

## AUDIT UNDER FISCAL LAWS

---

### Question 1

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

*(4 Marks)(November 2008)*

### Answer

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

- (i) Revision of accounts of a company after its adoption in the annual general meeting.
- (ii) Change in law with retrospective effect.
- (iii) Change in interpretation of law (e.g.) CBDT Circular, Notifications, Judgments, etc.

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

### Question 2

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

*(8 Marks) (June 2009)*

### Answer

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

- (i) Check the books of account and other records having regard to the system of accounting and internal control
- (ii) Vouch the transactions of the trust to satisfy that:
  - (a) the transaction falls within the ambit of the trust
  - (b) the transaction is properly authorized by the trustees or other delegated authority as may be permissible in law;

- (c) all incomes due to the trust have been properly accounted for on the basis of the system of accounting followed by the trust;
  - (d) all expenses and outgoings appertaining to the trust have been recorded on the basis of the system of accounting followed by the trust;
  - (e) amounts shown as applied towards the object of the trust are covered by the objects of trust as specified in the document governing the trust.
- (iii) Obtain trial balance on the closing date certified by the trustees' duty certified by the trustee;
  - (iv) Obtain Balance Sheet and Profit & Loss Account of the trust authenticated by the trustees and check the same with the trial balance with which they should agree.

### Question 3

*As the tax auditor of a non-corporate entity u/s 44AB of the Income Tax Act, 1961, how would you ensure compliance of section 145 of the Income Tax Act, 1961? (8 Marks)(June 2009)*

### Answer

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

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

- (i) AS (IT)-1: Disclosure of accounting policies.
- (ii) AS (IT)-2: Disclosure of prior period and extra ordinary items and disclosure of accounting policies.

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

- (i) Where the Assessing Officer is not satisfied about the correctness or completeness of the accounts of the assessee
- (ii) Where the method of accounting has not been regularly followed by the assessee.
- (iii) Where the AS notified u/s 145(2) have not been regularly followed by the assessee.

The auditor has to therefore ensure that:

- (a) the entity follows either the cash or accrual method of accounting and same is to be reported in 11(a) of form 3CD.
- (b) Accounting policies are required by AS (IT) -1 has been disclosed needs to be verified for compliance with ASI (11) of AS5 (11).

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

#### **Question 4**

*'A' Limited has paid minimum alternate tax under Section 115 JB of the Income Tax Act, 1961, for the year ended 31st March, 2009. The company wants to disclose the same as an 'Asset' since the company is eligible to claim credit for the same. (5 Marks) (November 2009)*

#### **Answer**

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

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

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

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

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

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

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

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

#### **Question 5**

*Answer the following:*

- (a) *ABC Printing Press, a proprietary concern, made a turnover of above ₹ 63 lacs for the year ended 31.03.2011. The Management explained its auditor Mr. Z that it undertakes different job work orders from customers. The raw materials required for every job are dissimilar. It purchases the raw materials as per specification/requirements of each*

*customer, and there is hardly any balance of raw materials remaining in the stock, except pending work-in-progress at the year end. Because of variety and complexity of materials, it is rather impossible to maintain a stock-register. Give your comments.*

(5 Marks)

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

(3 Marks) (November 2009)

**Answer**

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

In the case of any assessee like co-operative society where the accounts under the relevant law are allowed to be audited by a person other than a Chartered Accountant, the statutory auditor need not be a Chartered Accountant.

Thus, it shall be sufficient compliance with the provisions of this section and can be considered under section 44AB.

**Question 6**

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

*(4 Marks) (November 2009)*

**Answer*****Accounting Standards under the Income Tax Law:***

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

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

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

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

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

- A. Accounting Standard I relating to Disclosure of accounting policies.
- B. Accounting Standard II relating to Disclosure of Prior Period and Extraordinary Items and Changes in Accounting Policies.

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

**Question 7**

*T Ltd. an Indian company, subject to Indian Income tax Act, 1961, discloses advance Income-tax paid (Current tax asset) and provision for Income-tax (Current tax liability), separately in Balance Sheet for the year ended 31.3.2011, i.e., it does not offset the amount. Comment.*

*(5 Marks) (May 2010)*

### Answer

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

- (i) has a legally enforceable right to set off the recognized amounts and
- (ii) intends to settle the asset and liability on a net basis.

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

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

### Question 8

*Write short notes on the major steps required in preparation of Tax audit under VAT.*

*(5 Marks) (May 2010)*

### Answer

#### **Major steps required in preparation of Tax audit under VAT**

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

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

major customers to whom the sales are effected and the details of sales which are outside the scope of VAT law. Similarly the sources of purchase and the items sold should be listed out. Further it should be ascertained whether the auditee has opted for the composition scheme or not.

- (ii) **Obtaining a list of all the accounting records maintained by the auditee:** The auditor should obtain a complete list of all the accounting records relating to sale/purchase of goods, stocks, the various registers, the ledgers etc. maintained, in which the transactions are recorded, the various source documents in which the entries are recorded in the books of account and the process of their generation.
- (iii) **Ascertaining the major accounting policies adopted by the auditee:** The auditor should know the major accounting policies based on which books of account have been recorded. The accounting policy regarding recording of sales, purchases and valuation of inventory must be made known and the auditor should also find out whether there has been any change in those policies during the year covered by audit. If there is any significant change in the accounting policy giving rise to some material effect on the tax liability, the same should be invariably reported.
- (iv) **Evaluation of internal control etc.:** Before determining the extent of audit checks to be applied i.e. whether to go in- depth or to do only test check, the auditor should ascertain whether there is an internal check system in operation in the entity. He should particularly find out how the purchases and sales get initiated. For example, in case of purchase, receipt of indent by the purchase department, determining the need for purchases, initiation of purchase order, receipt of material, preparation of MRN, entries made in the books of accounts etc. should be verified. For sales, receipt of inquiry, acceptance of sales order, execution of sales, preparation of sale invoice and realization of transaction. If the internal control is reliable, the extent of audit may be reduced and should be focused only on those areas where the auditor feels that greater degree of audit risk is involved.
- (v) **Knowledge about the VAT law and allied laws :** The auditor and his staff should obtain a thorough knowledge of the State VAT law under which the audit is to be conducted. The auditor should study the VAT law starting from the definition of various terms, the procedure to be adopted, the provisions regarding issue of invoices, claiming of input tax credit, composition schedule in the VAT law, the manner in which the output tax is to be calculated the provisions of audit, the contents of the audit report, the periodicity of the return to be filed, the format of the forms of returns, and the various notifications issued. Further the auditor should know the Central Sales-tax law as he has to comment on the liability under that law also. The auditor should also have some knowledge about the judicial pronouncements made by the Tribunals and the Courts on the various facets of these laws.

**Question 9**

*Mr. R, the Tax Auditor finds that some payments inadmissible under Section 40 A(3) were made, and advised the client to report the same in form 3CD. The client contends that cash payments were made since the other parties insisted upon the same and did not have Bank Accounts. Comment.*  
(5 Marks) (November 2010)

**Answer****Form 3 CD**

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

Disallowance under section 40A(3) is attracted if the assessee incurs any expenses in respect of which payment of aggregate of payments made to a person in a day, otherwise than by an account payee cheque drawn on bank or account payee draft exceeds ₹20,000/- . However, exemption is provided in respect of certain expenditure in Rule 6DD. In such cases, disallowance under section 40A (3) would not be attracted.

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

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

**Question 10**

*While conducting the tax audit of A & Co. you observed that it made an escalation claim to one of its customers but which was not accounted as income. What is your reporting responsibility?*  
(4 Marks) (May 2011)

**Answer**

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

account under clause 13(c) of Form 3 CD.

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

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