed to be guilty of professional misconduct if, he accepts more than 60 tax audit assignments relating to an assessment year or such other limit as may be prescribed by ICAI from time to time under section 44AB, whether in respect of a person whose accounts have been audited under any other law or a person who carries on business or profession but who is not required by or under any other law to get his accounts audited.

9.25 (a) As per the Council Guidelines No.1- CA(7)/02/2008, dated 8th August, 2008, audit of books of account of persons carrying on businesses covered by sections 44AD and 44AE, is not included in the aforesaid limit. The auditor is advised to maintain the details of the audits conducted by virtue of the provisions of section 44AD and 44AE separately in the format mentioned in Para 9.26.

(b) Furthermore, a clarification was issued for reckoning the “specified number of tax audit assignments” conducted under section 44AB of the Income-tax Act, 1961, the text of the clarification is reproduced below:

"Various statutes prevailing in India like DVAT, 2004 requires the assessee to furnish an audit report in a form duly signed and verified by such particulars as may be prescribed under section 44AB of the Income-tax Act, 1961 i.e. Form 3CB/3CD. This had lead to the doubts as to whether such audits would be included in the ceiling of “specified number of tax audit assignments”.

Considering the same, the Council at its 311th meeting held on 8th and 9th November, 2011 clarified that audit prescribed under any statute which requires the audit report in the form as prescribed under section 44AB of the Income-tax Act, shall not be considered for the purpose of reckoning the specified number of tax audit assignments if the turnover of the auditee is below the turnover limit specified in section 44AB of the Income-tax Act, 1961. For instance audit under section 44AD, audit under DVAT, 2004 (for turnover between 40 to 60 Lakhs) etc. will not be considered for inclusion in the present limit of 60* audits"

*w.e.f 1.04.2014

9.26 In case the member is a partner of a firm of chartered accountants in practice, the ceiling of 60 tax audit assignments shall be computed with reference to each of the partner in
the said firm. Where any partner of the firm of chartered accountants in practice is also a
partner of any other firm or firms of chartered accountants in practice, the ceiling limit of 60
shall apply with reference to all the firms together in relation to such partner. Similarly, where
any partner accepts one or more tax audit assignments in his individual capacity, the total
number of such assignments under section 44AB which may be accepted by him whether
directly in his individual capacity or as partner of the firm of chartered accountants in practice
shall not exceed 45 tax audit assignments. If two members or firms of chartered accountants
are appointed as joint tax auditors, then the assignment will have to be included in the case of
both the members or firms separately. It has, however, been clarified that the audit of the
head office and branch offices concerned shall be regarded as one tax audit assignment.
Similarly, the audit of one or more branches of the same concern by one chartered accountant
in practice shall be construed as only one tax audit assignment. In computing the specified
number of tax audit assignments each year's audit would be taken as a separate assignment.
Every chartered accountant in practice shall maintain a record of the tax audit assignments
accepted by him in each financial year in the format prescribed by the Council. This format is
reproduced in Appendix VI (Page no. 242).

9.27 The Institute has recommended fees for professional services on the basis of time
devoted by a chartered accountant and his assistants. The fees for tax audit assignment can
be charged by a chartered accountant on the basis of the work involved in the assignment. It
may be appreciated that no uniform fees can be recommended on the basis of turnover
because an assessee having turnover of Rs.1 crore in a trading activity may have less
transactions as compared to an assessee having the same turnover in a manufacturing
activity. Similarly the transactions in a wholesale business will be less than the transactions in
a retail business. The revised minimum recommended scale of fees recommended by the
Committee of Capacity Building of CA Firms and small and medium Practitioners as on date
is given in Appendix VII (Page No. 243).

9.28 The chartered accountants should charge reasonable fees depending upon the
responsibility involved under the revised forms and taking into consideration the work involved
in tax audit assignment which has increased considerably consequent to the revision of the
forms. It is necessary that members of the profession should also maintain reasonable
standards of professional fees.

9.29 As mentioned in Paragraph 9.26 above, the audit of the head office and branch offices
of an assessee shall be regarded as one tax audit assignment.

10. Accounting Standards

10.1. Recognizing the need to harmonize the diverse accounting policies and practices in use
in India and keeping in view the International developments in the field of accounting, the
Council of the Institute has issued Accounting Standards.
10.2. The legal recognition to the Accounting Standards formulated by the ICAI was granted in October 1998 with insertion of Section 211(3A), (3B), and (3C) in the Companies Act, 1956. As per Section 211(3C) of the Act, Accounting Standards issued by the ICAI may be prescribed by the Central Government in consultation with the National Advisory Committee on Accounting Standards (NACAS). As per the proviso to the section, till the notification of the Accounting Standards by the Government, the Accounting Standards issued by the ICAI are required to be followed by companies. In the year 2006, Accounting Standards 1 to 7 and 9 to 29 were notified by the Ministry of Corporate Affairs, Government of India, under the Companies (Accounting Standards) Rules, 2006 vide its notification dated December 7, 2006 in the Gazette of India. These were made effective in respect of accounting periods commencing on or after the publication of these Accounting Standards (i.e., December 7, 2006). As per the Companies (Accounting Standards) Rules, 2006, Companies are classified into two categories, i.e., Small and Medium Companies (SMCs) and Non-SMCs. The Companies Act, 2013 has replaced Companies Act, 1956. Section 133 of the Companies Act, 2013 provides for compliance to Accounting Standards. The existing Accounting Standards notified under Companies (Accounting Standards) Rules, 2006 would continue to be followed.

10.3 ICAI, keeping in view the fact that the Accounting Standards notified under Companies (Accounting Standards) Rules, 2006, will be applicable to the companies, announced the scheme for applicability of accounting standards issued by ICAI to non-companies. The criteria for classification non-corporate entities as decided by ICAI and companies under the Companies (Accounting Standards) Rules, 2006 is given in Appendix-VIII (Page no. 254).

10.4 The Accounting Standards, issued by ICAI/notified under Companies (Accounting Standards) Rules, 2006 are for use in the presentation of general purpose financial statements which are issued to the public by such commercial, industrial or business enterprises as may be specified by the Institute from time to time and subject to the attest function of its members. The term ‘General Purpose Financial Statements’ includes balance sheet, statement of profit and loss, a cash flow statement (wherever applicable) and other statements and explanatory notes which form part thereof, issued for the use of various stakeholders, Governments and their agencies and the public at large.

10.5. The Institute has so far issued thirty two definitive standards as follows:

- AS 1 Disclosure of Accounting Policies
- AS 2 Valuation of Inventories
- AS 3 Cash Flow Statements
- AS 4 Contingencies and Events Occurring After the Balance Sheet Date.
- AS 5 Net Profit or Loss for the period, Prior Period items and changes in Accounting policies
- AS-6 Depreciation Accounting
Part-III: Guidance Notes  III.197

AS 7  Construction Contracts
AS 8  (Withdrawn pursuant to AS 26 becoming mandatory) Accounting for Research and Development
AS 9  Revenue Recognition
AS 10 Accounting for Fixed Assets
AS 11 The Effects of Changes in Foreign Exchange Rates
AS 12 Accounting for Government Grants
AS 13 Accounting for Investments
AS 14 Accounting for Amalgamations
AS 15 Employee Benefits
AS 16 Borrowing Costs
AS 17 Segment Reporting
AS 18 Related Party Disclosures
AS 19 Leases
AS 20 Earnings Per Share
AS 21 Consolidated Financial Statements
AS 22 Accounting for Taxes on Income
AS 23 Accounting for Investments in Associates in Consolidated Financial Statements
AS 24 Discontinuing Operations
AS 25 Interim Financial Reporting
AS 26 Intangible Assets
AS 27 Financial Reporting of Interests in Joint Ventures
AS 28 Impairment of Assets
AS 29 Provisions, Contingent Liabilities and Contingent Assets
AS 30 Financial Instruments: Recognition and Measurement
AS 31 Financial Instruments: Presentation
AS 32 Financial Instruments: Disclosures

10.6 AS 30, AS 31 and AS 32 issued by the Institute of Chartered Accountants of India (ICAI) in 2007 have not yet been notified by the Government under Section 211(3C)/133 of the Companies Act, 1956/2013 respectively. In respect of the financial statements or other financial information the status of AS 30 as announced by the Council of the ICAI is as
follows:

(i) To the extent of accounting treatments covered by any of the existing notified accounting standards (for eg. AS 11, AS 13 etc) the existing accounting standards would continue to prevail over AS 30.

(ii) In cases where a relevant regulatory authority has prescribed specific regulatory requirements (eg. Loan impairment, investment classification or accounting for securitizations by the RBI, etc), the prescribed regulatory requirements would continue to prevail over AS 30.

(iii) The preparers of the financial statements are encouraged to follow the principles enunciated in the accounting treatments contained in AS 30. The aforesaid is, however, subject to (i) and (ii) above.

10.7 The abovementioned clarifications would also be relevant to the existing AS 31, *Financial Instruments: Presentation* and AS 32, *Financial Instruments: Disclosures*

10.8 **Applicability of Accounting Standards and exemptions/relaxations for Small and Medium Sized Enterprises**

It may be noted that certain exemptions/relaxations from the applicability of accounting standards have been given to Small and Medium Size Enterprise (SMEs). Accordingly, the Council has decided upon the following scheme which has come into effect in respect of accounting periods commencing on or after 1.4.2004.

(1) For the purpose of applicability of Accounting Standards, enterprises are classified into three categories, viz., Level I, Level II and Level III. Level II and Level III enterprises are considered as SMEs.

(2) Level I enterprises are required to comply fully with all the accounting standards.

(3) It has been decided that no relaxation should be given to Level II and Level III enterprises in respect of recognition and measurement principles. Relaxations are provided with regard to disclosure requirements. Accordingly, Level II and Level III enterprises are fully exempted from certain accounting standards which primarily lay down disclosure requirements. In respect of certain other accounting standards, which lay down recognition, measurement and disclosure requirements, relaxations from certain disclosure requirements are given. The exemptions/relaxations are decided to be provided by modifying the applicability portion of the relevant accounting standards. The applicability of AS and exemptions/relaxations thereof for SMEs are given in *Appendix VIII (Page no. 254).*

10.9 AS also apply in respect of financial statements audited under section 44AB of the Income-tax Act, 1961. Accordingly, members should examine compliance with the mandatory accounting standards when conducting such audit.

10.10 AS apply in respect of commercial, industrial or business activities of an enterprise. In
the case of charitable or religious organisations, AS will not apply if all activities of such organisations are not of commercial, industrial or business nature (e.g. an activity of collecting donations and giving them to flood affected people). In other words, exclusion of an entity from the applicability of the AS would be permissible only if no part of the activity of such entity is commercial, industrial or business in nature. Even if a very small portion of the activities of an entity is considered to be commercial, industrial or business in nature, then it cannot claim exemption from the application of AS. The AS would apply to all its activities including those which are not commercial, industrial or business in nature.

10.11 The Companies Act, 2013, as well as many other statutes require that the financial statements of an enterprise should give a true and fair view of its financial position and working results. This requirement is implicit even in the absence of a specific statutory provision to this effect. However, what constitutes ‘true and fair’ view has not been defined either in the Companies Act, 2013, or in any other statute. The Accounting Standards (as well as other pronouncements of the Institute on accounting matters) seek to describe the accounting principles and the methods of applying these principles in preparation and presentation of financial statements so that they give a true and fair view.

10.12 In this connection, it may be noted that sub-section (1) of section 129 of the Companies Act, 2013, provides that the financial statements shall give a true and fair view of the state of affairs of the company or companies, comply with the accounting standards notified under section 133 and shall be in the form or forms as may be provided for different class or classes of companies in Schedule III thereof. It also provides that items contained in such financial statements shall be in accordance with the accounting standards. Sub-section (5) of section 129 provides that without prejudice to sub-section (1), where the financial statements of a company do not comply with the accounting standards referred to in sub-section (1), the company shall disclose in its financial statements, the deviation from the accounting standards, the reasons for such deviation and the financial effects, if any, arising out of such deviation.

10.13 Section 2(2) of Companies Act, 2013 provides that accounting standards” means the standards of accounting or any addendum thereto for companies or class of companies referred to in section 133.

10.14 The ‘Preface to the Statements of Accounting Standards’, issued by the Institute, inter alia, states:

*The Accounting Standards will be mandatory from the respective date(s) mentioned in the Accounting Standard(s). The mandatory status of an Accounting Standard implies that while discharging their attest functions, it will be the duty of the members of the Institute to examine whether the Accounting Standard is complied with in the presentation of financial statements covered by their audit. In the event of any deviation from the Accounting Standard, it will be their duty to make adequate disclosures in their audit reports so that the users of financial statements may be aware of such deviation.*
Ensuring compliance with the Accounting Standards while preparing the financial statements is the responsibility of the management of the enterprise. Statutes governing certain enterprises require of the enterprises that the financial statements should be prepared in compliance with the Accounting Standards, e.g., the Companies Act, 2013 (section 129), and the Insurance Regulatory and Development Authority (Preparation of Financial Statements and Auditor’s Report of Insurance Companies) Regulations, 2000.¹

10.15 While discharging their attest function, the members of the Institute may keep the following in mind with regard to the mandatory AS.

**AS 1 Disclosure of Accounting Policies¹**

In the case of a company, members should qualify their audit reports in case:

(a) accounting policies required to be disclosed under Schedule VI or any other provisions of the Companies Act, 1956, have not been disclosed, or

(b) accounts have not been prepared on accrual basis, or

(c) the fundamental accounting assumptions of going concern and consistency have not been followed and this fact has not been disclosed in the financial statements, or

(d) proper disclosures regarding changes in the accounting policies have not been made.

(e) Accounting Standards referred to in section 211(3C) of the Companies Act, 1956 have not been followed.

10.16 Where a company has been given a specific exemption regarding any of the matters stated above, but the fact of such exemption has not been adequately disclosed in the accounts, the member should mention the fact of exemption in his audit report without necessarily making it a subject matter of audit qualification.

10.17 In the case of an enterprise other than a company, members should qualify their audit reports in case AS issued, prescribed and made mandatory by the ICAI have not been followed.

10.18 Financial statements prepared on a basis other than accrual

With regard to the fundamental accounting assumption of accrual, the Council has made a specific announcement that in respect of (a) Sole proprietary concerns/individuals, (b) Partnership firms, (c) Societies registered under the Societies Registration Act, (d) Trusts, (e) Hindu undivided families and (f) Association of persons, the auditor should examine whether the financial statements have been prepared on accrual basis. In case where the statute

¹ As per the announcement of the Council ‘accounting Standards 1,7,8,9 and 10 made mandatory’ published in July 1990 issue of ‘The Chartered Accountants'
governing the enterprise requires the preparation and presentation of financial statements on accrual basis but the financial statements have not been so prepared, the auditor should qualify his report. On the other hand where there is no statutory requirement for preparation and presentation of financial statements on accrual basis, and the financial statements have been prepared on a basis other than 'accrual', the auditor should describe in his audit report, the basis of accounting followed, without necessarily making it a subject matter of a qualification. In such a case the auditor should also examine whether those provisions of the AS which are applicable in the context of the basis of accounting followed by the enterprise have been complied with or not and consider making suitable qualifications in his audit report accordingly.

10.19 Accounting Standards under taxation law

The Finance Act, 1995 substituted a new section 145 w.e.f. A.Y. 1997-98. The section deals with method of accounting and is reproduced below:

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

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

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

10.20 Standards notified by Government - AS (IT)

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

10.21 These AS (IT) are given below:

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

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

1. All significant accounting policies adopted in the preparation and presentation of financial statements shall be disclosed.

2. The disclosure of the significant accounting policies shall form part of the
financial statements and the significant accounting policies shall normally be disclosed
in one place.

3. Any change in an accounting policy which has a material effect in the previous
year or in the years subsequent to the previous years shall be disclosed. The impact of,
and the adjustments resulting from such change, if material, shall be shown in the
financial statements of the period in which such change is made to reflect the effect of
such change. Where the effect of such change is not ascertainable, wholly or in part,
the fact shall be indicated. If a change is made in the accounting policies which has no
material effect on the financial statements for the previous year but which is reasonably
expected to have a material effect in any year subsequent to the previous year, the fact
of such change shall be appropriately disclosed in the previous year in which the
change is adopted.

4. Accounting policies adopted by an assessee should be such so as to represent
a true and fair view of the state of affairs of the business, profession or vocation in the
financial statements prepared and presented on the basis of such accounting policies.
For this purpose, the major considerations governing the selection and application of
accounting policies are the following, namely:

(i) Prudence - Provisions should be made for all known liabilities and losses even
though the amount cannot be determined with certainty and represents only a
best estimate in the light of available information;

(ii) Substance over form - The accounting treatment and presentation in financial
statements of transactions and events should be governed by their substance
and not merely by the legal form;

(iii) Materiality - Financial statements should disclose all material items, the
knowledge of which might influence the decisions of the user of the financial
statements.

5. If the fundamental accounting assumptions relating to going concern,
Consistency and Accrual are followed in financial statements, specific disclosure in
respect of such assumptions is not required. If a fundamental accounting assumption is
not followed, such fact shall be disclosed.

6. For the purposes of paragraphs (1) to (5), the expressions, -

(a) “Accounting policies” means the specific accounting principles and the methods
of applying those principles adopted by the assessee in the preparation and
presentation of financial statements;

(b) “Accrual” refers to the assumption that revenues and costs are accrued, that is,
recognised as they are earned or incurred (and not as money is received or
paid) and recorded in the financial statements of the periods to which they
relate;

(c) “Consistency” refers to the assumption that accounting policies are consistent from one period to another;

(d) “Financial statements” means any statement to provide information about the financial position, performance and changes in the financial position of an assessee and includes balance sheet, profit and loss account and other statements and explanatory notes forming part thereof;

(e) “Going concern” refers to the assumption that the assessee has neither the intention nor the necessity of liquidation or of curtailing materially the scale of the business, profession or vocation and intends to continue his business, profession or vocation for the foreseeable future.

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

1. Prior period items shall be separately disclosed in the profit and loss account in the previous year together with their nature and amount in a manner so that their impact on profit or loss in the previous year can be perceived.

2. Extraordinary items of the enterprise during the previous year shall be disclosed in the profit and loss account as part of taxable income. The nature and amount of each such item shall be separately disclosed in a manner so that their relative significance and effect on the operating results of the previous year can be perceived.

3. A change in an accounting policy shall be made only if the adoption of a different accounting policy is required by statute or if it is considered that the change would result in a more appropriate preparation or presentation of the financial statements by an assessee.

4. Any change in an accounting policy which has a material effect shall be disclosed. The impact of, and the adjustments resulting from such change, if material, shall be shown in the financial statements of the period in which such change is made to reflect the effect of such change. Where the effect of such change is not ascertainable, wholly or in part, the fact shall be indicated. If a change is made in the accounting policies which has no material effect on the financial statements for the previous year but which is reasonably expected to have a material effect in years subsequent to the previous years, the fact of such change shall be appropriately disclosed in the previous year in which the change is adopted.

5. A change in an accounting estimate that has a material effect in the previous year shall be disclosed and quantified. Any change in an accounting estimate which is reasonably expected to have a material effect in years subsequent to the previous year shall also be disclosed.
6. If a question arises as to whether a change is a change in accounting policy or a change in an accounting estimate, such a question shall be referred to the Board for decision.

7. For the purposes of paragraphs (1) to (6), the expressions:
   (a) “Accounting estimate” means an estimate made for the purpose of preparation of financial statements which is based on the circumstances existing at the time when the financial statements are prepared;
   (b) “Accounting policies” means the specific accounting principles and the method of applying those principles adopted by the assessee in the preparation and presentation of financial statements;
   (c) “Extraordinary items” means gains or losses which arise from events or transactions which are distinct from the ordinary activities of the business and which are both material and expected not to recur frequently or regularly. Extraordinary items include material adjustments necessitated by circumstances which though related to the years preceding the previous years are determined in the previous year;
   Provided that income or expenses arising from the ordinary activities of the business or profession or vocation of an assessee, though abnormal in amount or infrequent in occurrence, shall not qualify as extraordinary items;
   (d) “Financial statements” means any statement to provide information about the financial position, performance and changes in the financial position of an assessee and includes balance sheet, profit and loss account and other statements and explanatory notes forming part thereof;
   (e) “Prior period items” means material charges or credits which arise in the previous year as a result of errors or omissions in the preparation of the financial statements of one or more previous years.
   Provided that the charge or credit arising on the outcome of a contingency, which at the time of occurrence could not be estimated accurately shall not constitute the correction of an error but a change in estimate and such an item shall not be treated as a prior period item.

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

10.23 Implications of non-compliance with the AS and AS (IT)
As mentioned earlier, AS are applicable to tax audit also when the tax auditor performs the attest function, i.e., report on whether the accounts are true and fair. Therefore, in case of
non-compliance with the AS, the chartered accountant should make appropriate qualifications/disclosures in the audit report. However, such qualifications/disclosures may or may not have any impact on the computation of total income for the purpose of the Act. Similarly, section 145 provides that the AS (IT) notified under that section should be followed by the assessee to whom they are made applicable. It should be noted that the tax auditor auditing accounts under section 44AB is not computing the income but is - (a) reporting on accounts, and (b) reporting on the relevant information furnished in Form No. 3CD. Form No. 3CD vide clause 11(d) requires reporting of the details of deviation, if any, in the method of accounting employed in the previous year from accounting standards prescribed under section 145 and the effect thereof on the profit or loss. Further, it may be noted that there is no material difference between AS (IT)-1 and AS (IT)-2 notified by the Government and the corresponding AS-1 and AS-5 of the ICAI respectively.

11. Audit Procedures

11.1 In the case of an audit, the tax auditor is required to express his opinion as to whether the financial statements give a true and fair view of the state of affairs of the assessee in the case of the balance sheet and in the case of the profit and loss account/ income and expenditure account, of the profit/loss or income/expenditure. As regards the statement of particulars to be annexed to the audit report, he is required to give his opinion as to whether the particulars are true and correct. In giving his report the tax auditor will have to use his professional skill and expertise and apply such audit tests as the circumstances of the case may require, considering the contents of the audit report. He will have to conduct the audit by applying the generally accepted auditing procedures which are applicable for any other audit. He should use his professional judgment to apply the technique of audit sampling in accordance with the principles enunciated in SA 530 (Revised) “Audit Sampling” depending on the nature and volume of transactions, the materiality involved and the internal control procedures followed by the assessee. He would also be well advised to refer to the other Standards on Auditing (SAs) as may be relevant, issued by ICAI, as well as the “Guidance Note on Audit Reports and Certificates for Special Purposes”. If the statutory auditor of a person is also appointed to undertake tax audit, it is advisable to carry out both the audits concurrently.

11.2 Section 227/143 of the Companies Act 1956/2013 gives certain powers to the auditors to call for the books of account, information, documents, explanations, etc. and to have access to all books and records. No such powers are given to the tax auditor appointed under section 44AB. Attention is invited to SA 210, Agreeing the Terms of Audit Engagements. The Standard requires an auditor to establish whether the pre-conditions for an audit are present so as to accept or continue an audit engagement. As per para 6(b) (iii) the auditor is required to obtain agreement of management that it acknowledges and understands its responsibilities to provide the auditor with (a) access to all information of which the management is aware that is relevant to the preparation of the financial statements such as records, documentation and other matters, (b) additional information that the auditor may request the management for the
purpose of the audit and (c) unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence. Moreover, since the appointment of the tax auditor is made by the assessee, it will be in the interest of the assessee to furnish all the information and explanations and produce books of account and records required by the tax auditor. If, however, after agreeing to the terms of the engagement, the assessee subsequently refuses to produce any particular record or to give any specific information or explanation in relation to the reporting requirement under section 44AB, the tax auditor should see the impact thereof from the perspective of “management integrity” vis-a-vis overall assessment of risk of misstatements in accordance with under SA 315, *Identifying and Assessing the risks of material misstatement through understanding the entity and its environment* and consequently on his/her opinion for reporting in clause (3) of Form No.3CA or Clause (5) of Form No. 3CB as the case may be.

11.3 The audit report given under section 44AB is to assist the income-tax department to assess the correct income of the assessee. In order that the tax auditor may be in a position to explain any question which may arise later on, it is necessary that he should keep necessary working papers about the evidence on which he has relied upon while conducting the audit and also maintain all his necessary working papers. Such working papers should include his notes on the following, amongst other matters:

(a) work done while conducting the audit and by whom;

(b) explanations and information given to him during the course of the audit and by whom;

(c) decision on the various points taken;

(d) the judicial pronouncements relied upon by him while making the audit report; and

(e) certificates issued by the client/management letters.

11.4 The requirements of documentation are applicable in respect of tax audit conducted by chartered accountants. For this purpose attention is also invited to SA 230, *Audit Documentation*, which provides that the tax auditor should prepare documentation that provides a sufficient and appropriate record of the basis for the auditor’s report and evidence that the audit was planned and performed in accordance with SA’s and applicable legal and regulatory requirements.

11.5 If the accounts of the business or profession of a person have been audited under any other law by the statutory auditor(s), it is not necessary for the tax auditor appointed under section 44AB to conduct the audit once again in the matter of expression of “true and fair view” of the state of affairs of the entity and of its profit/loss for the period covered by the audit. However, the said section envisages the certification of the particulars in the prescribed form on which the tax auditor has to express his opinion as to whether these are ‘true and correct’. In other words, where an audit has already been conducted and the opinion of the auditor has been expressed on the accounts, it would not be necessary to repeat the entire exercise to express similar opinion all over again. The tax auditor has only to annex a copy of the audited accounts and the auditor’s report and other documents forming part of these
Part-III: Guidance Notes  III.207

accounts to his report and verify the particulars in the prescribed form for expressing his opinion as to whether these are true and correct.

11.6 Just in case of the conduct of a statutory audit for the purpose of expression of the auditor’s opinion as to whether the financial statements depict a ‘true and fair’ view, the statutory auditor applies audit sampling, in case of tax audits also the tax auditor may apply audit sampling techniques as prescribed in SA 530, Audit Sampling on the information provided by the assessee to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the audit opinion. The extent of check undertaken would have to be indicated by the tax auditor in his working papers and audit notes. The tax auditor would be well advised to so design his tax audit programme as would reveal the extent of checking and to ensure adequate documentation in support of the information being certified.

11.7 Where the assessee has been subjected to an internal audit and the tax auditor decides to use the work of the internal auditor for the purpose of the tax audit under section 44AB, the latter’s procedures would be guided by the principles laid down in Standard on Auditing (SA) 610, Using the Work of Internal Auditors.

11.8 Audit procedures applicable to a person whose accounts of the business or profession have been audited under any other law will apply as well to a person who carries on business or profession but who is not required by or under any other law to get his accounts audited. In order to express his opinion on the accounts of a person belonging to the latter category the tax auditor should apply the same tests and checks as he would have applied in the conduct of audit of the former category. In case the relevant vouchers for the expenditure and payments made by a non-corporate entity are not available, it will be necessary for the tax auditor to call for any other evidence in support of such expenditure and payments. The entity should be advised to maintain vouchers/records in evidence of transactions to avoid a qualification/observation* in the matter by the tax auditors. The qualification in respect of this matter would, in the normal course, be necessary in case the vouchers or other evidence required to be maintained are not produced in evidence of the income/expenditure or assets/liabilities. The entity should be encouraged to maintain office vouchers with the recipient’s signatures for the amounts reimbursed on account of expenditure like local conveyance etc., for which other supporting evidence is not possible to obtain. It would also be advisable to give appropriate notes on accounts in the case of a person who carries on business or profession but who is not required by or under any other law to get his accounts audited. These may include disclosure regarding method of accounting and practices consistently and regularly followed, and whether a change in such matters or practice has been made during the year, notwithstanding the fact that such disclosures are required to be made in Form No.3CD.

* Attention of the members is invited to the principles laid out in SA 705, Modifications to the Opinion in the Independent Auditor’s Report.

11.9 The ICAI had pursuant to the issuance of the Revised SA 700, Forming an Opinion and
Reporting on Financial Statements, prescribed a revised format of the auditor’s report on financial statements, which has been made effective in respect of audits of financial statements for periods beginning on or after 1st April 2012. Since Form No. 3CA and Form No. 3CB are required to be filed online in a preset form and the same are not in line with the requirements of SA 700, there is no specifically allocated field for providing information relating to the respective responsibilities of the assessee and the tax auditor as required in terms of the principles laid out in SA 700. However, having regard to the importance of these respective responsibility paragraphs from the perspective of the readers of the tax audit report, it is suggested that these respective responsibility paragraphs relating can be provided in the space provided for giving observations, etc., under clause (3) of Form No.3CA or Clause (5) of Form No.3CB as the case may be.

11.10 The illustrative Assessee’s responsibility paragraph and Tax Auditor’s responsibility paragraphs in respect of Form No.3CB are given hereunder. The same may be suitably reworded to meet the situation envisaged in Form No.3CA.

“Assessee’s Responsibility for the Financial Statements and the Statement of Particulars in Form 3CD

1. The assessee is responsible for the preparation of the aforesaid financial statements that give a true and fair view of the financial position and financial performance (if applicable) in accordance with the applicable Accounting Standards issued by the Institute of Chartered Accountants of India. This responsibility includes the design, implementation and maintenance of internal control relevant to the preparation and presentation of the financial statements that give a true and fair view and are free from material misstatement, whether due to fraud or error.

2. The assessee is also responsible for the preparation of the statement of particulars required to be furnished under section 44AB of the Income-tax Act, 1961 annexed herewith in Form No. 3CD read with Rule 6G(1)(b) of Income Tax Rules, 1962 that give true and correct particulars as per the provisions of the Income-tax Act, 1961 read with Rules, Notifications, circulars etc. that are to be included in the Statement.

Tax Auditor's Responsibility

3. My/ Our responsibility is to express an opinion on these financial statements based on my/our audit. I/We have conducted this audit in accordance with the Standards on Auditing issued by the Institute of Chartered Accountants of India. Those Standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

© The Institute of Chartered Accountants of India
4. An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor’s judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances but not for the purposes of expressing an opinion on the effectiveness of the entity’s internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of the accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

5. I/we believe that the audit evidence I/we have obtained is sufficient and appropriate to provide a basis for my/our audit opinion.

6. I/we are also responsible for verifying the statement of particulars required to be furnished under section 44AB of the Income-tax Act, 1961 annexed herewith in Form No. 3CD read with Rule 6G (1) (b) of Income-tax Rules, 1962. I/We have conducted my/our verification of the statement in accordance with Guidance Note on Tax Audit under section 44AB of the Income-tax Act, 1961, issued by the Institute of Chartered Accountants of India.

11.11 In this regard, attention of the members is also invited to the Announcement regarding “Applicability of SA 700, forming an opinion and reporting on financial statements, to formats of auditor's reports prescribed under various laws and/or regulations” (22.08.2013), issued by ICAI, given in Appendix IX (Page No. 266).

12. Professional misconduct
12.1 It may be noted that when any question relating to professional misconduct in connection with tax audit arises, the tax auditor would be liable under the Chartered Accountants Act and the ICAI’s disciplinary jurisdiction will prevail in this regard.

13. Audit Report
13.1 Section 44AB requires the tax auditor to submit the audit report in the prescribed form and setting forth the prescribed particulars. Sub-rule (1) of Rule 6G provides that the report of audit of accounts of a person required to be furnished under section 44AB shall -

(a) in the case of a person who carries on business or profession and who is required by or under any other law to get his accounts audited, be in Form No. 3CA;

(b) in the case of a person who carries on business or profession, but not being a person referred to in clause (a), in Form No. 3CB.

13.2 Sub-rule (2) of Rule 6G further provides that the particulars which are required to be
furnished under section 44AB shall be in Form No. 3CD.

13.3 It may be noted that the audit report in Form No.3CB is in two parts. The first part requires the tax auditor to give his opinion as to whether or not the accounts audited by him give a true and fair view:

(i) in the case of the balance sheet, of the state of affairs as at the last date of the accounting year.

(ii) in the case of the profit and loss account, of the profit or loss of the assessee for the relevant accounting year.

13.4 The second part of the report states that the statement of particulars required to be furnished under section 44AB is annexed to the audit report in Form No. 3CD. The tax auditor is required to give his opinion whether the prescribed particulars furnished by the assessee are true and correct, subject to observations and qualifications, if any.

13.5 In paragraph 3 of Form No. 3CB the auditor has to report that the financial statements audited by him give a ‘true and fair’ view. With regard to the term “true and fair view” the auditor is advised to consider in the Framework for Preparation and Presentation of Financial Statements as also paragraph 12, 13, 14 and 27 of SA 700 (Revised), Forming an opinion and reporting on Financial Statements. Attention of the members is drawn to Para 5 of SA 200, Overall Objectives of the Independent Auditor reproduced below:

“5. As the basis for the auditor’s opinion, SAs require the auditor to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. Reasonable assurance is a high level of assurance. It is obtained when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk (i.e., the risk that the auditor expresses an inappropriate opinion when the financial statements are materially misstated) to an acceptably low level. However, reasonable assurance is not an absolute level of assurance, because there are inherent limitations of an audit which result in most of the audit evidence on which the auditor draws conclusions and bases the auditor’s opinion being persuasive rather than conclusive.”

13.6 The requirement in paragraph 3 of Form No.3CA and paragraph 5 of Form No.3CB relating to particulars in Form No.3CD is that the auditor should report that these particulars in Form No.3CD are "true and correct". The terminology "true and fair" is widely understood though not defined even under the Companies Act, 1956/2013. On the other hand, the words "true and correct" lay emphasis on factual accuracy of the information. In this context reference is invited to AS-1 and AS(IT)-I relating to disclosure of accounting policies. These standards recognise that the major considerations governing the selection and application of accounting policies are (i) prudence, (ii) substance over form and (iii) materiality. Therefore, while giving particulars in Form No.3CD these aspects should be kept in view. In particular, considering the nature of particulars to be given in Form No.3CD, the aspect of materiality
should be considered. In other words, particulars should be given in the respect of material items and the auditors should assess factual correctness relating to these particulars. Attention of the members, in this context is, however, also drawn to Para 51 of “Framework for Assurance Engagements” reproduced below:

“51. “Reasonable assurance” is less than absolute assurance. Reducing assurance engagement risk to zero is very rarely attainable or cost beneficial as a result of factors such as the following:

- The use of selective testing.
- The inherent limitations of internal control.
- The fact that much of the evidence available to the practitioner is persuasive rather than conclusive.
- The use of judgment in gathering and evaluating evidence and forming conclusions based on that evidence.
- In some cases, the characteristics of the subject matter when evaluated or measured against the identified criteria.”

13.7 In the case of a person whose accounts of the business or profession have been audited under any other law, it is not required for the tax auditor appointed under section 44AB to give his opinion, as to whether or not the accounts give a true and fair view as indicated herein above. It would only be necessary for him to annex a copy of the audited accounts as well as a copy of the audit report given by the statutory auditor with his report in Form No. 3CA along with Form No.3CD.

13.8 In the case of a person who carries on business and also renders professional services but who is not required by or under any other law to get his accounts audited, report should be given in Form No. 3CB. The statement of particulars should be given in Form No. 3CD.

13.9 In the case of a person who carries on business or profession but who is not required by or under any other law to get his accounts audited, the expression “proper books of account” should mean, the books of original entry and other books of account required to be maintained to record all the transactions of the assessee in the same manner, as in the case of a person whose accounts of the business or profession have been audited under any other law. Although, books of account have not yet been prescribed for a person who carries on business or profession (except under Section 44AA for certain categories of profession), the tax auditor should examine whether such books are maintained by the assessee to provide the information and the basis required to prepare the balance sheet and the profit and loss account correctly in the formats recommended in Appendices XV (Page no. 278) and XVI (Page no. 286) of this Guidance Note.

13.10 In case the accounts of a person who carries on business or profession are being audited for the first time, the tax auditor should ensure compliance with SA 510 (Revised), Initial Audit Engagements - Opening Balance.
13.11 In certain cases, members are called upon to report on the accounts reopened and revised by the board of directors. The accounts of a company once adopted at its annual general meeting should not normally be re-opened and revised. The Institute and the Ministry of Corporate Affairs have affirmed this position. In case of revision, the audit report should be given in the manner as required by the Institute in SA-560 (Revised), *Subsequent Events*. The Ministry of Corporate Affairs had also clarified that accounts can be revised to comply with technical requirements. It may be pointed out that report under section 44AB should not normally be revised. However, sometimes a member may be required to revise his tax audit report on grounds such as:

(i) revision of accounts of a company after its adoption in annual general meeting.
(ii) change of law e.g., retrospective amendment.
(iii) change in interpretation, e.g. CBDT Circular, judgements, etc.

13.12 In case where a member is called upon to report on the revised accounts, then he must mention in the revised report that the said report is a revised report and a reference should be made to the earlier report also. In the revised report, reasons for revising the report should also be mentioned.

13.13 In the case of companies having their accounting year which is different from the financial year, accounts of the financial year are required to be prepared and audited. The audit report shall be in Form 3CB. The above position has also been clarified by the CBDT in its Circular No. 561 dated 22.5.1990. The Circular is reproduced in *Appendix X (Page no 268)*.

### 14. Form No. 3CA

14.1 This form is to be used in a case where the accounts of the business or profession of a person have been audited under any other law. The first part of the report refers to the fact that the statutory audit of the assessee was conducted by a chartered accountant or any other auditor in pursuance of the provisions of the relevant Act, and the copy of the audit report along with the audited profit and loss account and balance sheet and the documents declared by the relevant Act to be part of or annexed to the profit and loss account and balance sheet, are annexed to the report in Form No. 3CA. In a case where the tax auditor carrying out the audit under section 44AB is different from the statutory auditor, a reference should be made to the name of such statutory auditor. In case the statutory auditor is carrying out the audit under section 44AB, the fact that he has carried out the statutory audit under the relevant Act should be stated. Attention of the members in this context is invited to SA 600 *Using the work of Another Auditor*.

14.2 The next paragraph states that the statement of particulars required to be furnished under section 44AB is annexed with the particulars in Form No. 3CD. The tax auditor has to further state that, in his opinion and to the best of his information and according to
examination of books of account including other relevant documents and explanations given to him, the particulars given in the said Form No.3CD and the annexure thereto are true and correct subject to the observations/qualifications, if any.

14.3 The auditor is required to examine not only the books of accounts but also other relevant documents directly related to transactions reflected in the books of accounts like original purchase invoice, copy of bank statements, bills, vouchers, various agreements/contracts or any other document on the basis of which preliminary entries are passed in the books of accounts.

14.4 Attention is also drawn to the definition of 'document' as per section 2(22AA) of the Act which is as under:

"document" includes an electronic record as defined in clause (t) of sub-section (1) of section 2 of the Information Technology Act, 2000 (21 of 2000).

Section 2(1)(t) of the Information Technology Act, 2000 as referred above is reproduced below:

"electronic record" means data, record or data generated, image or sound stored, received or sent in an electronic form or micro film or computer generated micro fiche.

The definition of term “document” is an inclusive definition and includes within its ambit documents other than those considered as electronic record as per section 2(1)(t) of the Information Technology Act, 2000. The above definition can also be relied when reporting under clause 11(c) of Form No. 3CD discussed later in this Guidance Note.

14.5 Where any of the requirements in this form is answered in negative or with qualification, the report shall state the reasons thereof. The tax auditor should state this qualification in the audit report so that the same becomes a comprehensive report and the user of the audited statement of particulars can realize the impact of such qualifications.

14.6 It is possible that in the case of a person whose accounts of the business or profession have been audited under any other law, which has branches at various places, the branch accounts might have been audited by branch auditors under the statute. If the audit under section 44AB is also carried out by the same branch auditors or other chartered accountants, they should submit the report in Form No. 3CA to the management or the principal tax auditor appointed for the head office under Section 44AB. Attention in this regard is drawn to SA 600, Using the Work of Another Auditor which discusses the procedures in this regard as well as the principal tax auditor's responsibility in relation to his use of the work of the branch auditor. The principal tax auditor should submit his consolidated report on the registered office/head office and branch accounts and report in his tax audit report as his observation in paragraph 3 of Form No. 3CA as under:

"I/We have taken into consideration the audit report and the audited statements of accounts, and particulars received from the auditors, duly appointed under the relevant law, of the branches not audited by me/us".
14.7 Item No. 4 of the notes to Form No. 3CA requires that the person, who signs this audit report, shall indicate reference of his membership No./certificate of practice number/authority under which he is entitled to sign this report. No separate certificate of practice number is allotted by ICAI. As such, where a chartered accountant acts as a tax auditor he should give his membership number with ICAI while registering himself in the e-filing portal. In case, the e-filing utility of Form No. 3CA requires the mention of the Firm Registration number and the name of the firm on whose behalf the member has conducted audit, the same should invariably be provided by the tax auditor.

14.8 An assessee may have one or more branches outside India. The accounts of such branches are normally audited by the professional accountants overseas. The results of such branches are also incorporated in the consolidated accounts prepared in this country. In the case of foreign branches, the relevant information in respect of such branches as is required by Form No. 3CD, may be obtained by the tax auditor in India from the assessee who should obtain the same from the overseas auditor who had audited the accounts of such foreign branches. The tax auditor in India while certifying the information in Form No. 3CD may rely upon the information obtained by him from the overseas auditor and while submitting his consolidated report in Form No. 3CD, he should specifically point out the following in his audit report in paragraph 3 of Form No. 3CA as his observation:

"I/We have taken into consideration the audit report and the audited statements of accounts, and particulars received from the auditors, appointed under the relevant law, of the overseas branches not audited by me/us".

If the assessee is unable to obtain relevant information in respect of the overseas branches duly certified by the overseas auditor, the relevant facts should be suitably disclosed and reported upon.

14.9 Where the tax auditor is unable to obtain the required information in respect of branches situated in India or outside India then the fact should be suitably disclosed along with its impact on the Auditor’s opinion on the particulars furnished in Form No. 3CD, as an observation in clause (3) of Form No. 3CA. Reference is drawn to SA 705, Modifications to the opinion in the Independent Auditor’s report.

15. Form No. 3CB

15.1 In the case of a person who carries on business or profession but who is not required by or under any other law to get his accounts audited, the audit report has to be given in Form No. 3CB. Form No. 3CB consists of five paragraphs.

15.2 The tax auditor has to state whether he has examined the balance sheet as on a particular relevant date and the profit and loss account/income and expenditure account for that period. Further, such a balance sheet and the profit and loss account must be attached with the audit report.
15.3 The tax auditor has to certify that the balance sheet and the profit and loss account/income and expenditure account are in agreement with the books of account maintained at the head office and branches. Also, he has to mention the total number of branches.

15.4 He has to report his observations, comments, discrepancies or inconsistencies, if any. Subject to the above observations, comments, discrepancies, inconsistencies he has to state whether:

(a) he has obtained all the information and explanations which, to the best of his knowledge and belief, were necessary for the purposes of the audit;

(b) in his opinion proper books of account have been kept by the head office and branches of the assessee so far as appears from his examination of the books;

(c) in his opinion and to the best of his information and according to the explanations given to him the said accounts, read with notes thereon, if any, give a true and fair view;

(i) in the case of the balance sheet of the state of the affairs of the assessee as at 31st March, ______ and

(ii) in the case of the profit and loss account/income and expenditure account of the profit/loss or surplus/deficit of the assessee for the year ended on that date.

15.5 Under clause (a) of paragraph 3 of Form No.3CB, the tax auditor has to report his “observations/comments/ discrepancies/inconsistencies,” if any. The expression “Subject to above” appearing in clause (b) makes it clear that such observations/comments/ discrepancies/ inconsistencies which are of qualificatory nature relate to necessary information and explanations for the purposes of the audit or the keeping of proper books of accounts or the true and fair view of the financial statements, respectively to be reported on in paragraphs (A), (B) and (C) under clause (b) of paragraph 3. While reporting on clause (a) of paragraph 3 of Form No. 3CB the tax auditor should report only such of those observations/comments/ discrepancies/ inconsistencies which are of qualificatory nature which affect his reporting about obtaining all the information and explanations which were necessary for the purposes of the audit, about the keeping of proper books of account by the head office and branches of the assessee and about the true and fair view of the financial statements. Further, only such observations/comments/ discrepancies/inconsistencies which are of a qualificatory nature should be mentioned under clause (a). Any other observations/comments/ discrepancies/inconsistencies, which do not affect the reporting on the matters specified above may form part of the notes to accounts forming part of the accounts. In case the tax auditor has no observations/comments/ discrepancies/inconsistencies to report which are of qualificatory nature, “NIL” should be reported in this part of paragraph 3. The tax auditor may then give his report as required by sub-paragraphs (A), (B), and (C) of paragraph 3 and paragraph 4.
III.216 Auditing Pronouncements

15.6 Paragraph 4 of Form No.3CB provides that the prescribed particulars are furnished in Form No.3CD annexed to the report. Paragraph 5 of Form No.3CB requires the auditor to report whether in his opinion and to the best of his information and according to the explanations given to him, the particulars given in Form No.3CD are true and correct subject to observations/qualifications, if any. The auditor may have a difference of opinion with regard to the particulars furnished by the assessee and he has to bring these differences under various clauses in Form No.3CD. The auditor should make a specific reference to those clauses in Form No.3CD in which he has expressed his reservations, difference of opinion, disclaimer etc. in this paragraph.

15.7 If a person who carries on business or profession but who is not required by or under any other law to get his accounts audited, has branches and separate accounts are maintained at the branches, the assessee can request the tax auditor appointed under section 44AB to audit the head office and branch accounts. In the alternative, the assessee can appoint separate tax auditors for branches. The branch tax auditor in such a case will have to give an audit report in Form No. 3CB to the management or the tax auditor appointed for the audit of head office accounts. The tax auditor appointed for the audit of head office can rely on the report of branch tax auditors subject to such checks and verifications as he may choose to make and shall submit his consolidated report on the head office and branch accounts. He should make suitable reference to the audit conducted by separate branch tax auditors in the same manner as stated in para 14.6 above.

15.8 If the tax auditor is called upon to give his report only in respect of one or more businesses carried on by the assessee and the books of accounts of the other businesses are not produced as the same are not required to be audited under the Act, the tax auditor should mention the fact that audit has not been conducted of those businesses whose books of account had not been produced. However, if the financial statements include, inter alia, the results of such business for which books of account have not been produced, the auditor should qualify his report in Form No. 3CB.

16. Form No. 3CD

16.1 The statement of particulars given in Form No. 3CD as annexure to the audit report contains forty one clauses. The tax auditor has to report whether the particulars are true and correct. This Form is a statement of particulars required to be furnished under section 44AB. The same is to be annexed to the reports in Forms No. 3CA and 3CB in respect of a person who carries on business or profession and whose accounts have been audited under any other law and in respect of person who carries on business or profession but who is not required by or under any other law to get his accounts audited respectively.

16.2 As stated earlier, the tax auditor should obtain from the assessee, the statement of particulars in Form No. 3CD duly authenticated by him. It would be advisable for the assessee to take into consideration the following general principles while preparing the statement of particulars:
(a) He can rely upon the judicial pronouncements while taking any particular view about inclusion or exclusion of any items in the particulars to be furnished under any of the clauses specified in Form No.3CD.

(b) If there is a conflict of judicial opinion on any particular issue, he may refer to the view which has been followed while giving the particulars under any specified clause.

(c) The AS, Guidance Notes, SA issued by the Institute from time to time should be followed.

16.3 While furnishing the particulars in Form No.3CD it would be advisable for the tax auditor to consider the following:

(a) If a particular item of income/expenditure is covered in more than one of the specified clauses in the statement of particulars, care should be taken to make a suitable cross reference to such items at the appropriate places.

(b) If there is any difference in the opinion of the tax auditor and that of the assessee in respect of any information furnished in Form No. 3CD, the tax auditor should state both the view points and also the relevant information in order to enable the tax authority to take a decision in the matter.

(c) If any particular clause in Form No.3CD is not applicable, he should state that the same is not applicable.

(d) In computing the allowance or disallowance, he should keep in view the law applicable in the relevant year, even though the form of audit report may not have been amended to bring it in conformity with the amended law.

(e) In case the prescribed particulars are given in part or piecemeal to the tax auditor or relevant form is incomplete and the assessee does not give the information against all or any of the clauses, the auditor should not withhold the entire audit report. In such a case, he can qualify his report on matters in respect of which information is not furnished to him. In the absence of relevant information, the tax auditor would have no option but to state in his report that the relevant information has not been furnished by the assessee.

(f) The information in Form No.3CD should be based on the books of accounts, records, documents, information and explanations made available to the tax auditor for his examination.

(g) In case the auditor relies on a judicial pronouncement, he may mention the fact as his observations in clause (3) of Form No.3CA or clause (5) provided in Form No.3CB, as the case may be.
PART – A

1. Name of the assessee : _______________________
2. Address : _______________________
3. Permanent Account Number : _______________________
4. Whether the assessee is liable to pay indirect tax like excise duty, service tax, sales tax, customs duty, etc. If yes, please furnish the registration number or any other identification number allotted for the same : _______________________
5. Status : _______________________
6. Previous year : from ________ to ________
7. Assessment year : _______________________
8. Indicate the relevant clause of section 44AB under which the audit has been conducted : _______________________

The requirements of clauses 1 to 8 of Part-A are discussed as follows:

17.1 Under clause (1) the name of the assessee whose accounts are being audited under section 44AB should be given. However, if the tax audit is in respect of a branch, name of such branch should be mentioned along with the name of the assessee.

17.2 The address to be mentioned under clause (2) should be the same as has been communicated by the assessee to the Income-tax Department for assessment purposes as on the date of signing of the audit report. If the tax audit is in respect of a branch or a unit, the address of the branch or the unit should be given. In the case of a company, the address of the registered office should also be stated. In the case of a new assessee, the address should be that of the principal place of business.

17.3 Under clause (3) the permanent account number (PAN) allotted to the assessee should be indicated. It may be noted that in the e-filing format PAN is a mandatory field.

17.4 Under clause (4), the auditor is required 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.

17.5 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.

17.6 The term “Indirect taxes” is neither defined in the Income-tax Act, 1961 nor under any other law. The levy of different types of indirect taxes on various transactions may differ from State to State. Thus, it is recommended that the auditor should obtain from the assessee the list of indirect taxes applicable to him. Once the auditor obtains this management representation, he is required to obtain a copy of the registration certificate clearly mentioning the registration number under that relevant law. For example, Service tax registration number, Excise registration number, VAT registration number/ Central Sales tax Registration number etc. The assessee may have multiple registrations for various manufacturing units, service units, godowns etc under the same law. In such circumstances also, a copy of all registration certificates is to be obtained from the assessee for appropriate disclosure under this clause. Where the indirect tax law does not require any registration, appropriate identification number may be reported in this clause. For example, in Customs Act, 1962, since there is no registration number, a copy of Export Import Code (IEC) may be obtained and information be accordingly furnished.

17.7 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>2</td>
<td>3</td>
<td>4</td>
</tr>
</tbody>
</table>

17.8 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 taxes laws is applicable on the business or profession of the assessee but the assessee is not registered under the said law, he should report the same appropriately.

17.9 Under clause (5) the status of the assessee is to be mentioned. Obviously this refers to the different classes of assessees included in the definition of “person” in section 2 (31) of the Act, namely, individual, Hindu undivided family, company, firm, an association of persons or a body of individuals whether incorporated or not, a local authority or artificial juridical person.

17.10 Under clause (6) the period of the previous year has to be stated. Since the previous year under the Act now uniformly begins on 1st April and ends on 31st March, the relevant previous year should be mentioned. In case of amalgamations, demergers, reconstitution, new business, closure of existing business etc the date of beginning/ ending of the previous year may be different, the auditor may accordingly, mention the relevant date of beginning and ending of the previous year in this clause. Hence, the tax auditor has to apply his professional judgement depending on the facts and circumstances of the same.
17.11 Under clause (7) the assessment year relevant to the previous year for which the accounts are being audited should be mentioned.

17.12 Under clause (8) the 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 twenty five 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 44AD, clause (d) is to be mentioned under this head.

18. (a) If firm or Association of Persons, indicate names of partners/members and their profit sharing ratios.

(b) If there is any change in the partners or members or in their profit sharing ratio since the last date of the preceding year, the particulars of such change.

[Clause 9(a) and (b)]

18.1 Where the assessee is a firm or association of persons (AOP) or body of individuals, the names of partners of the firm or members of the association of persons or body of individuals and their profit sharing ratios (%) have to be stated. In case where the partner of a firm or the member of AOP/ BOI acts in a representative capacity, the name of the beneficial partner/member should be stated. Thus, the details of partners or members during the entire previous year will have to be furnished. The term “profit sharing ratios” would include loss-sharing ratio also since loss is nothing but negative profits. This would not cover any specific ratio or understanding in relation to payment of remuneration or interest to partners or members. In this connection, reference may be made to Circular No.739 dated 25.3.1996 issued by the Board reproduced in Appendix XI (Page no. 269).

18.2 If there is any change in the partners of the firm or members of the association of persons/ body of individuals or their profit or loss sharing ratio since the last date of the preceding year, the particulars of such change must be stated. All the changes occurring during the entire previous year must be stated.

18.3 The particulars in this clause should be verified from the instrument or agreement or any other document evidencing partnership or association of persons including any supplementary documents or other documents effecting such changes. For this purpose, the tax auditor may also verify:

(i) in case of registered firms (including Indian LLPs), whether the relevant documents have been filed with the concerned authorities,
(ii) whether notice of changes, if required, has been given to the registrar of firms, and
(iii) any minutes or any other understanding recording any changes in the partners/members or their profit sharing ratios.

18.4 The tax auditor should obtain certified copies of the deeds, documents, understanding, notice of changes etc. including certified copies of the acknowledgment, if any, evidencing filing of documents with the concerned authorities, if registered.

18.5 In certain cases of association of persons or body of individuals, it may be possible that the shares of the members are not precisely ascertainable during the previous year resulting in a situation whereby the shares of the members are indeterminate or unknown. In such circumstances, the relevant fact should be stated.

18.6 As per section 2(23) of the Income-tax Act, 1961 the term “Firm” shall have the meaning assigned to it in the Indian Partnership Act, 1932, and shall include a Limited Liability partnership firm as defined in Limited Liability Partnership Act, 2008.

19. (a) Nature of business or profession (if more than one business or profession is carried on during the previous year, nature of every business or profession)

(b) If there is any change in the nature of business or profession, the particulars of such change.

[Clause 10 (a) and (b)]

19.1 In regard to the nature of business, the principal line of each business is to be determined and stated in this clause, i.e. the sector in which the business or profession falls such as manufacturing, trading, commission agent, builder, contractor, professionals, service sector, financial service sector or entertainment industry. In case of a person belongs to service sector the nature of each type of service should be broadly stated. Thereafter, the auditor is required to mention the sub-sector pertaining to the sector selected.

19.2 Information has to be furnished in respect of each business. The code to be mentioned against the nature of business pertains to the main area of business activity.

19.3 Any material change in the nature of business should be precisely set out. The change will include change from manufacturer to trader as well as change in the principal line of business. For example, an assessee switching over from wholesale business to retail business or an assessee switching over from manufacturing his own commodities to manufacturing goods on job basis for others. Likewise, any addition to or permanent discontinuance of, a particular line of business may also amount to change requiring reporting. However, temporary suspension of the business may not amount to change and therefore need not be reported.

19.4 A review of business report or the minutes of meetings would enable the tax auditor to
III.222 Auditing Pronouncements

note the changes, if any. Based thereon, he may make necessary enquiries and seek information and determine whether any change has occurred or not. If need be, the tax auditor should get a declaration from the assessee regarding change in the nature of business, if any.

19.5 In the case of business reorganization/ reconstruction if there is a similar line of activity, no reference needs to be made. However, if a new line of activity emerges because of business reorganization/ reconstruction, the same may be stated. In the case of restructuring, if any line of activity is being hived off, the same may also be reported.

19.6 The auditor should keep in mind the above guidance while furnishing information under this clause in the format provided for in the e-filing utility

20. (a) Whether books of account are prescribed under section 44AA, if yes, list of books so prescribed.

(b) List of books of account maintained and the address at which the books of account are kept.

(In case books of account are maintained in a computer system, mention the books of account generated by such computer system. If the books of accounts are not kept at one location, please furnish the addresses of locations along with the details of books of accounts maintained at each location.)

(c) List of books of account and nature of relevant documents examined.

[Clause 11 (a) to (c)]

20.1 The list of books of accounts prescribed, maintained and examined has to be stated under this clause. There may be difference between the three lists. For example, books of accounts may have been prescribed but all the prescribed books might not have been maintained or the entire books of accounts maintained might not have been produced for examination. The tax auditor should exercise his professional judgment in order to arrive at the conclusion whether such a situation warrants any disclosure or qualifications while forming his opinion on the matters covered by reporting requirements in Form No.3CB.

20.2 The CBDT under Rule 6F has prescribed the books of account and other documents to be kept and maintained by a person carrying on certain professions specified in sub-section (1) of section 44AA. As such, every person carrying on legal, medical, engineering or architectural profession or the profession of accountancy or technical consultancy or interior decoration or authorised representative or film artist and whose total gross receipts exceed one lakh fifty thousand rupees in all the three years immediately preceding the previous year, or where the profession has been newly set up in the previous year, his total gross receipts in the profession for that year are likely to exceed the said amount, is required to maintain the following books of account:

2. Journal, if the accounts are maintained according to the mercantile system of
Part-III: Guidance Notes

III.223

accounting.

3. Ledger.

Apart from the aforesaid books of account, a person carrying on medical profession is required to keep the following:

(a) daily case register in Form No.3C showing data, patient's name, nature of professional services rendered, fees received and date of receipt; and

(b) an inventory under broad heads, as on the first and the last days of the previous year, of the stock of drugs, medicines and other consumable accessories used for the purpose of his profession.

20.3 In the case of a person for whom the books of account have been prescribed under rule 6F, the list of books so prescribed have to be stated under clause 11(a). It may be noted that the daily case register and the inventory under broad heads do not constitute books of account and hence the same need not be mentioned under clause 11(a). Sometimes an assessee may carry on multiple activities. Books of account might have been prescribed for one of the activities. In that case, mention may be made of the activity for which books have been prescribed.

20.4 The tax auditor should obtain from the assessee a complete list of books of account and other documents maintained by him (both financial and non-financial records) and make appropriate marks of identification to ensure the identification of the books and records produced before him for audit. The list of books of account maintained by the assessee should be given under clause 11(b).

20.5 Section 44AA(2) provides that persons carrying on business or profession, other than those specified in sub-section (1), shall keep and maintain such books of account and other documents as may enable the Assessing Officer to compute his total income in accordance with the provisions of the Income-tax Act, if his income from business or profession exceeds the monetary limits prescribed under section 44AA(2) or his total sales, turnover or gross receipts in business or profession exceed the monetary limits prescribed under section 44AA(2) in any one of the three years immediately preceding the previous year. The tax auditor will, therefore, have to verify that the assessee has maintained such books of accounts and documents as may enable the Assessing Officer to compute the total income of the assessee in accordance with the provisions of the Act. It may be noted that though the Central Board of Direct Taxes has been empowered under sub-section (3) of section 44AA to prescribe books of account to be maintained under sub-section (2), so far no books of accounts have been prescribed.

20.6 For a person whose accounts of the business or profession have been audited under any other law, the requirement for maintenance of books of account is contained in the relevant statutes. In the case of other assesses, normal books of account to be maintained will be cash book/bank book, sales/purchase journal or register and ledger. Assessees
III.224  Auditing Pronouncements

engaged in trading/manufacturing activities should also maintain quantitative details of principal items of stores, raw materials and finished goods. While giving his report in Form No. 3CB about maintenance of proper books of account, the tax auditor should ensure that they are maintained in accordance with the above requirements. In case where stock records are not properly maintained by the assessee due to the nature, level, volume and variety of items/transactions, the tax auditor will have to consider the concept of materiality and practicality while giving particulars in Form No. 3CD.

20.7  (a) As per section 2(12A) of the Income-tax Act, 1961, “books or books of account” includes ledgers, day-books, cash books, account-books and other books, whether kept in the written form or as print-outs of data stored in a floppy, disc, tape or any other form of electromagnetic data storage device. As to the requirement regarding the mentioning of the books of accounts generated by the computer system, the tax auditor should obtain a list of books of account which are generated by the computer system. The list given by the assessee can be verified from the printout of such books obtained from the assessee. Only such books of account and other records which properly come within the scope of the expression “proper books of account” should be mentioned.

(b)  It may be noted that section 4 of the Information Technology Act, 2000 states that “Where any law provides that information or any other matter shall be in writing or in the typewritten or printed form, then, notwithstanding anything contained in such law, such requirement shall be deemed to have been satisfied if such information or matter is-

(i)  rendered or made available in an electronic form; and

(ii)  accessible so as to be usable for a subsequent reference.”

20.8  From AY 2014-15, the address at which the books so maintained are kept is also required to be mentioned under clause (b). In case the books of accounts are kept at more than one location then the auditor is required to mention the details of address of each such location along with the detail of books of account maintained thereof. The auditor is advised to obtain from the assessee a list in the following format and accordingly report the same in clause 11(b). In case of a company assessee auditor should also verify as to whether any forms are filed under the Companies Act for maintenance of books of accounts at a place other than the registered office:

<table>
<thead>
<tr>
<th>Sr No.</th>
<th>Principal place of maintenance of books of accounts</th>
<th>Details of books maintained</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>2</td>
<td>3</td>
</tr>
</tbody>
</table>

20.9 In case, where books of accounts are maintained and generated through computer system, the auditor should obtain from the assessee the details of address of the place where the server is located or the principal place of business/Head office or registered office by whatever name called and mention the same accordingly in clause 11(b).
20.10 Books of account examined would constitute the books of original entry and the other books of account. In addition to the list of books of accounts examined, the auditor is required to mention the nature of relevant documents examined also. Since the assessee is required to maintain evidence such as bills, vouchers, receipts, debit note, credit note, inventory register, agreements, orders etc., the auditor generally examines these documents while conducting audit. The underlying documents would differ from assessee to assessee depending on the nature of activity carried on by the assessee. Reference to such supporting evidence/ relevant documents is also required to be made under this clause. Attention is drawn to Para 14.3 and 14.4 for guidance with regard to the term “relevant documents”.

21. Whether the profit and loss account includes any profits and gains assessable on presumptive basis, if yes, indicate the amount and the relevant sections (44AD, 44AE, 44AF, 44B, 44BB, 44BBA, 44BBB Chapter XII-G, First Schedule or any other relevant section).

[Clause 12]

21.1 Where the profits and gains of the business are assessable to tax under presumptive basis under any of the sections mentioned below, the amount of such profits and gains credited/debited to the profit and loss account should be indicated under this clause:

<table>
<thead>
<tr>
<th>S. No.</th>
<th>Section</th>
<th>Business covered</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>44AD</td>
<td>Eligible business</td>
</tr>
<tr>
<td>2</td>
<td>44AE</td>
<td>Transport business</td>
</tr>
<tr>
<td>3</td>
<td>44B</td>
<td>Shipping business of a non-resident</td>
</tr>
<tr>
<td>4</td>
<td>44BB</td>
<td>Providing service or facilities in connection with, or supplying plant and machinery on hire used, or to be used, in the prospecting for, or extraction or production of, mineral oils</td>
</tr>
<tr>
<td>5</td>
<td>44BBA</td>
<td>Operation of aircraft by non-resident</td>
</tr>
<tr>
<td>6</td>
<td>44BBB</td>
<td>Civil construction etc. in certain turnkey power project by non-residents</td>
</tr>
<tr>
<td>7</td>
<td>Chapter XII-G</td>
<td>Special provisions relating to Shipping Companies (Section 115V to 115VT)</td>
</tr>
<tr>
<td>8</td>
<td>First Schedule</td>
<td>Insurance Business</td>
</tr>
<tr>
<td>9</td>
<td>Any other relevant section</td>
<td>This refers to the sections not listed above under which income may be assessable on presumptive basis like section 44D and section 115A(1)(b) and will include any other section that may be enacted in future for presumptive taxation</td>
</tr>
</tbody>
</table>

If the profit and loss account does not include profit assessable on presumptive basis, then, there is no requirement to furnish the particulars under this clause.

21.2 The amount to be mentioned under this clause means the amount included in the profit and loss account. The tax auditor is not required to indicate as to whether such amount corresponds to the amount assessable under the relevant section relating to presumptive
taxation. As such, the reporting requirement gets satisfied if the amount as per profit and loss account is reported.

21.3 The tax auditor may come across three different situations as follows:

(a) Where the assessee, maintaining regular books of account has more than one business which include business of the nature assessable on presumptive basis under any of the said sections and the profit and loss account prepared from such books of account, *inter alia*, includes the income of the business assessable under the scheme of presumptive taxation.

(b) Where the assessee has more than one business including some business(es) falling under any of the aforesaid sections, but maintains separate sets of accounts for each such business and opts for getting the accounts of all such businesses audited under section 44AB.

(c) Where the assessee, having regular books of account for his main business, has some additional business of the nature described in any of the aforesaid sections and no books of account whatsoever is maintained for such additional business but the net income is credited to the main profit & loss account of the assessee.

21.4 Under each of the aforesaid three situations, the tax auditor may proceed as follows:

(a) This situation may give rise to the problem of apportionment of common expenditure in order to arrive at the correct amount of profit credited to profit and loss account and assessable on a presumptive basis. In such a situation, the endeavour of the tax auditor should be to arrive at a fair and reasonable estimate of such expenditure on the basis of evidence in possession of the assessee or by asking the assessee to prepare such estimate which should be checked by him. It is also necessary to mention the basis of apportionment of common expenditure. However, if the tax auditor is not satisfied with the reasonableness of such apportionment, he should indicate such fact under this clause by a suitable note.

(b) In this case, since a separate set of accounts are maintained for respective businesses, it poses no problem for the tax auditor in ascertaining the amount of profit to be disclosed.

(c) Here, the tax auditor is unable to satisfy himself about the correctness of the net income from the presumptive business credited to the profit and loss account. He should, therefore, state the amount of income as appearing in the profit and loss account, with a suitable note expressing his inability to verify the said figure. In the absence of books of account, the tax auditor would be unable to form an opinion about the true and fair view of the profit and loss account or balance sheet of the assessee and therefore, it would become necessary for him to qualify his report in Form No. 3CB.

21.5 In the case of an assessee opting against presumptive taxation, the provisions of section 44AB (c) requires such an assessee to get his accounts audited irrespective of the fact that his turnover has not exceeded the prescribed limit (presently Rs. 1 crore w.e.f A.Y.
2013-14). There may be another circumstance where an assessee has mixed nature of business amenable to taxation on presumptive basis and under normal provisions of law – turnover of which does not exceed the prescribed limit (presently Rs. 1 crore w.e.f. A.Y. 2013-14). In such a case, the tax auditor auditing the books of account etc. relating to business covered by the provisions relating to presumptive taxation should sufficiently indicate in his report that his audit report in Form No. 3CB and particulars in Form No.3 CD only relate to the business covered by the provisions relating to presumptive taxation and his audit report does not relate to business assessable under the normal provisions of the Act.

21.6 Even where the assessee opts for presumptive taxation, the tax auditor should impress upon the assessee that it would be advisable to maintain some basic records to support the turnover/gross receipts declared for presumptive taxation.

21.7 Where the profit and loss account includes any profits and gains assessable by virtue of provisions of section 44AE, the auditor should obtain and verify the following information from the assessee:

<table>
<thead>
<tr>
<th>Sr No.</th>
<th>Nature of vehicle</th>
<th>No. of Vehicles</th>
<th>Month of acquisition in case of vehicle purchased during the relevant previous year</th>
<th>Presumptive income per month</th>
<th>Number of months Owned during the previous year (Part of the month to be rounded off)</th>
<th>Presumptive income for the previous year</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

21.8 In respect of provisions relating to Chapter XII-G, the auditor should obtain and verify the following information from the assessee being a qualifying shipping company:

<table>
<thead>
<tr>
<th>Sr No.</th>
<th>Name of the Ship</th>
<th>Net tonnage capacity as per DGS certificate</th>
<th>Net tonnage capacity rounded off to nearest 100</th>
<th>Tonnage income per day</th>
<th>No of days operated during the previous year as per DGS Certificate</th>
<th>Tonnage income per year</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

21.9 The auditor should keep in mind the above guidance while furnishing information under this clause in the format provided in the e-filing utility.

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

(b) Whether there had been any change in the method of accounting employed
III.228 Auditing Pronouncements

vis-a-vis the method employed in the immediately preceding previous year.

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

<table>
<thead>
<tr>
<th>Serial number</th>
<th>Particulars</th>
<th>Increase in profit (Rs.)</th>
<th>Decrease in profit (Rs.)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

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

[Clause 13 (a) to (d)]

22.1 The Finance Act, 1995 amended section 145 with effect from assessment year 1997-98 to provide that the income chargeable under the head “Profits and gains of business or profession” or “Income from other sources” must be computed in accordance with either cash or mercantile system of accounting regularly employed by the assessee. It has also been provided that the Central Government may notify in the Official Gazette from time to time the accounting standards to be followed by any class of assesses or in respect of any class of income. The hybrid system of accounting viz. mixture of cash and mercantile hitherto allowed to be followed by the assessee was not permitted from assessment year 1997-98 & onwards. However, the assessee may adopt cash system of accounting for one business and mercantile system of accounting for other business. Once the choice of method of accounting is decided, the assessee must follow consistently the method of accounting employed. If he employs different methods for different businesses regularly and consistently, the profits would have to be computed in accordance with the respective methods, provided the result is a proper determination of profits. As regards the accrual system of accounting, the Institute has published a “Guidance Note on Accrual Basis of Accounting” which may be referred to.

22.2 It may be noted that in view of amendment made by the Companies (Amendment) Act, 1988 in section 209 of the Companies Act, 1956/2013 every company is required to keep books of account on accrual basis. In other words, a company governed by the Companies Act, 1956 cannot follow cash system of accounting unless exempted under the Companies Act, 1956/2013. The provisions of section 209 (3) of the Companies Act, 1956 are, however, not applicable to entities other than companies. Section 209 has been replaced with the section 128/129 in the Companies Act, 2013 w.e.f.1.4.2014.

22.3 Under sub-clause (b), whether there has been any change in the method of accounting employed vis-à-vis the method employed in the immediately preceding previous year is to be stated. As already noted, an assessee can follow either cash or mercantile system of accounting.

22.4 If there is any change, the effect thereof i.e. increase or decrease in profits has to be stated under this clause. So far as the question of effect of such change on the profit or loss is
concerned, the concept of materiality is the basic governing factor. If it is not possible to quantify the effect of the change in the method of accounting, appropriate disclosure should be made under this clause.

22.5 An assessee can follow a number of accounting policies for the purpose of maintaining his books of account. As per AS-1 all significant accounting policies adopted in the preparation and presentation of financial statements shall be disclosed. The disclosure of the significant accounting policies shall form part of the financial statements and the significant accounting policies shall normally be disclosed in one place. Any change in an accounting policy which has a material effect in the previous year or in the years subsequent to the previous year shall be disclosed. The impact of, and the adjustments resulting from such change, if material, shall be shown in the financial statement of the period in which such change is made to reflect the effect of such change.

22.6 As per paragraph 9 under AS(IT) relating to disclosure of prior period and extraordinary items and changes in accounting policies, a change in an accounting policy can be made only if:

(a) adoption of different policy is required by the statute; or
(b) the change would result in a more appropriate presentation of the financial statements.

22.7 A change in an accounting policy will not amount to a change in the method of accounting and hence such change in the accounting policy need not be mentioned under sub-clause (b). This is due to the fact that as per the requirements of AS-1 and AS (IT)-1 such changes and the impact of such changes will be disclosed in the financial statements. It may be noted that a change in the method of valuation of stock will amount only to a change in an accounting policy and hence such a change need not be mentioned under sub-clause 13(b) but should be mentioned in the financial statements.

22.8 The tax auditor should apply reasonable checks to the earlier year’s accounts to ascertain whether there is any change in the method of accounting as compared to that of the year under audit, after obtaining a written confirmation from the assessee as to the method of accounting followed.

22.9 It must also be ascertained as to whether the AS (IT) as may be applicable to the assessee or to the class of income, have been followed. Presently, only two AS (IT) have been prescribed. – AS (IT)-I relating to disclosure of accounting policies and AS (IT)-II relating to disclosure of prior period and extraordinary items and changes in profit and loss account. The tax auditor has to report the details of the deviations in the method of accounting in the previous year from the AS(IT) and the effect thereon in the profit or loss. The tax auditor, while reporting on prior period and extraordinary items should report only such items which fall within the meaning of prior period items and extraordinary items in the relevant AS (IT). Attention is invited to AS (IT)-II, paragraph 10, according to which any change in an accounting policy which has a material effect is required to be disclosed. As stated above, a
III.230 Auditing Pronouncements

change in the method of valuation of closing stock would amount to a change in an accounting policy and has to be stated in the financial statements. The tax auditor should ensure that in case the same is not stated in the financial statements, the fact should suitably be stated under clause 13(d). He may rely on the various pronouncements and clarifications made by the ICAI.

22.10 The Finance (No. 2) Act, 2014 has amended section 145 w.e.f AY 2015-16 to the effect that the words ‘accounting standards’ be replaced with the words ‘income computation and disclosure standards’. As per the memorandum explaining the Finance (No. 2) Bill 2014, such an amendment has been made in order to clarify that the standards notified under section 145(2) are only meant for computation of income and disclosure of information and the assessee need not maintain books of account on the basis of AS notified under the Income-tax Act, 1961. The Accounting Standards issued by ICAI/Companies Accounting Standard Rule, 2006 would still be required to be followed by the assessee, for preparation of financial statements.

23. (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 the profit or loss, please furnish:

<table>
<thead>
<tr>
<th>Serial number</th>
<th>Particulars</th>
<th>Increase in profit (Rs.)</th>
<th>Decrease in profit (Rs.)</th>
</tr>
</thead>
</table>

[Clause 14 (a) and (b)]

23.1 The method of valuation of closing stock is to be stated under this clause. AS-2 “Valuation of Inventories” issued by ICAI requires disclosure of significant accounting policies. Accordingly, a reference may be invited to the same or the method of valuation may be again described in Form No.3CD.

23.2 The method of valuation followed by the assessee having regard to the articles or goods dealt in or manufactured by the assessee, should be clearly indicated. Some examples are given below:

(i) raw material at cost or net realisable value whichever is lower,
(ii) finished goods at cost or net realizable value whichever is lower.

23.3 In sub-clause (a) of clause 14 of Form No.3CD, the reference is made to "closing stock". The expression "stock-in-trade" means finished goods and raw materials. Since sub-clause (b) refers to section 145A where the term "inventories" is used, the term "closing stock" will include all items of inventories. AS-2 defines the term "inventories" to include finished goods, raw materials, work-in-progress, materials, maintenance supplies, consumables and loose tools. Therefore, method of valuation of items of inventories will have to be given under sub-clause (a).

23.4 The tax auditor should study the procedure followed by the assessee in taking the
inventory of closing stock at the end of the year and the valuation thereof. He should obtain the
inventory of closing stock, indicating the basis of valuation thereof, for reporting on the
method of valuation of closing stock under this clause.

23.5 The method of stock valuation must be consistently followed from year to year and the
method followed must be brought out clearly. The tax auditor should examine the basis
adopted for ascertaining the cost and this basis should be consistently followed. It is
necessary to ensure that the method followed for valuation of stock results in disclosure of
correct profit and gains. The Supreme Court in case of CIT v. British Paints Ltd. [1991] 188
ITR 44 (SC) has held that the method of valuation of stock at actual cost of raw materials and
not taking into account overhead charges was not the correct method of valuation even
though the said method has been consistently followed. As per AS-2 - Valuation of inventories
(Revised) (from accounting year starting from 1.4.1999), historical cost of manufactured
inventories can be arrived at on the basis of absorption costing alone and the allocation of
fixed costs of inventories should be based on the normal level of production only. It is further
provided that overheads should be included as part of the inventory cost only to the extent
that they clearly relate to putting the inventories in their present location and condition.

23.6 It is not necessary to indicate any change in the method of valuation of closing stock
under this clause. However, as stated earlier in paragraph 22.6, any such change in the
method of valuation of closing stock would amount to change in an accounting policy and
needs to be disclosed in the financial statements as required by AS-1 and AS(IT).

23.7 The details of deviation, if any, from the method of valuation prescribed under section
145A, and the effect thereof on the profit or loss have to be stated under clause 14(b).

23.8 Section 145A was enacted by the Finance (No.2) Act, 1998 and came into force from
A.Y. 1999-2000. This section provides that the valuation of purchase and sale of goods and
inventory for the purpose of computation of income from business or profession shall be made
on the basis of the method of accounting regularly employed by the assessee but this shall be
subject to certain adjustments. Therefore, it is not necessary to change the method of
valuation of purchase, sale and inventory regularly employed in the books of account. The
adjustments provided in this section can be made while computing the income for the purpose
of preparing the return of income. These adjustments are as follows:

(a) Any tax, duty, cess or fee actually paid or incurred on inputs should be added to the
cost of inputs (raw materials, stores etc.) if not already added in the books of account.

(b) Any tax, duty, cess or fee actually paid or incurred on sale of goods should be added to
the sales, if not already added in the books of account.

(c) Any tax, duty, cess or fee actually paid or incurred on the inventory (finished goods,
work-in-progress, raw materials etc.) should be added to the inventories, if not already
added while valuing the inventory in the accounts.

23.9 The statutory adjustments required under section 145A can be explained by the
following example.
III.232 Auditing Pronouncements

<table>
<thead>
<tr>
<th>Particulars</th>
<th>Qty</th>
<th>Rate excluding excise duty</th>
<th>Rate of excise duty</th>
</tr>
</thead>
<tbody>
<tr>
<td>Opening stock</td>
<td>10</td>
<td>10</td>
<td>2</td>
</tr>
<tr>
<td>Raw material purchased</td>
<td>90</td>
<td>10</td>
<td>2</td>
</tr>
<tr>
<td>Other manufacturing cost</td>
<td>80</td>
<td>10</td>
<td>-</td>
</tr>
<tr>
<td>Finished goods manufactured</td>
<td>80</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Sales of finished goods</td>
<td>60</td>
<td>25</td>
<td>3</td>
</tr>
<tr>
<td>Closing stock of raw material</td>
<td>20</td>
<td>10</td>
<td>2</td>
</tr>
<tr>
<td>Closing stock of finished goods</td>
<td>20</td>
<td>20</td>
<td>3</td>
</tr>
</tbody>
</table>

The input output ratio of raw material to finished goods is 1: 1

23.10 It may be stated that the CENVAT is a procedure whereby manufacturer can utilise credit for input duty against duty payable on final products. Duty credit taken on input is of the nature of set off available against the excise duty payable on the final products. For the accounting periods ending on or before 31st March, 1999, the following two alternative methods of treatment of CENVAT credit in the accounts are permissible.

I. Duty paid on inputs may be debited to a separate account, e.g. CENVAT credit receivable account. As and when the CENVAT credit is actually utilised against payment of excise duty on final products appropriate accounting entries will be required to adjust the excise duty paid out of "CENVAT credit receivable account" to the account maintained for payment/provision for excise duty on final product. In this case, the purchase cost of the inputs would be net of input duty. Therefore, the inputs consumed and the inventory of inputs would be valued on the basis of purchase cost net of input duty. This method is hereinafter referred to as "exclusive method".

II. In the second alternative, the cost of inputs may be recorded at the total amount paid to the supplier inclusive of input duty. To the extent the CENVAT credit is utilised for payment of excise duty on final products, the amount could be credited to a separate account, i.e. CENVAT credit availed account. Out of the CENVAT credit availed account, the amount of CENVAT credit availed in respect of consumption of inputs would be reduced from the total cost of inputs consumed. This method is hereinafter referred to as "inclusive method".

The effect of section 145A is to reflect the figures on "inclusive method".

Following two illustrations explain the above propositions.

The profit & loss account on "exclusive method" would be as under:
### Part III: Guidance Notes

#### III.233

<table>
<thead>
<tr>
<th>Item</th>
<th>Particulars</th>
<th>Unit</th>
<th>Rate</th>
<th>Amount</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a)</td>
<td>Opening Stock</td>
<td>10</td>
<td>10</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>(b)</td>
<td>Purchase of raw material</td>
<td>90</td>
<td>10</td>
<td>900</td>
<td>900</td>
</tr>
<tr>
<td></td>
<td><strong>Total</strong></td>
<td>100</td>
<td>10</td>
<td>1000</td>
<td>1000</td>
</tr>
<tr>
<td>(c)</td>
<td>Less closing stock of raw Material</td>
<td>20</td>
<td>10</td>
<td>200</td>
<td>200</td>
</tr>
<tr>
<td>(d)</td>
<td>Raw material consumed</td>
<td>80</td>
<td>10</td>
<td>800</td>
<td>800</td>
</tr>
<tr>
<td>(e)</td>
<td>To manufacturing Cost</td>
<td>80</td>
<td>10</td>
<td>800</td>
<td>800</td>
</tr>
<tr>
<td>(f)</td>
<td>To excise duty on finished goods sold</td>
<td></td>
<td></td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>(g)</td>
<td>To gross Profit</td>
<td></td>
<td></td>
<td>300</td>
<td>300</td>
</tr>
<tr>
<td></td>
<td><strong>TOTAL</strong></td>
<td></td>
<td></td>
<td>1900</td>
<td>1900</td>
</tr>
</tbody>
</table>

The profit & loss account on “inclusive method” which is also in accordance with the provisions of section 145A would be as under:

<table>
<thead>
<tr>
<th>Item</th>
<th>Particulars</th>
<th>Unit</th>
<th>Rate</th>
<th>Amount</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>(j)</td>
<td>Opening stock</td>
<td>10</td>
<td>12</td>
<td>120</td>
<td>120</td>
</tr>
<tr>
<td>(k)</td>
<td>Purchase of raw material</td>
<td>90</td>
<td>12</td>
<td>1080</td>
<td>1080</td>
</tr>
<tr>
<td></td>
<td><strong>Total</strong></td>
<td>100</td>
<td>12</td>
<td>1200</td>
<td>1200</td>
</tr>
<tr>
<td>(l)</td>
<td>Less closing stock</td>
<td>20</td>
<td>12</td>
<td>240</td>
<td>240</td>
</tr>
<tr>
<td>(m)</td>
<td>Less CENVAT credit</td>
<td>80</td>
<td>2</td>
<td>160</td>
<td>160</td>
</tr>
<tr>
<td>(n)</td>
<td>Raw material Consumed</td>
<td>80</td>
<td>10</td>
<td>800</td>
<td>800</td>
</tr>
<tr>
<td>(o)</td>
<td>To manufacturing cost</td>
<td>80</td>
<td>10</td>
<td>800</td>
<td>800</td>
</tr>
<tr>
<td>(p)</td>
<td>To excise duty on finished goods sold</td>
<td>60</td>
<td>3</td>
<td>180</td>
<td>180</td>
</tr>
</tbody>
</table>
III.234  Auditing Pronouncements

(q) To excise duty on closing stock of finished goods 20 3 60
(r) To gross profit 300

TOTAL 2140 2140

23.11 It may be pointed out that the "inclusive method" is not permitted by AS-2 which is made mandatory from accounting year beginning on or after 01.04.1999. Further, in the Guidance Note on Accounting for CENVAT the second method (inclusive method) has been withdrawn with effect from accounting year commencing from 1.4.1999. In view of the above, the adjustments under section 145A will have to be made in all cases where 'exclusive method' is followed.

23.12 In this connection, it is worthwhile to note that the Memorandum explaining the provisions of section 145A inserted by the Finance (No.2) Bill, 1998 states as follows:

"Computation of value of inventory.

The issue relating to whether the value of closing stock of the inputs, work-in-progress and finished goods must necessarily include the element for which MODVAT* credit is available has been the matter of considerable litigation.

In order to ensure that the value of opening and closing stock (bold for emphasis) reflect the correct value, it is proposed to insert a new section to clarify that while computing the value of the inventory as per the method of accounting regularly employed by the assessee, the same shall include the amount of any tax, duty, cess or fees paid or liability incurred for the same under any law in force.

The proposed amendment which is clarificatory in nature shall take effect retrospectively from the 1st day of April, 1986 and will accordingly apply in relation to assessment year 1986-87 and subsequent years.

[Clause 45]"

*Now CENVAT.

(Section 145A was initially proposed to be applicable in relation to assessment year 1986-87 and subsequent years. However, later on, when the Finance (No.2) Bill, 1998 was enacted into law the provision was made applicable from 1.4.1999 i.e. assessment year 1999-2000)

23.13 It may be noted that when the adjustments are made in the valuation of inventories, this will affect both the opening as well as closing stock. Whatever adjustment is made in the valuation of closing stock, the same will be reflected in the opening stock also. Question for consideration is whether the opening stock as on 1.4.1998 should be adjusted as required under section 145A. It is now well settled that if any adjustment is required to be made by a statute, effect to the same should be given irrespective of any consequences on the
computation of income for tax purposes. Section 145A starts with the *non obstante* clause "Notwithstanding anything to the contrary contained in section 145". Therefore, to give effect to section 145A, the opening stock as on 1.4.98 will have to be increased by any tax, duty, cess or fee actually paid or incurred with reference to such stock if the same has not been added for the purpose of valuation in the accounts.

23.14 It may be noted that while making the adjustments stated in Para 23.8 and 23.13 above, the tax auditor should ensure that if any deduction is claimed for any tax, duty, cess or fee on the items covered by these two paragraphs by way of debit in the profit and loss account, either in the earlier year or in the year under report, adjustment for the same should be made in such a manner that no double deduction is claimed for the same expenditure. Similarly, adjustment should be made for any item of income to ensure that the same item is not treated as income twice.

23.15 When the exclusive method is followed in the accounts, the adjustments to be made under section 145A can be explained by the following illustrations which are required to be reported under clause 14(b).

<table>
<thead>
<tr>
<th>Sl. No.</th>
<th>Particulars</th>
<th>(Rupees) Increase in Profit</th>
<th>(Rupees) Decrease in Profit</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Increase in cost of opening stock on inclusion of excise duty on which CENVAT credit is available/availed (j - a)</td>
<td>20</td>
<td></td>
</tr>
<tr>
<td>2.</td>
<td>Increase in purchase cost of raw material on inclusion of excise duty on which CENVAT credit is available/availed (k - b)</td>
<td></td>
<td>180</td>
</tr>
<tr>
<td>3.</td>
<td>Increase in sales of finished goods on inclusion of excise duty (s - h)</td>
<td>180</td>
<td></td>
</tr>
<tr>
<td>4.</td>
<td>Excise duty paid on sale of finished goods as a result of its inclusion in sales (p-f)</td>
<td>-</td>
<td>180</td>
</tr>
<tr>
<td>5.</td>
<td>Increase in closing stock of raw material on inclusion of excise duty (l - c)</td>
<td>40</td>
<td>-</td>
</tr>
<tr>
<td>6.</td>
<td>Increase in closing stock of finished goods on inclusion of excise duty (t - i)</td>
<td>60</td>
<td>-</td>
</tr>
<tr>
<td>7.</td>
<td>Increase in excise duty on closing stock of finished goods as a result of its inclusion in closing stock of finished goods (q)</td>
<td>-</td>
<td>60</td>
</tr>
<tr>
<td>8.</td>
<td>Accounting of CENVAT credit availed and utilised on raw materials consumed in payment of excise duty on finished goods accounted on the basis of raw material consumed (m)</td>
<td>160</td>
<td>-</td>
</tr>
<tr>
<td>TOTAL</td>
<td></td>
<td>440</td>
<td>440</td>
</tr>
</tbody>
</table>

It may be noted that the net impact on the profit or loss will be nil.
Note 1: The reference in brackets is to items in the illustration given in paragraphs 23.10 above.

Note 2: The CENVAT credit in the "inclusive method" has been worked out on the basis of quantity of raw material consumed multiplied by excise duty paid on purchase of such raw material (Rs.160) (item m), though the CENVAT credit set off availed and utilized by the assessee against payment of excise duty on finished goods is Rs.180. This is so because the raw material consumed during the year under both the methods is Rs.800. The CENVAT credit in the inclusive method would have to be deducted from purchase of raw material on the basis of consumption of raw material and not on the basis of set off availed in excise law to arrive at correct cost of consumption. In the illustration if CENVAT credit of Rs.180 is accounted, then the raw material consumed would be Rs.780. This figure would not be the correct figure of consumption, since 80 units have been consumed and the net cost of each raw material is Rs.10 (12-2). In other words, the consumption of raw material to be debited during the year should be Rs.800 i.e. 80 units multiplied by 10. So also the figure of excise duty on finished goods sold of Rs.180 is correctly debited because the same represents excise duty on finished goods sold and the same cannot be changed on account of CENVAT credit set off availed.

In the inclusive method the cost of the finished goods have been taken at Rs.20 plus Rs.3 excise duty. The raw material component included in the finished goods has been taken at Rs.10 since CENVAT credit have been accounted at the rate of Rs.2 in arriving at consumption of raw material.

Note 3: Similar treatment should be given for other tax, duty, cess, or fee paid by the assessee i.e. sales tax etc.

Note 4: It may be noted that liability for sales tax arises on sale as against liability for excise duty which arises on manufacture. As such the liability for sales tax need not be adjusted in the closing stock of finished goods before the same are sold.

23.16 It may be noted that after making the above addition to the closing stock under section 145A, it will be possible to claim a separate deduction for excise duty actually paid after the year end but before the due date for filing the return of income on production of evidence as provided under section 43B. Therefore, in the above illustration if the assessee has paid Rs.60 added in the valuation of closing stock of finished goods before the due date for filing the return, deduction for the same can be separately claimed in the computation of income under section 43B, if other conditions of those sections are satisfied.

23.17 The computation of total income would appear as under:

\[
\begin{align*}
\text{Rs.} & \quad \text{Rs.} & \quad \text{Rs.} \\
\text{Profit as per Profit and Loss account} & \quad \text{on the basis of exclusive method} \quad \text{(see paragraph 23.10)} & \quad \text{300} \\
\text{Add: Adjustments required under section 145A:} & & \\
\end{align*}
\]
1) Excise duty on sales  
(Rs. 3/- per unit for 60 units)  180

2) Excise duty on closing stock of raw materials  
(Rs. 2/- per unit for 20 units)  40

3) Excise duty on closing stock of finished goods  
(Rs. 3/- per unit for 20 units)  60

4) CENVAT credit utilized on consumption of raw materials  
(Rs. 2/- per unit for 80 units)  160  440

---

Less:

1) Excise duty on opening stock of raw material  
(Rs. 2/- per unit for 10 units)  20

2) Excise duty on purchase of raw materials  
(Rs. 2/- per unit on 90 units)  180

3) Excise duty on sales (paid or incurred as per section 145A)  
180  380  60

-----  -----  -----  360

*Less: Deduction under section 43B on the assumption that the amount is paid on or before due date of filing return of income in respect of excise duty payable on finished goods  60

-----

Profit 300

23.18 The input State-Level Value Added Tax (VAT) paid on purchases cannot be included in the cost of purchases where the tax paid on inputs is available for set-off against the tax payable on sales or is refundable, it is in the nature of taxes recoverable from taxing authorities. The Accounting Standard (AS) 2 “Valuation of Inventories” deals with “cost of inventories” and “cost of purchases”. As per para 6 and 7 of the said AS-2, the cost of purchases cannot include duties and the taxes which are subsequently recoverable from the taxing authorities. Hence the input tax which is refundable, should not be included in the cost.
III.238  Auditing Pronouncements

of purchases.

23.19 The Input State-Level VAT, to the extent it is refundable, will not form part of the cost of the inventory. The inventory of inputs is to be valued at net of the input tax which is refundable. If the inputs are obtained from the dealers who are exempt from the VAT, the actual cost of purchase should be considered as a part of cost of inventory.

23.20 A dealer may purchase certain common inputs which can be used for manufacturing goods which are declared tax free as well as taxable goods. In such case, the dealer should estimate inputs expected to be used for making tax free goods and for making taxable goods. The dealer should recognize VAT credit only in respect of those inputs which are used for making taxable goods and no VAT credit should be recognized in respect of inputs used for making tax free goods. Similar accounting treatment should be given in the case of stock transfer/consignment sale of goods out of the State where VAT credit is available only to the extent of a certain portion of input tax paid.

23.21 VAT is collected from the customers on behalf of the VAT authorities and, therefore, its collection from the customers is not an economic benefit for the enterprise. It does not result in any increase in the equity of the enterprise. Accordingly, it should not be recognized as an income of the enterprise. Similarly, the payment of VAT should not be treated as an expense in the financial statements of the enterprise. Therefore, it should be credited to an appropriate account, say, ‘VAT Payable Account’. In case the VAT has not been charged separately but has made a composite charge, it should segregate the portion of sales which is attributable to tax and should credit the same to ‘VAT Payable Account’ at periodic intervals. The amount of VAT payable adjusted against the VAT Credit Receivable (Capital Goods) Account and amounts paid in cash will be debited to this account. The credit balance in VAT Payable Account at the year-end should be shown on the ‘Liabilities’ side of the balance sheet under the head ‘Current Liabilities’. It is important to note that where the assessee is enjoying tax holiday under the relevant state law as a result of which the liability to pay is deferred for a period of more than one year then it should be reflected as a long term liability.

23.22 Section 145A of the Income-tax Act provides that the valuation of purchase and sales of goods and inventory for the purpose of computation of income from business or profession shall be made on the basis of method of accounting regularly employed by the assessee but this shall be subject to certain adjustments. Therefore, it is not necessary to change the method of valuation of purchase, sale and inventory regularly employed in the books of account. The adjustment provided for in this section should be made while computing the income for the purpose of preparing the return of income. Therefore, the recommended method for accounting of VAT will not result in non-compliance of section 145A of the Income-tax Act.

23.23 The adjustments envisaged by section 145A will not have any impact on the trading account of the assessee. In other words both under exclusive method of accounting and
inclusive method of accounting, the gross profit in the trading account will remain the same. The same is illustrated for a trading concern and a manufacturing concern as follows:

(I) Trading Concern

Assuming that the assessee has opening stock of Rs.3,30,000/- on which input tax rebate of Rs.30,000/- is available. During the year three items purchased @ Rs.3,00,000/- per item. VAT on purchase @ 10%. There is no opening stock. Two items are sold @ Rs.4,50,000/- per item. VAT on sales @ 10%

The Trading Account on “EXCLUSIVE METHOD”

<table>
<thead>
<tr>
<th>Particulars</th>
<th>Qty.</th>
<th>Rate</th>
<th>Amount</th>
<th>Particulars</th>
<th>Qty.</th>
<th>Rate</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>To Opening Stock</td>
<td>1</td>
<td>3,30,000</td>
<td>3,30,000</td>
<td>By Sales</td>
<td>2</td>
<td>4,50,000</td>
<td>9,00,000</td>
</tr>
<tr>
<td>Less Input tax rebate</td>
<td></td>
<td></td>
<td>30,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>3,00,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>To Purchases</td>
<td>3</td>
<td>3,00,000</td>
<td>9,00,000</td>
<td>By Closing Stock</td>
<td>2</td>
<td>3,00,000</td>
<td>6,00,000</td>
</tr>
<tr>
<td>To Gross Profit</td>
<td></td>
<td></td>
<td>3,00,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td></td>
<td>15,00,000</td>
<td></td>
<td></td>
<td></td>
<td>15,00,000</td>
</tr>
</tbody>
</table>

The Trading Account on “INCLUSIVE METHOD”

<table>
<thead>
<tr>
<th>Particulars</th>
<th>Qty.</th>
<th>Rate</th>
<th>Amount</th>
<th>Particulars</th>
<th>Qty.</th>
<th>Rate</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>To Opening Stock</td>
<td>1</td>
<td>3,30,000</td>
<td>3,30,000</td>
<td>By Sales</td>
<td>2</td>
<td>4,95,000</td>
<td>9,90,000</td>
</tr>
<tr>
<td>To Purchases</td>
<td>3</td>
<td>3,30,000</td>
<td>9,90,000</td>
<td>By Closing Stock</td>
<td>2</td>
<td>3,30,000</td>
<td>6,60,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>13,20,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Less: VAT credit availed on cost of goods sold</td>
<td></td>
<td></td>
<td>60,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>12,60,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>VAT paid on sales</td>
<td></td>
<td></td>
<td>90,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gross Profit</td>
<td></td>
<td>3,00,000</td>
<td>3,00,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>16,50,000</td>
<td></td>
<td></td>
<td></td>
<td>16,50,000</td>
</tr>
</tbody>
</table>

The statutory adjustments required under section 145A can be explained by the following
example:

<table>
<thead>
<tr>
<th>Sl. No.</th>
<th>Particulars</th>
<th>Increase in profit (Rs.)</th>
<th>Decrease in profit (Rs.)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Increase in Opening Stock on inclusion of VAT</td>
<td>30,000</td>
<td></td>
</tr>
<tr>
<td>2.</td>
<td>Increase in Purchases on inclusion of VAT</td>
<td>90,000</td>
<td></td>
</tr>
<tr>
<td>3.</td>
<td>Increase in Sales on inclusion of VAT</td>
<td>90,000</td>
<td></td>
</tr>
<tr>
<td>4.</td>
<td>Increase in Closing Stock on inclusion of VAT</td>
<td>60,000</td>
<td></td>
</tr>
<tr>
<td>5.</td>
<td>VAT paid on sales</td>
<td></td>
<td>90,000</td>
</tr>
<tr>
<td>6.</td>
<td>VAT credit availed on cost of goods sold</td>
<td>60,000</td>
<td></td>
</tr>
</tbody>
</table>

The net impact on Profit & Loss Account is NIL.

The computation of total income would appear as under:-

Profit as per Profit & Loss account on the basis of exclusive method: Rs. 3,00,000

Add: Adjustments required under section 145A
1. Increase in Sales on inclusion of VAT: Rs. 90,000
2. Increase in Closing Stock on inclusion of VAT: Rs. 60,000
   Total: Rs. 4,50,000

Less:
1. Increase in Opening Stock on inclusion of VAT: Rs. 30,000
2. VAT Credit Receivables (Input) A/c: Rs. 90,000
3. VAT Paid on sales: 90,000
   Less: VAT Credit availed on Cost of Goods Sold: 60,000
   Net VAT Paid: Rs. 30,000

Profit: Rs. 3,00,000

(II) Manufacturing concern

The following information is considered in the case of a manufacturing concern:

Opening Stock of Raw Material 50 units @ Rs.100 per unit
Part-III: Guidance Notes

<table>
<thead>
<tr>
<th>Purchases of Raw Material 300 units @ Rs.100 per unit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales 250 units @ Rs.150 per unit</td>
</tr>
<tr>
<td>Manufacturing Expenses Rs.3,000</td>
</tr>
<tr>
<td>Closing Stock of Raw Material 50 units</td>
</tr>
<tr>
<td>Closing Stock of Finished Goods 50 units</td>
</tr>
<tr>
<td>Rate of VAT on purchases and sales 4%</td>
</tr>
</tbody>
</table>

### Manufacturing Account on “EXCLUSIVE METHOD”

<table>
<thead>
<tr>
<th>Particulars</th>
<th>Qty</th>
<th>Rate</th>
<th>Amount</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Opening Stock</td>
<td>50</td>
<td>100</td>
<td>5,000</td>
<td>By Sales</td>
</tr>
<tr>
<td>Purchase of raw materials</td>
<td>300</td>
<td>100</td>
<td>30,000</td>
<td>By closing stock of finished goods</td>
</tr>
<tr>
<td>Total</td>
<td>350</td>
<td>100</td>
<td>35,000</td>
<td></td>
</tr>
<tr>
<td>Less: Closing Stock of raw material</td>
<td>50</td>
<td>100</td>
<td>5,000</td>
<td></td>
</tr>
<tr>
<td>Raw material Consumed (C) = (A) – (B)</td>
<td>300</td>
<td></td>
<td>30,000</td>
<td></td>
</tr>
<tr>
<td>To manufacturing Expenses</td>
<td>300</td>
<td>10</td>
<td>3,000</td>
<td></td>
</tr>
<tr>
<td>To VAT on finished goods sold</td>
<td></td>
<td></td>
<td>0</td>
<td></td>
</tr>
<tr>
<td>To gross profit</td>
<td></td>
<td></td>
<td>10,000</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td></td>
<td>43,000</td>
<td></td>
</tr>
</tbody>
</table>

### Manufacturing Account on “INCLUSIVE METHOD”

<table>
<thead>
<tr>
<th>Particulars</th>
<th>Qty</th>
<th>Rate</th>
<th>Amount</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Opening Stock</td>
<td>50</td>
<td>104</td>
<td>5,200</td>
<td>By Sales</td>
</tr>
<tr>
<td>Purchase of raw materials</td>
<td>300</td>
<td>104</td>
<td>31,200</td>
<td>By closing stock of finished goods</td>
</tr>
<tr>
<td>Total</td>
<td>350</td>
<td>104</td>
<td>36,400</td>
<td></td>
</tr>
<tr>
<td>Less: Closing Stock of raw material</td>
<td>50</td>
<td>104</td>
<td>5,200</td>
<td></td>
</tr>
<tr>
<td>Less: VAT on Raw</td>
<td>300</td>
<td>4</td>
<td>1200</td>
<td></td>
</tr>
</tbody>
</table>
The valuation of finished goods includes the raw material cost and the manufacturing expenses. The raw material costs is taken at Rs.100 per unit in the exclusive method and Rs.104 in the inclusive method. The overhead cost is Rs.10 per unit.

23.24 It will be seen from the above that the gross profit is the same both under the inclusive and the exclusive method. Further, the closing stock of raw materials includes the appropriate VAT. But the VAT is not includible in the closing stock of finished goods since the incidence of VAT arises only on sale. However, VAT on raw material included in the finished goods has also been included in the value of closing stock of finished goods.

The statutory adjustments required under section 145A can be explained by the following example:

<table>
<thead>
<tr>
<th>Sl. No.</th>
<th>Particulars</th>
<th>Increase in Profit (Rupees)</th>
<th>Decrease in Profit (Rupees)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Increase in cost of opening stock of raw material on inclusion of VAT</td>
<td>200</td>
<td></td>
</tr>
<tr>
<td>2.</td>
<td>Increase in purchase on account of inclusion of VAT.</td>
<td>1,200</td>
<td></td>
</tr>
<tr>
<td>3.</td>
<td>Increase in sales of finished goods on inclusion of VAT.</td>
<td>1,500</td>
<td></td>
</tr>
<tr>
<td>4.</td>
<td>VAT paid on sale of finished goods as a result of its inclusion in sales</td>
<td></td>
<td>1,500</td>
</tr>
<tr>
<td>5.</td>
<td>Increase in closing stock of raw material on inclusion of VAT</td>
<td>200</td>
<td></td>
</tr>
<tr>
<td>6.</td>
<td>Accounting of VAT credit availed and utilized on raw material consumed in payment of VAT on finished goods, accounted on the basis of raw</td>
<td>1,200</td>
<td></td>
</tr>
</tbody>
</table>
### Part-III: Guidance Notes

#### III.243

<table>
<thead>
<tr>
<th>Sl. No.</th>
<th>Particulars</th>
<th>Increase in Profit (Rupees)</th>
<th>Decrease in Profit (Rupees)</th>
</tr>
</thead>
<tbody>
<tr>
<td>7.</td>
<td>Increase on account of VAT included in finished goods on account of inclusion of VAT in the raw material value</td>
<td>200</td>
<td></td>
</tr>
<tr>
<td>8.</td>
<td>Increase in VAT on closing stock of finished goods on account of inclusion of VAT in the raw material value</td>
<td></td>
<td>200</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td><strong>3,100</strong></td>
<td><strong>3,100</strong></td>
</tr>
</tbody>
</table>

The net impact on the Profit & Loss Account is NIL.

The computation of total income total income would appear as under:-

Profit as per Profit & Loss account on the basis of exclusive method Rs.10,000

Add: Adjustments required under section 145A

1. Increase in Sales on inclusion of VAT Rs. 1,500
2. Increase in Closing Stock of Raw Material on inclusion of VAT Rs. 200
3. Increase in Stock of finished goods on account of inclusion of VAT in the raw material value Rs. 200 Rs.1,100

**Total** Rs.11,900

Less:

1. VAT on Opening Stock of Raw Material Rs.200
2. VAT included in Purchases Rs.1200
3. VAT Paid on Sales Rs.1500
   Less: Input Tax Credit on Raw Material Consumed Rs.1200
   Add: VAT included in Closing Stock Of Finished Goods Rs.200 Rs.500

**Profit** Rs 10,000

24. Give the following particulars of the capital asset converted into stock-in-trade:-

(a) Description of capital asset;
(b) Date of acquisition;
(c) Cost of acquisition;
(d) Amount at which the asset is converted into stock-in-trade.

[Clause 15]

24.1 For furnishing the particulars required by clause 15, the provisions of section 2(47), 45(2), 47(iv), (v) and 47A have to be kept in mind.

24.2 From the A.Y. 1985-86 onwards the conversion by the owner of an asset into or treatment of such asset as stock-in-trade of a business carried on by him is treated as a ‘transfer’ within the meaning of section 2(47). Under section 45(2) such a conversion or treatment of capital asset into stock-in-trade will be deemed to be a transfer of the previous year in which the asset is so converted or treated as stock-in-trade. However, the capital gains arising from such a transfer will become chargeable in the previous year in which such converted asset is sold or otherwise transferred. In the case of long-term capital asset, indexation of cost of acquisition and cost of improvement, if any, will be with respect to the previous year in which such conversion took place. The fair market value of the asset, as on the date of such conversion or treatment as stock-in-trade, shall be deemed to be the full value of the consideration of the asset. The excess of the sale price over the fair market value as on the date of conversion would be treated as business income and taxed under the head ‘profits and gains of business or profession’. The capital gains being the difference between the cost of acquisition and the fair market value on the date of the conversion or treatment as stock-in-trade will be chargeable to tax in the year in which the asset is sold.

24.3 Section 47 of the Act enumerates the transactions which will not be regarded as transfer. Under clause (iv) any transfer of a capital asset by a company to its subsidiary company if the parent company or its nominees hold the whole of the share capital of the subsidiary company and the subsidiary company is an Indian company will not be treated as a transfer. Under clause (v) any transfer of a capital asset by a subsidiary company to the holding company if the whole of the share capital of the subsidiary company is held by the holding company and the holding company is an Indian company will not be considered as a transfer.

24.4 The capital gains exempted by virtue of clause (iv) or clause (v) of section 47 may become chargeable under certain circumstances. The provisions of section 47A are relevant here. Accordingly, where at any time before the expiry of a period of 8 years from the date of transfer of a capital asset referred to in clause (iv) or clause (v) of section 47, such capital asset is converted by the transferee company into, or is treated by it as, stock-in-trade of its business or the parent company or its nominees or, as the case may be, the holding company ceases to hold the whole of the share capital of the subsidiary company, the amount of profits or gains arising from the transfer of such capital assets not charged under section 45 by virtue of the provisions contained in clause (iv) or clause (v) of section 47 shall be deemed to be
income chargeable under the head “capital gains” of the previous year in which such transfer took place.

24.5 The particulars to be stated under new clause 15 should be furnished with respect to the previous year in which the asset has been converted into stock-in-trade. The clause does not require details regarding the taxability of capital gains or business income arising from such deemed transfer.

24.6 Under clause (a) description of the capital asset is required to be mentioned for example shares, security, land, building, plant, machinery etc.

24.7 Under Clause (b) the date of acquisition is to be reported. For ascertaining the correct date the tax auditor will have to refer the accounts of the financial year in which such capital asset is acquired. The date assumes importance for the purpose of determining whether the asset is long-term or short-term in nature.

24.8 Under clause (c) the cost of acquisition is required to be reported. Here the cost of acquisition as per the books of account is to be mentioned. In case of depreciable assets, the carrying cost appearing in the books will be the written down value. But the value to be reported will be the original cost of acquisition. Even in case of an asset acquired prior to the 1st day of April, 1981 the value to be reported will be the original cost of acquisition. The assessee may exercise the option of considering the fair market value of the asset as on 1st April, 1981 for assets acquired prior to that date for the purpose of computation of capital gains as provided under section 55(2)(b)(i). Further, in case of block of assets a particular asset loses its identity and therefore to report the original cost of acquisition may not be possible in all cases. In case of corporate entities where the requirements of CARO are applicable the cost may be available from the fixed asset register. However, in case of companies where CARO is not applicable and other partnership concerns, the reporting requirements as to the original cost of acquisition may not be practically possible.

24.9 Under clause (d) the amount recorded in the books of account at which the asset is converted into stock-in-trade should be stated. Such an amount may not be the fair market value as on the date of conversion or treatment as stock-in-trade. If a value other than carrying cost is recorded then the auditor has to examine the basis of arriving at such a value. The valuation of stock-in-trade is to be examined with reference to AS-2 – Valuation of Inventories. Non-compliance with AS-2 is to be suitably qualified in the main audit report.

24.10 It is desirable that necessary accounting entry is passed in the books of account at the time of conversion of the asset into or treatment of the same as stock-in-trade.

24.11 In the case of assessee like a proprietorship concern, prior to the conversion of the asset into stock-in-trade, the details regarding the date of acquisition and cost of acquisition may not be recorded in the books of account. It is also possible that the year in which the capital asset is acquired, the accounts of the assessee may not have been subjected to audit. Also an assessee can acquire a capital asset through various modes such as discussed under
III.246 Auditing Pronouncements

section 49 of the Act. Under such circumstances the auditor may have to verify the cost and the date of acquisition. The following broad principles need to be kept in mind.

24.12 While verifying the cost of acquisition of the fixed asset, the auditor should bear in mind the principles enunciated in Accounting Standard (AS) 10, Accounting for Fixed Assets. As per paragraph 20 of the said Accounting Standard, the cost of a fixed asset comprises of its purchase price and any attributable cost of bringing the asset to its working condition for its intended use. Thus, in case of capital assets purchased by the assessee, it would relatively be easy for the auditor to verify the cost of acquisition, the evidence being provided by the supporting purchase invoices from the supplier, entries appearing in the bank statements in respect of payment to the supplier, entries appearing in the cash book/bank statement for payment of cartage installment etc. In case of self-constructed capital assets, the cost would comprise those costs that relate directly to the specific capital asset and those that are attributable to the construction activity in general and can be allocated to the specific asset. In case of Capital assets acquired in exchange or in part exchange for another asset, the cost of the asset acquired is either the fair market value or the net book value of the asset given up, whichever is more clearly evident, adjusted for any balancing payment or receipt of cash or other consideration. In case the capital asset is recorded at the net book value of the asset, the fixed asset register would provide the prime evidence of the value. If, however the capital asset so acquired is recorded at the market value the auditor would need to examine the basis for arriving at the fair market value, for example, the valuer’s report, market quotes (in case of listed securities). Where the valuer is the tax auditor’s internal/external, the tax auditor should have regard to the principles laid down in SA 620, Using the Work of An Auditor’s Expert. In any case the auditor would also need to look into how the assessee has decided the value at which the asset is recorded in the books of account is more clearly evident than the other value. In case of a capital asset acquired by way of inheritance, the auditor may find it difficult to verify the cost of acquisition to the original owner. In case there does not exist any documentary evidence as to the cost of acquisition of the asset to the original owner, say the sale/purchase agreement the auditor may need to rely upon the reports of the experts such as valuers. In addition to the above, the auditor should also refer to the guidance contained in the Guidance Note on Audit of Property, Plant and Equipment issued by the Institute.

25. Amounts not credited to the profit and loss account, being,-

(a) the items falling within the scope of section 28;
(b) the proforma credits, drawbacks, refund of duty of customs or excise or service tax, or refund of sales tax or value added tax, where such credits, drawbacks or refunds are admitted as due by the authorities concerned;
(c) escalation claims accepted during the previous year;
(d) any other item of income;
(e) capital receipt, if any.

[Clause 16 (a) to (e)]
25.1 Under this clause various amounts falling within the scope of section 28 which are not credited to the profit and loss account are to be stated. The information under sub-clauses (a), (d) and (e) of clause (16) is to be given with reference to the entries in the books of account and records made available to the tax auditor for the purpose of tax audit under section 44AB. Sub-clauses 16 (b), (c) & (d) require information in respect of items which may also be covered under section 28 and as such will also fall in clause 16 (a). However, those items which are reported in clauses 16(b), (c) and (d) need not be reported in clause 16 (a). The tax auditor may obtain a management representation in writing from the assessee in respect of all items falling under this clause.

25.2 Section 28 refers to

(i) the profits and gains of any business or profession,
(ii) any compensation received on termination of employment, agency etc.
(iii) income derived by a trade, professional or similar association from specific services performed for its members,
(iiiia) profits on sale of a licence granted under the Imports Control Order, 1955,
(iiiib) cash assistance against exports
(iiiic) customs duty or excise repaid or repayable as drawback against exports,
(iiiid) profit on the transfer of DEPB Scheme being the Duty Remission Scheme,
(iiiie) profit on the transfer of DFRC being the Duty Remission Scheme
(iv) the value of any benefit or perquisite arising from business or the exercise of a profession
(v) any interest, salary, bonus, commission or remuneration, by whatever name called, received by a partner of the firm from such firm,
(va) any sum, whether received for (a) not carrying out any activity in relation to any business (b) not sharing any know how, patent, copyright, trade mark, licence, franchise or any other business or commercial right of similar nature or information or technique likely to assist in the manufacture or processing of goods or provision for services
(vi) any sum received under a Keyman insurance policy including the sum allocated by way of bonus on such policy
(vii) any sum received on account of any capital assets (other than land or goodwill or financial instrument) being demolished, destroyed, discarded or transferred if the whole of the expenditure on such capital assets has been allowed under Section 35AD.
25.3 As per Explanation 2, where speculative transactions constitute a business, such speculation business is deemed to be distinct and separate business from any other business.

25.4 The details of the following claims, if admitted as due by the concerned authorities but not credited to the profit and loss account, are to be stated under sub-clause (b).

   (i)  Pro forma credits
   (ii) Drawback
   (iii) Refund of duty of customs
   (iv) Refund of excise duty
   (v)  Refund of service tax
   (vi) Refund of sales tax or value added tax

In respect of items falling under sub-clause (b) the tax auditor should examine all relevant correspondence, records and evidence in order to determine whether any particular refund/claim has been admitted as due and accepted during the relevant financial year.

25.5 There may be practical difficulties in verifying the information in regard to such refunds and credits. It may, therefore, be necessary for the tax auditor to scrutinise the relevant files or subsequent records relating to such refunds while verifying the particulars and also obtain an appropriate management representation.

25.6 The words ‘admitted by the concerned authorities’ would mean ‘admitted by the authorities within the relevant previous year’.

25.7 The system of accounting followed in respect of these particular items may also be brought out in appropriate cases. If the assessee is following cash basis of accounting, it should be clearly brought out, since the admittance of claims during the relevant previous year without actual receipt has no significance in cases where cash method of accounting is followed. Credits/claims which have been admitted as due after the relevant previous year need not be reported here.

Where such amounts have not been credited in the profit and loss account but netted against the relevant expenditure/income heads, such fact should be clearly brought out.

25.8 Under sub-clause (c), the escalation claims accepted during the previous year but not credited to the profit and loss account are to be stated. The escalation claims accepted during the year would normally mean “accepted during the relevant previous year”. If such amount has not been credited to the profit and loss account the fact should be brought out. 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.
25.9 Escalation claims would 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 of claims by the assessee or claims under negotiations or claims which are sub-judice [CIT v. Hindustan Housing & Land Development Trust Ltd. [1986] 161 ITR 524 (SC)] cannot constitute claims accepted. The Auditor should take a professional judgment about acceptance of claim based on facts and circumstances of each case.

25.10 Sub-clause (d) covers any other items which the tax auditor considers as an income of the assessee based on his verification of records and other documents and information gathered, but which has not been credited to the profit and loss account. In giving the details under sub-clauses (c) and (d), due regard should be given to AS-9 - Revenue Recognition.

25.11 The tax auditor should scrutinise all the items including casual and nonrecurring items appearing in the books of account, particularly the credit items, and ensure himself whether any such credit which is in the nature of income has been credited to the profit and loss account or not.

25.12 Under sub-clause (e), capital receipt, if any, which has not been credited to the profit and loss account has to be stated. The tax auditor should use his professional expertise and judgement in determining whether the receipt is capital or revenue. The tax auditor may record various judicial pronouncements on which he has relied in his working papers.

25.13 The following is an illustrative list of capital receipts which, if not credited to the profit and loss account, are to be stated under this sub-clause.

(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.

25.14 Loans and borrowings are not required to be stated under this sub-clause.

25.15 If during the course of audit auditor finds that certain income (e.g. income referred to in section 41(1)) are not credited to profit and loss account, the particulars of the same along with the amount is required to be reported under this clause.
26. Where 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, please furnish:

<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>

26.1 Section 43CA is applicable where the assessee has transferred an asset (other than a capital asset) being land or building or both and the value of such an asset is less than the value adopted or assessed or assessable by any State Government authority for the purpose of payment of stamp duty. In such a case for purpose of computing profit & gains from such transfer, the value so adopted or assessed or assessable shall be deemed to be the full value of consideration.

26.2 Section 50C is applicable where the assessee has transferred a capital asset being land or building or both and the value of such an asset is less than the value adopted or assessed or assessable by any State Government authority for the purpose of payment of stamp duty. In such a case, for purpose of section 48, the value so adopted or assessed or assessable by stamp duty authority shall be deemed to be the full value of consideration.

26.3 Where 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, the auditor is required to furnish the following details:

(a) Details of property
(b) Consideration received or accrued
(c) Value adopted or assessed or assessable

26.4 In the column requiring the details of property, the auditor has to furnish the details about the nature of property i.e. whether the property transferred by him is land or a building along with the address of such property. If the assessee has transferred more than one property, the detail of all such properties is required to be mentioned. 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. Attention is invited to the meaning of the term “transfer” as defined in section 2(47) of the Act.

26.5 Under the heading “consideration received or accrued”, 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.
26.6 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.

26.7 Auditor would have to apply professional judgment as to what constitutes land or building for e.g. whether leasehold right / development rights / TDR / FSI etc would fall under this provisions or not, would require to be evaluated based on facts & circumstances of transactions.

27. Particulars of depreciation allowable as per the Income-tax Act, 1961 in respect of each asset or block of assets, as the case may be, in the following form:

(a) Description of asset/block of assets.
(b) Rate of depreciation.
(c) Actual cost or written down value, as the case may be.
(d) Additions/deductions during the year with dates; in the case of any addition of an asset, date put to use; including adjustments on account of –
   (i)   Central Value Added Tax credits claimed and allowed under the Central Excise Rules, 1944, in respect of assets acquired on or after 1st March, 1994,
   (ii)  change in rate of exchange of currency, and
   (iii)  subsidy or grant or reimbursement, by whatever name called.
(e) Depreciation allowable.
(f) Written down value at the end of the year.

[Clause 18 (a) to (f)]

27.1 Having regard to the nature of requirements prescribed, it may be necessary for the tax auditor to examine:

(a) Classification of the asset
(b) Classification thereof to a block
(c) The working of actual cost or written down value
(d) The date of acquisition and the date on which it is put to use
(e) The applicable rate of depreciation
III.252 Auditing Pronouncements

(f) The additions / deductions and dates thereof

(g) Adjustments required – specified as well as on account of sale, etc.

27.2 The word “allowable” implies that depreciation should be permissible as a deduction, as per the provisions of the Act and the Rules. This would require exercise of judgement having regard to the facts and circumstances of the case, developments in law from time to time, etc.

27.3 For the purpose of determining the rate of depreciation, the tax auditor has to examine the classification of the assets into various blocks. For example, a particular asset may be classified as plant or machinery from the viewpoint of one class of assessees, yet it may not be plant or machinery from the viewpoint of another class of assessees. The purpose for which the asset is used is also very material in this regard. Hence, the tax auditor should ensure that the classification as made by the assessee is in consonance with legal principles. In this connection, he should traverse through judicial pronouncements as well as through the past assessment history of the assessee, and upon an analysis thereof, if he comes to the conclusion that the matter is not free from doubt or controversy, he has to indicate the fact in his report by way of suitable qualification. It may also be necessary to rely upon technical data for determining the proper classification of the block. Since the tax auditor is not a technical expert, he has to obtain suitable certificate from concerned experts.

27.4 Once the classification has been ascertained and checked properly, the rates applicable as per the Income-tax Rules, 1962 follow as a natural corollary. The tax auditor must have due regard to the Income-tax Rules, 1962, relevant clarifications from the Department and judicial decisions.

27.5 Under sub-clauses (a) to (b), information in respect of description of assets, block of assets under which the concerned asset is classifiable and the rate of depreciation are to be stated. This will include information about the existing assets. In respect of the existing assets, the computation of depreciation would involve stating the opening written down value of the block of assets which should be taken from the relevant income-tax records. The tax auditor will be conducting the audit in the current year only. As such the tax auditor can rely upon the classification of assets and written down value stated in the income tax records available with the assessee. The tax auditor should mention the fact that he has relied upon the income tax records of the assessee in respect of the information regarding the classification of assets and written down value of the existing assets.

27.6 If there is any dispute with regard to the classification of an asset in a particular block or the rate of depreciation applied, the tax auditor must give his working with suitable reasons. Further, there may be disputes in the earlier years between the assessee and the Department regarding classification, rate of depreciation etc. in respect of which the tax auditor should give suitable disclosure depending upon the facts and circumstances of the case. Alternatively, where the tax auditor adopts a system of classification different from the one adopted by the assessee, suitable disclosure should be made regarding the effect thereof.
27.7 It will, therefore, be advisable to put a suitable note with regard to those items in
respect of which disputes for the earlier years are not resolved up to the date of giving the
audit report and it should be clarified that the amount of depreciation allowable may change as
a result of any decision which may be received after the audit report is given. This note can be
in the following manner:

“NOTE: Certain disputes about
(a) the rate of depreciation on ________
(b) determination of WDV of block of assets relating to ___________ and
(c) ownership of ______________ have arisen in the assessment years ___________ for
which assessments are pending/appeals are pending. The figures of WDV and/or rate
of depreciation mentioned in the above statement may require modification when these
disputes are resolved. Therefore, the amount of depreciation allowable as stated in the
above statement will have to be accordingly modified.”

27.8 For the purpose of determination of actual cost, the tax auditor has to be guided by the
relevant legal provisions. Since determination of actual cost has got accounting implications,
he can rely on the relevant Accounting Standards and Guidance Notes. Due to the
amendments made by the Finance (No.2) Act, 1998, depreciation is allowable on intangible
assets like know-how, patents, copyrights, trademarks, licenses, franchises or any other
business or commercial rights of similar nature. There may be intangible assets like patents
invented by the company, brand names, etc. for which the assessee might have incurred
costs. The tax auditor should examine the basis on which the cost of such intangible assets
has been arrived at.

27.9 The additions/deductions during the year have to be reported, with dates. The tax
auditor is advised to get the details of each asset or block of asset added during the year or
disposed of during the year with the dates of acquisition/disposal. Where any addition was
made, the date on which the asset was put to use is to be reported. In respect of deductions,
the sale value of the assets disposed of along with dates should be mentioned. The provisions
of Section 36(1)(iii) and Explanation 8 to section 43(1) of the Act, should be kept in mind for
capitalization of interest to the cost of assets. The tax auditor should check the working
regarding the calculation of depreciation allowable under the Act. To ascertain when the asset
has been put to use, the tax auditor could call for basic records like production
records/installation details/excise records/service tax records/records relating to power
connection for operating the machine and any other relevant evidence. In the absence of any
specific documentation with regard to the effective date from which the asset is put to use, he
could get a representation letter from the management, in respect of the assets acquired. He
should examine whether the apportionment of depreciation in cases like succession,
amalgamation, demerger etc. has been properly made.
III.254 Auditing Pronouncements

27.10 Section 43(1) of the Act defines actual cost as under:

“Actual Cost” means the actual cost of the assets to the assessee, reduced by that portion of the cost thereof, if any, as has been met directly or indirectly by any other person or authority.

Further section 43(1) has explanation from 1 to 13 which provides for different situations for the purpose of calculating the actual cost.

Section 43(2) defines the word “Paid” and Section 43(3) defines the word “Plant”.

Section 2(11) defines “Block of assets” and section 43(6) read with explanations 1 to 7 defines “Written Down Value”.

27.11 The Guidance Note on Accounting for State-level Value Added Tax issued by ICAI has suggested the following treatment in respect of VAT Credit on Capital Goods.

“24. The accounting treatment recommended in the following paragraphs applies only to those capital goods which are eligible for the credit.

25. Paragraph 9.1 of Accounting Standard (AS) 10, Accounting for Fixed Assets, issued by the Institute of Chartered Accountants of India, inter-alia, provides as below:

“9.1 The cost of an item of fixed asset comprises its purchase price, including import duties and other nonrefundable taxes or levies and any directly attributable cost of bringing the asset to its working condition for its intended use; any trade discounts and rebates are deducted in arriving at the purchase price.

…”

VAT credit is considered to be of the nature of a refundable tax. Therefore, the tax paid on purchase of capital goods should not be included in the cost of such capital goods.”

In view of above, the VAT Credit eligible on capital goods should be reduced from the cost of the assets for the purpose of claim of depreciation.

27.12 Details have to be given in respect of adjustments on account of three factors. The first adjustment relates to CENVAT claimed and allowed under the Central Excise Rules, 1944 in respect of assets acquired on or after 1st March, 1994. Explanation 9 to section 43(1) of the Act provides that where an asset is or has been acquired on or after the 1st day of March, 1994 by an assessee, the actual cost of asset shall be reduced by the amount of duty of excise or the additional duty leivable under section 3 of the Customs Tariff Act, 1974 (51 of 1975) or Service Tax in respect of which a claim of credit has been made and allowed under the Central Excise Rules, 1944 and Finance Act 1994 (relating to Service Tax) read with CENVAT Credit Rules 2004. It is necessary, therefore, for the tax auditor to examine the details of assets acquired on or after 1st March, 1994 and the details of CENVAT credit claimed and allowed in respect of those assets.

27.13 In Clause 18(d)(i) the amount of CENVAT credit claimed and allowed on capital goods
and deducted from the cost of the asset has to be mentioned. Under the CENVAT Credit Rules, 2004, the assessee is entitled to avail credit of duty paid on capital goods and utilise the same, in payment of excise duty leviable on final products, or in payment of service tax on taxable output services. However the CENVAT credit of duty paid on capital goods is not allowed if the assessee claims depreciation under the Act on an amount including the amount of CENVAT credit [Rule 4 (4) of the CENVAT credit rules, 2004].

27.14 As such the assessee should not include duty paid on capital goods eligible for CENVAT credit as part of the cost of fixed assets, otherwise he will not eligible to claim the CENVAT credit. Whenever, CENVAT credit is rejected in the subsequent year, the auditor should make separate disclosure for the amount of CENVAT credit adjusted during the year which pertains to earlier years. Similarly, if the CENVAT credit is claimed and allowed but which has not been deducted from the cost of the asset, such credit should be deducted from the cost and the appropriate disclosure should be made separately for such adjustment.

27.15 The tax auditor should also verify that the amount of CENVAT credit deducted from cost of capital goods tallies with the credit availed on this account.

27.16 The second adjustment relates to the change in the rate of exchange of currency. Section 43A deals with the adjustment on account of change in the rate of exchange of currency. The Finance Act, 2002 has substituted a new section 43A w.e.f. A.Y. 2002-03. As per this amendment,

(i) where an assessee has acquired any asset in any previous year from a country outside India for the purposes of his business or profession and,

(ii) in consequence of a change in the rate of the exchange during any previous year after the acquisition of such asset,

(iii) there is an increase or reduction in the liability of the assessee as expressed in Indian currency (as compared to the liability existing at the time of acquisition of the asset) at the time of making the payment towards the whole or part of the cost of the asset or towards repayment of the whole or a part of the monies borrowed by him from any person,

(iv) directly, or indirectly in any foreign currency specifically for the purpose of acquiring the asset along with the interest, if any,

(v) the increase or reduction in the liability during the previous year which is taken into account at the time of making the payment,

(vi) irrespective of the method of accounting followed by the assessee, is to be added to, or as the case may be, deducted from the cost of the asset as defined in clause (1) of section 43.

27.17 In other words the extent of addition or reduction will be limited to the exchange difference actually paid during the previous year. The tax auditor is required to verify that the
adjustments in the cost of fixed assets on account of changes in the rate of exchange of currency in the schedule of fixed assets prepared for computation of depreciation as per Income-tax Rules are in accordance with the provisions of section 43A and information about such adjustment is provided under sub-clause (ii) of clause 18(d). The Tax Auditor may also prepare a reconciliation statement for his own records for any different treatment followed for the purpose of books of accounts as per applicable accounting treatment under Accounting Standards. The auditor should also refer the explanations to section 43A.

27.18 The third adjustment relates to the subsidy or grant or reimbursement, by whatever name called. Explanation 10 to section 43(1) provides that where a portion of the cost of an asset acquired by the assessee has been met directly or indirectly by the Central Government or a State Government or any authority established under any law or by any other person, in the form of a subsidy or grant or reimbursement (by whatever name called), then, so much of the cost as is relatable to such subsidy or grant or reimbursement shall not be included in the actual cost of the asset to the assessee. As per the proviso to the above Explanation, where such subsidy or grant or reimbursement is of such nature that it cannot be directly relatable to the asset acquired, such of the amount which bears to the total subsidy or reimbursement or grant the same proportion as such asset bears to all the assets in respect of or with reference to which the subsidy or grant or reimbursement is so received, shall not be included in the actual cost of the asset to the assessee. Subsidy coming within the scope of Explanation 10 to section 43(1) in respect of asset acquired in any earlier year(s) and received during the year has to be deducted from the written down value of such assets in the year of receipt.

27.19 Finally, the amount of depreciation allowable and the WDV at the year end have to be stated. Wherever a claim for depreciation involves any reliance on any judgement or opinion or other contentions (as to its classification, rate applicable, cost, date on which put to use etc.), it may be advisable for tax auditor to disclose full particulars thereof and the basis on which the depreciation allowable has been determined and vouched by him.

27.20 The Finance Act, 2001 had inserted Explanation 5 below sub-section (1) of section 32, to the effect that the provisions of section 32(1) regarding allowing of depreciation shall apply whether or not the assessee has claimed the deduction in respect of depreciation in computing his total income. Thus, the claim for depreciation is now mandatory and the written down value of each asset every year has to be reduced by the amount of depreciation allowable under the Income-tax Rules and the details required under the relevant sub-clauses need to be stated.

27.21 Section 32(1)(iia) effective from Financial year 2002-03 provide for additional depreciation to a concern engaged in the business of manufacturing or production of an article or thing or installation of a new machinery on fulfillment of the prescribed conditions like specified percentage of increase in installed capacity. Additional depreciation shall be allowable in respect of new machinery or plant installed on or after 31st day of March, 2005, which is
(i) engaged in the business of manufacture or production of any article or thing or
(ii) In the business of generation or generation or distribution of power
except those machinery or plant which before installation by the assessee was used by any
other person, machinery or plant installed in office premises or residential accommodation,
office appliances, road transport vehicles and that machinery or plant the actual cost of which
is allowed in computing the income. The tax auditor will need to verify the claim of additional
depreciation under this clause as well.

27.22 Wherever, the full deduction of the cost of capital goods is allowed (e.g. expenditure on
Scientific Research u/s. 35) the auditor should verify that the cost of such asset is not included
in the block of assets for the purpose of depreciation.

27.23 The tax auditor has to keep in mind the above guidance while furnishing details in
respect of this clause in the format provided in the e-filing utility.

28. (a) Amounts admissible under sections:

<table>
<thead>
<tr>
<th>Section</th>
<th>Amount debited to profit and loss account</th>
<th>Amounts admissible as per the provisions of the Income-tax Act, 1961 and also fulfills 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.</th>
</tr>
</thead>
<tbody>
<tr>
<td>32AC</td>
<td></td>
<td></td>
</tr>
<tr>
<td>33AB</td>
<td></td>
<td></td>
</tr>
<tr>
<td>33ABA</td>
<td></td>
<td></td>
</tr>
<tr>
<td>35(1)(i)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>35(1)(ii)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>35(1)(iia)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>35(1)(iii)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>35(1)(iv)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>35(2AA)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>35(2AB)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>35ABB</td>
<td></td>
<td></td>
</tr>
<tr>
<td>35AC</td>
<td></td>
<td></td>
</tr>
<tr>
<td>35AD</td>
<td></td>
<td></td>
</tr>
<tr>
<td>35CCA</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
28.1 The assessee can claim deduction under the sections 32AC, 33AB, 33ABA, 35, 35ABB, 35AC, 35AD, 35CCA, 35CCB, 35CCC, 35CCD, 35D, 35DD, 35DDA and 35E subject to the terms and conditions mentioned in these Sections.

28.2 In case the assessee has obtained a separate Audit Report for claiming deductions under any of these sections, he must make a reference to that report while giving the details under this clause.

28.3 The Tax Auditor should indicate the amount debited to the Profit & Loss Account and the amount actually admissible in accordance with the applicable provisions of law.

28.4 The amount not debited to the Profit & Loss Account but admissible under any of the Sections mentioned in the clause have to be stated. For example sections 33AB and 33ABA allow deduction in respect of amount deposited in designated account for specified purposes which, as per accounting principles, are not to be debited to the Profit & Loss Account. In this connection, the Tax Auditor has to work out, on the basis of the conditions prescribed in the concerned Section, the amount admissible there under and report the same.

28.5 An assessee may be eligible for deduction under one or more sub-sections of section 35. In such case, the Tax Auditor should state the deduction allowable under each sub-section separately under applicable part, i.e. the amount deductible in respect of the amount debited in Profit & Loss Account and the amount not debited to the Profit & Loss Account.

28.6 The Tax Auditor should also ensure the eligibility of the expenditure/payment for deduction and compliance of the conditions prescribed in the sub-section including approval from the relevant/prescribed authority, notification issued by the Central Government, any other guideline circular etc issued in this behalf. Tax auditor should also refer Rule 6 of Income-tax Rules, 1962.

28.7 In case the auditor relies on a judicial pronouncement, he may mention the fact in his observations para provided in Form No.3CA or Form No.3CB, as the case may be.

28.8 The following Table summarizes Sub-section-wise eligibility, requirement of compliance of the conditions and the amount of deductions required to be mentioned under this clause.
(The summary is only illustrative and Tax Auditor is advised to refer actual provision of the Act):

### Table showing deductions applicable from A.Y. 2014-15 onwards (as per law prevailing on 1-4-2014)

<table>
<thead>
<tr>
<th>Section &amp; Sub-section</th>
<th>Eligible expenditure/payment</th>
<th>Amount/Quantum of Deduction</th>
</tr>
</thead>
<tbody>
<tr>
<td>32AC</td>
<td>Investment in New Plant &amp; Machinery</td>
<td>15% of the actual cost of such new assets.</td>
</tr>
<tr>
<td>33AB</td>
<td>Amount deposited in Tea/Coffee/Rubber Development Account</td>
<td>Deduction is allowed for the least of the following: (a) Sum equal to the amount or the aggregate of the amounts so deposited. (b) Sum equal to 40% of the profits of such business.</td>
</tr>
<tr>
<td>33ABA</td>
<td>Where an amount is being deposited by an assessee in a scheme approved by the Government of India in the Ministry of Petroleum and Natural Gas for the purpose of prospecting or extraction etc. of petroleum or natural gas.</td>
<td>Deduction is allowed for the least of the following: (a) Sum equal to the amount or the aggregate of the amounts so deposited. (b) Sum equal to 20% of the profits of such business.</td>
</tr>
<tr>
<td>35(1)(i)</td>
<td>Any Expenditure other than Capital Expenditure incurred by the assessee for scientific research related to its own business.</td>
<td>100% of the expenditure</td>
</tr>
<tr>
<td>35(1)(ii)</td>
<td>Amount paid to Research association which has as its object the undertaking of scientific research Or amount paid to a University, college or other institutions to be used for scientific research. Provided that, such association, university, college or other institution is approved and is specified as such, by notification in the</td>
<td>175% of amount paid/contributed from A.Y. 2011-12 and onwards 125% of amount paid/contributed till A.Y. 2010-11.</td>
</tr>
<tr>
<td>Section &amp; Sub- section</td>
<td>Eligible expenditure/payment</td>
<td>Amount/Quantum of Deduction</td>
</tr>
<tr>
<td>------------------------</td>
<td>---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------</td>
<td>------------------------------------------------------------------</td>
</tr>
<tr>
<td>35(1)(iia)</td>
<td>Amount paid to a Company which is registered in India, having its main object of carrying out of scientific research and development and is approved by the jurisdictional Chief Commissioner of Income Tax in the prescribed manner.</td>
<td>125% of amount paid from A.Y. 2009-10</td>
</tr>
</tbody>
</table>
| 35(1)(iii)             | Amount paid to a research association which has as its main object the undertaking of research in social science or statistical research  
Or  
Amount paid to a university, college or other institutions to be used for research in social science or statistical research.  
Provided that, such association, university, college or other institution is approved and is specified as such, by notification in the official gazette, by Central Govt. | 125% of amount paid.                                             |
<p>| 35(1)(iv)              | Expenditure of capital nature on scientific research, other than expenditure on acquisition of any land, incurred related to the business carried on by the assessee.                                                                                       | 100% of the capital expenditure incurred                          |
| 35(2AA)                | Any amount paid to National Laboratory; or a University; or Indian Institute of Technology or specified person as defined in the explanation 2 to the section with a specific direction that the said sum shall be used for scientific research undertaken under a programme approved by the prescribed authority. | 200% of amount paid from A.Y. 12-13 and onwards.                  |
|                        |                                                                                                                                                                                                                             | 175% for A.Y.2011-12                                           |
|                        |                                                                                                                                                                                                                             | 125% till A.Y.2010-11                                          |
| 35(2AB)                | Deduction is available only to company (refer section 2 (17) of Income Tax Act, 1961)                                                                                                                                                     | 200% of Expenditure incurred from A.Y. 2011-12 and onwards.      |
|                        | (Applicable from 01/04/2009 i.e. A.Y 2010-11 &amp; onwards)                                                                                                                                                                                  | 150% of Expenditure incurred from A.Y. 2001-02 to A.Y. 2011-12  |
|                        |                                                                                                                                                                                                                             | 125% till A.Y. 2000-01.                                        |</p>
<table>
<thead>
<tr>
<th>Section &amp; Sub-section</th>
<th>Eligible expenditure/payment</th>
<th>Amount/Quantum of Deduction</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>From A.Y. 2012-13 and onwards:</strong> Company engaged in the business of Bio Technology or in any business of manufacture or production of any article or thing, not being an article or thing specified in the list of the Eleventh Schedule.</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Upto A.Y. 2011-12:</strong></td>
<td>Finance Act, 2009, i.e. from A.Y. 2010-11 provides that, company engaged in the business of business of manufacture or production of any drugs, pharmaceuticals, electronic equipments, computers, telecommunication equipments, chemicals or any other article or thing notified by the Board. Expenditure incurred both revenue and capital, not being expenditure in the nature of cost of any land or building; on in house research and development facility as approved by the prescribed authority. Expenditure incurred in relation to drugs and pharmaceuticals shall include expenditure on clinical drug trial, for regulatory approvals and filing an application for patent. Prescribed authority is Secretary, Department of Scientific and Industrial Research.</td>
<td></td>
</tr>
<tr>
<td>35ABB</td>
<td>Any expenditure, being in the nature of capital expenditure incurred for acquiring any right to operate telecommunication services[either before the commencement of the business to operate telecommunication services or thereafter at any time during any previous year]</td>
<td>Deduction equal to the appropriate fraction of the amount of such expenditure. Where “appropriate fraction” means the fraction the numerator of which is one and the denominator of which is</td>
</tr>
<tr>
<td>Section &amp; Sub-section</td>
<td>Eligible expenditure/payment</td>
<td>Amount/Quantum of Deduction</td>
</tr>
<tr>
<td>----------------------</td>
<td>---------------------------------------------------------------------------------------------</td>
<td>---------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>35AC</td>
<td>Expenditure by way of payment of any sum to a public sector company or a local authority or to an association or institution approved by the National Committee for carrying out any eligible project or scheme</td>
<td>100% of such expenditure</td>
</tr>
<tr>
<td>35AD</td>
<td>Deduction in respect of any expenditure of capital nature incurred wholly &amp; exclusively for any specified business.</td>
<td>Setting up and Operating cold chain facility-150% of expenditure</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Setting up and Operating warehousing facility for storage of Agriculture produce-150% of expenditure</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Laying and operating a cross country natural gas pipeline network for distribution-100% of expenditure</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Building and operating a new Hotel in India, of two star or above category- 100% of such expenditure</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Building and operating a new Hospital in India, with at least one hundred beds for patients- 150% of expenditure</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Developing and building a housing project under a scheme for slum rehabilitation-100% of expenditure</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Developing and building a housing project under a scheme for affordable</td>
</tr>
<tr>
<td>Section &amp; Sub-section</td>
<td>Eligible expenditure/payment</td>
<td>Amount/Quantum of Deduction</td>
</tr>
<tr>
<td>-----------------------</td>
<td>----------------------------------------------------------------------------------------------</td>
<td>-----------------------------</td>
</tr>
<tr>
<td></td>
<td>housing-150% of expenditure</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Production of fertilizer in India-150% of expenditure</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Setting up and operating an inland container depot or a container freight station-100% of expenditure</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Bee-keeping and production of honey and beeswax-100% of expenditure</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Setting up and operating a warehousing facility for storage of sugar-100% of expenditure</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Laying and operating a slurry pipeline for the transportation of iron ore – 100% of expenditure w.e.f AY 2015-16</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Setting and operating a semi-conductor wafer fabrication manufacturing unit – 100% of expenditure wef AY 2015-16</td>
<td></td>
</tr>
<tr>
<td>35CCA</td>
<td>Expenditure by way of payment to association and institutions for carrying out rural development programmes</td>
<td>100% of expenditure</td>
</tr>
<tr>
<td>35CCB</td>
<td>Expenditure by way of payment to associations and institutions for carrying out programmes of conservation of natural resources</td>
<td>100% of expenditure</td>
</tr>
<tr>
<td>35CCC</td>
<td>Expenditure on agricultural extension project notified by the Board</td>
<td>150% of expenditure</td>
</tr>
<tr>
<td>Section &amp; Sub-section</td>
<td>Eligible expenditure/payment</td>
<td>Amount/Quantum of Deduction</td>
</tr>
<tr>
<td>------------------------</td>
<td>------------------------------</td>
<td>-----------------------------</td>
</tr>
<tr>
<td>35CCD</td>
<td>Expenditure incurred by a company on any skill development project notified by the Board</td>
<td>150% of expenditure</td>
</tr>
<tr>
<td>35D</td>
<td>Expenditure incurred by an Indian Company or a person who is resident in India on amortization of certain preliminary expenses.</td>
<td>One tenth of such expenditure for each of the ten successive previous years beginning with the previous year in which business commences or as the case may be.</td>
</tr>
<tr>
<td>35DD</td>
<td>Amortisation of Expenditure incurred by an Indian Company for the purpose of amalgamation or demerger</td>
<td>One fifth of such expenditure for each of the five successive previous years beginning with the previous year in which amalgamation or demerger takes place.</td>
</tr>
<tr>
<td>35DDA</td>
<td>Expenditure incurred by way of payment of any sum to an employee in connection with his voluntary retirement, in accordance with any scheme or scheme of voluntary retirement.</td>
<td>One-fifth of the amount so paid shall be deducted in computing the profits and gains of the business for that previous year, and the balance shall be deducted in equal installments for each of the four immediately succeeding previous years.</td>
</tr>
<tr>
<td>35E</td>
<td>Deduction for expenditure on prospecting or extraction or production of certain minerals.</td>
<td>One tenth of amount of such expenditure for each of ten successive previous years.</td>
</tr>
</tbody>
</table>

Members are advised to refer the Income-tax Act, 1961 for any change in the provisions of Act at the time of signing the audit report.

28.8 Where under any section an assessee is eligible for deduction under one or more of the sub-sections of the said section, the Tax Auditor should certify the amount of deduction.
available under each sub-section separately in the applicable part, i.e. the amount deductible in respect of the amount debited to Profit & Loss Account and the amount not debited to the Profit & Loss Account.

29. (a) Any sum paid to an employee as bonus or commission for services rendered, where such sum was otherwise payable to him as profits or dividend. [Section 36(1)(ii)].

(b) Details of contributions received from employees for various funds as referred to in section 36(1)(va):

<table>
<thead>
<tr>
<th>Serial number</th>
<th>Nature of fund</th>
<th>Sum received from employees</th>
<th>Due date for payment</th>
<th>The actual amount paid</th>
<th>The actual date of payment to the concerned authorities</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

[Clause 20 (a) and (b)]

29.1 Section 36(1)(ii) provides for deduction of any sum paid to an employee as bonus or commission for services rendered where such sum would not have been payable to him as profit or dividend, if it had not been paid as bonus or commission. In other words, if bonus or commission is in the nature of profit or dividend, it may not be normally allowable as a deduction unless such payment is wholly and exclusively made to the employee. [Shahzada Nand & Sons v. CIT (1977)] 108 ITR 358 (SC).

29.2 Under Clause 20(b), the requirement is only in respect of the disclosure of the amount and the tax auditor is not expected to express his opinion about its allowability or otherwise. The tax auditor should verify the employment/contract details of the employees so as to ascertain the nature of payments.

29.3 Section 36(i)(va) of the Act permits deduction of any sum received by the assessee from any of his employees to which the provisions of section 2(24)(x) are applicable, if it is credited by the assessee to the account of the employees in the relevant statutory fund on or before the due date.

29.4 Section 2(24)(x) includes within the scope of income any sum received by the assessee from his employees as contributions to any provident fund or superannuation fund or ESI Fund or any other Fund for employees’ welfare (hereafter referred to as “Welfare Fund”).

29.5 As per the explanation provided in section 36(1)(va), “due date” means the date by which the assessee is required as an employer to credit an employee’s contribution to the employee’s account in the relevant fund under any Act, rule, order or notification issued there under or under any standing order, award, contract of service or otherwise, i.e., the date by
which it is required to be credited as per the provisions of the applicable law etc. It may be noted that Employees’ P.F. manual provides for 5 days of grace period for payment of contribution. This can be taken into consideration for determining the due date of payment.

29.6 The tax auditor should get a list of various contributions recovered from the employees which come within the scope of this clause and the date on which it is deposited. He should also verify the documents relating to provident funds and other welfare funds. He should verify the agreement under which employees have to make contributions to provident fund and other welfare funds. The ledger account of contributions from employees should be reviewed; the due dates of payments and the actual dates of payment should be verified with the evidence available. In view of the voluminous nature of the information, the tax auditor can apply test checks and compliance tests to satisfy himself that the system of recovery and remittance is proper. Under this clause, details regarding the nature of fund, details of the amount deducted, due date for payment, actual amount paid and actual date of payment to the concerned authorities in respect of provident fund, ESI fund or other staff welfare fund have to be stated.

29.7 The tax auditor should maintain the following information in his working papers for the purpose of reporting in the format provided in the e-filing utility:

(a)

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>2</td>
</tr>
</tbody>
</table>

(b)

<table>
<thead>
<tr>
<th>Serial number</th>
<th>Nature of fund</th>
<th>Sum received from employees</th>
<th>Due date for payment</th>
<th>The actual amount paid</th>
<th>The actual date of payment to the concerned authorities</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
<td>6</td>
</tr>
</tbody>
</table>

30. (a) Please furnish the details of amounts debited to the profit and loss account, being in the nature of Capital, personal, advertisement expenditure etc:

[Clause 21(a)]
<table>
<thead>
<tr>
<th>Nature</th>
<th>Serial number</th>
<th>Particulars</th>
<th>Amount in Rs.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital Expenditure</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Personal Expenditure</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Advertisement expenditure in any souvenir, brochure, tract, pamphlet</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>or the like published by a political party</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Expenditure incurred at clubs being entrance fees and subscriptions</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Expenditure incurred at clubs being cost for club services and</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>facilities used.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Expenditure by way of penalty or fine for violation of any law for</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>the time being force</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Expenditure by way of any other penalty or fine not covered above</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Expenditure incurred for any</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
III.268 Auditing Pronouncements

31. (b) Amounts inadmissible under section 40(a):
   (i) as payment to non-resident referred to in sub-clause (i)

   (A) Details of payment on which tax is not deducted:
       (I) date of payment
       (II) amount of payment
       (III) nature of payment
       (IV) name and address of the payee

   (B) Details of payment on which tax has been deducted but has not been paid during the previous year or in the subsequent year before the expiry of time prescribed under section 200(1)
       (I) date of payment
       (II) amount of payment
       (III) nature of payment
       (IV) name and address of the payee
       (V) amount of tax deducted

   (ii) as payment referred to in sub-clause (ia)

   (A) Details of payment on which tax is not deducted:
       (I) Date of payment
       (II) Amount of payment
       (III) Nature of payment
       (IV) Name and address of the payee

   (B) Details of payment on which tax has been deducted but has not been paid on or before the due date specified in sub-section (1) of section 139.
       (I) Date of payment
       (II) Amount of payment
       (III) Nature of payment
       (IV) Name and address of the payer
       (V) Amount of tax deducted
(VI) Amount out of (V) deposited, if any

(iii) Under sub-clause (ic) [wherever applicable]

(iv) Under sub-clause (iia)

(v) Under sub-clause (iib)

(vi) Under sub-clause (iii)
  (A) Date of payment
  (B) Amount of payment
  (C) Name and address of the payee

(vii) Under sub-clause (iv)

(viii) Under sub-clause (v)
* should be read as “payee” for proper reporting

[Clause 21(b)]

32. (c) Amounts debited to profit and loss account being, interest, salary, bonus, commission or remuneration inadmissible under section 40(b)/40(ba) and computation thereof;

[Clause 21(c)]

33. (d) Disallowance/deemed income under section 40A(3):

(A) 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, please furnish the details:

<table>
<thead>
<tr>
<th>Serial number</th>
<th>Date of payment</th>
<th>Nature of payment</th>
<th>Amount</th>
<th>Name and Permanent Account Number of the payee, if available</th>
</tr>
</thead>
</table>

(B) On the basis of the examination of books of account and other relevant documents/evidence, whether the payment referred to in section 40A(3A) read with rule 6DD were made by account payee cheque drawn on a bank or account payee bank draft. If not, please furnish the details of amount deemed to be the profits and gains of business or profession under section 40A(3A);
30. Clause 21

This clause requires the tax auditor to state the amount of expenditure incurred by the assessee in respect of various items listed above. These expenses may be allowable or may not be allowable or may be allowable subject to certain limits. It is important to note that the amount of expenditure in respect of each of the items is required to be stated. Accordingly, tax auditor will have to obtain the information and make necessary enquiries in that behalf. It will necessitate verification of books of account and other relevant documents, basis of classification, groups under which such expenses have been debited, and so on.

30.1 Clause 21(a) - Expenditure in the nature of capital, personal, advertisement expenditure etc.

Expenditure of Capital nature:

Capital expenditure is not allowable in computing business income unless specifically provided in any sections of the Act. The word “capital expenditure” is not defined in the Act and no conclusive test or rules can be laid down to determine whether a particular expenditure is capital or revenue in the nature. Different tests have been applied by the courts in different
cases depending upon the facts and circumstances of each case and the case law on the subject, as evolved over a period of years, gives guidance for determining the nature of expenditure.

30.2 Some tests which, however, are generally applied to determine whether a particular item of expenditure is of capital nature, are set out hereunder:

(i) Whether it brings into existence an asset or advantage of enduring benefit. The question whether a particular benefit is of an enduring or permanent nature will depend upon the facts and circumstances of each case, the concept of permanency being relative.

(ii) Whether it is referable to fixed capital or fixed assets in contrast to circulating capital or current assets.

(iii) Whether it relates to the basic framework of the assessee’s business.

(iv) Whether it is an expenditure to acquire an intangible asset.

30.3 The above factors are not exhaustive and the tax auditor is required to verify the expenditure based on facts of the case after considering the applicable provisions of the Act.

30.4 The nature of receipt in the hands of the recipient is not a determining factor to decide the nature of payment in the hands of payer. If the amount is in the nature of capital receipt in the hands of the payee, it does not necessarily imply that it is a capital expenditure for the payer and vice versa. The case of the payer has to be considered independently based on the facts concerning him.

30.5 Under the Act, capital expenditure of certain types e.g., on scientific research referred to in section 35, is deductible in computing the income. Similarly depreciation at 100% is allowed in respect of certain assets as prescribed in New Appendix I of the Income-tax Rules, 1962. Ordinarily the capital expenditure should not be debited to profit and loss account. The tax auditor needs to keep in mind that the accounting standards also apply in respect of financial statements audited under section 44AB of the Act. Therefore, besides disclosing the amount of such capital expenditure debited to profit and loss account under this clause, the tax auditor should give suitable disclosure/ qualifications in para 3(a) of Form No. 3CB, depending on the facts of the case.

30.6 The details of capital expenditure, if any, debited to the profit and loss account should be maintained in a classified manner stating the amount under various heads separately. Since part of this capital expenditure may be allowable as deduction in the computation of total income, it is advisable to maintain particulars regarding the nature of expenditure, the amount of expenditure incurred, and the relevant provision under which the expenditure is admissible. However, the total amount of capital expenditure debited to the profit and loss account is to be reported under this clause in the e-filing portal.
III.272 Auditing Pronouncements

Expenditure of personal nature:

30.7 Personal expenses debited to the profit and loss account are to be specified under this sub-clause as they are not deductible in the computation of total income under section 37. It may be noted that the word “personal” is confined to and attached with the “assessee” and not necessarily to and with persons other than the assessee.

30.8 Section 143(1)(e) of the Companies Act 2013 specifically requires the auditor to inquire whether personal expenses have been charged to revenue account. In the case of a person whose accounts of the business or profession have been audited under any other law, the tax auditor will have to report in respect of personal expenses debited in the profit and loss account. In the case of a person who carries on business or profession but who is not required by or under any other law to get his accounts audited, the tax auditor will have to verify the personal expenses if debited in the expenses account while conducting the audit and verify the amount of expenses mentioned under this clause.

30.9 The tax auditor is advised to maintain the following details as part of his working papers for the purpose of reporting in the format provided in the e-filing utility:

<table>
<thead>
<tr>
<th>Sl. No.</th>
<th>Nature and particulars of expenditure</th>
<th>Account head under which debited</th>
<th>Amount of expenditure</th>
<th>Remarks</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
</tr>
</tbody>
</table>

Expenditure on advertisement in any souvenir, brochure, tract, pamphlet or the like, published by a political party:

30.10 Section 37(2B) provides that no allowance shall be made in respect of expenditure incurred by an assessee on advertisement in any souvenir, brochure, tract, pamphlet or the like published by a political party. Therefore, the expenditure of this nature should be segregated and reported under this clause.

30.11 The tax auditor may come across advertising expenditure incurred on advertising in a souvenir, brochure, tract, pamphlet or journal published by a trade union or a labour union formed by a political party. The trade union or labour union though promoted or formed by a political party may have a distinct legal entity. In that event, expenditure incurred by the assessee by way of advertisement given in the souvenir, brochure, tract, pamphlet or journal published by the trade union or the labour union is not required to be indicated against clause 21(a) in Form No. 3CD. If the trade union or labour union formed by the political party does not have a separate and distinct legal entity, then the expenditure incurred on such an advertisement will have to be indicated against this clause.

30.12 The auditor may also keep in mind the provisions of section 80GGB and 80GGC which allow deduction in respect of contribution made by corporate and non-corporate assessees...
respectively to political parties and electoral trust, as required to be reported by him in clause 33 of Form no. 3CD.

**Expenditure incurred at clubs being cost for club services and facilities used, entrance fees and subscriptions:**

30.13 The amount of payments made to clubs by the assessee during the year being cost for club services and facilities used should be indicated under this clause. The payments may be for entrance fees as well as membership subscription and for catering and other services by the club, both in respect of directors and other employees in case of companies and for partners or proprietors in other cases. The fact whether such expenses are incurred in the course of business or whether they are of personal nature should be ascertained. If they are personal in nature, they are to be shown separately under Clause 21(a) referred to earlier.

30.14 Details of payments made to clubs are also required by tax authorities for the purpose of determining whether any portion of club expenses could be treated as perquisite in the hands of the person concerned. All payments made to credit card agencies should be carefully scrutinised. Credit card agency is nothing but credit/collecting agency. In order to determine whether the payments have been made to a club, one has to look into the substantive activity of the institution concerned.

30.15 This clause requires reporting of particulars and the amount of such expenses incurred in the respective fields. However, the following particulars may be maintained as working papers by the auditor for the purpose of reporting in the format provided in the e-filing utility:

<table>
<thead>
<tr>
<th>Sr. No.</th>
<th>Name of the Club</th>
<th>Nature of Amount paid</th>
<th>Remarks</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1)</td>
<td>(2)</td>
<td>(3)</td>
<td>(4)</td>
</tr>
</tbody>
</table>

**Expenditure by way of penalty or fine for violation of any law for the time being in force; Expenditure by way of penalty or fine not covered above; Expenditure incurred for any other purpose which is an offence or is prohibited by law:**

30.16 This clause requires separate reporting of penalty or fine for violation of any law for the time being in force, and any other penalty or fine. The tax auditor should obtain in writing from the assessee the details of all payments by way of penalty or fine for violation of any laws have been made and paid or incurred during the relevant previous year and how such amounts have been dealt with in the books of accounts produced for audit.

30.17 The tax auditor may not be an expert to decide the nature of payment (as to whether it is prohibited by law or not) and may not be aware of the intricacies of all the laws of the land. He can rely on the expert opinion. It must be borne in mind that the tax auditor while reporting...
under this clause is not required to express any opinion as to the allowability or otherwise of the amount of penalty or fine for violation of law. He is only required to give the details of such items as have been charged in the books of accounts. This clause covers only penalty or fine for violation of law and not the payment for contractual breach or liquidator damages. The tax auditor should keep in mind the difference between the amount prohibited by law and the amount paid which is compulsory in nature under the relevant statute. While stating the particulars under this clause, the tax auditor should also take into consideration the concept of materiality.

30.18 In order to ascertain the facts whether the sum debited in the profit and loss account is by way of penalty or fine for any violation of law, the tax auditor will have to refer to the relevant law under which the amount has been paid or incurred and ascertain whether such amount is in the nature of penalty or fine. He should also ascertain all the facts by having recourse to the order of the jurisdictional authority which has levied the penalty or fine. Even if the assessee is contesting against such order before higher authorities, the same will not be relevant and the mere point for ascertaining is whether such sum is debited to the profit and loss account and if yes, the same has to be disclosed.

30.19 The courts have laid down that any penalty or fine for violation of law is not admissible as expenditure. It is in this context the requirement stipulated by clause 21(a) is to be answered.

30.20 The following Explanation to section 37(1) of the Act has been inserted by Finance Act (No.2) Act, 1998 with effect from assessment year 1962-63.

“For the removal of doubts, it is hereby declared that any expenditure incurred by an assessee for any purpose which is offence or which is prohibited by law shall not be deemed to have been incurred for the purpose of business or profession and no deduction or allowance shall be made in respect of such expenditure”.

30.21 Under this sub-clause, any expenditure incurred by an assessee for any purpose which is an offence or which is prohibited by law is to be stated.

30.22 Any expenditure in consequence of violation of law like penalty or fine levied for evading provisions of the Act, FEMA, Excise and Customs law etc., cannot be claimed as deduction under the Act. A penalty imposed for violation of any law during the course of trade cannot be described as a commercial loss. Even if the need for making payments has arisen out of trading operations, the payments are not wholly and exclusively for the purpose of the trade. Violation of law is not a normal incidence of business. This principle was laid down by Hon’ble Supreme Court in case of CIT v. Maddi Venkataratnam & Co. (P) Ltd [1998] 96 Taxman 643 and in the case of Hazi Aziz Shekoor Bros v. CIT [1961] 41 ITR 350. In both the cases it was held that one can carry business or his trade without violating the law.

30.23 In Prakash Cotton Mills (P) Ltd. v CIT [1993] 201 ITR 684 (SC) it has been held that whenever any statutory impost paid by an assessee by way of damages or penalty or interest
is claimed as an allowable expenditure under section 37(1) of the Act, the assessing authority is required to examine the scheme of the provisions of the relevant statute providing for payment of such impost notwithstanding the nomenclature of the impost as given by the statute, to find whether it is compensatory or penal in nature.

30.24 The authority has to allow deduction under section 37(1) wherever such examination reveals the concerned impost to be purely compensatory in nature. Wherever such impost is found to be of a composite nature, that is, partly of compensatory nature and partly of penal nature, the authority would have to bifurcate the two components of the impost and give deduction of that component which is compensatory in nature and refuse to give deduction of that component which is penal in nature. The above principle was reiterated in the case of Swadeshi Cotton Mills (1998) 233 ITR 199.

30.25 Further, in CIT v Ahmedabad Cotton Mfg. Co. Ltd. [1993] 205 ITR 163(SC), the Supreme Court held that what needs to be done by an Assessing Authority under the Act, in examining the claim of an assessee that the payment made by such assessee was a deductible expenditure under section 37 although called a penalty, is to see whether the law or scheme under which the amount was paid, required such payment to be made, as penalty or as something akin to penalty, that is, imposed by way of punishment for breach for infraction of the law or the statutory scheme. If the amount so paid is found to be not a penalty or something akin to penalty due to the fact that the amount paid by the assessee was in exercise of the option conferred upon him under the levy, law or scheme concerned, then one has to regard such payment as business expenditure of the assessee, allowable under section 37 as incidental to business laid out and expended wholly and exclusively for the purposes of the business.

30.26 In case of Malwa Vanaspati & Chemical Co. v. CIT [1997] 225 ITR 383(SC), it was held that where the assessee is required to pay an amount comprising both the elements of compensation and penalty, the compensation is allowable as business expenditure, but not the penalty.

30.27 Where the penalty or fine is in the nature of penalty or fine only, the entire amount thereof will have to be stated. As discussed above, with reference to certain penalty/penal interest courts have held that it is partially compensatory payment and partially in the nature of penalty. In such a case, on the basis of appropriate criteria, the amount charged will have to be bifurcated and only the amount relating to penalty may be stated.

31. Clause 21(b) - amounts inadmissible under section 40(a)

31.1 This clause is substantially expanded to furnish detailed information for deduction and deposit of TDS. Section 40(a) specifies certain amounts which shall not be deducted in computing the income chargeable under the head “Profits and gains of business or profession”. The relevant provisions for A.Y. 2014-15 are as under:

(i) **Non-Resident Payments:** Any interest, royalty, fees for technical services or other sum
chargeable under the Income-tax Act which is payable outside India or in India to a non-resident or a foreign company on which tax is deductible at source under Chapter XVII-B and such tax has not been deducted or after deduction has not been paid during the previous year or in the subsequent year before the expiry of the time prescribed under sub-section (1) of section 200.

Provided that where in respect of any such sum, tax has been deducted in any subsequent year or has been deducted in the previous year but paid in any subsequent year after the expiry of the time prescribed under sub-section (1) of section 200, such sum shall be allowed as a deduction in computing the income of the previous year in which such tax has been paid.

Finance Act, 2014 has amended section 40(a)(i) to provide that if the tax deducted is paid during the previous year or in the subsequent year before the expiry of time prescribed for filling the tax return u/s. 139(1), the same shall be allowed as deduction in the previous year in which the tax is deducted.

(iii) Resident Payments: Any interest, commission or brokerage, rent, royalty, fees for professional services or fees for technical services payable to a resident or amounts payable to a contractor or sub-contractor, being resident, for carrying out any work (including supply or labour for carrying out any work) on which tax is deductible at source 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 section 139(1).

As per first proviso to Section 40(a)(ia), where tax is deducted in any subsequent year, or has been deducted during the previous year but paid after the due date specified in section 139(1), the expenditure is allowable as a deduction in the year in which such tax has been paid. The Finance Act 2012, inserted second proviso in section 40(a)(ia) with effect from 01-04-2013 (A.Y.2013-14) as a consequence to amendment in Section 201. The second proviso provides that where an assessee fails to deduct the whole or any part of the tax in accordance with the provisions of Chapter XVII-B on any such sum but is not deemed to be an assessee in default under the first proviso to subsection (1) of section 201, then, for the purpose of clause(ia) of section 40(a), it shall be deemed that the assessee has deducted and paid the tax on such sum on the date of furnishing of return of income by the resident payee referred to in the said proviso.

(iii) Any sum paid on account of wealth tax.

(iv) The Finance Act, 2013 inserted a sub-clause (iib) in section 40(a) with effect from A.Y. 2014-15. Accordingly, any amount paid by way of a Royalty, License Fees, Service Fees, Privilege Fees, Service Charges or any other fees or charge by whatever name called, which is levied exclusively on or which is appropriated directly or indirectly from a State Government undertaking by the State Government shall not be allowed as a deduction from the income under the head “profit and gains from business or profession”.
(v) Any payment which is chargeable under the head “salaries”, if it is payable outside India or to a non-resident and if the tax has not been paid thereon nor deducted therefrom under Chapter XVII-B.

(vi) Any payment to a provident or other fund established for the benefit of employees of the assessee, unless the assessee has made effective arrangement to secure that tax shall be deducted at source from any payment made from the fund which are chargeable to tax under the head “Salaries”.

(vii) Any tax actually paid by an employer referred to in clause (10CC) of section 10.

31.2 The Finance (No.2) Act, 2014 has amended the provisions of section 40(a)(ia) w.e.f. AY 2015-16 to disallow only 30% of any sum payable to a resident on which tax is deductible at source 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 under section 139(1). The first proviso to section 40(a)(ia) has also been amended to provide that where any sum on which tax has been deducted in any subsequent year, or has been deducted during the previous year but paid after the due date specified in sub-section (1) of section 139, thirty percent of such sum shall be allowed as a deduction in computing the income of the previous year in which such tax has been paid.

31.3 In respect of item (i) and (vi) above, the tax auditor should obtain in writing from the assessee the details of all payments debited to the profit and loss account. Where an actual remittance overseas has been made by the assessee during the relevant previous year without deducting any tax at source, the tax auditor may rely upon the legal opinion and/or certificates from chartered accountants based upon which remittances have been made without deduction of tax at source. The tax auditor may refer SA 620, Using the work of an auditor’s expert issued by ICAI for reliance on certificates/legal opinion. In this connection the tax auditor is advised to refer the applicable Double Taxation Avoidance Agreement (DTAA). Where no remittances have been made during the relevant year, the tax auditor may examine the relevant provisions vis-à-vis the agreement or correspondence in pursuant to which the liability is provided by the assessee in his books of account in order to determine whether any amount so provided is at all chargeable to tax under the Act. The tax auditor may use his professional judgement in these matters based upon decided cases and he may rely upon a legal opinion obtained by the assessee where no tax is required to be deducted in respect of the amount so provided. In case he disagrees with the stand taken by the assessee, he should give both the views in his report.

31.4 Under clause 21(b)(ii)(A), the auditor is required to report payments to non residents on which tax is required to be deducted but not deducted in respect of interest, royalty, fees for technical services and other such chargeable amount under the Income tax Act. The Auditor is advised to give details under this clause for each individual payee.

31.5 Similarly under clause 21(b)(ii)(B), the auditor is required to report payments on which tax is deducted but is not deposited within the time prescribed during the previous year or in
subsequent year. Such details are also required to be given for each individual payee prescribed under Section 40(a)(i).

31.6 Under this sub-clause the tax auditor is required to report the details of payment on which tax is not deducted at source and also the details of payment on which tax has been deducted but not paid during the previous year or in the subsequent year before the expiry of time prescribed under section 200(1)/139(1). The tax auditor should maintain the following data in his working papers for the purpose of reporting under this sub-clause:

(a) Details of payment on which tax was not deducted:

<table>
<thead>
<tr>
<th>Sr. No</th>
<th>Date of payment</th>
<th>Amount of payment</th>
<th>Nature of payment</th>
<th>Name and address of the payee</th>
<th>PAN of the payee, if available</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
<td>6</td>
</tr>
</tbody>
</table>

(b) Details of payment on which tax has been deducted but has not been paid during the previous year or in the subsequent year before the expiry of time prescribed under section 200(1)/139(1):

<table>
<thead>
<tr>
<th>Sr. No</th>
<th>Date of payment</th>
<th>Amount of payment</th>
<th>Nature of payment</th>
<th>Name and address of the payee</th>
<th>PAN of the payee, if available</th>
<th>Amount of tax deducted</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
<td>6</td>
<td>7</td>
</tr>
</tbody>
</table>

31.7 With the introduction of clause (ia) in section 40(a), the scope of disallowance of the expenditure has been widened to include interest, commission, brokerage, rent, royalty, fees for professional services or fees for technical services payable to a resident or amounts payable to a contractor or subcontractor, being resident for carrying out any work including supply of labour for carrying out any work. Under this sub-clause any payment of the expenses, specified therein on which tax is deductible under Chapter XVIIB and such tax has not been deducted or after deduction has not been paid on or before the date of filing of return specified under section 139(1), is not eligible for deduction while computing income chargeable under the head “profits and gains of business or profession”. Accordingly, such amount will be inadmissible and will be required to be disclosed under this clause. For this purpose the tax auditor will be required to examine whether the provisions relating to tax deduction at source have been complied with in respect of payments specified under the clause. For this purpose the tax auditor may examine the books of accounts and tax deduction returns pertaining to these payments.

31.8 Where the auditee claims deduction under the second proviso to sub-section (ia) it is deemed that he has deducted and paid the tax and hence such sum on which tax is so deemed to be deducted and paid is not inadmissible, the tax auditor should verify compliance with the requirements of section 201. He should also obtain and keep in his record a copy of certificate in Form 26A as required by section 201 read with section 40(a)(ia).
31.9 Under clause 21(b)(ii)(A), auditor is required to report payments to residents on which tax is required to be deducted but not deducted in respect of interest, royalty, fees for technical services and other such chargeable under Chapter XVII-B of the Income Tax Act. The auditor is advised to give details under this clause for each individual payee.

31.10 Similarly under clause 21(b)(ii)(B), auditor is required to report payments on which tax is deducted but is not deposited within the time prescribed during the previous year or in subsequent year. Such details are also required to be given for each individual payee prescribed under section 40(a)(ia).

31.11 Tax auditor should also verify that the particulars given under this clause do not differ from the particulars given under clause 34 of Form no. 3CD to the extent applicable. Under this sub-clause, the tax auditor is required to report the details of payment on which tax is not deducted at source and also the details of payment on which tax has been deducted but not paid on or before the due date specified in section 139(1). The tax auditor should maintain the following data in his working papers for the purpose of reporting under this sub-clause:

(a) Details of payment on which tax was not deducted:

<table>
<thead>
<tr>
<th>Sr. No</th>
<th>Date of payment</th>
<th>Amount of payment</th>
<th>Nature of payment</th>
<th>Name and address of the payee</th>
<th>PAN of the payee, if available</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
<td>6</td>
</tr>
</tbody>
</table>

(b) Details of payment on which tax has been deducted but has not been paid on or before the due date specified under section 139(1):

<table>
<thead>
<tr>
<th>Sr. No</th>
<th>Date of payment</th>
<th>Amount of payment</th>
<th>Nature of payment</th>
<th>Name and address of the payee</th>
<th>PAN of the payee, if available</th>
<th>Amount of tax deducted</th>
<th>Amount out of (5) deposited, if any</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
<td>6</td>
<td>7</td>
<td>8</td>
</tr>
</tbody>
</table>

31.12 The Item no. (iii) of clause 21(b) requires reporting of any sum paid on account of fringe benefit tax under Chapter XIIH, wherever applicable. Since Fringe benefit tax was abolished by the Finance (No.2) Act, 2009 with effect from 1-04-2009, the tax auditor will be required to furnish information under this item only if the audit report relates to an assessment year to which the provisions of chapter XIIH were applicable. For all other cases, the tax auditor may report “NIL” or “Not Applicable” as per the requirement of the format of e-filing utility. The provision relating to Fringe Benefit Tax (FBT) has been omitted from A.Y. 2010-11. If any such tax is paid during the year, the same is not allowed as deduction u/s. 40(a)(i)(c). The auditor is required to report such amount of tax paid under clause 21(b)(iii), if any liability has been incurred due to any order of any authority up to AY 2010-11.
31.13 The amount of Wealth Tax paid is not allowed as a deduction u/s. 40(a)(iia) and thus is required to be reported under clause 21(b)(iv).

31.14 Finance Act, 2013 inserted new sub clause 40(a)(iib) w.e.f. A.Y. 2014-15 to provide that (a) any amount paid by way of a royalty, license fees, service fees, privilege fees, service charge or any other fees or charge by whatever name called, which is levied exclusively on; or (b) which is appropriated, directly or indirectly from, a State Government undertaking by the State Government is inadmissible expenditure. The explanation to this sub clause (iib) also defines a State Government undertaking. The Tax auditor should verify any such payment made by State Government undertaking to the State Government and should report under clause 21(b)(v).

31.15 The amount of salary which is paid outside India or to a non-resident in respect of which tax has not been deducted but which is required to be deducted under the applicable provisions of the Income Tax Act or tax has not been paid after deduction, the same is not allowed as a deduction u/s. 40(a)(iii) and the same is required to be reported under clause 21(b)(vi). This information is required to be given for each individual payee. The tax auditor should also furnish the date of payment along with the name and address of the payee. The tax auditor should maintain the following information in his working papers for the purpose of reporting in the format provided in the e-filing utility:

<table>
<thead>
<tr>
<th>Sr No.</th>
<th>Date of payment</th>
<th>Amount of payment</th>
<th>Name of payee</th>
<th>PAN of the payee, if available</th>
<th>Address</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
<td>6</td>
</tr>
</tbody>
</table>

31.16 Section 40(a)(iv) provides that any payment to a provident or other fund established for the benefit of employees of the assessee shall be disallowed, unless the assessee has made effective arrangements to secure that tax shall be deducted at source from any payments made from the fund which are chargeable to tax under the head “Salaries”. The auditor is also required to report the same under item (vii) of this sub-clause.

31.17 Any tax paid by an employer on non-monetary perquisites is exempt in the hands of the employee as per section 10(10CC). Further, as per section 40(a)(v) the tax paid by the employer on non-monetary perquisites provided to employees shall not be deductible in computing profits and gains from business or profession. The tax auditor is required to report the amount of such tax paid by the employer, in case it is debited to the profit and loss account under clause 21(b)(viii).

31.18 In case where the assessee submits that any sum debited to profit and loss account is not inadmissible under the provisions of sub-section (a) of section 40, the tax auditor may exercise his judgement in the light of the applicable laws and report accordingly about the compliance of this provision. The tax auditor may rely upon the judicial pronouncements while taking any particular view. In case of difference of opinion between the tax auditor and the
assessee, the tax auditor should state both the viewpoints. In case of voluminous nature of the information, the tax auditor can apply materiality principles, tests checks and compliance tests for verifying the information required to be provided under this clause.

32. **Clause 21(c)- Amount debited to profit and loss account being, interest, salary, bonus, commission or remuneration inadmissible under section 40(b)/40(ba) and computation thereof;**

32.1 The tax auditor is required to state the inadmissible amount under section 40(b)/40(ba) and such information is also required to be given in respect of interest/ remuneration paid to a member of an Association of persons (AOP)/Body of individuals (BOI). By Finance Act (No.2) 2009, w.e.f. 1.4.2010, the term firm includes LLP (as registered under the provisions of LLP Act, 2008) The word "inadmissible" implies that the tax auditor will have to examine the facts, apply the conditions for allowance or disallowance and accordingly determine the prima facie inadmissibility of the deduction and also quantify the same.

32.2 Salary, bonus, commission or remuneration or interest are not admissible, unless the following conditions are satisfied:

(a) Remuneration is paid to working partner(s).

(b) Remuneration or interest is authorised by the partnership deed and is in accordance with the partnership deed.

(c) Remuneration or interest does not pertain to a period prior to the date of partnership deed.

32.3 The inadmissible remuneration, salary, bonus or commission under section 40(b) has to be determined on the basis of the provisions of sub-clause (v) thereof read with the limits laid down therein. Such limits are laid down as a percentage of book profits. Explanation 3 to section 40(b) provides that "book profits" means the net profit, as shown in the profit and loss account for the relevant previous year, computed in the manner laid down in Chapter IV-D as increased by the aggregate amount of the remuneration paid or payable to all the partners of the firm if such amount has been deducted while computing the net profit. The inadmissible amount of salary, bonus, commission or remuneration is to be worked out after deducting interest allowable to partners as per the provisions of section 40(b). According to Explanation 4, "working partner" means an individual who is actively engaged in conducting the affairs of the business or profession of the firm of which he is a partner. It is advisable for the auditor to obtain from the assessee a detailed working of the inadmissible remuneration, salary, bonus or commission under section 40(b). He has to verify the computation from the instrument or agreement or any other document evidencing partnership including any supplementary documents or other documents effecting changes which would affect the computation of the inadmissible amounts under section 40(b).

32.4 Under section 40(b)(iv), any payment of interest to any partner which is authorised by, and is in accordance with, the terms of the partnership deed and relates to any period falling
after the date of such partnership deed in so far as such amount exceeds the amount calculated at the rate specified under the Income-tax Act from time to time will not be admissible as a deduction.

32.5 Section 40(ba) lays down that any interest or remuneration paid by an AOP to its member shall not be allowed as a deduction to the AOP. It may also be noted that in computing such disallowance:

(a) where interest is paid by AOP / BOI to a member who has also paid interest to AOP/ BOI, only net amount of interest, if any, shall be disallowed;

(b) where a member is in a representative capacity, the disallowance of net interest paid by AOP/BOI shall be the amount of net interest received by the member in a representative capacity or by the person who is so represented by the member;

(c) where a person who is a member in his individual capacity receives the interest for the benefit of or on behalf of any other person, then, interest so paid by AOP/ BOI shall not be disallowed;

32.6 In order to determine the amounts inadmissible under section 40(b), the tax auditor should obtain the computation of total income from the assessee.

32.7 In working out the inadmissible amount the tax auditor must have due regard to the Circular No.739 dated 25.3.1996 issued by the Board reproduced in Appendix XI (Page no. 269).

32.8 The tax auditor should maintain the information in the following format as a part of his working papers and report appropriately in the format provided in the e-filing utility:

<table>
<thead>
<tr>
<th>Sr. No.</th>
<th>Nature of payments made to partner/memb er</th>
<th>Section 40(b)/40 (ba)</th>
<th>Amount debited to profit and loss account</th>
<th>Amount admissible u/s 40(b)/ 40(ba)</th>
<th>Amount inadmissible u/s 40(b)/ 40(ba) (difference between (c) and (d))</th>
<th>Remarks, if any</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a)</td>
<td>(b)</td>
<td>(c)</td>
<td>(d)</td>
<td>(e)</td>
<td>(f)</td>
<td>(g)</td>
</tr>
</tbody>
</table>

32.9 The tax auditor may note that the information required to be reported is the amount of inadmissible expenditure as per section 40(b) or 40(ba) and not the total amount debited to profit and loss account.

33. Clause 21(d) – Disallowance/deemed income under section 40A(3):

(A) 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, please furnish the details:
33.1  (a) As per the provisions of the sub-section (3) of section 40A where the assessee incurs any expenditure in respect of a payment or aggregate of payments made to a person in a day, otherwise than by an account payee cheque drawn on a bank or account payee bank draft, exceeding rupees twenty thousand, no deduction would be allowed in respect of such expenditure. In case of payment made for plying, hiring or leasing of goods carriage, limit is Rs.35,000/- instead of Rs.20,000/-.  

(b) Further, as per the provisions of section 40A(3A) where any 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 the previous year the assessee makes payment in respect thereof, otherwise than an account payee cheque drawn on a bank or account payee bank draft exceeding Rs.20,000, the payment so made shall be deemed to be the profits and gains of business or profession and accordingly chargeable to income tax with respect to that previous year. In case of payment made for plying, hiring or leasing of goods carriage, limit is Rs.35,000/- instead of Rs.20,000/-.  

(c) Further, no disallowance would be made if the payment or aggregate of payments, exceeding Rs. 20,000 (Rs. 35000 in case of plying, hiring or leasing of goods carriage) is made to a person in a day otherwise than by an account payee cheque drawn on a bank or account payee bank draft in respect of cases and circumstances prescribed under Rule 6DD having regard to the nature and extent of banking facilities available, considerations of business expediency and other relevant factors. Notification No.97/2008 dated 10.10.2008 has amended Rule 6DD w.e.f. A.Y. 2008-09
III.284 Auditing Pronouncements

33.2 For the purpose of furnishing the above particulars, the tax auditor should obtain a list of all cash payments in respect of expenditure exceeding Rs.20,000 (Rs.35000/- in case of plying, hiring or leasing goods carriages w.e.f. 1.10.2009) made by the assessee during the relevant year which should include the list of payments exempted in terms of Rule 6DD with reasons. This list should be verified by the tax auditor with the books of account in order to ascertain whether the conditions for specific exemption granted under clauses (a) to (l) of Rule 6DD are satisfied. Details of payments which do not satisfy the above conditions should be stated under this clause.

33.3 The tax auditor has to take into account the technological advancements in the field of banking and information technology where payments have been taken other than through an account payee cheque or bank draft. Rule 6DD of the Rule specifically exempts the cases where the payment is made by any letter of credit arrangements through a bank; a mail or telegraphic transfer through a bank; a book adjustment from any account in a bank to any other account in that or any other bank; a bill of exchange made payable only to a bank; the use of electronic clearing system through a bank account; a credit card; a debit card. 33.4 Practically, it may not be possible to verify each payment, reflected in the bank statement, as to whether the payment has been made through account payee cheque, demand draft, pay order or not, it is thus desirable that the tax auditor should obtain suitable certificate from the assessee to the effect that the payments for expenditure referred to in section 40A(3) and section 40A(3A) were made by account payee cheque drawn on a bank or account payee bank draft, as the case may be. Where the reporting has been done on the basis of the certificate of the assessee, the fact shall be reported as an observation in clause (3) of Form No. 3CA and clause (5) of Form No.3CB, as the case may be.

33.4 The tax auditor should maintain the following particulars in his audit working papers file for the purpose of reporting in the format provided in the e-filing utility:

<table>
<thead>
<tr>
<th>Sl. No.</th>
<th>Nature and particulars of expenditure</th>
<th>Date of payment</th>
<th>Payment or aggregate payments made to a person in a day, otherwise than by an account payee cheque drawn on a bank or account payee bank draft</th>
<th>Total amount of expenditure</th>
<th>Name and Permanent Account number of the payee, if available</th>
<th>Remarks</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>5</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>6</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>7</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
33.5 Wherever possible individual items of inadmissible expenses may be given. However, where, in view of the large volume of transactions it is not possible to give individual items of inadmissible amounts, the tax auditor may furnish such details under broad heads of accounts.

33.6 Items of expenditure in respect of which specific exemption has been given under Clauses (a) to (l) of Rule 6DD are not required to be stated under this clause.

34. Clause 21(e) - provision for payment of gratuity not allowable under section 40A(7);

34.1 As per section 40A(7), the deduction shall be allowed in relation to any provision made by the assessee for the purpose of payment of a sum by way of any contribution towards an approved gratuity fund, or for the purpose of payment of any gratuity, that has become payable during the previous year.

34.2 The tax auditor should call for the order of the Commissioner of Income-tax granting approval to the gratuity fund, verify the date from which it is effective and also verify whether the provision has been made as provided in the trust deed.

34.3 In case the provision made for payment of gratuity is not allowable under section 40A(7), the same is to be stated under this sub-clause.

35. Clause 21(f) - any sum paid by the assessee as an employer not allowable under section 40A(9);

35.1 Under section 40A(9) any payment made by an employer towards the setting up or formation of or as contribution to any fund, trust, company, association of persons, body of individuals, society registered under the Societies Registration Act, 1860, or other institutions (other than contributions to recognised provident fund or approved superannuation fund or notified pension scheme or approved gratuity fund) is not allowable. The tax auditor should furnish the details of payments which are not allowable under this section.

35.2 It may be noted that section 40A(9) allows deduction of any contributions made as an employer towards recognized provident fund or approved superannuation fund or notified pension scheme or approved gratuity fund or as required by or under any other law for the time being in force. Thus, any contribution made to Employees’ Welfare Co-op Society will not be allowed as a deduction in the case of the employer company under section 40A(9), unless such contribution is required by or under any other law for the time being in force. Instruction: No. 1799, dated 3-10-1988.

36. Clause 21(g) - particulars of any liability of a contingent nature:

36.1 The assessee is required to furnish particulars of any liability of a contingent nature debited to the profit and loss account. The tax auditor may not be able to immediately ascertain the details of contingent liabilities debited to the profit and loss account without a detailed scrutiny of various account heads e.g. outstanding liabilities, provision etc.
III.286 Auditing Pronouncements

Accounting policy followed and disclosed would be helpful in ascertaining and verifying details. The expenses relating to disputed claims will be revealed only on the basis of the scrutiny of records relating to contingent liabilities. The tax auditor may look into particular items of contingent liabilities of the earlier year in order to determine whether or not any items has been charged to the profit and loss account of the current year and if so, whether the liability continues to be contingent in nature. Wherever necessary, a suitable note should be given by the tax auditor as to the non-availability of such particulars relating to the contingent liabilities.

36.2 Reference may be made to AS-29, ‘Provisions, Contingent Liabilities and Contingent Assets’ to determine what should normally be treated as a contingent liability.

36.3 The tax auditor should maintain the following information in his working papers for the purpose of reporting in the format provided in the e-filing utility

<table>
<thead>
<tr>
<th>Nature of liability</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>2</td>
</tr>
</tbody>
</table>

37. Clause 21(h) - Amount of deduction inadmissible in terms of section 14A in respect of the expenditure incurred in relation to income which does not form part of the total income;

37.1 Section 14A was inserted in Chapter IV – Computation of total income by the Finance Act, 2001 with retrospective effect from 1.4.1962 i.e. A.Y. 1962-63. Accordingly, for the purposes of computing the total income under Chapter IV of the Act, no deduction shall be allowed in respect of expenditure incurred by the assessee in relation to income which does not form part of the total income under the Act. The Finance Act, 2002 added a proviso to section 14A to the effect that nothing contained in the section shall empower the Assessing Officer either to reassess under section 147 or pass an order enhancing the assessment or reducing a refund already made or otherwise increasing the liability of the assessee under section 154, for any assessment year beginning on or before the first day of April, 2001.

37.2 As per sub-section (2), the Assessing Officer shall determine the amount of expenditure incurred in relation to such income, which does not form part of the total income under the Act. Such determination should be in accordance with the method as may be prescribed. Such power of the Assessing Officer can be exercised only when he, having regard to the accounts of the assessee, is not satisfied with the correctness of the claim of the assessee.

37.3 Sub-section (3) provides that the provisions of subsection (2) shall also apply in relation to a case where an assessee claims that no expenditure has been incurred by him in relation to income which does not form part of the total income under this Act.

37.4 The expenditure which is relatable to the income which does not form part of the total income is not allowed as a deduction in terms of section 14A of the Act. Such income are dealt with in Part III- Incomes Which Do Not Form Part Of Total Income. Section 10 deals with
Incomes not included in total income. Sections 10A to 10C deals with the special provisions in respect of the specified undertakings. In general, an assessee may have besides his business income, income from agriculture which is exempt under sub-section (1), share of profit in a partnership firm which is exempt under sub-section (2A), income from dividends referred to in section 115-O which is exempt under sub-section (34), long term capital gains on the transfer of equity shares which is exempt under sub-section (38) etc. In all such cases, the expenditure relating to the income which is not included in total income is inadmissible under section 14A. In case of an investment in a partnership firm, while the interest and the salary received by the partner are taxable, the share of profit is exempt. The amount of inadmissible expenditure depends on the facts and circumstances of each case.

37.5 The Central Board of Direct Taxes, had through Income-tax (Fifth Amendment) Rules, 2008 inserted a new Rule 8D which lays down the method for determining the amount of expenditure in relation to income not includible in total income. Sub-rule (1) of Rule 8D provides that having regard to the accounts of the assessee of a previous year, if the Assessing Officer is not satisfied with the correctness of the claim of expenditure made by the assessee or with the claim made by the assessee that no expenditure has been incurred, in relation to income which does not form part of the total income under the Act for such previous year, he shall determine the amount of such inadmissible expenditure in accordance with the method of computation laid down in sub-rule (2) of Rule 8D.

37.6 Sub-rule (2) of Rule 8D provides for the method of computation of the expenditure in relation to income not forming part of the total income. The disallowance shall be the aggregate of the following:

(i) the amount of expenditure directly relating to income which does not form part of total income;

(ii) in a case where the assessee has incurred expenditure by way of interest during the previous year which is not directly attributable to any particular income or receipt, an amount computed in accordance with the following formula, namely:

\[
\frac{A \times B}{C}
\]

Where

A = amount of expenditure by way of interest other than the amount of interest included in clause (i) incurred during the previous year;

B = the average of value of investment, income from which does not or shall not form part of the total income, as appearing in the balance sheet of the assessee, on the first day and the last day of the previous year;

C = the average of total assets as appearing in the balance sheet of the assessee, on the first day and the last day of the previous year.
(iii) an amount equal to one-half per cent of the average of the value of investment, income from which does not or shall not form part of the total income, as appearing in the balance sheet of the assessee, on the first day and the last day of the previous year.

“Total Assets” for the purpose of Rule 8D shall mean, total assets as appearing in the balance sheet excluding the increase on account of revaluation of assets but including the decrease on account of revaluation of assets.

37.7 The method prescribed under sub-rule (2) of Rule 8D is applicable when the Assessing Officer is not satisfied with the correctness of the claim of expenditure made by the assessee or with the claim made by the assessee that no expenditure has been incurred. Normally this situation would arise at the time of assessment i.e. after the tax audit has been completed and the return has been filed. Therefore, at the time of tax audit the tax auditor will have to verify the amount of inadmissible expenditure as determined by the assessee. The method under sub-rule (2) of Rule 8D is to be adopted by the Assessing Officer when he is not satisfied with the amount as determined by the assessee. Rule 8D does not mandate that the assessee should necessarily compute the disallowance as per the method prescribed under sub rule (2). Therefore, the assessee may or may not adopt the same.

37.8 It is primarily the responsibility of the assessee to furnish the details of amount of deduction inadmissible in terms of section 14A i.e. in respect of the expenditure incurred in relation to income, which does not form part of the total income. The tax auditor shall examine the details of amount of inadmissible expenditure as furnished by the assessee. While carrying out such examination the tax auditor is entitled to rely on the management representation. However, Standard on Auditing (SA) 580, Written representations may be referred to.

37.9 The tax auditor will verify the amount of inadmissible expenditure as estimated by the assessee with reference to established principles of allocation of expenditure based on logical parameters like proportion of exempt and taxable income recorded, turnover, man hours spent to earn the relevant income etc. For allocation of interest between taxable and non-taxable income, the quantum of investment, the period and the rate of interest are generally the relevant factors to be considered. This requires proper estimates to be made by the assessee. The tax auditor is required to audit such estimates. Attention is invited to Standard on Auditing - 540 “Audit of Accounting Estimates”.

37.10 An assessee may claim that no expenditure has been incurred by him in relation to income which does not form part of the total income under the Act. Even in such a case the provisions of section 14A will apply. Accordingly, the tax auditor is required to verify such contention of the assessee.

37.11 As stated before the method prescribed under sub-rule (2) of Rule 8D is to be adopted by the Assessing Officer when he is not satisfied with the correctness of claim made by the assessee. As per clause (i) of sub-rule (2) the expenditure which is directly relatable to income which does not form part of total income is inadmissible expenditure. Besides such
expenditure there may be expenditure such as interest, which is relatable to both taxable and non-taxable income which needs to be properly allocated while calculating the inadmissible amount. Interest which, can be directly attributable to any particular income or receipt chargeable to tax needs to be excluded while determining the inadmissible amount. Clause (ii) of sub-rule (2) of rule 8D deals with allocation of interest which, is not directly attributable to any particular income or receipt. However the variable A used in the formula in clause (ii) of sub-rule (2) is said to be equal to the amount of expenditure by way of interest other than the amount of interest included in clause (i) incurred during the previous year. It may be seen that what is proposed to be allocated as per clause (ii) is interest which is not directly attributable to any particular income or receipt. Therefore, variable A is the amount of expenditure by way of interest other than the amount of interest directly attributable to any non taxable income as per clause (i) and also interest which may be directly attributable to any taxable income. Interest on term loan may be an example of such interest which is generally related to taxable income and is therefore excluded.

37.12 The broad principles enunciated in para 16.3 may be kept in mind while verifying the amount of inadmissible expenditure. After verifying the amount of inadmissible expenditure, if the tax auditor:

(a) is in agreement with the assessee, he should report the amount with suitable disclosures of material assumptions, if any.

(b) is not in agreement with the assessee with regard to the amount of expenditure determined, he may give:

- **A qualified opinion:**

  A qualified opinion can be given when the auditor is of the opinion that the effect of any disagreement with the assessee is not so material and pervasive as to require an adverse opinion or limitation on scope is not so material and pervasive as to require a disclaimer of opinion.

- **An adverse opinion:**

  The auditor in rare circumstances may come across a situation where the impact of his disagreement about the computation of such inadmissible expenditure is so material and pervasive that it affects the overall opinion. In such a case the tax auditor may give an adverse opinion.

- **The disclaimer of opinion:**

  When the assessee has neither provided the basis nor the supporting documents, for the claim of such inadmissible expenditure, then due to limitation on the scope of auditors work, the auditor can give disclaimer of opinion.

38. Clause 21(i)- amount inadmissible under the proviso to section 36(1)(iii).
38.1 The provisions of section 36(1)(iii) provide that the amount of the interest paid in respect of capital borrowed for the purposes of the business or profession would be allowed as a deduction in computing the income referred to in section 28 of the Act.

38.2 The proviso thereunder (inserted by the Finance Act, 2003 w.e.f. A.Y. 2004-05) provides that any amount of the interest paid, in respect of capital borrowed for acquisition of an asset for extension of existing business or profession (whether capitalized in the books or account or not) for any period beginning from the date on which the capital was borrowed for acquisition of the asset till the date on which such asset was put to use, shall not be allowed as a deduction.

38.3 The extension of an existing business or profession is a fact based exercise and the tax auditor should apply the professional judgment in determining the applicability of the proviso. The tax auditor is also advised to verify the treatment given for such asset under other provision of the Act like Chapter VI A deductions or under other statutes.

38.4 The requirements of sub-clause (i) are applicable in respect of capital borrowed for acquisition of an asset for extension of the existing business or profession. The assessee has to furnish the details of amount inadmissible under the proviso to section 36(1)(iii). The tax auditor has to verify the correctness of the particulars furnished by the assessee with the documentary evidence.

38.5 The Tax Auditor while determining the admissible/inadmissible amount under section 36(1)(iii) should also keep in mind the requirements of Accounting Standards 16 of Indian GAAP – “Borrowing Cost”.

38.6 The Explanation provides that recurring subscription paid periodically by shareholders or subscribers in Mutual Benefit Society which fulfill such conditions as may be prescribed, shall be deemed to be capital borrowed within the meaning of section 36(1)(iii).

38.7 The Explanation becomes applicable only where the computation of the income of such mutual benefit society is to be made under section 28 read with section 44A.


[Clause (22)]

39.1 This clause was inserted by the Central Board of Direct Taxes through its Notification No. 36/2009 dated 13-4-2009, in the Form No.3CD in Appendix II of the Income-tax Rules, 1962.

39.2 The tax auditor is required to state the amount of interest inadmissible under section 23 of the Micro, Small and Medium Enterprises Development Act, 2006. The Micro, Small and Medium Enterprises Development Act, 2006 (MSME Act) is an Act to provide for facilitating the promotion and development and enhancing the competitiveness of micro, small and medium enterprises and for matters connected therewith or incidental thereto.
39.3 Section 23 of the MSME Act lays down that an interest payable or paid by the buyer, under or in accordance with the provisions of this Act, shall not for the purposes of the computation of income under the Income-tax Act, 1961 be allowed as a deduction.

39.4 The inadmissible interest has to be determined on the basis of the provisions of the MSME Act. Section 16 of the MSME Act provides for the date from which and the rate at which the interest is payable. Accordingly, where a buyer fails to make payment of the amount to the supplier, as required under section 15, the buyer shall, notwithstanding anything contained in any agreement between the buyer and the supplier or any law for the time being in force, be liable to pay compound interest with monthly rests to the supplier on that amount from the appointed date or, as the case may be, from the date immediately following the date agreed upon, at three times of the bank rate notified by the Reserve Bank.

39.5 Section 15 of the MSME Act, requires the buyer to make payment on or before the date agreed upon in writing, or where there is no agreement in this behalf, before the appointed day. It also provides that the period agreed upon in writing shall not exceed forty five days from the day of acceptance or the day of deemed acceptance.

39.6 Section 22 of the MSME Act provides that where any buyer is required to get his annual accounts audited under any law for the time being in force, such buyer shall furnish the following additional information in his annual statement of accounts, namely:-

(i) The principal amount and interest due thereon (to be shown separately) remaining unpaid to any supplier as at the end of each accounting year;

(ii) The amount of interest paid by the buyer in terms of Section 16, along with the amount of payment made to supplier beyond the appointed date during each accounting year;

(iii) The amount of interest due and payable for the delay in making payment (which have been paid but beyond the appointed day during the year) but without adding the interest specified under this Act;

(iv) The amount of interest accrued and remaining unpaid at the end of each accounting year; and

(v) The amount of further interest remaining due and payable even in the succeeding years, until such date when the interest dues as above are actually paid to the small enterprise, for the purpose of disallowance as a deductible expenditure under section 23.

39.7 Where the tax auditor is issuing his report in Form No.3CB, he should verify that the financial statements audited by him contain the information as prescribed under section 22 of the MSME Act. If no disclosure is made by the auditee in the financial statements he should give an appropriate qualification in Form No.3CB, in addition to the reporting requirement in clause 22 of Form No. 3CD.

39.8 The tax auditor while reporting in respect of clause 22 should take the following steps:
III.292  Auditing Pronouncements

(a) The auditor should seek information regarding status of the enterprise i.e. whether the same is covered under the Micro, Small and Medium Enterprises Development Act, 2006. Where the information is available and has been disclosed the same should be reported as such in Form No. 3CD. Where the information is not available the auditor should also mention the same in the Form No.3CD.

(b) Since Section 22 of the Micro, Small and Medium Enterprises Development Act, 2006 requires disclosure of information, the tax auditor should cross check the disclosure made in the financial statements.

(c) Obtain a full list of suppliers of the assessee which fall within the purview of the definition of “Supplier” under section 2(n) of the Micro, Small and Medium Enterprises Development Act, 2006. It is the responsibility of the auditee to classify and identify those suppliers who are covered by this Act.

(d) Review the list so obtained.

(e) Verify from the books of account whether any interest payable or paid to the buyer in terms of section 16 of the MSME Act has been debited or provided for in the books of account.

(f) Verify the interest payable or paid as mentioned above on test check basis.

(g) Verify the additional information provided by the auditee relating to interest under section 16 in his financial statement.

(h) If on test check basis, the auditor is satisfied, then the amount so debited to the profit and loss account should be reported under clause 22.

39.9 Where the tax auditor, upon due verification, finds that the auditee has neither provided for nor paid any interest payable under the MSME Act, the no amount is inadmissible under section 23 of MSME Act. In such a case, appropriate reporting should be made against this clause in the format provided in the e-filing utility.

39.10 A question may come up, as to what would be disallowance, in case the auditee is liable to pay any interest under MSME Act, but he has not provided the interest in his accounts. In such a case, there can be no disallowance, as he has not claimed the same in his accounts. But whenever he pays and claim such interest, the same will be disallowable in year of payment. In case the auditee has adopted mercantile system of accounting, the non-provision may affect true and fair view and the auditor should give suitable qualification.

39.11 The relevant extracts of the MSME Act are given in Appendix XII (Page no 271).

40. Particulars of payments made to persons specified under section 40A(2)(b). [Clause 23]

40.1 Section 40(A)(2) provides that expenditure for which payment has been or is to be made to certain specified persons listed in the section- Refer Appendix XIII (Page no. 273) may be disallowed if, in the opinion of the Assessing Officer, such expenditure is excessive or
unreasonable having regard to:

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

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

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

Further, proviso to section 40A(2)(a) provides that no disallowance on account of any expenditure being excessive or unreasonable having regard to the fair market value, shall be made in respect of a specified domestic transaction referred to in section 92BA, if such transaction is at arm’s length price as defined in clause (ii) of section 92F.

40.2 The section enjoins on the Assessing Officer the power to fix the quantum of disallowance. Under this clause, the particulars of payments coming under this sub-section are to be stated. The following steps may be taken by the tax auditor in this connection:

(a) Obtain full list of specified persons as contemplated in this section.

(b) Obtain details of expenditure/payments made to the specified persons.

(c) Scrutinise all items of expenditure/payments to the above persons.

(d) It may be difficult to locate all such payments and it may also involve a time consuming effort. It is, however, possible to localise the area of enquiry by ascertaining the following:

(i) Call for all contracts or agreements entered into by the assessee and list out the contracts or agreements entered into with the specified persons and segregate the items of payments made to them under these agreements.

(ii) In case of payments for purchases and expenses on credit basis, the appropriate ledger accounts can be scrutinised to identify the dealings with the specified persons.

(iii) In case of cash purchases and expenses, the purchase or expense account should be scrutinised. It may be difficult to identify such payments in each and every case where the volume of transactions is rather huge and voluminous. Therefore, it may be necessary to restrict the scrutiny only to such payments in excess of certain monetary limits depending upon the size of the concern and the volume of business of the assessee.

(iv) In case of a large company, it may not be possible to verify the list of all persons covered by this section and, therefore, the information supplied by the assessee can be relied upon. In this context, a reference may be made to Circular No.143 dated 20.8.1974, issued by the Board, in which it is clarified that an tax auditor can rely upon the list of persons covered under Section 13(3) as given by the managing trustee of a Public Trust. (Refer Appendix ‘B’ of “A Guide to Audit of Public Trusts under the Income-tax Act” published by the Institute). Where the
III.294 Auditing Pronouncements

tax auditor relies upon the information in this regard furnished to him by the assessee it would be advisable to make an appropriate disclosure.

40.3 The tax auditor should maintain the following information in his working papers for the purpose of reporting in the format provided in the e-filing utility:

<table>
<thead>
<tr>
<th>Name of the related party</th>
<th>PAN of related person</th>
<th>Relation</th>
<th>Date</th>
<th>Payment made (Amount)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
</tr>
</tbody>
</table>

40.4 The Finance Act, 2012 had amended Section 40A(2)(a) to provide that the transactions referred to in Section 92BA (called Specified Domestic Transactions) with persons referred to in 40A(2)(b) shall be at Arm’s Length Price. The tax auditor is advised to refer the “Guidance Note on Report under section 92E of the Income tax Act, 1961” issued by ICAI for compliance of these provisions.

41. Amounts deemed to be profits and gains under section 32AC, 33AB or 33ABA or 33AC.

41.1 Section 32AC allows deduction @ 15% in respect of Investment in new Plant & Machinery to a company who is engaged in the business of manufacture or production of any article or thing and who acquires and installs new asset after the 31st day of March, 2013 but before the 1st day of April, 2015 and the aggregate actual cost of such new assets exceeds one hundred crore rupees. The Finance Act, 2014 has amended section 32AC w.e.f. financial year 2014-15. The investment limit in the plant and machinery has been reduced to Rs. 25 crores from Rs. 100 crores. The auditor is required to report the deemed income chargeable as profits and gains of business under the circumstances specified in sub sections (2) of section 32AC. Only because section 32AC(2) provides for chargeability of deemed income under the head “profit and gains from business or profession” in addition to taxability of capital gains, the auditor is not required to report any capital gains/losses arising on transfer on the said asset. The tax auditor will be required to verify the compliance to the conditions of the provisions of section 32AC and report the claim of deduction accordingly.

41.2 Section 33AB allows deduction in respect of Tea Development Account, Coffee Development Account and Rubber Development Account. The auditor is required to report the deemed income chargeable as profits and gains of business under the circumstances specified in sub sections [4], [5], [7] and [8] of section 33AB.

41.3 Section 33ABA allows deduction in respect of Site Restoration Fund. The auditor is required to report the deemed income chargeable as profits and gains of business under the circumstances specified in sub sections [5], [7] and [8] of section 33ABA. Where deduction has been claimed with respect to interest credited in Special Account or the Site Restoration
41.4 Likewise, section 33AC allows deduction in respect of reserve created out of the profit of the assessee engaged in shipping business to be utilized in accordance with the provision of sub section (2) of section 33AC. The tax auditor is required to report the deemed income chargeable as profits and gains of business under the circumstances specified in sub-sections (3) and (4) of section 33AC for the amount of reserves created on or before 31st March, 2004. However, consequent to the amendment made by the Finance (No.2) Act, 2004, no deduction shall be allowed under section 33AC for any assessment year commencing on or after 1st day of April, 2005.

41.5 The tax auditor should maintain the following information in his working papers for the purpose of reporting in the format provided in the e-filing utility:

<table>
<thead>
<tr>
<th>Section</th>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>2</td>
<td>3</td>
</tr>
</tbody>
</table>

42. Any amount of profit chargeable to tax under section 41 and computation thereof.  

(Clause 25)

42.1 (i) Section 41(1) provides that where any allowance or deduction has been made in the assessment for any year in respect of loss, expenditure or trading liability incurred by the assessee and subsequently during any previous year the assessee obtains any amount, whether in cash or in any other manner whatsoever, in respect of such loss or expenditure or some benefits in respect of trading liability by way of remission or cessation thereof, the amount obtained by him or the value of benefit accruing to him is chargeable to tax as business income.

(ii) Where the assessee who has suffered loss or has incurred expenditure for which deduction has been allowed or by whom the trading liability has been incurred is succeeded in his business either because of amalgamation of companies or demerger or on account of the constitution of new firm or the business if continued by some other person when the assessee ceases to carry on the business, then the successor in the business will be chargeable to tax on any amount received in respect of such loss, expenditure or trading liability.

(iii) *Explanation* (1) to section 41(1) provides that the expression “loss or expenditure or some benefit in respect of any such trading liability by way of remission or cession thereof” shall include the remission or cession of any liability by a unilateral act of the assessee or successor in the business by way of writing off such liability in his accounts.

(iv) Liability of assessee does not cease merely because liability has become barred by limitation. Liability ceases when it has become barred by limitation and the assessee has unequivocally expressed its intention not to honour the liability, when demanded. This is a question of fact whether or not assessee has expressed unequivocally his intentions.  

© The Institute of Chartered Accountants of India
III.296 Auditing Pronouncements

Chase Bright Steel Ltd 177 ITR 128 (BOM). When a liability is shown outstanding for more than 4 years, in case of an assessee company, this amounted to acknowledging the debt in favour of creditors for the purposes of section 18 of the Limitation Act, 1963. The assessee’s liability to the creditors thus subsisted and did not cease nor was it remitted by the creditors. The liability was enforceable in the court of Law. The amount was not assessable under section 41(1). This was so held by Delhi High Court in the case of CIT V/s Shri Vardhman Overseas Ltd(2012) 343 ITR 408(Del). [SLP has been dismissed by the Supreme Court against this decision.]

42.2 Section 41(2) provides for chargeability to income-tax as income of the business of the previous year in which the moneys payable for the building, machinery, plant or furniture of an undertaking engaged in generation or generation and distribution of power is sold, discarded, demolished or destroyed. Such undertakings are allowed depreciation on such percentage on the actual cost as are prescribed. The depreciation rate are prescribed vide Rule 5(IA) in Appendix IA. Depreciation is to be calculated on Straight Line Method (SLM) on individual asset and not on block of assets, under clause (i) of sub-section (1) of section 32. Where the moneys payable in respect of such building, machinery, plant or furniture, as the case may be, together with the amount of scrap value, if any, exceeds the written down value, so much of the excess as does not exceed the difference between the actual cost and the written down value shall be chargeable to income-tax as income of the business of the previous year in which the moneys payable for the building, machinery, plant or furniture become due. Where the moneys payable in respect of the building, machinery, plant or furniture become due in a previous year in which the business, for the purpose of which the building, machinery, plant or furniture was being used, is no longer in existence, the above provision shall apply as if the business is in existence in that previous year. To ascertain capital gain, if any, provisions of section 50A are relevant.

42.3 Section 41(3) provides that where any capital asset used in scientific research is sold without having been used for other purposes and the sale proceeds together with the amount of deduction allowed under section 35 exceeds the amount of capital expenditure, such surplus or the amount of deduction allowed, whichever is less, is chargeable to tax as business income in the year in which the sale took place. This is irrespective of whether the business of the assessee is in existence or not during the previous year in which the capital asset is sold.

42.4 It may be noted that section 41(3) is applicable only if an asset is sold without having been used for other purposes. In other words, if an asset which is initially purchased for the purpose of scientific research is utilised for business purposes on completion of scientific research and later on is sold or transferred, then section 41(3) is not applicable but in such case section 50 would apply.

42.5 Section 41(4) provides where any bad debt has been allowed as deduction under section 36(1) (vii) and the amount subsequently recovered on such debt is greater than the
difference between the debt and the deduction so allowed, the excess realisation is chargeable to tax as business income of the year in which debt is recovered. For this purpose, it is immaterial whether the business of the assessee is in existence or not during the previous year in which recovery is made.

42.6 Section 41(4A) provides that if any amount is withdrawn from the special reserve created under section 36(1)(viii), then it will be chargeable to tax in the year in which the amount is withdrawn, regardless of the fact whether the business is in existence in that year or not.

42.7 Section 41(5) provides that where the business or profession referred to in section 41 is no longer in existence and there is income chargeable to tax under sub-section (1), sub-section (3), sub-section (4) or sub-section (4A) in respect of that business or profession, any loss, not being a loss sustained in speculation business which arose in that business or profession during the previous year in which it ceased to exist and which could not be set off against any other income of that previous year shall, so far as may be, be set off against the income chargeable to tax under the sub-sections aforesaid. This is irrespective of the number of years that may have elapsed from the year in which the loss has been suffered.

42.8 The tax auditor should obtain a list containing all the amounts chargeable under section 41 with the accompanying evidence, correspondence, etc. He should in all relevant cases examine the past records to satisfy himself about the correctness of the information provided by the assessee. The tax auditor has to state the profit chargeable to tax under this section. This information has to be given irrespective of the fact whether the relevant amount has been credited to the profit and loss account or not. The computation of the profit chargeable under this clause is also to be stated.

42.9 The tax auditor should maintain the following in his working papers for the purpose of furnishing details required in the format provided in the e-filing utility:

<table>
<thead>
<tr>
<th>Sr. No.</th>
<th>Name of person</th>
<th>Amount of income</th>
<th>Section</th>
<th>Description of transaction</th>
<th>Computation if any</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
<td>6</td>
</tr>
</tbody>
</table>

43. In respect of any sum referred to in clause (a), (b), (c), (d), (e) or (f) of section 43B, the liability for which:-

(A) pre-existed on the first day of the previous year but was not allowed in the assessment of any preceding previous year and was

(a) paid during the previous year;
(b) not paid during the previous year;

(B) was incurred in the previous year and was

(a) paid on or before the due date for furnishing the return of income of the previous year under section 139(1);
III.298  Auditing Pronouncements

(b) not paid on or before the aforesaid date.

(State whether sales tax, customs duty, excise duty or any other indirect tax, levy, cess, impost etc. is passed through the profit and loss account.)

[Clause 26]

43.1 In the case of an assessee maintaining its accounts on the mercantile system, the tax auditor should verify the aforesaid particulars of section 43B from the books of account for the year under audit as well as from the books of account, vouchers and documents of the immediately succeeding assessment year as well as return of income for the earlier assessment years so that the information about the aforesaid payments made in the subsequent year can be furnished.

43.2 Section 43B provides that notwithstanding anything contained in any other provisions of the Act, the following amounts shall be allowed as deduction in computing the business income of an assessee in the previous year in which such amounts are actually paid:

(a) any tax, duty (sales tax, value added tax, service tax, excise duty, municipal/property tax, etc.), cess or fee, by whatever name called, payable by the assessee under any law for the time being in force.

(b) any sum payable as an employer by way of contribution to any provident fund or superannuation fund or gratuity fund or any other fund for the welfare of employees.

(c) any bonus or commission payable by the assessee to its employees for services rendered, where such sum would not have been payable to him as profits or dividend, if it had not been paid as bonus or commission.

(d) interest on any loan or borrowing from any public financial institution, a state financial corporation or a state industrial investment corporation payable in accordance with the terms and conditions of the agreement governing such loan or borrowing.

(e) any sum payable by the assessee as interest on any loan or advances from a scheduled bank in accordance with the terms and conditions of the agreement governing such loan or advances.

(f) any sum payable by the assessee as an employer in lieu of any leave at the credit of his employee.

43.3 All the payments referred in clause (a) to (f) above whether pre-existed on the first day of previous year but not allowed in assessment of any preceding previous years or incurred in the previous year are to be reckoned. In respect of the liability which pre-existed on the first day of the previous year is allowable as deduction if paid during the previous year. This is required to be reported in clause 26(A)(a). In respect of the liability which is incurred in the previous year is allowable to the extent it is paid on or before the due date for furnishing the return of the income under section 139(1). Such items are to be disclosed in clause 26(B)(a).
43.4 The tax auditor, in his tax audit report, should, therefore, clearly distinguish the liability incurred during the previous year in respect of all the specified sums referred to in clauses (a) to (f) from the liability that pre-existed on the first day of the relevant previous year.

43.5 If the assessee is following the cash basis of accounting, sums referred to in clause (a), (b), (c), (d), (e) and (f) of section 43B which are debited to the profit and loss account will be allowable as they would have been actually paid during the year.

43.6 Under the first proviso to section 43B, deduction is available in respect of any sum which is actually paid by the assessee on or before the due date applicable in his case for furnishing the return of income under sub-section (1) of section 139. Since the due date of filing of the return would usually be subsequent to the signing of the tax audit report the tax auditor would be able to give information in respect of matters only up to the date of signing of the tax audit report. The payment made subsequent to that date but before the date of filing of the return, will still be eligible for deduction under section 43B. Where due date for filing of return of income is extended, payments made up to the extended due date also qualify for deduction.

43.7 The provision made in the accounts for excise duty payable on finished goods in the bonded warehouse will also have to be disclosed under this clause. For enabling the assessee to claim this amount as a deduction the tax auditor may have to verify that the said goods have been cleared and that excise duty thereon has been paid or adjusted against CENVAT credits before the due date applicable in his case for furnishing the return of income under section 139 (1).

43.8 Under section 43B(a), sales-tax when paid is allowed as a deduction. Although under clause (a) of section 43B items that have been debited to the profit and loss account but not paid during the previous year, are to be specified, where it is the practice of the company to maintain a separate sales-tax/service tax/excise duty account and treat the sales tax/excise duty collected as a liability, it would be necessary to show by way of note under this clause, the amount of sales tax/excise duty collected but not paid. In case, any sum has been paid before the due date of filing the return, the date and the amount of payment along with the amount paid should also be disclosed.

43.9 There are different legal decisions with respect to allowability of employees contribution towards PF, EPF, etc not paid within due date. Bombay High Court in the case CIT vs Pamwi Tissues Ltd (2008)215 CTR (Bom)150 and Gujarat High Court in the case of CIT vs. Gujarat State Road Transport Corp. (2014) 223 taxmann 398 (Guj.) held that employees contribution not paid within the due dates prescribed in Explanation to section 36(1)(va) was disallowable under section 43B. On the other hand Delhi High Court in the following cases has held in the favour of assessees.

*CIT vs Dharmendra Sharma 297 ITR 320*
*CIT vs P.M. Electronics Ltd 313 ITR 161*
III.300 Auditing Pronouncements

CIT vs AIMIL Ltd and others 321 ITR 508

43.10 It may be noted that emoluments in the nature of good work reward, incentives or ex-gratia are not bonus or commission as contemplated under section 36(1)(ii) but are deductible under section 37 of the Act as held by Delhi High Court in Shri Ram Pistons and Rings Ltd. 307 ITR 363 and Autopins (India) Ltd. 192ITR161.

43.11 The Explanations 3C and 3D to section 43B clarify that a deduction of any sum being interest payable under clause (d) and clause (e) of section 43B shall be allowed, if such interest has been actually paid and any interest referred to in that clause which has been converted into a loan or advance shall not be deemed to have been actually paid. Circular No.7/2006 dated 17th July, 2006 observes that the clarificatory Explanations only reiterate the rationale that conversion of interest into a loan or borrowing or advance does not amount to “actual payment”. The circular clarifies that the unpaid interest whenever actually paid to the bank or financial institution will be in the nature of revenue expenditure deserving deduction in the computation of income. Therefore, the converted interest, by whatever name called, in the wake of its conversion into a loan or borrowing or advance, will be eligible for deduction in the computation of income of the previous year in which the converted interest is ‘actually paid’. In other words, nomenclature of the sum of converted interest will make no difference as the sum of converted interest whenever is actually paid will not represent repayment of the principal. The circular clarifies that the fundamental principle remains that once an amount has been determined as interest payable to the banks or financial institutions, any subsequent change of nomenclature of interest will not affect its allowability and deduction in terms of section 43B will have to be allowed on its actual payment. The Assessing Officer would therefore be justified in seeking a certificate from the assessee to be obtained by the assessee from the lender bank or financial institution etc. as evidence of “actual payment” of interest to banks or financial institutions.

43.12 As per clause (f) sum payable by the assessee as an employer in lieu of any leave at the credit of his employees will be disallowed if not paid before the due date of filling of the return under section 139 (1).

43.13 The above particulars are required to be given irrespective of the fact whether they have been debited to profit and loss account or not and such a fact should be stated under this clause. For example, where excise, sales tax, etc. collected is accounted for as a Balance Sheet item.

43.14 In some cases the tax auditor may find amounts of the nature referred to in section 43B being credited to the profit and loss account although the relevant provisions for such liability had not been allowed as a deduction in any previous year in view of the specific provisions of section 43B requiring actual payment as a condition precedent to allowance. The amounts so credited to the profit and loss account are not chargeable to tax since the conditions referred to in section 41(1) have not been satisfied. The tax auditor should identify such items and maintain the same in his working papers.
43.15 The tax auditor should maintain the following information in his working papers for the purpose of reporting in the format provided in the e-filing utility:

<table>
<thead>
<tr>
<th>S.No.</th>
<th>Section</th>
<th>Nature of liability</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
</tr>
</tbody>
</table>

44. (a) Amount of Central Value Added Tax credits availed of or utilized during the previous year and its treatment in the profit and loss account and treatment of outstanding Central Value Added Tax credits in the accounts.

45. (b) Particulars of income or expenditure of prior period credited or debited to the profit and loss account.

[Clause 27 (a) and (b)]

44.1 Sub-clause (a) requires the factual reporting about the amount of CENVAT credits availed of or utilised during the year as well as its treatment in profit and loss account and treatment of outstanding CENVAT credits in the accounts. CENVAT credit Rules, 2002 were first introduced in place of MODVAT credit and thereafter, effective 10 September 2004, CENVAT Credit Rules, 2004 have now become applicable. CENVAT credit is available on eligible inputs, input services and capital goods. Such credits are utilized for the payment of the excise duty and service tax liability. Accordingly the tax auditor should check relevant statutory records maintained under the Central Excise Rules, 2002 and the records maintained under CENVAT Credit Rules, 2004 and ascertain therefrom the amount of credit on eligible inputs, input services and the capital goods and the amount utilised during the previous year. Records maintained in RG-23, wherever available should also be verified.

44.2 The tax auditor should verify that there is a proper reconciliation between balance of CENVAT credit in the accounts and relevant excise and service tax records. The tax auditor should report the amount of CENVAT availed and utilised under this sub-clause. In a given case CENVAT availed may be lesser than the CENVAT credit utilised during the year on account of opening balance in CENVAT account or vice-versa and as such it would be advisable, in order to avoid any misleading conclusion and inferences, to report the opening and closing balances of CENVAT. Further the sub-clause requires reporting of the credits availed of or utilized during the previous year, it is desirable to report both the credits availed and the credits utilized.

44.3 In so far as the reporting of accounting treatment of CENVAT credit is concerned the clause requires that its treatment in profit and loss account and the treatment of outstanding CENVAT credit in the account have to be reported upon.

44.4 Where the assessee follows exclusive method of accounting, the excise duty paid on purchase of raw material, capital goods and service tax paid on input services is debited to the CENVAT/ Service Tax Credit Receivable Account and not as part of the purchase cost of
raw material, capital goods or cost of input services. The credit utilized is debited to the Excise Duty/ Service Tax Payable A/c and credited to CENVAT/ Service Tax Credit Receivable Account. Thus, the credit availed and utilized will not have any impact on the profit and loss account.

44.5 The reporting requirement under clause 14(b) of Form No.3CD is a requirement distinct and separate from the reporting requirement under this clause. The tax auditor should verify that information furnished under this sub-clause is compatible with the information furnished under clause 14(b).

44.6 The tax auditor should consider the above guidance while reporting in the format provided in the e-filing utility with respect of this clause.

44.7 With regard to reporting of the amount of CENVAT credits availed or utilized during the previous year and its treatment in the profit and loss account wherever possible, it is advisable to give the details of the credit availed and utilized as separate line items.

44.8 With regard to reporting of the treatment of outstanding CENVAT Credits in the account, it is desirable to mention the opening and the closing outstanding balances in the CENVAT Credits accounts as separate line items. The account in which the outstanding amount is appearing should also be mentioned appropriately.

44.9 The tax auditor should maintain the following information in his working papers for the purpose of reporting in the format provided in the e-filing utility:

<table>
<thead>
<tr>
<th>CENVAT</th>
<th>Amount</th>
<th>Treatment in Profit &amp; Loss /Accounts</th>
</tr>
</thead>
<tbody>
<tr>
<td>Opening balance</td>
<td></td>
<td></td>
</tr>
<tr>
<td>CENVAT Availed</td>
<td></td>
<td></td>
</tr>
<tr>
<td>CENVAT utilized</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Closing/outstanding Balance</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

45. Clause 27(b)

45.1 It may be noted that information under this clause would be relevant only in those cases where the assessee follows mercantile system of accounting. Under cash system of accounting, expenses debited/ income credited to the profit and loss account would be current year’s expenses/income even though they may relate to earlier years. The tax auditor should obtain the particulars of expenditure or income of any earlier year debited or credited to the profit and loss account of the relevant previous year when mercantile system of accounting is followed. In the case of a person whose accounts of the business or profession have been audited under any other law, the information may be available from annual accounts. In the case of a person who carries on business or profession but who is not required by or under
any other law to get his accounts audited, however, a close scrutiny of the ledger in regard to
the period for which expenditure or income is entered in the account books may be necessary.

45.2 It may be noted that there is a difference between expenditure of any earlier year
debited to the profit and loss account and the expenditure relating to any earlier year, which
has crystallised during the relevant year. Material adjustments necessitated by circumstances
which though related to previous periods but determined in the current period, will not be
considered as prior period items.

45.3 In such cases, though the expenditure may relate to the earlier year, it can be
considered as arising during the year on the basis that the liability materialised or crystallised
during the year and such cases will not be reported under this clause. Similar consideration
will apply in relation to income also.

45.4 In AS - 5 as also in AS II notified by the Government under section 145, it has been
explained that material charges (expenses) or credits (income) which arise in the current year
as a result of errors or omissions in the accounts of the earlier years will be considered as
prior period items. In view of this, the statutory auditor would normally take into consideration
all items of prior period income and expenditure while giving his report on the financial
statements. It would, therefore, be advisable for the tax auditor to ascertain the circumstances
under which a particular expenditure has not been considered as a prior period expenditure.
If, on making the enquiries he comes to the conclusion that a particular item has to be treated
as prior period expenditure, he should disclose the same against this sub-clause.

45.5 The tax auditor should maintain the following information in his working papers file for
the purpose of reporting in the format provided in the e-filing utility:

<table>
<thead>
<tr>
<th>Sr. No.</th>
<th>Type</th>
<th>Particulars</th>
<th>Amount</th>
<th>Prior Period to which it relates (Year in yyyy-yy format)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
</tr>
</tbody>
</table>

46. Whether during the previous year the assessee has received any property, being
share of a company not being a company in which the public are substantially
interested, without consideration or for inadequate consideration as referred to in
section 56(2)(viia), if yes, please furnish the details of the same.

[Clause 28]

46.1 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 value of which exceeds rupees fifty
thousand, the whole of the aggregate fair market value of such property
III.304 Auditing Pronouncements

(ii) for a consideration which is less than the aggregate fair market value of the property by an amount exceeding fifty thousand rupees, 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”

46.2 Section 56(2)(viia) does not apply to the property received by way of a transaction not regarded as transfer under section 47(via), 47(vic), 47(vicb), 47(vid) and 47(vii). The fair market value of shares means the value determined in accordance with the method prescribed in rule 11UA of the Income-tax Rules, 1962.

46.3 Since section 56(2)(viia) is applicable to firms and companies in which public is not substantially interested, reporting under this clause is required only for them and not for other assesses. The auditor should obtain from the auditee, a list containing the details of shares received, if any, by him from any other company and verify the same from the books of accounts and other relevant documents. Such shares, if received will be reflected in the books of accounts either as investments or as stock in trade. In case such shares are received without consideration, the same may not be reflected in the books of accounts. Such shares may be verified from the relevant documents such as share certificates issued, if any, demat account statement etc. In either case, the same have to be reported under this clause. Attention is invited to the provisions of section 2(18) which defines the company in which public are substantially interested.

46.4 For reporting under this clause, the auditor has to consider the provisions of Rule 11UA(1)(c) which provides for manner of determining:

(a) fair market value of quoted shares and securities received by way of transaction carried out through any recognized stock exchange

(b) fair market value of quoted shares and securities received by way of transaction carried out OTHER THAN through any recognized stock exchange

(c) fair market value of unquoted equity shares

(d) fair market value of unquoted shares and securities other than equity shares in a company which are not listed in any recognized stock exchange

46.5 Where for determining the fair market value of unquoted shares and securities other than equity shares in a company which are not listed in any recognized stock exchange, a valuation report has been obtained by the assessee from a merchant banker or an accountant, the auditor should obtain a copy of the same. Here, attention is invited to the Standard on Auditing-620 “Using the work of an Auditor’s expert”.

46.6 The auditor should maintain the following information in his working paper file for the purpose of reporting in the format provided in the e-filing utility:-
### Guidance Notes

#### III.305

<table>
<thead>
<tr>
<th>Sr. No.</th>
<th>Name of the person from whom shares have been received</th>
<th>PAN of the person, if available</th>
<th>Name of shares (Quoted in RSE/URSE/unquoted shares etc)</th>
<th>Name of the Company whose shares received</th>
<th>CIN of the company</th>
<th>No. of Shares Received</th>
<th>Fair Market value as per Rule 11UA(1)(c)</th>
<th>Consideration paid</th>
<th>Amount taxable under section 56(2)(viia) (if the difference (e)-(f) exceeds Rs.50,000)</th>
<th>Remarks, if any</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a)</td>
<td>(b)</td>
<td>(c)</td>
<td>(d)</td>
<td>(e)</td>
<td>(f)</td>
<td>(g)</td>
<td>(h)</td>
<td>(i)</td>
<td>(j)</td>
<td>(k)</td>
</tr>
</tbody>
</table>

47. Whether during the previous year 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), if yes, please furnish the details of the same.

**[Clause 29]**

47.1 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”.

47.2 The provisions of this clause are not applicable where the consideration is received

- (a) by a venture capital undertaking from a venture capital company or a venture capital fund
- (b) by a company from a class or classes of persons as may be notified by the Central Government in this behalf.

47.3 As per the explanation to section 56(2)(viib), the fair market value shall be the value as may be determined in accordance with such method as prescribed under Rule 11UA or as may be substantiated by the company to the satisfaction of the Assessing Officer, based on the value, on the date of issue of shares, of its assets, including intangible assets being goodwill, know-how, patents, copyrights, trademarks, licences, franchises or any other business or commercial rights of similar nature, whichever is higher.

47.4 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 assessees. 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. Attention is invited to the provisions of section 2(18) which defines the company in which public are substantially interested.
III.306 Auditing Pronouncements

47.5 For reporting under this clause with respect to quoted shares, the auditor has to consider the provisions of Rule 11UA(1)(c)(a) which provides for manner of determining:

(a) fair market value of quoted shares and securities received by way of transaction carried out through any recognized stock exchange

(b) fair market value of quoted shares and securities received by way of transaction carried out OTHER THAN through any recognized stock exchange

47.6 For reporting under this clause with respect to unquoted equity shares, the auditor has to consider the provisions of Rule 11UA(2) which provides for manner of determining the fair market value of unquoted equity shares.

47.7 Where for determining the fair market value of unquoted equity shares, a valuation report has been obtained by the assessee from a merchant banker or an accountant, the auditor should obtain a copy of the same. Here, attention is invited to the Standard on Auditing-620 “Using the work of an Auditor’s expert”.

47.8 The auditor should maintain the following information in his working paper file for the purpose of reporting in the format provided in the e-filing utility:

<table>
<thead>
<tr>
<th>Sr No</th>
<th>Name and status of the person to whom shares have been issued</th>
<th>PAN of person, if available</th>
<th>Nature of shares (Quoted in RSE/Quoted in URSE/unquoted equity shares etc.)</th>
<th>No. of Shares issued</th>
<th>Consideration received</th>
<th>Fair Market value as per Rule 11UA(1)(c)/11UA(2)</th>
<th>Face value of shares issued</th>
<th>Amount taxable under section 56(2)(viib) (Report the difference (e)-(f), ONLY if (e) is greater than (g), else report “Not Applicable”)</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a)</td>
<td>(b)</td>
<td>(c)</td>
<td>(d)</td>
<td>(e)</td>
<td>(f)</td>
<td>(g)</td>
<td>(h)</td>
<td>(i)</td>
</tr>
</tbody>
</table>

48. Details of any amount borrowed on hundi or any amount due thereon (including interest on the amount borrowed) repaid, otherwise than through an account payee cheque. [Section 69D].

[Clause 30]

48.1 Details of the amount borrowed on hundi (including interest on such amount borrowed) and details of repayment otherwise than by an account payee cheque, are required to be indicated under this clause. In this context, a reference may also be made to Circular No.208 dated 15th November, 1976 and Circular No. 221 dated 6th June,1977 issued by Board explaining the provisions of section 69D - vide Appendix XIV (Page no. 275).
48.2 For this purpose, the tax auditor should obtain a complete list of borrowings and repayments of hundi loans otherwise than by account payee cheques and verify the same with the books of account.

48.3 There will be practical difficulties in verifying the loan taken or repaid on hundi by account payee cheque. In such cases, the tax auditor should verify the borrowing/repayments with reference to such evidence which may be available and in the absence of conclusive or satisfactory evidence or the auditor may obtain suitable certificate/ management representation in this regard.

48.4 The tax auditor should maintain the following information in his working papers for the purpose of reporting against the said clause in the format provided in the e-filing utility:

<table>
<thead>
<tr>
<th>Sr. No.</th>
<th>Name of the concerned person</th>
<th>PAN of (b) if available</th>
<th>Address of (b)</th>
<th>Amount borrowed</th>
<th>Date of borrowing</th>
<th>Amount due including interest</th>
<th>Amount repaid</th>
<th>Date of repayment</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a)</td>
<td>(b)</td>
<td>(c)</td>
<td>(d)</td>
<td>(e)</td>
<td>(f)</td>
<td>(g)</td>
<td>(h)</td>
<td>(i)</td>
</tr>
</tbody>
</table>

49. (a)* Particulars of each loan or deposit in an amount exceeding the limit specified in section 269SS taken or accepted during the previous year:

(i) name, address and permanent account number (if available with the assessee) of the lender or depositor;
(ii) amount of loan or deposit taken or accepted;
(iii) whether the loan or deposit was squared up during the previous year;
(iv) maximum amount outstanding in the account at any time during the previous year;
(v) whether the loan or deposit was taken or accepted otherwise than by an account payee cheque or an account payee bank draft.

*These particulars need not be given in the case of a Government company, a banking company or a corporation established by a Central, State or Provincial Act.

50. (b) Particulars of each repayment of loan or deposit in an amount exceeding the limit specified in section 269T made during the previous year:

(i) name, address and permanent account number (if available with the assessee) of the payee;
(ii) amount of the repayment;
(iii) maximum amount outstanding in the account at any time during the previous year;
(iv) whether the repayment was made otherwise than by account payee cheque or account payee bank draft.

51. (c) 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.

(The particulars (i) to (iv) at (b) and comment at (c) above need not be given in the case of a repayment of any loan or deposit taken or accepted from Government, Government company, banking company or a corporation established by a Central, State or Provincial Act.)

[Clause 31 (a), (b) and (c)]

49. Clause 31(a)

49.1 Section 269SS prescribes the mode of taking or accepting certain loans and deposits. As per this section, no person shall take or accept from any other person any loan or deposit otherwise than by an account payee cheque or account payee bank draft if,-

(a) the amount of such loan or deposit or the aggregate amount of such loan and deposit; or
(b) on the date of taking or accepting such loan or deposit, any loan or deposit taken or accepted earlier by such person from the depositor is remaining unpaid (whether repayment has fallen due or not), the amount or the aggregate amount remaining unpaid; or
(c) the amount or the aggregate amount referred to in clause (a) together with the amount or the aggregate amount referred to in clause (b), is twenty thousand rupees or more.

49.2 For the purposes of section 269SS "loan or deposit" means loan or deposit of money.

49.3 Particulars of each loan or deposit falling within the scope of this section as mentioned above taken or accepted during the previous year have to be stated under this sub-clause. This sub-clause requires five specific particulars in respect of each loan or deposit including the permanent account number of the lender, if available.

49.4 The tax auditor should obtain the above details from the assessee in respect of each loan or deposit and verify the same from the records maintained by him.

49.5 If the total of all loans/deposits from a person exceed Rs.20,000/- but each individual item is less than Rs.20,000/-, the information will still be required to be given in respect of all
such entries starting from the entry when the balance reaches Rs.20,000/- or more and until the balance goes down below Rs.20,000/-. As such the tax auditor should verify all loans/deposits taken or accepted where balance has reached Rs.20,000 or more during the year for the purpose of reporting under this clause.

49.6 There will be practical difficulties in verifying the loan or deposit taken or accepted by account payee cheque or an account payee bank draft. In such cases, the tax auditor should verify the transactions with reference to such evidence which may be available. In the absence of satisfactory evidence, the guidance given by the Council of the Institute of Chartered Accountants of India to the tax auditors has been to make a suitable comment in his report as suggested below.

“It is not possible for me/us to verify whether loans or deposits have been taken or accepted otherwise than by an account payee cheque or account payee bank draft, as the necessary evidence is not in the possession of the assessee”.

49.7 The tax auditor has to take into account the technological advancements in the field of banking and information technology where loans have been taken other than through an account payee cheque or bank draft which are capable of being tracked such as bank transactions made electronically through the internet or through mail transfer or telegraphic transfer. These types of payments, though not made by account payee cheques in the conventional manner are capable of being tracked. In order to judicially apply the provisions of section 269SS, the tax auditor need not report such cases under this clause. The Finance (No.2) Act, 2014 has acknowledged the fact and allowed the “use of electronic clearing system through a bank account” as a permissible mode for the purposes of section 269SS.

49.8 For the purposes of this clause, the tax auditor may keep in mind the following typical situations:

(i) Sale proceeds collected by the selling agent will not be considered as loan or deposit.

(ii) A current account is not excluded from the definition of the term “deposit”. Therefore, if the transactions in a current account exceed the amount of Rs.20,000/-, it will be necessary to give the information against this sub-clause. This is the position even if no interest is paid on current account.

(iii) When there is a mixed account, the transactions relating to loans and deposits (temporary advances) should be segregated from other accounts and the transactions relating to loans and deposits (including temporary advances) should be stated under this clause.

(iv) Advance received against agreement of sale of goods is not a loan or deposit.

(v) Opening credit balance of loan taken in earlier years is not specifically required to be disclosed. However, while giving figures of maximum amount outstanding at any time during the year or while giving information about acceptance and repayment of
III.310 Auditing Pronouncements

loan/deposit, the opening balances in the loan accounts will have to be taken into consideration.

(vi) Even if the loans are taken free of interest the information will still have to be given.

(vii) Security deposits against contracts, etc. will be covered by the definition of ‘deposit’ and therefore, such information will have to be given. However, the amount retained by the contractee against performance of contract will not be covered as loans/deposits for reporting as amount is not received.

(viii) Loans and deposits taken or accepted by means of transfer entries in the books of account constitute acceptance of deposits or loans otherwise than by account payee cheques. Hence, such entries have to be reported under this clause. The entries that relate to transactions with a supplier and customer on account of purchase or sale of goods/services will not be treated as loans or deposits accepted.

(ix) Share application money advance supported by appropriate documentation is neither deposit nor loan and subsequent allotment of shares or repayment of application money as a part of allotment process does not alter the character of application money and provision of Section 269SS/T are not attracted in such a case. Rugmini Ram Ragav Spinners P. Ltd. 304 ITR 417 Madras High Court and IP India P. Ltd. 343 ITR 353 and Numero Uno Financial Services P. Ltd. 345 ITR 84 Delhi High Court However, contrary view has been taken in Bhalotia Engineering Works (P) Ltd. 275 ITR 399

49.9 As per the proviso to section 269SS, the provisions of section 269SS shall not apply to any loan or deposit taken or accepted from, or any loan or deposit taken or accepted by,

(a) Government;
(b) any banking company, post office savings bank or co-operative bank;
(c) any corporation established by a Central, State or Provincial Act;
(d) any Government company as defined in section 2(45) of the Companies Act, 2013; Section 617 of the Companies Act, 1956 has been replaced with section 2(45) in the Companies Act, 2013 with effect from 1.4.2014.
(e) such other institution, association or body or class of institutions, associations or bodies which the Central Government may, for reasons to be recorded in writing, notify in this behalf in the Official Gazette.

49.10 The footnote in clause 31(a) states that the particulars required under this sub-clause need not be given in the case of a Government company, a banking company or a corporation established by a Central, State or Provincial Act. This is in accordance with the proviso to section 269SS mentioned above. As such, information about loans or deposits taken or accepted from or any loan or deposit taken or accepted by Government, banking company, etc. need not be reported under this sub-clause.
49.11 The auditor should maintain the following information in his working papers for the purpose of reporting against this clause in the format provided in the e-filing utility:

<table>
<thead>
<tr>
<th>Sr. No</th>
<th>Name of the lender or depositor</th>
<th>Address of the lender or depositor</th>
<th>PAN of the lender or depositor, if available</th>
<th>Amount of loan or deposit taken or accepted</th>
<th>Whether the loan/deposit was squared up during the previous year</th>
<th>Maximum amount outstanding in the account at any time during the Previous year</th>
<th>Whether the loan/deposit was taken or accepted otherwise than by an account payee bank cheque or account bank draft</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

These particulars need not be given in case of a Government Company, a banking company or a corporation established by a Central, State or Provincial Act.

50. Clause 31(b)

50.1 This sub-clause requires particulars of each repayment of loan or deposit in an amount exceeding the limits specified in section 269T made during the previous year. Section 269T after amendment by the Finance Act, 2002 w.e.f. 1.6.2002 is now applicable to repayment of both loans and deposits. Section 269T is attracted where repayment of the loan or deposit is made to a person, where the aggregate amount of loans or deposits held by such person either in his own name or jointly with any other person on the date of such repayment together with interest, if any, payable on such deposit is Rs.20,000 or more. Explanation (iii) contains a definition of the term “loan or deposit” for the purposes of section 269T. Accordingly, “loan or deposit” means any deposit of money which is repayable after notice or repayable after a period and, in the case of a person other than a company, includes loan or deposit of any nature. As such, all repayments made to any person where the loan or deposit along with interest is Rs.20,000 or more are to be reported under this sub-clause, even though the amount of repayment may be less than Rs.20,000. The tax auditor should verify such repayments and report accordingly.

50.2 The second proviso to section 269T inserted by the Finance Act, 2003 w.e.f. 1.6.2002 excludes repayments of loans taken from Government, Government company, Banking company, Corporation established by a Central, State or Provincial Act etc from the scope of the above section and therefore the tax auditor need not report such repayments in his report. However, section 269T does not exclude Government companies, banking companies from
III.312 Auditing Pronouncements

the scope of its applicability. As such, details of repayment are to be shown in the case of these entities also.

50.3 In the case of company assessee loan or deposit is defined to mean deposit repayable after notice or loan or deposit repayable after a period. Therefore, in case of a company loan or deposit repayable on demand will not be considered for the purpose of this section as loan or deposit.

50.4 However, in the case of non-company assessee loan or deposit is defined to mean loan or deposit of any nature. This distinction will have to be kept in mind while giving information under this sub-clause.

50.5 Loan or deposits discharged by means of transfer entries in the books of account constitute repayment of loan or deposits otherwise than by account payee cheques or account payee bank drafts. Hence, such entries have to be reported under this clause.

50.6 The tax auditor has to take into account the technological advancements in the field of banking and information technology where loans have been repaid other than through an account payee cheque of bank draft which are capable of being tracked such as bank transactions made electronically through the internet or through mail transfer or telegraphic transfer. These types of payments, though not made by account payee cheques in the conventional manner, are capable of being tracked. In order to judicially apply the provisions of section 269T, the tax auditor need not report such cases under this clause. The Finance (No.2) Act, 2014 has acknowledged the fact and allowed the “use of electronic clearing system through a bank account” as a permissible mode for the purposes of section 269T. The entries that relate to transactions with a supplier and customer on account of purchase or sale of goods/services will not be treated as loans or deposits repaid.

50.7 The monetary limit of Rs. 20,000 or more is applicable in respect of a banking company or a cooperative bank with reference to each branch and in all other cases assessee as a whole.

50.8 The auditor should maintain the following information in his working papers for the purpose of reporting against this clause in the format provided in the e-filing utility:

<table>
<thead>
<tr>
<th>Sr. No.</th>
<th>Name of the payee</th>
<th>Address of the payee</th>
<th>PAN of the payee, if available</th>
<th>Amount of loan or deposit taken or accepted</th>
<th>Amount of the repayment</th>
<th>Maximum amount outstanding in the account at any time during the Previous year</th>
<th>Whether the repayment was made otherwise than by an account payee bank cheque or account bank draft</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
<td>6</td>
<td>7</td>
<td>8</td>
</tr>
</tbody>
</table>
51 Clause 31(c)

51.1 Under this sub clause the tax auditor has to comment as to whether the taking or accepting loan or deposit, or repayment of the same through an account payee cheque or an account payee bank draft based on the examination of books of accounts & other relevant documents.

51.2 In the case of a repayment of any loan or deposit taken or accepted from Government, Government company, banking company or a corporation established by a Central, State or Provincial Act, the particulars (i) to (iv) mentioned in sub-clause (b) of clause 31 and also the comment mentioned above need not be given.

51.3 However, section 269T does not exclude loans repaid by Government companies, banking companies, corporation established by a Central, State or Provincial Act from the scope of its applicability. As such, details of repayment made by such entities are to be shown.

51.4 It may be noted that the new requirement should be made applicable for the loans and the advances which are in excess of Rs 20,000/-. This is evident from a harmonious reading of the clause (c) with the clauses (a) and (b).

51.5 Practically, it may not possible to verify each payment, reflected in the bank statement, as to whether the payment/ acceptance of deposits or loans has been made through account payee cheque, demand draft, pay order or not, it is thus desirable that the tax auditor should obtain suitable certificate from the assessee to the effect that the payments/ receipts referred to in section 269SS and 269T were made by account payee cheque drawn on a bank or account payee bank draft as the case may be. Where the reporting has been done on the basis of the certificate of the assessee, the same shall be reported as an observation in clause (3) of Form No. 3CA and clause (5) of Form No.3CB, as the case may be.

51.6 The tax auditor has to consider the above guidance while reporting against this clause in the format provided in the e-filing utility.

52. (a) Details of brought forward loss or depreciation allowance, in the following manner, to the extent available:

<table>
<thead>
<tr>
<th>Sl No.</th>
<th>Assessment year</th>
<th>Nature of loss/ allowance (in rupees)</th>
<th>Amount as returned (in rupees)</th>
<th>Amount as assessed (give reference to relevant order)</th>
<th>Remarks</th>
</tr>
</thead>
</table>

53. (b) whether a change in shareholding of the company has taken place in the previous year due to which the losses incurred prior to the previous year cannot be allowed to be carried forward in terms of section 79.
54. (c) whether the assessee has incurred any speculation loss referred to in section 73 during the previous year, if yes, please furnish the details of the same.

55. (d) whether the assessee has incurred any loss referred to in section 73A in respect of any specified business during the previous year, if yes, please furnish details of the same.

56. (e) In case of a company, please state that whether the company is deemed to be carrying on a speculation business as referred in explanation to section 73, if yes, please furnish the details of speculation loss if any incurred during the previous year.

[Clause 32(a) to (e)]

52. Clause 32(a)- Details of brought forward loss or depreciation allowance

52.1 The amount of brought forward loss or depreciation allowance is required to be quantified as per return and assessment orders.

52.2 A reporting format is prescribed for the sake of standardization.

52.3 At times while the particular claim for loss/allowance pertains to a particular assessment year as per the return of income, the same may relate to another assessment year as per the assessment order, e.g., Depreciation claim in respect of assets capitalized at the end of the financial year. In those cases, once the assessment order is received, the particulars have to be re-stated with reference to the assessment year to which they relate as per the assessment order. This should be accompanied by suitable explanation in the remarks column.

52.4 Brought forward losses may relate to different heads of income such as property income, profits and gains of business or profession, speculation business or capital gains. Different provisions are contained in sections 32 and 70 to 79 of the Income-tax Act with regard to loss/depreciation under different heads. In the remarks column information about the pending assessment or appellate proceedings or about delay in filing loss returns should be given. For giving the above information, the auditors should study the assessment records i.e. income-tax returns filed, assessment orders, appellate orders and rectification/revisional orders for the earlier years and ascertain if the figures given in the above clause are correct.

Attention of the members is invited to provisions of section 80 read with section 139(3) of the Income-tax Act, 1961. Section 80 provides that notwithstanding anything contained in Chapter VI of the Act, no loss which has not been determined in pursuance of a return filed in accordance with the provisions of sub-section (3) of section 139 shall be carried forward and set off under sub-section (1) of section 72 or sub-section (2) of section 73 or sub-sections (1) or (3) of section 74 or sub-section (3) of section 74A. Besides these, the tax auditor should keep in mind the provisions of section 71B regarding Carry Forward and Set Off of Loss From House Property, section 73A regarding Carry Forward and Set Off of Losses by Specified Business and also section 78 regarding Carry Forward and Set Off of Losses in case of Change in Constitution of Firm or on Succession.
52.5 Any assessment, rectification, revision or appeal proceedings pending at the time of tax audit have to be disclosed in the remarks column by way of information. If consequential orders for any revision/appellate order is yet to be passed, the same can be disclosed along with the impact thereof if material.

52.6 The e filing utility may require additional information regarding the relevant order. The information is required to be disclosed to the extent available. The tax auditor should consider the above guidance for the purpose of reporting under this clause in the format provided in the e-filing utility.

53. Clause 32(b)- Details of change in shareholding, if any

53.1 Section 79 of the Act provides that, notwithstanding anything contained in Chapter VI of the Act, in the case of a company, not being a company in which the public are substantially interested, where a change in shareholding has taken place in a previous year, then no loss incurred in any year prior to the previous year shall be carried forward and set off against the income of the previous year unless on the last day of that previous year and on the last day of the previous year in which the loss was incurred, the shares of the company carrying not less than 51% of the voting power were beneficially held by the same persons.

53.2 This provision shall not apply to a change in the voting power consequent upon:

(a) the death of a shareholder, or
(b) on account of transfer of shares by way of gifts to any relative of the shareholder making such gift.
(c) any change in the shareholding of an Indian company which is subsidiary of a foreign company arising as a result of amalgamation or demerger of a foreign company subject to the condition that 51 per cent of the shareholders of the amalgamating or demerged foreign company continue to remain the shareholders of the amalgamated or the resulting foreign company.

53.3 However, the overriding provisions of section 79 do not affect the set off of unabsorbed depreciation which is governed by section 32(2). [CIT v Concord Industries Ltd. (1979) 119 ITR 458 (Mad)], CIT v. Shri Subbulaxmi Mills Ltd. 249 ITR 795 (SC).

53.4 Sub-clause 32(b) requires a statement whether a change in shareholding of the company has taken place in the previous year due to which the losses incurred prior to the previous year cannot be allowed to be carried forward in terms of section 79.

53.5 The comparison of the composition of the shareholding is to be done with reference to the last day of the current previous year and the last day of every previous year in which the loss was incurred. The carry forward of the loss incurred in respect of different previous years is to be determined with respect to the individual previous years. Such comparison of the shareholding can be done by referring to the Register of Members.
54. Clause 32(c) – Speculation Loss under section 73 of the Income Tax Act:

54.1 Section 73 of the Act provides for the treatment of losses in speculation business. Section 73(1) provides that any loss, computed in respect of a speculation business carried on by the assessee, shall not be set off except against profits and gains, if any, of another speculation business.

54.2 Section 73(2) further provides that where for any assessment year any loss computed in respect of a speculation business has not been wholly set off under section 73(1), so much of the loss as is not so set off or the whole loss where the assessee had no income from any other speculation business, shall, subject to the other provisions of Chapter VI, be carried forward to the following assessment year, and-

(i) it shall be set off against the profits and gains, if any, of any speculation business carried on by him assessable for that assessment year; and

(ii) if the loss cannot be wholly so set off, the amount of loss not so set off shall be carried forward to the following assessment year and so on.

54.3 Section 73(3) provides that in respect of allowance on account of depreciation or capital expenditure on scientific research, the provisions of sub-section (2) of section 72 shall apply in relation to speculation business as they apply in relation to any other business.

54.4 Furthermore, section 73(4) provides that no loss shall be carried forward under this section for more than four assessment years immediately succeeding the assessment year for which the loss was first computed.

54.5 As per Explanation 2 to section 28.—Where speculative transactions carried on by an assessee are of such a nature as to constitute a business, the business (hereinafter referred to as "speculation business") shall be deemed to be distinct and separate from any other business.

54.6 As per section 43(5) “speculative transaction” means a transaction in which a contract for the purchase or sale of any commodity, including stocks and shares, is periodically or ultimately settled otherwise than by the actual delivery or transfer of the commodity or scrips:

Provided that for the purposes of this clause—

(a) a contract in respect of raw materials or merchandise entered into by a person in the course of his manufacturing or merchanting business to guard against loss through future price fluctuations in respect of his contracts for actual delivery of goods manufactured by him or merchandise sold by him; or

(b) a contract in respect of stocks and shares entered into by a dealer or investor therein to guard against loss in his holdings of stocks and shares through price fluctuations; or
Part-III: Guidance Notes

III.317

(c) a contract entered into by a member of a forward market or a stock exchange in the course of any transaction in the nature of jobbing or arbitrage to guard against loss which may arise in the ordinary course of his business as such member; or

(d) an eligible transaction in respect of trading in derivatives referred to in clause (ac) of section 2 of the Securities Contracts (Regulation) Act, 1956 (42 of 1956) carried out in a recognised stock exchange; or

(e) an eligible transaction in respect of trading in commodity derivatives carried out in a recognised association, which is chargeable to commodities transaction tax under Chapter VII of the Finance Act, 2013,

shall not be deemed to be a speculative transaction.

54.7 Having regard to the definition of “speculative Business”, the tax auditor has to verify from the books of account and other relevant documents as to whether the assessee is carrying on any speculation business. On verification if the auditor is of the opinion that the auditee is carrying on speculation business, under this clause, the tax auditor has to furnish the details regarding speculation loss referred to in section 73, if any incurred by the assessee during the previous year. Attention is invited to Para 16.3(b) of this Guidance Note.

54.8 The tax auditor should maintain the following information in his working papers for the purpose of reporting against this clause in the format provided in the e-filing utility:

<table>
<thead>
<tr>
<th>S. No.</th>
<th>Nature of loss</th>
<th>Amount of loss for the current year</th>
<th>Brought forward loss of the earlier year(s)</th>
<th>Total loss to be carried forward to the subsequent year</th>
<th>Break-up of the speculation loss in terms of the number of years for which it has been carried forward</th>
<th>Whether the speculation loss has been set off against any other income other than profit &amp; loss, if any, of speculation business</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

55. Clause 32(d) – Details of Losses incurred in respect of a Specified business as referred to under section 73A

55.1 Section 73A provides for provisions relating to carry forward and set off of losses by specified business. It provides that any loss, computed in respect of any specified business referred to in section 35AD shall not be set off except against profits and gains, if any, of any other specified business.

55.2 Section 73A(2) provides that where for any assessment year any loss computed in respect of the specified business referred to in sub-section (1) has not been wholly set off...
under sub-section (1), so much of the loss as is not so set off or the whole loss where the 
assessee has no income from any other specified business, shall, subject to the other 
provisions of this Chapter, be carried forward to the following assessment year, and—

(i) it shall be set off against the profits and gains, if any, of any specified business carried 
on by him assessable for that assessment year; and

(ii) if the loss cannot be wholly so set off, the amount of loss not so set off shall be carried 
forward to the following assessment year and so on.]

55.3 Under clause 32(d), the tax auditor has to verify from the books of accounts and other 
relevant documents as to whether the assessee is carrying on specified business as referred 
to under section 35AD. In case the auditor is of the opinion that the assessee is carrying on 
such specified business, he has to furnish the details of the loss incurred, if any, in respect of 
any specified business during the previous year. In case the assessee carries on more than 
one specified businesses and loss has been incurred in both the business, the details of the 
loss incurred with respect of each business is to be specified separately.

55.4 The tax auditor should maintain the following information in his working papers for the 
purpose of reporting against this clause in the format provided in the e-filing utility:

<table>
<thead>
<tr>
<th>Sr. No.</th>
<th>Nature of specified business</th>
<th>Amount of loss incurred, if any, during the previous year, with regard to the specified business mentioned in (b)</th>
<th>Loss from specified business brought forward from the earlier year</th>
<th>Amount of loss being set off against other specified business</th>
<th>Year of loss</th>
<th>Amount of loss being carried forward to the next assessment year ((c) – (d))</th>
<th>Whether loss set off against any other income other than from specified business as per sec. 35AD of the Act.</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a)</td>
<td>(b)</td>
<td>(c)</td>
<td>(d)</td>
<td>(e)</td>
<td>(f)</td>
<td>(g)</td>
<td>(h)</td>
</tr>
</tbody>
</table>

56. Clause 32(e) – Details of speculation loss, if any, incurred from deemed Speculation business as referred to in Explanation to section 73:

56.1 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. The Finance Act, 2014 has
amended the explanation to section 73 by deleting the words “the principal business of which is the business of trading in shares” from financial year 2014-2015.

56.2 Under this clause, the tax auditor has to furnish the details regarding the speculation losses incurred, if any, as referred in explanation to section 73. The auditor may obtain information in the following format from the assessee and verify the same from the books of account, income tax returns of earlier years and other relevant documents:

<table>
<thead>
<tr>
<th>Sr No</th>
<th>Applicable section</th>
<th>Nature of loss</th>
<th>AY of incurring loss</th>
<th>Amount of Loss</th>
<th>Amount set off during current AY</th>
<th>Amount to be carried forward</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

56.3 The above information so maintained may be used by the tax auditor for the purpose of reporting against this clause in the format provided in the e-filing utility.

57. Section-wise details of deductions, if any, admissible under Chapter VIA or Chapter III (Section 10A, Section 10AA).

<table>
<thead>
<tr>
<th>Section under which deduction is claimed</th>
<th>Amounts admissible as per the provision of the Income Tax Act, 1961 and 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.</th>
</tr>
</thead>
</table>

57.1 Chapter VIA of the Act deals with various deductions which have to be given effect to by way of allowance from gross total Income of the assessee and they have been categorised under the Act as follows:

A. Deduction in respect of certain payments.
B. Deduction in respect of certain incomes.
C. Other Deductions.

While Chapter III relates to Income which do not form part of total income, the reporting under this clause is required only with respect to exemptions claimed under section 10A (Special provisions in respect of newly established undertakings in free trade Zone etc) and section 10AA (Special provisions in respect of newly established units in Special Economic Zones)
As stated earlier, the tax audit report in Form No.3CA/3CB relates to business or professional activity of the assessee covered by section 44AB. Form No.3CD is an annexure to this Form giving particulars relating to the business/profession covered by the tax audit report. Therefore, the requirement under clause 33 relating to the deductions admissible under Chapter VIA, section 10A and section 10AA will have to be with reference to the items appearing in the books of accounts audited by the tax auditor. If the tax auditor is issuing tax audit report in respect of the accounts of a specific branch or a specific unit he will have to examine the particulars relating to deduction admissible under Chapter VIA and exemption relating to section 10A/10AA, as the case may be, with reference to the books of account of that branch or that unit which is audited by him. Similarly when the tax auditor is issuing report regarding tax audit of the head office he will have to take into consideration the tax audit reports of the branches as well as other units of the assessee which may have been audited by the other tax auditors. He will have to consider the particulars of deductions admissible under Chapter VIA and exemption relating to section 10A/10AA, as the case may be with reference to the particulars given by the tax auditor of other branches/units and also particulars of such deductions from books of the head office.

In the case of a sole proprietor being an individual or HUF it may so happen that the tax auditor is auditing the accounts of the business/profession and the sole proprietor is having other activities and other sources of income in respect of which tax audit is not mandatory. In such cases the particulars of deductions admissible under Chapter VIA will have to be given with reference to the items appearing in the books of accounts of the business/profession which is subject to audit under section 44AB.

The admissibility of the aforesaid deductions/exemptions is dependent upon various conditions laid down in the section under which deduction/exemption is admissible. It is, therefore, advised that while working out the amount of admissible deduction the tax auditor has to ascertain that those condition stand fulfilled or not. For ascertaining this, the tax auditor has to obtain all necessary evidence which would enable him to express the opinion regarding the admissibility of deductions. For example, under section 80IA one of the conditions is that the new Industrial undertaking which qualifies for deduction thereunder should not have been formed by splitting up or by the reconstitution of a business already in existence or by transfer to a new business of machinery or plant previously used for any purpose. In order to ascertain the fulfillment of this condition the tax auditor may have to check all documentary evidence in respect of plant and machinery installed in the industrial undertaking to arrive at the conclusion that plant and machinery is new and has not been used previously for any other purpose. Likewise if there is any condition which qualifies the admissibility of the amount of deduction, the tax auditor has to see and ascertain that those qualifying conditions are fulfilled on the basis of documentary evidence available with the assessee. There may be cases where there is difference between the amount claimed by the assessee and the amount computed out by the tax auditor. In such cases it is quite possible that the client's claim is based on some judicial pronouncement on the subject. In such case it may be advisable for the tax auditor to report the amount admissible. The amount claimed and the background
behind and the basis of the claim of the assessee may form part of the working papers. If the claim of the assessee is well-founded and settled by judicial pronouncement the tax auditor may accept the claim but he has to record in his working papers that admissible amount has been reported on the basis of such judicial pronouncement.

57.5 It may be noted that there are certain sections under Chapter VIA like section 80-IA, 80-IB, 80-JJA etc. where separate audit report or certificate is required to be issued. Under the said sections, a non-corporate assessee who has income from industrial undertaking covered under the above sections has also to obtain audit report with reference to the accounts of these undertakings. While giving information with regard to the deduction allowable under these sections the tax auditor should refer to separate audit reports/certificates obtained by the assessee. These audit reports/certificates may have been given by the tax auditor or by any other auditor. The figures given in this separate audit reports/certificates should be taken into consideration while giving information with regard to income covered by these sections.

57.6 Since the details of exemptions admissible under sections 10A and 10AA are also to be reported in the desired format, the said information can be verified from the certificate issued by the chartered accountant in this regard. In case, a report under section 10A and 10AA has been issued by any other chartered accountant, then the same may be taken into consideration while reporting under this clause. Here attention is invited to SA-600, Using the work of another auditor.

57.7 Some sections in Chapter VIA such as section 80-G (donations), Section 80-GGB/80-GGC (contributions to political parties), section 80-JJAA (wages of new workmen) etc. relate to the expenditure incurred by an assessee. There are other sections such as section 80-P (income of co-operative societies), 80-JJA (certain specified business relating treatment of biodegradable waste) etc. which relate to income of the assessee. In respect of all these sections the tax auditor should ascertain whether there is any expenditure or income covered by the above sections recorded in the books of accounts audited by him. Information with regard to such expenditure/income in respect of deduction allowable under Chapter VIA should be given on the basis of the examination of the books of account and other records under clause 33.

58. (a) Whether the assessee is required to deduct or collect tax as per the provisions of Chapter XVII-B or Chapter XVII-BB, if yes please furnish:

<table>
<thead>
<tr>
<th>Tax deduction and collection Account Number (TAN)</th>
<th>Section</th>
<th>Nature of payment</th>
<th>Total amount of payment or receipt of the nature specified in column (3)</th>
<th>Total amount on which tax was required to be deducted or collected out of (4)</th>
<th>Total amount on which tax was deducted or collected at specified rate out of (5)</th>
<th>Amount of tax deducted or collected out of (6)</th>
<th>Total amount on which tax was deducted or collected at less than specified rate out of (7)</th>
<th>Amount of tax deducted or collected on (8)</th>
<th>Amount of tax deducted or collected not deposited to the credit of the Central Government out of **(6) and *<strong>(8)</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>(1)</td>
<td>(2)</td>
<td>(3)</td>
<td>(4)</td>
<td>(5)</td>
<td>(6)</td>
<td>(7)</td>
<td>(8)</td>
<td>(9)</td>
<td>(10)</td>
</tr>
</tbody>
</table>

*Should be read as (5) for proper reporting
III.322 Auditing Pronouncements

** Should be read as (7) for proper reporting
*** Should be read as (9) for proper reporting

59. (b) Whether the assessee has furnished the statement of tax deducted or tax collected within the prescribed time. If not, please furnish the details:

<table>
<thead>
<tr>
<th>Tax deduction and collection Account Number (TAN)</th>
<th>Type of Form</th>
<th>Due date for furnishing</th>
<th>Date of furnishing, if furnished</th>
<th>Whether the statement of tax deducted or collected contains information about all transactions which are required to be reported</th>
</tr>
</thead>
</table>

60. (c) whether the assessee is liable to pay interest under section 201(1A) or section 206C(7). If yes, please furnish:

<table>
<thead>
<tr>
<th>Tax deduction and collection Account Number (TAN)</th>
<th>Amount of interest under section 201(1A)/206C(7) is payable</th>
<th>Amount paid out of column (2) along with date of payment.</th>
</tr>
</thead>
</table>

[Clause 34(a), (b) and (c)]

58. Clause 34(a)

58.1 While reporting under this clause the tax auditor may exercise his judgement in the light of the applicable laws and report accordingly about the applicability of the provisions of Chapter XVII-B or XVII-BB with regard to the auditee. The tax auditor may rely upon the judicial pronouncements while taking any particular view. While answering the issue of applicability of the provisions of Chapter XVII-B and/or XVII-BB, a number of debatable issues may arise before the assessee as well as the tax auditor. Where it is not possible to say yes/no, the answer to the question may have to be qualified depending upon the facts and circumstances of each case. Having verified the applicability of the provisions of Chapter XVII-B and Chapter XVII-BB, the tax auditor should answer the question as “Yes” and thereafter provide further details. Where the tax auditor is of the opinion that provisions of Chapter XVII-B and Chapter XVII-BB are not applicable he should answer the question as “No”.

© The Institute of Chartered Accountants of India
58.2 Once the tax auditor gives his affirmation with regard to applicability of the provisions of Chapter XVII-B and/or Chapter XVII-BB, he is required to furnish further details in Clause 34(a). The auditor should obtain a copy of the TDS/TCS returns filed by the assessee which shall form the basis of reporting under this clause, to the extent possible. Further, in view of the voluminous nature of the transactions, the tax auditor can apply test checks and compliance tests on the transactions reported in the TDS return by the assessee for verifying the information required to be provided under this clause.

58.3 Column (1) of Clause 34(a) requires reporting of each Tax deduction and collection Account number with regard to which tax has been deducted or collected at source.

58.4 In column (2), the tax auditor is required to furnish the details of the applicable section in respect to which tax has been deducted or collected at source.

58.5 In column (3), the tax auditor is required to furnish the details regarding the nature of payment.

58.6 In column (4), the auditor is required to furnish the details of the total amount of payment or receipt of the nature specified in column (3). The details in the said column may be drawn from the TDS/TCS statements furnished by the assessee to the Department along with the books of accounts and other relevant documents which include aggregate of payments on which tax is liable to be deducted as well as not liable to be deducted. Auditor may maintain working paper giving reconciliation of amount as per books of accounts and amount on which is TDS/TCS is required to be deducted/collected.

58.7 Column (5) casts an onerous responsibility on the auditor, wherein he is required to furnish the details of total amount on which the tax was required to be deducted or collected out of the amount mentioned in column (4) having regard to the nature of payments/receipts under the relevant sections of Chapter XVII-B/XVII-BB. Since the reporting under column (4) is required to be made with regard to the nature of payments made or amount received, there may be a difference in the amounts reported under column (4) and column (5). The reasons for difference may be applicability of certificates issued under section 195/197 or threshold limits provided in specific sections or difference of opinion with regard to applicability of a particular section and the like.

58.8 While answering the issue of applicability of the provisions of Chapter XVII-B and/or XVII-BB, a number of debatable issues may arise before the assessee as well as the tax auditor. The auditor may have a difference of opinion with regard to the applicability of the provisions of TDS/TCS on a particular payment. In such a case, the tax auditor has to bring the difference of opinion appropriately as an observation in the clause (3) of Form No. 3CA or clause (5) of Form No.3CB as the case may be.

58.9 It is essential to note that it is the primary responsibility of the assessee to prepare the information in such a manner that the tax auditor can verify the compliance as required in the new clause. The tax auditor is required to verify that no items have been omitted in the
information furnished to him and reasonable test checks would reveal whether or not the information furnished is correct. The extent of check undertaken would have to be indicated by the tax auditor in his working papers and audit notes. The tax auditor would be well advised to so design his tax audit programme as would reveal the extent of checking and to ensure adequate documentation in support of the information being certified.

58.10 In column (6) the tax auditor is required to furnish the total amount out of the amount deductible or collectible as mentioned in column (5) at which the tax was deducted or collected at the specified rate. The auditor has to consider the rates of deduction as per the law relevant to the previous year. Further, as per the provisions of sections 195/197 certificate can be issued for no deduction or lower deduction of tax at source. The tax auditor should refer to the relevant provisions, rules, circulars, notifications and such certificates obtained from the auditee to verify the cases where tax has been short deducted at source. In case the payer deducts/recipient collects tax at source at a rate lower than the specified rate on the basis of certificate issued under section 195 or 197, the lower rate or nil rate, as the case may be will be considered as the specified rate for the purpose of reporting under this clause. In the case of payment to non-residents the applicable rate of tax deduction at source is to be read along with the Double Taxation Avoidance Agreement. Column (7) requires furnishing of total amount of tax deducted/collected out of the amount furnished in column (6).

58.11 Similarly, column (8) requires the tax auditor to furnish the total amount out of the amount deductible or collectible as mentioned in column (5) at which the tax was deducted or collected at the rate less than the specified rate. The lesser deduction is required to be reported in this clause. This will include deduction at a lower rate than what is prescribed, application of wrong section for deduction of tax at source, etc. For example section 194C requires deduction @2% in case payment is made to a person other than individual or HUF, but the deductor deducts only 1%, the same has to be reported under this clause. In case there is difference of opinion with regard to rate of deduction or applicability of a particular section, the auditor may appropriately report the difference of opinion in the clause (3) of Form No. 3CA or clause (5) of Form No.3CB as the case may be giving both the views. Further, column (9) requires furnishing of total amount of tax deducted/collected out of the amount furnished in column (8).

58.12 Column (10) requires the auditor to furnish the details of the amount of tax deducted or collected but not deposited to the credit of the Central Government. As such the tax auditor should verify the cases where the tax has been deducted at source but not paid to the credit of the Central Government till the date of the audit. It may be seen that tax deducted but deposited late will not be required to be reported in this clause.

58.13 The details in the column (6), (7), (8), (9) and (10) may be drawn from the TDS/TCS returns furnished by the assessee to the Department and be verified from the books of accounts and other relevant documents.
59. Clause 34(b)

59.1 Under clause 34(b), the tax auditor has to ascertain and report as to whether the assessee has furnished the statement of tax deducted or tax collected at source within the prescribed time. If all the TDS/TCS statement(s) relating to the previous year have been filed within the prescribed time, the auditor has to mention “yes”. In case the assessee has not filed any of the quarterly TDS/TCS statement(s) within the prescribed time, the auditor has to mention “No” in this clause. In such a case, the auditor shall provide further details in Clause 34(b) only with regard to the statement not filed within the prescribed time. Clause 34(b) requires the auditor to report the transactions with regard to each TAN for which tax has been deducted but the return has either not been filed or has been filed after the expiry of the prescribed time. With regard to each TAN, the auditor is required to mention the “Type of form” that was applicable like Form 24, 24G, 24Q, 26, 26A, 26B, 26Q etc, due date of furnishing such statement and the actual date of furnishing, if the statement(s) has been furnished. Lastly, the auditor is required to state as to whether the statement of tax deducted or collected, which has been furnished beyond prescribed time contains information about all the transactions which are required to be reported. As stated earlier, it is extremely difficult for the tax auditor to verify each and every transaction in this regard. Therefore, while verifying such transactions, the tax auditor can apply the concepts of materiality and audit sampling. The reporting requirement in clause (b) arises only where the assessee has either not furnished or furnished the statement of tax deducted or tax collected after the expiry of prescribed time.

59.2 In regard to clause 34(b), the tax auditor has to verify the particulars regarding tax deductible and tax collectible from the information furnished by the assessee. The various provisions of Chapter XVII-B and XVII-BB require different classes of assessees to deduct/collect tax at source on various nature of payments. The tax auditor should consider the applicability of the different provisions relating to tax deduction at source taking into consideration the status of the assessee and the applicability of the relevant provision. As regards the applicability of the provisions the tax auditor should take into consideration the relevant sections, rules, notifications, circulars and various judicial pronouncements in relation to transactions of relevant payments or collections. There may be occasions when the tax auditor may not agree with the interpretation/view taken by the auditee. In such cases the tax auditor may report both the views as an observation in clause (3) of Form No. 3CA or clause (5) of Form No. 3CB, as the case may be.

59.3 The information given in clause 34 should tally with the disallowances reported u/s 40(a) in clause 21(b) to the extent applicable.

60. Clause 34(c)

60.1 Under this clause, the auditor is required to furnish detailed information in case the assessee is liable to pay interest under section 201(1A) or section 206C(7) of the Act. Section 201(1A) provides for payment of interest at a specified rate in case the tax has not been deducted wholly or partly or after deducting has not been paid to the credit of Central
III.326 Auditing Pronouncements

Government as required by the Act. Similarly, section 206C(7) provides for payment of interest at a specified rate in case the tax is not collected wholly or partly or if collected not paid to the credit of the Central Government as required by the Act. The reporting as to whether the assessee is liable to pay such interest, should be in consonance with the reporting under clause 34(a) where the details of non-deduction are required to be reported by him.

60.2 Where the assessee is liable to pay interest u/s 201(1A) or 206C(7), the auditor should verify such amount from the books of account as on 31st March of the relevant previous year and also from PART G of the statement generated by the Department in Form No.26AS. In case the assessee had disputed the levy or calculation of interest under TRACES, in Form No.26AS, the auditor may re-calculate the amount of interest under section 201(1A) or section 206C(7) up to the date of audit report for reporting under this clause and also mention the fact in his observations paragraph provided in Form No.3CA or Form No.3CB, as the case may be.

61. (a) In the case of a trading concern, give quantitative details of the principal items of goods traded:
   (i) Opening stock;
   (ii) Purchases during the previous year;
   (iii) Sales during the previous year;
   (iv) Closing stock;
   (v) shortage / excess, if any.

62. (b) In the case of a manufacturing concern, give quantitative details of the principal items of raw materials, finished products and by-products:
   A. Raw materials:
      (i) opening stock;
      (ii) purchases during the previous year;
      (iii) consumption during the previous year;
      (iv) sales during the previous year;
      (v) closing stock;
      (vi) yield of finished products;
      (vii) percentage of yield;
      (viii) shortage/excess, if any.
   B. Finished products/By-products:
      (i) opening stock;
      (ii) purchases during the previous year;
Part-III: Guidance Notes

(iii) quantity manufactured during the previous year;
(iv) sales during the previous year;
(v) closing stock;
(vi) shortage/excess, if any.

[Clause 35 (a) and (b)]

61. Clause 35(a)

61.1 The tax auditor should obtain certificates from the assessee in respect of the principal items of goods traded, the balance of the opening stock, purchases, sales and closing stock and the extent of shortage/excess/damage and the reasons thereof.

62. Clause 35(b)

62.1 This information should be given only in respect of those items where it is practicable to do so, having regard to the records maintained by the assessee.

62.2 In a large concern it may be difficult for tax auditor to verify each and every item of purchase, consumption and production. In such cases, he may verify the figures on a sampling method and satisfy himself as to the correctness of the figures furnished. This clause requires that quantitative details of “principal items” of raw materials and finished goods should be given. Therefore, information about petty items need not be given. What would constitute principal items will depend on the facts of each case. Normally, items which constitute more than 10% of the aggregate value of purchases, consumption or turnover may be classified as principal items.

62.3 The information about ‘yield’, ‘percentage of yield’, and ‘shortages/excess’ is also required to be given.

62.4 In respect of assessees other than companies and those whose accounts have not been audited under any other law, the tax auditor should obtain the following certified documents for the principal items of raw materials, finished goods and by-products:

(a) Certificate from the assessee certifying the balance of the opening stock, purchases, sales and closing stock.

(b) Certificate to the extent of shortage/excess/damage and the reasons thereof.

62.5 By-products represent products whose manufacture results incidentally from the manufacture of the main product or where the waste arising in the manufacture of main product is further processed to create a by-product. Where the by-product so produced or is continuously generated it should be treated for the purpose of sale and disposal at par with any other product produced by the company and similar records should be maintained. The quantitative details on the above lines are to be given in respect of by-product also.
63. In the case of a domestic company, details of tax on distributed profits under section 115-O in the following form:—

(a) total amount of distributed profits;
(b) amount of reduction as referred to in section 115-O(1A)(i);
(c) amount of reduction as referred to in section 115-O(1A)(ii);
(d) total tax paid thereon;
(e) dates of payment with amounts.

[Clause 36]

63.1 Section 115-O provides for a special levy at the prescribed rate, on the amount of dividend declared, distributed or paid by such company whether such dividend is out of current profit or accumulated profits. Vide this clause the tax auditor has to report on profit distributed during the financial year and therefore, the amount of tax worked and paid out on such distributed profit at the prescribed rate plus surcharge at the applicable rate on the tax along with the education cess thereon has to be reported against this clause. The amount of the dividend referred to in sub-section (1) is to be reduced by the amount referred to in sub-section (1A). Since the tax is payable on such reduced amount, the gross amount may be reported in the sub-clause (a) and the amount of reduction as referred to in section 115-O(1A)(i) and 115-O(1A)(ii) shall be reported in sub-clause (b) and (c) separately. The tax auditor should keep the working papers to reveal how the net amount has been arrived at.

63.2 It may be noted that for the purposes of chapter XII-D containing special provisions relating to tax on distributed profits of domestic companies the expression “dividends” shall have the same meaning as is given to “dividend” in clause (22) of section 2 but shall not include sub-clause (e) thereof. However, the tax auditor need not go into the question of how the total amount of distributed profits has been arrived at.

63.3 The next requirement is to report the tax paid thereon and the date of payment. The date of payment of tax can be ascertained by the tax auditor from the duly received challan and books of account etc.

63.4 In this clause, the total amount of profits distributed in the previous year, tax paid thereon and the date of payment of tax is required to be given. Information about the date of declaration/distribution of dividend or payment of dividend is not required to be given.

63.5 The tax auditor should maintain the information in the following format for the purpose of reporting in the format provided in the e-filing utility:
### Part-III: Guidance Notes

#### III.329

<table>
<thead>
<tr>
<th>S. No.</th>
<th>Total Amount of distributed profits</th>
<th>Amount of reduction as referred to in section 115-O(1A)(i)</th>
<th>Amount of reduction as referred to in section 115-O(1A)(ii)</th>
<th>Total tax paid</th>
<th>Date of payments with Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

64. **Whether any cost audit was carried out, if yes, give the details, if any, of disqualification or disagreement on any matter/item/value/quantity as may be reported/identified by the cost auditor**  
   
   **[Clause 37]**  

64.1 The tax auditor should ascertain from the management whether cost audit was carried out and if yes, a copy of the same should be obtained 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.

64.2 In cases where cost audit which might have been ordered is not completed by the time the tax auditor issues his report, he has to report appropriately in this report stating that since cost audit is not completed and the cost audit report is not available with the assessee.

64.3 The tax auditor should examine the time period for which the cost audit if any has been required to be carried out. Information is required to be given only in respect of such cost audit report the time period of which falls within the relevant previous year. In effect the information is required to be given in respect of that cost audit report which is received upto the date of tax audit report.

65. **Whether any audit was conducted under the Central Excise Act, 1944, if yes, give the details, if any, of disqualification or disagreement on any matter/item/value/quantity as may be reported/identified by the auditor**  
   
   **[Clause 38]**  

65.1 The tax auditor should ascertain from the management whether any audit was conducted under the Central Excise Act, 1944 and if such audit was carried out, obtain a copy of the report. Even though the tax auditor is not required to make any detailed study of such report, he has to take note of the details if any, of disqualification or disagreement on any matter/item/value/quantity as may be reported/identified by the 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.
III.330  Auditing Pronouncements

65.2 In cases where excise audit which might have been ordered is not completed by the time the tax auditor gives his report, he has to report appropriately in this report stating that since excise audit is not completed and the excise audit report is not available with the assessee.

65.3 The tax auditor should examine the time period for which the excise audit, if any, has been required to be carried out. Information is required to be given only in respect of such excise audit report the time period of which falls within the relevant previous year. In effect the information is required to be given in respect of that excise audit report which is received upto the date of tax audit report.

66. Whether any audit was conducted under section 72A of the Finance Act, 1994 in relation to valuation of taxable services, if yes, give the details, if any, of disqualification or disagreement on any matter/item/value/quantity as may be reported/identified by the auditor.

66.1 The tax auditor should ascertain from the management whether any audit was conducted under section 72A of the Finance Act, 1994 and if such audit was carried out, obtain a copy of the report. 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 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.

66.2 In cases where service tax audit, which might have been ordered is not completed by the time the tax auditor gives his report, he has to report appropriately in this report stating that since service tax audit is not completed and the service tax audit report is not available with the assessee.

66.3 The tax auditor should examine the time period for which the service tax audit, if any, has been required to be carried out. Information is required to be given only in respect of such service tax audit report the time period of which falls within the relevant previous year. In effect the information is required to be given in respect of that service tax audit report which is received upto the date of tax audit report.

67. Details regarding turnover, gross profit, etc., for the previous year and preceding previous year:

<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 assessee</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></td>
<td>Stock-in-trade/turnover</td>
<td></td>
<td></td>
</tr>
<tr>
<td>---</td>
<td>------------------------</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)

[Clause 40]

67.1 These ratios have to be calculated only for assessees who are engaged in manufacturing or trading activities. Moreover, the ratios have to be given for the business as a whole and need not be given product wise. Further, the ratio mentioned in (5) need not be given for trading concern or service provider.

67.2 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 this clause are to be calculated in terms of value only.

67.3 The following definitions given by the ICAI in its Guidance Note on the Terms Used in Financial Statements may be noted.

(a) **Gross Profit**: The excess of the proceeds of goods sold and services rendered during a period over their cost, before taking into account administration, selling, distribution and financing expenses. When the result of this computation is negative it is referred to as gross loss.

(b) **Turnover**: The aggregate amount for which sales are effected or services rendered by an enterprise. The terms gross turnover and net turnover (or gross sales and net sales) are sometimes used to distinguish the sales aggregate before and after deduction of returns and trade discounts. Attention is also invited to Para 5 (Sales, Turnover, Gross receipts) of this Guidance Note.

(c) **Net Profit**: The excess of revenue over expenses during a particular accounting period. When the result of this computation is negative, it is referred to as net loss. The net profit may be shown before or after tax.

It may be noted that the net profit to be shown here in this clause is net profit before tax.

67.4 For the purpose of calculating the ratio mentioned in (4), only closing stock is to be considered. The term “stock-in-trade” used therein does not include stores and spare parts or loose tools. The term “stock-in-trade” would include only finished goods and would not include the stock of raw material and work-in-progress since the objective here is to compute the stock-turnover ratio.

67.5 Material consumed would, apart from raw material consumed, include stores, spare parts and loose tools.
67.6 The value of finished goods produced may be arrived at by using the following formula:

(a) Raw material consumption -
(b) Stores and spare parts consumption -
(c) Wages -
(d) Other manufacturing expenses excluding depreciation -

Sub total -

Add: Opening stock in process -

Deduct: Closing stocks in process -

Value of finished goods produced

67.7 Under this clause, calculation of the ratios are also to be stated. As such, computation of various components based upon which these ratios have been worked out is required to be stated under this clause. However, if any of the above component is stated in the financial statements themselves, a reference to the same may be made, to the extent possible.

67.8 There should be consistency between the numerator and the denominator while calculating the above ratios. Any significant deviation thereof should be pointed out.

67.9 The relevant previous year figures are to be taken from last previous year audit report. In case the preceding previous year is not subject to audit, nothing should be mentioned in the relevant column.

68. Please 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.

[Clause 41]

68.1 The auditee may be assessed under various tax laws other than Income-tax Act, 1961 and Wealth-tax Act, 1956 resulting into a demand order or a refund order. 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. Normally, the Indirect tax laws such as Central Excise Duty, Service Tax, Customs Duty, Value Added Tax, CST, Professional Tax etc would be covered as other tax laws. Hence, the cess or duty like Marketing Cess, Cess on Royalty, Octroi Duty, Entry Tax etc. would not be covered as other tax laws. However, the auditor should excercise his professional judgment in determining the applicability to relevant tax laws for reporting under this clause.

68.2 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. The tax auditor should verify the books of account and the orders passed by the respective Department for ascertaining whether any
such demand has been raised or refund order has been issued under any other tax law and accordingly report the same. If there is any adjustment of refund against any demand, the auditor shall also report the same under this clause.

68.3 The tax auditor should maintain the following information in his working papers for the purpose of reporting against this clause in the format provided in the e-filing utility.

<table>
<thead>
<tr>
<th>S. No.</th>
<th>Name of the applicable Act</th>
<th>Demand/Refund Order No., if any</th>
<th>Date of Demand raised/ refund issued</th>
<th>Financial Year to which the Demand / refund relates</th>
<th>Amount of demand raised/ refund issued</th>
<th>Adjustment of refund against demand, if any</th>
<th>Remarks</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>5</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>6</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>7</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>8</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

69. Signature and stamp/Seal of the signatory

69.1 Form 3CD has to be signed by the person competent to sign Form No. 3CA or Form No.3CB as the case may be. He has also to give his full name, address, membership number, firm registration number, wherever applicable, place and date. Further, the e-filing portal requires the tax auditor to affix his Digital Signature while registering himself. He is also required to put his stamp/Seal as well.

70. Code of Ethics and other matters

70.1 Some of the issues which are commonly raised in regard to different aspects of tax audit vis-à-vis the liability/obligations of the tax auditor are considered hereunder.

70.2 The liability of the tax auditor in respect of tax audit will be the same as in any other audit assignment. It may be noted that when any question relating to the audit conducted by a tax auditor arises, he is answerable to the Council of the Institute under the Chartered Accountants Act. In all matters concerning tax audit, ICAI’s disciplinary jurisdiction will prevail.

70.3 In case the assessee is found guilty of having concealed the particulars of his income it would not ipso facto mean that the tax auditor is also responsible. If the Assessing Officer comes to the conclusion that the tax auditor was grossly negligent in the performance of his duties, he can refer the matter to the ICAI so that appropriate action can be taken against the tax auditor under the Chartered Accountants Act.

70.4 The Assessing Officer or any other authority who is authorised to issue summons and to call for evidence or documents, can call upon the tax auditor who has audited the accounts to give any evidence or produce documents. For this purpose notice under section 131 can be issued by the Assessing Officer or other tax authority mentioned in the said section.

70.5 If the actual work relating to examination of books and records is done by a qualified assistant in a firm of chartered accountants and the partner of the firm signing the audit report has relied upon this work, action, if any, for professional negligence can be initiated against the member who has signed the report and in such an event, it would be open for the member
III.334  Auditing Pronouncements

concerned to prove that he has taken due care and diligence in the performance of his duties and is not aware of any reason to believe that he should not have so relied.

70.6 If the qualified assistant (whether or not holding the certificate of practice) is found to be grossly negligent in the performance of his duties, the Council of the Institute can take disciplinary action against him.

70.7 A tax auditor can accept the assignment of tax representation.

70.8 Under the Code of Ethics, no tax auditor can charge professional fees by way of percentage of profits or which are contingent upon findings, or results of such employment, except as permitted under any regulation made under this Act. In this connection, reference is invited to Clause (10) of Part I of the First Schedule to the Chartered Accountants Act and the commentary on the subject at page 210 of the Code of Ethics (2009 Edition). Certain exceptions are made in Regulation 192, but these exceptions do not apply for charging of fees for tax audit.

70.9 Since the figures in Form No. 3CD are duly verified by a chartered accountant, they should normally be accepted by tax authorities. If, however, there is a specific reason for differing from the view taken by tax auditor, the Assessing Officer may compute the income of the assessee by adopting different figures.

70.10 The opinion expressed by the tax auditor is not binding on the assessee. If the tax auditor has qualified his report and expressed an opinion on a particular item, the assessee may take a different view while preparing his return of income. In such cases, it is advisable for the assessee to state his viewpoint and support the same by any judicial pronouncements on which he wants to rely.

71. Format of Financial Statements

71.1 The tax auditor of a person who carries on business or profession but who is not required by or under any other law to get his accounts audited has to give his report in Forms No. 3CB/3CD and will have to ensure that the financial statements i.e. balance sheet and profit and loss account/ income and expenditure statement, are prepared in such a manner that adequate information which is necessary to convey a true and fair view of the state of affairs of the assessee is given. So far as a person whose accounts of the business or profession have been audited under any other law is concerned, the information to be given in the financial statements is normally provided in the particular statute by which the assessee is governed. Since there is no such legislation in respect of a person who carries on business or profession but who is not required by or under any other law to get his accounts audited, it is necessary to achieve some uniformity in respect of information to be provided in the financial statements.

71.2 It should be noted that the responsibility for maintenance of books and records and that for preparation of financial statements is that of the assessee. It is, therefore, desirable that guidance is given to a person who carries on business or profession but who is not required
Part-III: Guidance Notes  III.335

by or under any other law to get his accounts audited about the maintenance of books of accounts and records as well as about the requirements of auditing. Similarly, guidance is also required to be given about the preparation of financial statements and the information to be provided in such statements. (See “Monograph on Compulsory Maintenance of Accounts” published by ICAI)

71.3 Two separate sets of forms of balance sheet and profit and loss account have, therefore, been prepared and given as Appendices to this Guidance Note. Appendix XV (Page no. 278) gives the recommended format of the balance sheet and also the information to be provided in the profit and loss account, in case of an assessee engaged in trading business. This format can be used in the case of an assessee, who is engaged in profession and other service activities, by making such changes as may be considered to suit the circumstances. Appendix XVI (Page no. 286) gives the recommended format of the balance sheet and the requirements of the profit and loss account in the case of an assessee engaged in the manufacturing activities. It is suggested that the balance sheet and the profit and loss account can be prepared either in the vertical or in the horizontal form according to the circumstances of each case. If the information required to be given in any item or sub-item of the financial statements cannot conveniently be given on the face of the financial statements, the same may be given by way of footnotes/ annexures to and forming part of such financial statements. Since the formats are designed also for accounts of non-corporate borrowers form banks, they may be modified so as to exclude the information, which may not be relevant for accounts for tax audit. For presentation and disclosure requirements, applicable AS and AS (IT) should be kept in mind.