

How to Conduct a Tax Audit

**BCAS Programme For Students /
New Entrants to the Profession.**

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Role of a Chartered Accountant & Articled Assistants in carrying out Tax Audit

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- ❑ As a tax auditor
 - Primarily an auditor – who is also aware of tax provisions
 - ❑ Accordingly, has to consider all of the following when carrying out the assignment of Tax Audit.
 - Auditing & Assurance Standards
 - Accounting Standards prescribed by ICAI (and notified standards under section 211 in the case of Companies)
 - Accounting Standards notified by CBDT
 - Guidance issued by ICAI
 - Directions issued by Council including those relating to ethical requirements in regard to communication with previous auditor, limits for tax audit etc.
 - ❑ Role of the articled student – crucial
 - inputs will decide quality of audit & level of professional services

Responsibility In Carrying Out Tax Audit

- ☐ Responsibility for preparation of accounts lies with the assessee himself.
- ☐ G.N.(para 13.4) states that “Tax auditor is required to give his opinion whether prescribed particulars furnished by the assessee are true and correct.”
- ☐ Hence, signature of Assessee should be obtained on Form 3CD though the form itself does not provide for the same
- ☐ Documentation and professional responsibility of CA

17. Amounts debited to the profit and loss account, being :-

- (a) expenditure of capital nature;
- (b) expenditure of personal nature;

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- ☐ Items 17(a) to 17(d) & (k) require reporting factual information - without auditor being required to express any opinion
 - ☐ Items 17(f) to 17(j) & (m) require auditor to express opinion - sum debited to the Profit & Loss Account are not allowable
 - ☐ What is capital expenditure - concepts as per accounting standards and tax laws may differ.
 - Reference to be made to Ss.30 & 31 and large number of precedents.
 - refer CIT V Saravana Spg Mills P Ltd (2007) 293 ITR 201(SC); CIT vs. Mangayarkasi Mills (SC)
 - ☐ personal expenditure in case of corporate bodies
 - –Also refer 227(1A)(e)
 - ☐ expenditure on vehicle provided to director etc. per terms of contract

Verification Process & Reporting:

Clause 17 (a) - Capital Expenditure

Clause 17 (b) – Personal Expenditure

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- ☐ Ascertain normal monthly expenditure under each head
 - ☐ Verify whether expenditure shows abnormal deviation
 - ☐ Normal heads include Repairs & maintenance/ Sales Promotion / Advertising
 - ☐ If admissible u/s 35 or other section spell out separately
 - ☐ if capital expenditure debited to P&L account is significant, it may require qualification of true & fair view. - **Clause 17 (a)**

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- ☐ The expenditure has to be personal qua assessee
 - ☐ If contractual obligation to corporate assessee, ask for contracts / resolutions.
 - ☐ If estimated personal element in expenditure like conveyance, telephone etc is directly disallowed / not claimed by the assessee, the fact to be highlighted. - **Clause 17 (b)**

17. Amounts debited to the profit and loss account, being :-
- (c) expenditure on advertisement in any souvenir, brochure, tract, pamphlet or the like, **published by a political party**;
 - (d) expenditure incurred at clubs, -
 - (i) as entrance fees and subscriptions.
 - (ii) as cost for club services and facilities used
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- ☐ Contributions to “DurgaPuja or Dahi Handi”
- ☐ Clubs do not include Social service organisations
- ☐ Report specifically
 - entrance fees
 - Subscriptions
 - cost for club services and facilities

Verification Process & Reporting:

Clause 17 (c) – Expenditure on advertisement in souvenir etc published by Political Party

Clause 17 (d) Expenditure incurred at Clubs.

- ☐ Verify normal accounts like advertisement / sales promotion etc.
 - ☐ Reporting restricted to - publications by Political parties, independent entities are not covered. - **Clause 17 (c)**
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- ☐ Verify entertainment / sales Promotion heads
- ☐ If not claimed as having personal element, state that fact. - **Clause 17 (d)**

- (e) (i) expenditure by way of penalty or fine for violation of any law for the time being in force;
- (ii) any other penalty or fine :
- (iii) expenditure incurred for any purpose which is an offence or which is prohibited by law;
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- ☐ Penalty and fine are to be distinguished from contractual obligations - even if such payments are labeled as “penalty” in a contract. (para 32.1 of G.N.)
- ☐ Para 32.4 G.N. –precedents given – why not allowable
- ☐ Insertion of explanation to S. 37(1)
- ☐ “expenditure for purpose which is an offence” should also be carefully considered – draw attention of senior – note.
- ☐ Compounding Charges
- ☐ Compensatory payments

Verification Process:

- ☐ Verify Miscellaneous Expenditure.
- ☐ Accounts pertaining to Tax
- ☐ Payments to statutory / regulatory authorities.

- (f) amounts inadmissible under section 40(a);
 - (g) interest, salary, bonus, commission or remuneration inadmissible under section 40(b)/40(ba) and computation thereof;
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- ❑ Numerous interpretational issues arise- there can be considerable subjectivity.
- ❑ The determination of appropriate head by which a particular payment is covered.
- ❑ Where certain reimbursements are claimed and TDS on the amount actually billed excluding reimbursement - issue could arise in the matter of reporting.
- ❑ Where there is inadvertent short deduction or deduction by application by erroneous rate or any situation where tax is appropriately deducted, but surcharge, education cess not correctly applied, numerous problematic issues in regard to reporting under this clause could arise.
- ❑ Must know provisions of TDS, business expenditures and deductions
 - Amendment by Fin Act 2008 – for Mar upto due date – others – during previous year
- ❑ Must carefully examine the contracts, partnership deed, earlier assessment / appellate orders and be aware of the precedents -Must play a fair & cautious role

Verification Process:

Clause 17(f) amounts inadmissible u/s 40 (a)

**Clause 17 (g) amounts inadmissible u/s 40 (b) / 40 (ba)
and Computations thereof**

- ☐ Ask for details from the assessee in a specific format
 - ☐ Do a test check of the details called for
 - ☐ Test checking of the expenditure heads to verify the accuracy of the details. - **Clause 17 (f)**
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- ☐ Verify the clause of Partnership deed.
- ☐ Verify waiver of remuneration / interest by partners, if any.
- **Clause 17 (g)**

(h) (A) whether a certificate has been obtained from the assessee regarding payments relating to any expenditure covered under section 40A(3) that the payments were made by account payee cheques drawn on a bank or account payee bank draft, as the case may be, [Yes/No]

(B) amount inadmissible under section 40A(3), read with rule 6DD [with break-up of inadmissible amounts]

- ☐ Obtain necessary certificate
- ☐ Applicability to payments made as advances
- ☐ Manner of preparation and reporting in audit notes.
- ☐ Crossed Cheques – not enough
- ☐ Credit Card Payments ??

Verification Process:

- ☐ Call for details from the assessee in specific format.
- ☐ Verify accounts to find out possibility of cash payments. This will depend on the business of the assessee -

- (i) provision for payment of gratuity not allowable under section 40A(7);
 - (j) any sum paid by the assessee as an employer not allowable under section 40A(9);
 - (k) particulars of any liability of a contingent nature.
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Per AS 29 - A contingent liability is:

- (a) a possible obligation that arises from past events occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise; or
- (b) a present obligation that arises from past events but is not recognised because:
 - (i) it is not probable that an outflow of resources will be required or
 - (ii) a reliable estimate of the amount of the obligation cannot be made.

☐ Precedents & facts to be carefully evaluated

- (l) 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,
- (m) amount inadmissible under the proviso to section 36(1)(iii)
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- ☐ Sweeping impact of the provision
- ☐ Determination of expenditure – Rule 8D
- ☐ Interpretation of the words ‘ expenditure directly relating to income’ and ‘interest attributable to any income or receipt’

- ☐ Interest capitalisation – criteria –
 - borrowing should be for acquisition of capital asset
 - in extension of existing business
 - Explanation 8 to sec 43 - prohibits capitalization of interest after it is put to use

Verification Process & Reporting: Clause 17 (m)

- ☐ Ask the assessee to furnish the information under Rule 8D
- ☐ If the computation is based on particular interpretation, give basis of interpretation.

17 A. (New Clause):Amount of interest inadmissible under section 23 of The Micro Small and Medium Enterprises Development Act, 2006 (MSMEDA)

- ☐ As per 'section 23' of MSMEDA
 - If the assessee has purchased goods or obtained services from a supplier as defined in Section 2 (m) under MSMEDA and
 - there has been a delay in payment to such a supplier payments (i.e.beyond 45 days);
 - the interest paid / payable to such supplier is not to be allowed as a deduction

Verification Process & Reporting:

- ☐ Check whether assessee has obtained information regarding supplier recognized under MSMEDA
- ☐ If identified, whether interest has been paid / provided
- ☐ If not identified, give suitable disclosure.

18. Particulars of payments made to persons specified under section 40A(2)(b).

19. Amounts deemed to be profits and gains under S. 33AB/ ABA / 33AC.

20. Any amount of profit chargeable to tax under section 41 and computation thereof.

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- ☐ Obtain list of specified persons from assessee
 - ☐ Consider disclosure in the register maintained u/s 301 & per AS 18
 - ☐ Give full particulars of transactions
 - No Judgment or rationalisation on part of auditor required – only state facts
 - ☐ Word used is 'payment'. However rational interpretation is payment in respect of 'expenditure' of the assessee should be given.
 - ☐ Mere Applicability of Limitation Act does not result in Section 41 (1) being triggered.

21. *(i) 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), (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.
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☐ Details to be given

- whether or not sums are debited to P&L

☐ No requirement to determine admissible/inadmissible amounts

Verification Process & Reporting: Clause 21

- ☐ Obtain details from the assessee.
- ☐ Verify details on test check basis
- ☐ If tax payment is being computed / paid on the basis of advise of another professional, apply concerned Standard on Auditing
- ☐ If the payments are not made by the assessee as at the date of report, but assesee asserts that he will pay the sums before due date, consequential note /disclosure to be made.

- 22.(a) Amount of Modified Value Added Tax credits availed of or utilised during the previous year and its treatment in the P&L account & treatment of outstanding Modified Value Added Tax credits in the accounts.
- (b) Particulars of income or expenditure of prior period credited or debited to the profit and loss account.
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- ☐ See that properly reconciled data derived from the P&L and B/S is furnished in regard to CENVAT utilisation, outstandings etc.
- ☐ Relevant for those following accrual system
- ☐ Revision of estimates does not result in a prior period item – errors or omissions in earlier period – See AS 5

23. 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]

- ☐ Negotiable instruments drawn in vernacular language
- ☐ Repayment otherwise than by account payee cheque
- ☐ Presently- Not commonly used as a means of finance

24. (*a/b) Particulars of each loan or deposit / b)Particulars of each repayment of loan or deposit – of an amount exceeding the limit specified in S 269SS/ 269T taken or accepted / made during the previous year :-

- (i) name, address and PAN (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/ repaid otherwise than by an account payee cheque or an account payee bank draft.
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*(These particulars needs not be given in the case of a Government company, a banking company or a corporation established by a Central, State or Provincial Act.)

- ☐ Guidance Note proceeds on the footing that transfers by book entries are covered. Accordingly, must bring to attention of senior.
- ☐ For determining the threshold level of Rs 20,000, aggregation of entries to be made (para 46.5 - G.N.)
- ☐ Practical difficulties for e.g.where loans are rolled over - but nonetheless, duty to report cannot be diluted

(c) **Whether a certificate has been obtained from the assessee regarding taking or accepting loan or deposit, or repayment of the same through an account payee cheque or an account payee bank draft.**

[Yes/No]

The particulars (i) to (iv) at (b) and the Certificate 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

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- ☐ The obtaining of certificate as referred to above does not absolve responsibility of the auditor to verify and report the facts

Verification Process & Reporting

- ☐ Obtain details from the assessee
- ☐ If credits / debits to certain accounts of persons / entities have not been included by the assessee, verify reasons.

25.(a) Details of brought forward loss or depreciation allowance, in the following manner, to the extent available :

Serial Number	Assessment Year	Nature of loss/ allowance (jn rupees)	Amount as returned (in rupees)	Amounts as assessed (give reference to relevant order)	Remarks
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- ☐ In reporting these details care may be taken to give updated position.
- ☐ In remarks, reference may also be made to the appellate orders and pending proceedings where the relevant
- ☐ Where certain information is taken from outside the books i.e. the basis of returns etc., suitable Note may be given.

(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.

- ☐ Applicability- company in which public is not substantially interested
- ☐ Beneficial interest to be compared on last day of previous year in which loss was incurred & of previous year when loss is to be set off
- ☐ Exceptions – gift to relative or succession

26. Section-wise details of deductions, if any,
Admissible under Chapter VIA.

- ☐ Assessee/his tax adviser would indicate Sections under which relief is to be claimed.
- ☐ Each to be verified independently and every year
- ☐ If the deductions is not emanating from the books of accounts audited but from other records, the fact should be disclosed.
- ☐ Development of the case law to be particularly looked into

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

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

- (i) Tax deductible and not deducted at all**
- (ii) shortfall on account of lesser deduction than required to be deducted**
- (iii) tax deducted late**
- (iv) tax deducted but not paid to the credit of the Central Government**

“Please give the details of cases covered in (i) to (iv) above.”

☐ Tax deductible and not deducted at all

■ Verification of this aspect is extremely important

■ Guidance Note accepts the use of test check

☐ May be reconciled with e-TDS return

**Verification for reporting in clause 17 &
clause 27 (a) should be reconciled.**

28. (a) In the case of a trading concern, give quantitative details of 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

(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) purchase during the previous year;
- (iii) quantity manufactured during the previous year;
- (iv) sales during the previous year;
- (v) closing stock;
- (vi) shortage/excess, if any.

* Information may be given to the extent available.

☐ Information to be given as per books of accounts

- Any non-reconciliation with stock records may be mentioned
- Materiality can be kept in mind
- If stating non availability or non maintenance of record, please reconcile with Clause 9

29. In the case of a domestic company, details of tax on distributed profits under section 115O in the following form :- (a) total amount of distributed profits; (b) total tax paid thereon; (c) dates of payment with amounts.

30. Whether any cost audit was carried out, if yes, enclose a copy of the report of such audit [See section 139(9)].

- ☐ Factual information & data to be furnished
 - Dividend under 2(22)(e) in any case is excluded- hence there would not normally be any interpretation issues.

31. Whether any audit was conducted under the Central Excise Act, 1944, if yes, enclose a copy of the report of such audit
- 32 Accounting ratios with calculations as follows :-
(a) Gross profit/Turnover; (b) Net profit/Turnover;
(c) Stock-in-trade/Turnover; (d) Material consumed/Finished goods produced.
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- ☐ Ratios required to be furnished
 - are to be given in value terms and
 - for the business as a whole
- ☐ Where significant of if there is a change in methodology– give note explaining computation

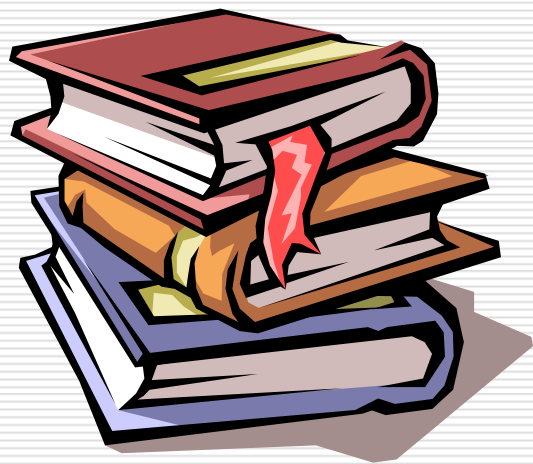
Annexure II relating to FBT

Tax auditor to report on the following aspects of Fringe benefits.

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1. Section under which the expenditure/ payment is chargeable to FBT
 2. Nature of expenditure/ Payment
 3. Amount of expenditure/ payment –
 - a) Debited to Profit & Loss A/c
 - b) Accounted for in the Balance Sheet
 - c) Reimbursement
 - d) Any other head
 4. Deductions, if any (Expenditure on Hospitality, less Expenditure on food & beverages in office)
 5. Total (Net amount of expenditure/ payment for the purpose of Fringe Benefits)
 6. Percentage of expenditure/ payment liable to tax. (e.g. 100%, 50%, 20%, 5%)
 7. Value of taxable fringe benefits.

Points to Consider re FBT reporting

- ❑ Auditor must consider Chapter XII-H (Ss.115W to 115WL)
 - In particular S. 115WB (1), (2) & S. 115WC + Circulars
- ❑ Following possibilities arise.
 - If agreement is total and based on plain reading of the provisions or CBDT Circular, no specific disclosure required.
 - Where the agreement based on a judicial pronouncement, - advisable to mention the judicial pronouncement relied upon.
 - Where there is a disagreement, total or partial, - advisable to put forth both views and their basis.
 - Where the tax auditor cannot express an opinion, on account of absence or inadequacy of data, the attention of the reader should be drawn to this fact.



Thank You