

Guidance Note on Audit Reports and Certificates for Special Purposes

1. Introduction

1.1 Government authorities may, under various statutes or notifications, require reports or certificates from auditors in support of statements or other information prepared by an enterprise. Reports or certificates on specific matters may also be required from auditors by an enterprise, for its own special purposes. These reports or certificates cater to specific requirements of the individual users unlike a 'general purpose report' e.g. an auditor's report on financial statements which is intended for general use. An audit report or certificate for special purpose is one to which the format of general purpose audit report is not applicable.

1.2 This note is intended to provide guidance to members who may be called upon to give audit reports or certificates for special purposes (herein referred to as 'reporting auditors'). Reports on profit and/or financial forecasts and on tax audit do not fall within the scope of this guidance note.*

2. Scope of Special Purpose Audit Reports and Certificates

2.1 Audit reports or certificates for special purposes may be issued in connection with:

- a. financial statements which are prepared in addition to general purpose financial statements;
- b. specified elements, accounts or items of a financial statement;
- c. compliance with requirements of any agreement or statute or regulation;
- d. financial information given in special purpose formats or schedules;
- e. compilation of statistics or ascertainment of basic figures e.g., for the purpose of fixing quotas or levies.

2.2 A reporting 'auditor' should appreciate the difference between the terms 'certificate' and 'report'. A certificate is a written confirmation of the accuracy of the facts stated therein and does not involve any estimate or opinion. A report, on the other hand, is a formal statement usually made after an enquiry, examination or review of specified matters under report and includes the reporting auditor's opinion thereon. Thus, when a reporting auditor issues a certificate, he is responsible for the factual accuracy of what is stated therein. On the other hand, when a reporting auditor gives a report, he is responsible for ensuring that the report is based on factual data, that his opinion is in due accordance with facts, and that it is arrived at by the application of due care and skill.

3. Responsibility for Preparation of Special Purpose Statements

The primary responsibility for the contents of a special purpose statement rests with the enterprise and this would be evidenced by a suitable declaration or authentication by the management on the face of the statement.

4. Scope of a Reporting Auditor's Function

4.1 A reporting auditor should have a clear understanding of the scope and nature of the terms of his assignment. It is desirable for him to obtain the terms in writing to avoid any misunderstanding,

4.2 A reporting auditor is not an expert on purely technical matters and as such, when he is required to report on or certify such matters (e.g., composition or quality of a product) which are of paramount importance and constitute the very basis of the figures contained in the statement, he should state his limitations clearly in the report or certificate. At the same time he should indicate the extent to which he has been able to exercise his own professional skill and judgement with regard to the matter being reported upon. For instance, he may state that, for the purpose of forming his opinion, he has relied upon a certificate from technical experts. He should, of course, satisfy himself about the technical qualifications of the expert, and subject the expert's certificate to a reasonable review.

5. Contents of Reports and Certificates for Special Purposes

5.1 In many cases, a reporting auditor can choose the form and contents of his report or certificate. In other cases the form and contents of the report or certificate are specified by statute or notification and cannot be changed.

5.2 Where a reporting auditor is free to draft his report or certificate, he should consider the following:

- a. Specific elements, accounts or items covered by the report or certificate should be clearly identified and indicated.
- b. The report or certificate should indicate the manner in which the audit was conducted, e.g., by the application of generally accepted auditing practices, or any other specific tests.
- c. If the report or certificate is subject to any limitations in scope, such limitations should be clearly mentioned.
- d. Assumptions on which the special purpose statement is based should be clearly indicated if they are fundamental to the appreciation of the statement.
- e. Reference to the information and explanations obtained should be included in the report or certificate. In certain cases, apart from a general reference to information and explanations obtained, a reporting auditor may also find it necessary to refer in his report or certificate to specific information or explanations on which he has relied.
- f. The title of the report or certificate should clearly indicate its nature, i.e., whether it is a report or a certificate. Similarly, the language should be unambiguous, i.e., it should clearly bring out whether the reporting auditor is expressing an opinion (as in the case of a report) or whether he is only confirming the accuracy of certain facts (as in the case of a certificate). For this, the choice of appropriate words and phrases is important.
- g. If the special purpose statement is based on general purpose financial statements, the report or certificate should contain a reference to such statements. However, the report or certificate should not contain a reference to any, other statement unless the same is

attached herewith. It should be clearly indicated whether or not the statutory audit of the general purpose financial statements has been completed and also, whether such audit has been conducted by the reporting auditor or by another auditor. In case the general purpose financial statements have been audited by another auditor, the reporting auditor should specify the extent to which he has relied on them. He may communicate with the statutory auditor for securing his co-operation and in appropriate circumstances, discuss relevant matters with him, if possible.

- h. Where a report requires the interpretation of a statute, the reporting auditor should clearly indicate the fact that he is merely expressing his opinion in the matter. He should take sufficient care to ensure that in respect of matters which are capable of more than one interpretation, his report is not misconstrued as representing a settled legal position.
- i. An audit report or certificate should ordinarily be a self-contained document. It should not confine itself to a mere reference to another report or certificate issued by the reporting auditor but should include all relevant information contained in such report or certificate.
- j. The reporting auditor should clearly indicate in his report or certificate, the extent of responsibility which he assumes. Where the statement on which he is required to give his report or certificate, includes some information which has not been audited, he should clearly indicate in his report or certificate the particulars of such information.

5.3 In certain cases, the form and/or contents of the report or certificate, as prescribed by a statute or a notification, may not be appropriate or adequate. In such situations, the reporting auditor may consider modifying the report or certificate on the basis of the suggestions made in para 5.2 supra, to the extent applicable. In case this is not possible, he should clearly indicate the limitations in his report or certificate itself.

6. Extent of Reliance on General Purpose Audit Report

6.1 Where a special purpose engagement is undertaken after the statutory audit has been completed, a reporting auditor should invariably review the statutory audit report to ascertain whether there are any matters which have a bearing on his report or certificate.

6.2 In cases, where a reporting auditor is required to report or certify certain specific matters arising from the financial statements taken as a whole, he should not normally issue his report or certificate until the statutory audit has been completed. For instance, a reporting auditor may be required to state whether, in the case of an Indian branch of a foreign company, the profit shown in the accounts represents the remittable surplus of the branch, or he may be asked to report on the computation of gross profit for the purpose of bonus under the Payment of Bonus Act, MS. In such cases, it would normally not be proper for him to give his report or certificate until the statutory audit has been completed, since he would not really be in a position to state whether the profit shown in the accounts itself has been properly computed.

6.3 Where an audit report or certificate is required before the statutory audit is completed, a reporting auditor should clearly state in his audit report or certificate that he is reporting on or certifying specific matters arising out of the financial statements of the enterprise, the statutory audit of which has not been completed.

6.4 Where the reporting auditor prepares his report or certificate on the basis of duly audited general purpose financial statements, he may take the following precautions:

- i. He may clearly state in his report or certificate that the figures from the audited general purpose financial statements, have been used and relied upon.
- ii. He may include in his report or certificate a statement showing the reconciliation between the figures in the general purpose financial statements and the figures appearing in his report or certificate.

7. Limited Review Report

7.1 In certain circumstances, a reporting auditor may be called upon to give a special report based on a limited review of the accounts rather than on a complete audit, e.g., review of interim financial information for the purpose of ascertaining their compliance with the generally accepted accounting principles or a quick review of the accounts to help an intending buyer of a business in taking a final decision in this regard.

7.2 The scope of a limited review is substantially narrower as compared to an examination in accordance with the generally accepted auditing standards for the expression of an opinion on the financial statements.

7.3 A limited review primarily consists of the following steps:

- i. Obtaining an understanding of the system of preparation of the information contained in the special purpose statement on which the reporting auditor is required to give his report;
- ii. Applying analytical review procedures to data under examination; and
- iii. Making such enquiries and obtaining such information as is considered necessary.

7.4 In addition to the reporting requirements discussed in para 5.2 above, the limited review report should contain-

- a. a description of the procedures used for the review;
- b. a statement that the scope of the review was substantially narrower as compared to an examination made in accordance with the generally accepted auditing practices for expressing an opinion whether the statements show a true and fair view;
- c. an opinion that the statements give the information in accordance with the books of account, records and other statements produced and that they have been drawn up, in accordance with the applicable and generally accepted accounting principles; and
- d. in appropriate circumstances, a qualification or disclaimer so as to dispel any doubt about the conclusions which may be arrived at on the basis of the report.

Reports and Certificates on Specified Accounts or Items of Financial Statements

The test of materiality which a reporting auditor uses in connection with special purpose reports may be different, depending upon the circumstances, from the test he would use in connection with a general purpose report. For example, where he is required to express an opinion on specified accounts or items of financial statements, he may judge the materiality of an item solely in relation to such individual accounts or items rather than to the aggregate thereof or to the financial statements as a whole. A reporting auditor's examination of certain records for an audit report or certificate for special purpose may also be more intensive than the examination of the same records by the statutory auditor for the purpose of expressing an opinion on the general purpose financial statements as a whole.

8.2 Certain accounts or items of financial statements are inter-related, e.g., sales and debtors, purchases and creditors, fixed assets and depreciation, etc. Therefore, where reporting auditor is required to examine and report upon or certify a specified account or items of financial statements, he may also need to examine the related accounts or items to discover the inconsistencies, if any, between these inter-related accounts or items.

9. Other Engagements

9.1 In some cases, a member may be required merely to compile financial statements or to report whether the financial statements are in conformity with the books of account. The association of the name of a member with the statements may be misconstrued by a user of the statements as the same having been audited by him. Therefore, it is essential that the member clearly brings out the nature of his association with the financial statements. The following precautions are suggested in this regard:

- i. The title of the report should be 'Chartered Accountant's Report' rather than 'Auditor's Report'.
- ii. The report should clearly state that the statements were not audited.
- iii. In describing the engagement, ambiguous terms such as 'review', 'general review', 'check', etc., should be avoided.
- iv. The client should be requested not to use the word 'audit' in describing the nature of services of the members. Similarly, his fee should not be described as 'audit fee' in the accounts, correspondence, or any other document.

10. Communication of Report or Certificate

10.1 The reporting auditor may address his report or certificate to client or to the public authority or person requiring it, as may be. In appropriate circumstances, a certificate may be issued without reference to any particular person or by using the words, "To whomsoever it may concern".

10.2 The report or certificate should normally be issued to the client who should be responsible for forwarding the same to the concerned authority, where so required.

11. Communication with the Previous Reporting Auditor

It, would be a healthy tradition if the practice of communicating with the member who had done the work previously is followed in every case where a member is required to give a report or certificate for a special purpose.

12. Illustrations

The appendices to this Note give certain illustrations of audit reports and certificates for special purposes. Appendix I contains certain statutory certificates while Appendix II comprises of specimen certificates of non-statutory nature. It may be noted that there are a large number of other certificates - statutory and non-statutory - which a Chartered Accountant may be called upon to issue under specific circumstances.

APPENDIX I

Illustrations of Statutory Audit Reports and Certificates for Special Purposes.

(1) Auditors' certificate in the application for consent to the issue of bonus shares made to the Controller of Capital Issues¹:

"We have verified the information furnished by the company, for issue of bonus shares and find the same as correct. We also certify that we have received all the information required by us for the verification.

We hereby certify that the proposal contained in the application for the issue of bonus shares meets all the requirements of the bonus issue guidelines, including the guidelines contained in paragraphs 8, 9, 11 and 13 in force issued by the Government in this regard according to the information furnished to us and to the best of our knowledge."

(2) Auditors' certificate in the application form² for issue of securities other than bonus shares under the Capital Issues Control Act, 1947.

"We have verified the information furnished in the above application of the company for issue of fresh capital and find the same as correct. We also certify that we have received all the information required by us for the verification.

We hereby certify that the requirements of clause 5 of the Capital Issues (Exemption) Order, 1969, have been fully met by the company for the issue of acknowledgment/ consent by the Controller of Capital Issues to the information furnished to us and to the best of our knowledge."

(3) Chartered Accountant's Certificate³ on Exports

Ref No.

Date

Place

CHARTERED ACCOUNTANT'S CERTIFICATE

"The is to certify that we have checked and verified the above particulars of exports from the books/documents of MIs and found the same to be correct."

(Signature	of	the	Chartered	Accountant)
Official				Stamp
Full	Address		Regn.	No.....

(4) *Chartered Accountant's Certificate⁴ on Certain Matters in the Application for Grant/Renewal of 'Export House' certificate under Import-Export Policy 1983-84*

Certificate of The Chartered Accountant

"We (name and address of the Chartered Accountant) hereby certify that we have checked and verified the above particulars of exports from the books/documents of M/S and found the same to be correct. We also certify that the exports mentioned in this statement, excluding those exports which were made as associates of the STC/MMTC are direct exports of M/s and the export documents viz. export order/contract, bank certificate and invoice were in the name of M/s

We have verified that each export invoice is properly supported by a purchase voucher."

Signature	of the	Chartered	Accountant.....
Official		Stamp	
Full		Address	
Registration No.			

Dated:

(5) *Chartered Accountant's Certificate⁵ on the Statement Showing Consumption of imported Raw Materials, Components and Consumables under Import-Export Policy 1983-84.*

"I/We have verified that the applicant unit has duly furnished to the D.C.T.D., Department of Electronics, Textile Commissioner or other sponsoring authorities concerned, its production returns for the year 1982-83 and other prescribed returns/statements. for the same year, as it was required to furnish under the provisions of Imports and Exports Control Rules, Industrial (Development and Regulation) Act, Textile Control Order, etc.

2 I/We do hereby certify that consumption as certified in the statement has been verified from the books maintained by M/s and found the same as correct. I/We have also put my/our office seal and signature on the books from which the information has been verified.

3. I/We also certify that the applicant unit has been maintaining proper account of consumption in the prescribed form as indicated in the Hand Book of Import-Export Procedures, 1983-84.

4. I am not a partner, a Dire~ or an employee of the applicant firm or its associates.

5. I have been duly appointed for the purpose by the Board of Directors of the Company or management as the case may be (In the case of Chartered Accountants/ Cost Accountant)."

Signature and Seal of Chartered Accountant

Name of the Signatory
Full address
Date
(Seal)

(6) Chartered Accountant's Certificate⁶ Regarding Certain Matters in the Application for Grant of Export Performance Certificate under Import-Export Policy 1983-84.

"I/We do hereby certify that the information given in this statement has been verified from the books maintained by M/s and found the same as correct. I/We have also put my/our office seal and signature on the books from which the information has been verified.

I/We am/are neither a partner, a Director nor an employee of the applicant or its associates."

Place

Date

Signature and seal of Chartered Accountant

Name of the signatory
Full address
Membership No.
(Seal)
Residential Address

APPENDIX-II

Illustration of non-statutory audit reports and certificates for special purposes

(1) Chartered Accountant certificate⁷ regarding employers' bonus computation:

"We have reviewed the figure in the above computation, in comparison with the books and records of X Company Limited, produced to us, the audit of which has already been completed by us or another firm of chartered accountants and report that, subject to the notes given on the face of computation, in our opinion, and to the best of our knowledge and belief and according to the information and explanations given to us, the above computation is in due accordance therewith and has been made on a basis reasonably consistent with the provisions of the Payment of Bonus Act, 1965."

(2) Auditors' certificate⁸ pursuant to Companies (Acceptance of Deposit) Rules, 1975.

"We have examined the books of account and records maintained by Company Ltd. in respect of the particulars furnished in the Return of Deposits as on 31st March 19.... and certify that to the best of our knowledge and according to the information and explanations given to us and as shown by us, the figures of deposits and interest rates under Parts A, B, and C of the Return are correct.

We further certify the correctness of the particulars of the paid up capital and free reserves, etc. given in the Manager's Certificate."

(3) Chartered Accountants' Report on the basis of a limited review of interim financial statements

As requested, we have carried out, a limited review of the attached balance sheet of _____ as at _____ and the profit and loss account for the quarter ended on that date annexed thereto.

We clarify that these financial statements have not been subjected by us to a complete audit, in accordance with generally, accepted auditing practices, necessary for expressing an opinion whether the statements show a true and fair view. We have, however, made a limited review including an understanding of the manner in which the financial statements have been complied, and have made such enquiries and analytical review and obtained such information and explanations, as were considered necessary.

Subject to the above and based on our limited review, we report that the financial statements referred to in this report give the information in accordance with the books of account, records and other statements produced before us and have been drawn up in accordance with the applicable and generally accepted accounting principles.

(4) Accountants' Report on Unaudited Statements

In accordance with the instructions given to us, we have without carrying out an audit, compiled the attached financial statements (pages _____) for the period _____ from the accounting records of _____ and from the information and explanations given to us. As these statements have not been audited by us, we do not express an opinion on them."

* These subjects have been dealt with in separate publications of the Institute, viz. "Guidance Note on Accountants' Report on Profit Forecasts and/or Financial Forecasts" and "Guide to Tax Audit".

1. Part E of Schedule B to the Capital Issues (Application for Consent) Rules, 1966, Notification No. G.S.R.600, dated 29th March 1966, Government of India, Ministry of Finance.
2. Part G of Schedule A to the Capital Issues (Application for Consent) Rules, 1966, Notification No. G.S.R.600, dated 29th March 1966, Government of India, Ministry of Finance.
3. Annexure XI of Appendix 10 to the Hand Book of Import-Export Procedures, 1983-84, Vol. II, Government of India, Ministry of Commerce, page 162.
4. Annexure XX of Appendix 10 to the Hand Book of Import-Export Procedures, 1983-84, Vol. II, Government of India, Ministry of Commerce, page 171.
5. Appendix 11 of the Import & Export Policy, 1983-84, Vol.I, Government of India, Ministry of Finance, page 182.
6. Appendix 13 of the Import & Export Policy, 1983-84, Vol.I, Government of India, Ministry of Finance, page 185.
7. The Payment of Bonus Act, 1965 - An Accountant's Study, The Institute of Chartered Accountants of India, page 7.
8. A Note on the Companies (Acceptance of Deposits) Rules, 1975, The Institute of Chartered Accountants of India, page 77.

AUDIT OF FIXED ASSETS

The following is the text of the Guidance Note on "Audit of Fixed Assets" 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 "Preface to the Statements on Standard Auditing Practices" 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. Chapter 3 of the existing "Statement on Auditing Practices" related to "Fixed Assets" provides guidance in respect of both accounting and auditing aspects of fixed assets. The accounting aspects of fixed assets form the subject matter of an Accounting Standard on "Accounting for Fixed Assets" which is being prepared by the Accounting Standards Board of the Institute of Chartered Accountants of India. This Guidance Note on Audit of Fixed Assets therefore supersedes auditing aspects of the said Chapter 3 of the existing Statement.
3. This Guidance Note, however, does not supersede the Institute's publications which provide guidance on audit of fixed assets with special reference to certain statutes, e.g., the Statement on Manufacturing and Other Companies (Auditor's Report) Order, 1975.
4. In the event of a possible or perceived contradiction between the Guidance Note and a Statement on Standard Auditing Practices (SAP) issued by the Institute, the practices laid down in the SAP will prevail.

Introduction

5. Fixed assets are assets held for the purpose of providing or producing goods or services and are not meant for sale in the normal course of business. Therefore, an asset can be classified as a fixed asset or otherwise depending upon the use to which it is put or intended to be put. For example, assets which are classified as fixed assets in one type of business may be considered as current assets in another. Similarly, the same asset may be classified differently in an enterprise at different points of time.

6. Fixed assets normally constitute a significant portion of the total assets, particularly in a manufacturing enterprise. Audit of fixed assets therefore assumes considerable importance.

7. The following features of fixed assets have an impact on the related audit procedures;

(i) By their very nature, fixed assets are turned over much slower than current assets. Normally, fixed assets are carried over from year to year.

(ii) The average unit of fixed assets is normally of a relatively larger rupee value.

(iii) Since fixed assets are high value items, their acquisition is more effectively controlled. The control aspect assumes special significance where fixed assets are self-constructed.

(iv) In an inflationary situation, normally the book values of fixed assets are considerably lower than their replacement values.

Internal Controls

8. An auditor should review the system of internal controls relating to fixed assets particularly the following:

(i) Control over expenditure incurred on fixed assets acquired or self-constructed - an effective method of exercising this control is capital budgeting, which, apart from ensuring proper authorisation of the expenditure incurred, also shows in general how effectively such expenditure is being controlled through periodical comparisons of actuals with budgeted figures.

(ii) Accountability and utilisation controls - accountability over each fixed asset (or each class of fixed assets) is established, among other things, by maintaining, appropriate records. This facilitates control aspects of custodianship of such assets, for example, physical verification by the management or establishment of procedures relating to disposal of fixed assets. On the other hand utilisation controls ensure that the individual fixed assets have been properly used for meeting the objectives of the enterprise.

(iii) Information controls - these controls ensure that reliable information is available for calculating and allocating depreciation, recording disposals or retirements, preparing tax returns, establishing the amount of insurance coverage, filing insurance claims controlling repairs and maintenance charges etc.

Verification

9. Verification of fixed assets consists of examination of related records and physical verification. The auditor should normally verify the records with reference to the documentary evidence and by evaluation of internal controls. Physical verification of fixed assets is primarily the responsibility of the management.

Verification of Records

10. The opening balances of the existing fixed assets should be verified from records such as the schedule of fixed assets, ledger or register balances.

11. Acquisition of new fixed assets and improvements in the existing ones should be verified with reference to supporting documents such as orders, invoices, receiving reports and title deeds.

12. Self-constructed fixed assets, improvements and capital work-in-progress should be verified with reference to the supporting documents such as contractors' bills, work-order records and independent confirmation of the work performed.

13. The auditor should scrutinise expense accounts (e.g. Repairs and Renewals) to ascertain that new capital assets and improvements have not been included therein.

14. Where fixed assets have been written-off or fully depreciated in the year of acquisition/construction the auditor should examine whether these were recorded in the fixed assets register before being written-off or depreciated.

15. In respect of fixed assets retired, i.e., destroyed, scrapped or sold, the auditor should examine (a) whether the retirements have been properly authorised and appropriate procedures for invitation of quotations have been followed wherever applicable; (b) whether the assets and depreciation accounts have been properly adjusted; (c) whether the sale proceeds, if any, have been fully accounted for; and (d) whether the resulting gains or losses, if material, have been properly adjusted and disclosed in the profit and loss account.

16. It is possible that certain assets destroyed, scrapped or sold during the year have not been recorded. The auditor may use the following procedures to ascertain such omissions:

(i) Review work orders/physical verification reports to trace any indicated retirements.

(ii) Examine major additions to ascertain whether they represent additional facilities or replacement of old assets which may have been retired.

(iii) Make enquiries of key management and supervisory personnel.

(iv) Obtain a certificate from a senior official and/or departmental managers that all assets scrapped, destroyed or sold have been recorded in the books.

17. The ownership of assets like land and buildings should be verified by examining title deeds. In case, the title deeds are held by other persons, such as solicitors or bankers, confirmation should be obtained directly by the auditors through a request signed by the client.

Physical Verification

18. It is the responsibility of the management to carry out physical verification of fixed assets at appropriate intervals in order to ensure that they are in existence. However, the auditor should satisfy himself that such verification was done by observing the verification being conducted by the management wherever possible and by examining the written instructions issued to the staff by the management and the relevant working papers.

The auditor should also satisfy himself that the persons conducting the verification, whether the employees of the enterprise or outside experts (if employed), had the necessary competence.

19. The auditor should examine whether the method of verification was reasonable in the circumstances relating to each asset. For example, in the case of certain process industries, verification by direct physical check may not be possible in the case of assets which are in continuous use or which are concealed within larger units. It would not be realistic to expect the management to suspend manufacturing operations merely to conduct a physical verification of the fixed assets, unless there are compelling reasons which would justify such an extreme procedure. In such cases indirect evidence of the existence of the assets may suffice. For example, the very fact that an oil refinery is producing at normal levels of efficiency may be sufficient to indicate the existence of the various process units even where each such unit cannot be verified by physical or visual inspection. It may not be necessary to verify assets like building by measurement except where there is evidence of alteration/demolition. At the same time in view of the possibility of encroachment, adverse possession, etc., it may be necessary for a survey to be made periodically of open land. Where the fixed assets can be moved and where verification of all assets cannot be conducted at the same time, they should be marked with distinctive numbers.

20. The auditor should examine whether the frequency of verification was reasonable in the circumstances of each case. Where the assets are few and can be easily verified, an annual verification may be considered as reasonable. However, where the assets are numerous and difficult to verify, a verification, say, once every three years by rotation - so that all assets are verified at least once in every three years - may be sufficient.

21. The auditor should test check the book records of fixed assets with the physical verification reports. He should examine whether discrepancies noticed on physical verification have been properly dealt with. In this regard the auditor has to use his judgement as to whether having regard to the circumstances the discrepancy is material enough to warrant an adjustment in the accounts and/or modification in the internal control system.

Valuation and Disclosure

22. The auditor should satisfy himself that the fixed assets have been valued and disclosed in the financial statements according to the generally accepted bases of accounting which are determined by law, professional pronouncements¹ (An illustrative list of professional pronouncements on the subject is given in Appendix A.) and prevailing practices.

23. The auditor should test check the calculations of depreciation and the total depreciation arrived at should be compared with that of the preceding years to identify reasons for variations. He should particularly examine whether the depreciation charge is adequate keeping in view the generally accepted bases of accounting for depreciation.

24. Revaluation of fixed assets implies restatement of their book values on the basis of systematic scientific appraisal which would include ascertainment of working condition of each unit of fixed assets, technical estimates of future working life and the possibility of obsolescence. Such an appraisal is usually made by independent and qualified persons such as engineers, architects, etc. To the extent possible, the auditor should examine these appraisals. As long as the appraisals appear reasonable and based on adequate facts, he is entitled to accept the revaluation made by the experts.

25. Where several assets have been purchased for a consolidated price, the auditor should examine the method by which the consideration has been apportioned to the various assets. In case this has been done on the basis of an expert valuation, he should examine whether the same appears reasonable and based on adequate facts.

26. Where an enterprise owns assets jointly with others (otherwise than as a partner in a firm) the auditor should examine the relevant documents such as title deeds, agreements etc., in order to ascertain the extent of the enterprise's share in such assets.

APPENDIX A

List of publications issued by the Institute of Chartered Accountants of India which indicate the generally accepted bases of accounting of fixed assets.

A. Accounting Standards

1. Disclosure of Accounting Policies (AS 1).
2. Prior Period and Extraordinary Items and Changes in Accounting Policies (AS 5).
3. Depreciation Accounting (AS 6).
4. Accounting for fixed Assets (AS 10).

B. Other Publications

1. Guidance Note on Treatment of Expenditure During Construction Period.
2. Statement on Accounting for Foreign Currency Translation.
3. Guidance Note on Accounting Treatment of Interest on Deferred Payments.
4. Guidance Note on Accounting for Capital Based Grants.

5. Guidance Note on Treatment of Reserves Created on Revaluation of Fixed Assets.

6. Compendium of Guidance Notes - Guidance Notes on 'Provision for Depreciation' and 'Mode of Valuation of Fixed Assets'.

Guidance Note on Audit of Abridged Financial Statements

The following is the text of the Guidance Note on 'Audit of Abridged Financial Statements' issued by the Auditing Practices Committee of the Council of the Institute of Chartered Accountants of India.¹ This Guidance Note should be read in conjunction with the 'Preface to the Statements on Standard Auditing Practices' issued by the Institute.

Introduction

1. Sub-section (1) of section 219 of the Companies Act, 1956 requires every company to send a copy of its balance sheet, profit and loss account and other documents attached or annexed to the balance sheet to its members and other persons specified therein. The Companies (Amendment) Act, 1988 has inserted a new proviso (b)(iv) to sub-section (1) which provides that a company listed on a recognised stock exchange may, instead of sending a copy of the documents as aforesaid, send a statement containing the salient features thereof in the prescribed form, subject to complying with certain conditions. The purpose of this Guidance Note is to provide guidance to members on issues relating to audit of such a statement.

Legal Requirements

2. Sub-section (1) of section 219 of the Companies Act, 1956 provide

"(1) A copy, of every balance sheet (including the profit and loss account, the auditors' report and every other document required by law to be annexed or attached, as the case may be, to the balance sheet) which is to be laid before a company in general meeting shall, not less than twenty-one days before date of the meeting, be sent to every member of the company, to every trustee for the holders of any debentures issued by the company, whether such member or trustee is or is not entitled to have notices of general meetings of the company sent to him, and to all persons other than such members or trustees, being persons so entitled;

Provided that -

(a) in the case of a company not having a share capital, this sub-section shall not require the sending of a copy of the documents aforesaid to a member, or holder of debentures, of the company who is not entitled to have notices of general meetings of the company sent to him;

(b) this sub-section shall not require a copy of the documents aforesaid to be sent -

(i) to a member, or holder of debentures, of the company, who is not entitled to have notices of general meetings of the company sent to him and of whose address the company is unaware;

(ii) to more than one of the joint holders of any shares or debentures none of whom is entitled to have such notices sent to him;

(iii) in the case of joint holders of any shares or debentures some of whom are and some of whom are not entitled to have such notices sent to them, to those who are not so entitled;

(iv) in the case of P company whose shares are listed on a recognised stock exchange, if the copies of the documents aforesaid are made available for inspection at its registered office during working hours for a period of twenty-one days before the date of the meeting and a statement containing the salient features of such documents in the prescribed form or copies of the documents aforesaid, as the company may deem fit, is sent to every member of the company and to every trustee for the holders of any debentures issued by the company not less than twenty-one days before the date of the meeting."

It can be seen that proviso (b)(iv) gives an option to a company whose shares are listed on a recognised stock exchange to send either (a) a copy of the balance sheet and other documents listed in sub-section (1), or (b) a statement containing the salient features of those documents in the prescribed form. In the latter case, however, copies of the documents listed in sub-section (1) (i.e., balance sheet, profit and loss account, auditors' report and other documents required by law to be annexed or attached to the balance sheet) have to be made available for inspection at the registered office of the company during working hours for a period of twenty-one days before the date of the meeting.

3. The Central Government has prescribed the form and content of the statement to be sent in pursuance of proviso (b) (iv) to section 219(1).² Accordingly, such a statement should contain -

(a) an abridged balance sheet in the prescribed form;

(b) an abridged profit and loss account in the prescribed form;

(c) the auditors' report in full; and

(d) the report of the board of directors in full, except that the particulars of employees (to be included in the board's report pursuant to the requirements of sub-section (2A) of section 217 of the Act) need not be given.

The documents at (a) and (b) are collectively referred to in this Guidance Note as 'abridged financial statements'. The terms 'balance sheet' and 'profit and loss account' used in this guidance note refer to those statements prepared in accordance with the requirements of Schedule VI to the Companies Act, 1956.

4. It may be emphasised that the format of abridged financial statements, as prescribed by the Central Government, represents the minimum disclosure requirements. Therefore, if in the circumstances of a particular case, disclosure of certain information is considered necessary or desirable to enable the readers to appreciate properly the financial position or the working results, it is recommended that the company should disclose such information in its abridged financial statements even in the absence of a specific requirement to do so.

Form and Content of Abridged Balance Sheet

5. The abridged balance sheet is required to be prepared in vertical form and has to disclose the various sources of funds and applications thereof.

6. The sources of funds are to be broadly classified into shareholders' funds and loan funds. Shareholders' funds comprise (a) capital (equity and preference capital to be disclosed separately) and (b) reserves and surplus (classified into capital reserve, revenue reserve, revaluation reserve and surplus in the profit and loss account). Loan funds comprise debentures, public deposits, secured loans (other than debentures) and unsecured loans. It may be noted that deferred payment liabilities would also be included in loan funds.

7. With regard to the disclosure of reserves, the- following extracts from Part III of Schedule VI to the Companies Act, 1956, setting out the definitions of the terms *reserve*, *capital reserve* and *revenue reserve*, may be noted.

"(1) For the purposes of Parts 1 and I1 of this Schedule, unless the context otherwise requires:

(a) the expression 'provision' shall, subject to sub-clause (2) of this clause, mean any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets, or retained by way of providing for any known liability of which the amount cannot be determined with substantial accuracy;

(b) the expression, "reserve" shall not, subject as aforesaid, include any amount written off or retained by way of providing for any known liability.

(c) the expression 'capital reserve' shall not include any amount regarded as free for distribution through the profit and loss account; and the expression 'revenue reserve' shall mean any reserve other- than a capital reserve;

and in this sub-clause the expression 'liability shall include all liabilities in respect of expenditure contracted for and all disputed or contingent liabilities.

(2) Where -

(a) any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets, not being an amount written off in relation to fixed assets before the commencement of this Act; or

(b) any amount retained by way of providing for any known liability

is in excess of the amount which in the opinion of the directors is reasonably necessary for the purpose, the excess shall be treated for the purposes of this Schedule as a reserve and not as a provision."

8. The disclosure of reserves in the abridged balance sheet is somewhat different from that in the case of the balance sheet. For example, Capital Redemption Reserve is required to be shown separately in the balance sheet. In the abridged balance sheet, however, separate disclosure of capital redemption reserve is not required. In this regard, the following recommendations are made.

(a) Capital Reserves, Capital Redemption Reserve and Share Premium Account, as appearing in the balance sheet, may be included under the head 'Capital Reserves' in the abridged balance sheet.

(b) Revenue reserves are required to be disclosed separately in the abridged balance sheet. Revenue reserves, by definition, are available for distribution as dividend under the provisions of the Companies Act, 1956. However, investment allowance reserve, though a revenue reserve within the meaning of the Companies Act, cannot be distributed before the period specified in this behalf in the Income-tax Act, 1961, without foregoing the deduction claimed in respect thereof. Therefore, for a proper appreciation of the nature of various revenue reserves, it is suggested that investment allowance reserve, if material, should be shown separately from other revenue reserves.

9. The applications of funds comprise fixed assets, investments, current assets, loans and advances less current liabilities and provisions, miscellaneous expenditure to the extent not written off or adjusted, and the debit balance of profit and loss account. Investments are to be classified into those in government securities, in subsidiary companies (quoted and unquoted investments to be shown separately) and others (quoted and unquoted investments to be shown separately). Current assets are to be classified into inventories, sundry debtors, cash and bank balances, and other current assets. Loans and advances to subsidiaries and to others are to be shown separately. Current liabilities have to be shown separately from provisions. The debit balance of profit and loss account should be shown after deduction of the uncommitted reserves, if any.

10. It is required that where fixed assets are revalued, the amount of revaluation should be shown separately for the first five years subsequent to the date of revaluation. This requirement is similar to that applicable in the case of disclosure of fixed assets in the balance sheet. Thus, a company which has revalued its assets will have to show the revalued amounts in place of the original cost in the abridged balance sheet. For the first five years subsequent to the date of revaluation, the amount of increase or decrease in the value of assets consequent to the revaluation will also have to be shown.

11. The market value of quoted investments has to be stated, both for the current year as also for the previous year.

Form and Content of Abridged Profit and Loss Account

12. The form of abridged profit and loss account requires the disclosure of income, expenditure, profit/loss before tax, provision for taxation, profit/loss after tax, proposed dividend (separately in respect of preference shares and equity shares) and transfer to reserves/surplus.

13. Under the head 'income', details of sales/services rendered have to be given in the form prescribed in this behalf. Income in the form of dividend and in the form of interest have to be shown separately. Any other income, which does not fall within the sub-heads of 'sales/services rendered', 'dividend' and 'interest', has to be shown under the head 'other income'. In this regard, it is provided that any item which constitutes 20% or more of the total income should be shown separately in the abridged profit and loss account.

14. Under the head 'expenditure', the following details are required to be given: cost of goods consumed/sold (opening stock, purchases and closing stock to be shown separately); manufacturing expenses; selling expenses; salaries, wages and other employee benefits; managerial remuneration; interest; depreciation; auditor's remuneration; and provisions for (i) doubtful debts and (ii) other contingencies (to be specified). Those items of expenditure which do not fall in any of the above categories are to be shown under the head 'any other expenses'. As in the case of income, it is required that any item of expenditure which constitutes 20% or more of the total expenditure (including provisions) should be shown separately. The term 'managerial remuneration', for purposes of disclosure in the abridged profit and loss account, maybe construed as having the same meaning as is assigned thereto in the Explanation to section 198 of the Companies Act, 1956. It may be mentioned that Schedule VI also requires a separate disclosure of 'managerial remuneration under section 198 paid or payable during the financial year'.

15. It may be noted that disclosure is required in the abridged profit and loss account of 'manufacturing expenses' and 'selling expenses'. The requirements of Part 11 of Schedule VI regarding the information to be disclosed in the profit and loss account do not envisage disclosure under these categories and follow a somewhat different classification of expenses. For example, Schedule VI requires disclosure of the total expenditure on rent, irrespective of whether the rent is paid in respect of factory premises or retail outlets. In the abridged profit and loss account, on the other hand, the rent on factory premises would be included under the head 'manufacturing expenses' whereas the rent in respect of retail outlets would form a part of 'selling expenses'. Thus, some of the items appearing in the profit and loss account may require analysis and re-classification for the purpose of inclusion under the heads 'manufacturing expenses' and 'selling expenses'. In this context, the term 'manufacturing expenses' may be construed as referring to direct production costs and production overheads other than those which are required to be disclosed separately in the abridged profit and loss account. Similarly, selling expenses may include all direct and indirect expenses on selling and distribution other than those which are required to be disclosed separately in the abridged profit and loss account. The re-classification of the relevant items, as stated above, should be done on a reasonable basis, considering in particular the materiality of the items involved.

Other Requirements Regarding Abridged Financial Statements

16. In the abridged financial statements, figures have to be given for the current year as well as for the previous year.

17. The total amount of contingent liabilities and that of capital commitments has to be shown separately, as a note to the abridged balance sheet.

18. The amount, if material, by which any item shown in the profit and loss account is affected due to any change in the basis of accounting has to be disclosed separately. It is also required that where no provision is made for depreciation, the---fact that no provision has been made should be stated along with the quantum of arrears of depreciation computed in accordance with section 205(2) of the Act. These requirements are similar to those applicable in the case of the profit and loss account.

19. The instructions for preparation of abridged financial statements clearly specify that the amounts to be shown in the abridged statements should be the same as shown in the corresponding aggregated heads in the accounts as per Schedule VI or as near thereto as possible. It is also required that all notes forming part of the accounts as per Schedule VI to which specific attention has been drawn by the auditors or which form a subject matter of a qualification by the auditors should be reproduced. Similarly, any note forming part of the accounts as per Schedule VI which is in the nature of any explanation regarding compliance with any law should be reproduced.

20. Since all the notes forming part of the annual accounts as per Schedule VI are not required to be given in the abridged financial statements, a problem about their numbering may arise. To illustrate, suppose the abridged financial statements contain five notes, numbered sequentially from 1 to 5. These notes may have been numbered in the annual accounts as per Schedule VI as notes number 3, 4, 11, 16 and 21. The different numbering of the notes would make it difficult for a reader to relate the auditor's observations with reference to a specific note as contained in his report on annual accounts, with the notes appearing in the abridged financial statements. To overcome this difficulty, it is suggested that while giving a note on abridged financial statements, wherever necessary, its number in the annual accounts should also be specified.

Authentication of Abridged Financial Statements

21. The abridged balance sheet and the abridged profit and loss account are required to be authenticated in the same manner as the balance sheet and profit and loss account are required to be authenticated.

Audit of Abridged Financial Statements

22. Although the Companies Act, 1956 does not specifically require the abridged financial statements to be audited, it is a healthy practice to get these audited by statutory auditors. The audit of abridged financial statements assures the readers that the relevant information is properly disclosed in such statements and thus lends a greater degree of credibility to them.

23. It is recommended that where an auditor carries out an audit of the abridged financial statements, he should examine whether the requirements relating to preparation of such statements as laid down in the relevant notification have been duly complied with. In case the audit report on abridged financial statements is issued on a date subsequent to the issuance of the audit report on annual accounts as per Schedule VI, the auditor's responsibility in relation to event occurring after the balance sheet date is limited to the events occurring up to the date of his report on the annual accounts.

24. If, based on his examination as aforesaid, the auditor is satisfied that the abridged financial statements are proper in all respects, he should issue an unqualified audit report. An example of an unqualified audit report on the abridged financial statements of a company is given in Appendix B to this Guidance Note.

25. Where the auditor has certain reservations about the abridged financial statements, e.g., he is of the opinion that a material piece of information has not been disclosed in the abridged financial statements or has been disclosed in an inappropriate manner, he should express a qualified opinion or an adverse opinion, as appropriate. In this regard, he should bear in mind the relevant requirements of the *Statement on Qualifications in Auditor's Report*³ issued by the Institute. An example of a qualified audit report on the abridged financial statements of a company is given in Appendix C to this Guidance Note.

Appendix A

(Ref. Para 3)

FORM NO. 23AB⁴

(See Rule 7A)

STATEMENT CONTAINING SALIENT FEATURES OF BALANCE SHEET AND PROFIT AND LOSS ACCOUNT ETC. AS PER SECTION 219 (1) (b) (iv)

FORM OF ABRIDGED BALANCE SHEET

Name of the company _____

Abridged Balance Sheet as at _____

Particulars	<i>Figures as at the end of</i>	
	Current Financial Year	Previous Financial Year
I. Sources of Funds		
(1) Shareholders' funds		
(a) Capital		
(i) Equity		
(ii) Preference		
(b) Reserves and surplus		
(i) Capital reserve		
(ii) Revenue reserve		
(iii) Revaluation reserve		
(iv) Surplus in Profit and Loss Account		
(2) Loan funds		
(a) Debentures		
(b) Public deposits		
(c) Secured loans (other than. debentures)		
(d) Unsecured loans		
Total of (1) and (2)	_____	_____
II. Applications of funds		
(1) Fixed assets		
(a) Net block (original cost less depreciation)		
(b) Capital work in progress		
(2) Investments		
(a) Government securities		
(b) Investment in subsidiary companies		
(a) Quoted		
(b) Unquoted		
(c) Others		
(a) Quoted		
(b) Unquoted		
(3) (i) Current assets, loans and advances	_____	_____

- (a) Inventories
- (b) Sundry debtors
- (c) Cash and bank balances
- (d) Other current assets
- (e) Loans and advances

- (i) To Subsidiary companies
- (ii) To others

Less

- (ii) Current liabilities and provisions

- (a) Liabilities
- (b) Provisions

Net current assets (i-ii)

(4) Miscellaneous expenditure to the extent not written off or adjusted

(5) Profit and Loss Account

Total of (1) to (5)

Abridged Profit and Loss Account For the year ending _____

Particulars	<i>Figures for the</i>	
	Current year	Previous year
<i>I. Income</i>		
Sales/Services rendered (Details to be given separately as per Annexure)		
Dividend		
Interest		
Other income (See Note 5)	_____	_____
Total	_____	_____
<i>II. Expenditure</i>		
Cost of goods consumed/sold		
(i) Opening stock		
(ii) Purchases	_____	_____

Less Closing stock		
Manufacturing expenses		
Selling expenses		
Salaries, wages and other employee benefits		
Managerial remuneration		
Interest		
Depreciation		
Auditor's remuneration		
Provisions for		
(i) doubtful debts; and		
(ii) other contingencies		
(to be specified)		
Any other expenses (See Note 5)		
Total		
III. Profit/loss before Tax (I - II)		
IV. Provision for taxation		
V. Proposed dividend		
- Preference shares		
- Equity shares		
VII. transfer to reserves/surplus		

NOTES TO THE ABRIDGED BALANCE SHEET AND THE ABRIDGED PROFIT AND LOSS ACCOUNT

1. The amounts to be shown here should be the same as shown in the corresponding aggregated heads in the accounts as per Schedule VI or as near thereto as possible.
2. The total amount of contingent liabilities and that of capital commitments should be shown separately.

3. All notes forming part of the Accounts as per Schedule VI to which specific attention has been drawn by the auditors or which form a subject matter of a qualification by the auditor should be reproduced.

4. If fixed assets are revalued, the amount of revaluation to be shown separately for the first five years subsequent to the date of revaluation.

5. Any item which constitutes 20% or more of the total income or expenditure (including provisions) should be shown separately.

6. Amount, if material, by which any items shown in the profit and loss account are affected by any change in the basis of accounting, should be disclosed separately.

7. If no provision is made for depreciation, the fact that no provision has been made shall be stated along with the quantum of arrears of depreciation computed in accordance with section 205(2) of the Act.

8. Market value of Quoted Investments (both for current year as also previous year) be mentioned.

9. Any note forming part of the Accounts as per Schedule VI which is in the nature of any explanation regarding compliance with any law should be reproduced.

The above stated salient features of Balance Sheet and Profit and Loss account should be authenticated in the same manner as the Main Accounts are to be authenticated.

AUDITOR'S REPORT

- Should be given in full.

DIRECTORS' REPORT

Should be given in full except the information about employees under section 214(2A)

(Signed by Directors/Secretary)
in the manner prescribed in
section 215(1).

ANNEXURE

SALIENT FEATURES OF ADDITIONAL INFORMATION ON THE PROFIT AND LOSS ACCOUNT FOR THE YEAR ENDED _____

	Figures for the Current year Rs.'000	Figures for the Previous year Rs.'000

<i>Sales</i>					
Class of Goods	Units	Quantity	Rs.	Quantity	Rs.
		('000)		('000)	

Appendix B
(Ref. Para 24)

**Specimen Auditor's Report On Abridged Financial Statements
(Unqualified. Opinion)**

To the members of _____ Limited

We have examined the abridged balance sheet of _____ Limited as at _____ and the abridged profit and loss account for the year ended on that date, together with the notes thereon. These abridged financial statements have been prepared by the company pursuant to Rule 7A of the Companies (Central Government's) General Rules and Forms, 1956 and are based on the accounts of the company for the year ended _____ prepared in accordance with Schedule V1 to the Companies Act, 1956 and covered by our report of even date to the members of the company which report is attached.

For _____
Chartered Accountants
Partner

Dated:

Place:

Appendix C
(Ref. Para 25)

**Specimen Auditor's Report on Abridged Financial Statements
(Qualified Opinion)**

To the members of _____ Limited

We have examined the abridged balance sheet of _____ Limited as at _____ and the abridged profit and loss account for the year ended on that date, together with the notes thereon. Contrary to the requirements of Rule 7A of the Companies (Central Government's) General Rules and Forms, 1956, these abridged financial statements do not include notes nos. _____ (reproduced below) which form subject matters of qualifications in our report on the accounts prepared by the company in accordance with Schedule VI.

(Here, reproduce the notes referred to above.)

Subject to the above, these abridged financial statements have been prepared by the company pursuant to Rule 7A aforesaid and are based on the accounts of the company for the year ended _____ prepared in accordance with Schedule VI to the Companies Act, 1956 and covered by our report of even date to the members of the company which report is attached.

For _____
Chartered Accountants
Partner

Dated:

Place:

1. Attention of the members is invited to the 'Clarification Regarding Authority Attached to the Documents Issued by the Institute' published in the December 1985 issue of the journal. (An updated version of the same was published in the July 1990 issue.) Accordingly, 'Guidance Notes' are primarily designed to provide guidance to members on matters which may arise in the course of their professional work and on which they may desire assistance in resolving issues which may pose difficulty. Guidance Notes are recommendatory in nature. A member should ordinarily follow recommendations in a guidance note relating to an auditing matter except where he is satisfied that, in the circumstances of the case, it may not be necessary to do so.

2. Form No. 23AB, prescribed by Notification No. GSR 449(E) dated April 17, 1989, Department of Company Affairs, Ministry of Industry, Government of India. The form is reproduced in Appendix A to this Guidance Note.

3. Statement on Qualifications in Auditor's Report, ICAI, New Delhi, 3rd Edition, 1984.

4. Prescribed by Notification No. GSR 449(E) dated April 17, 1989, Department of Company Affairs, Ministry of Industry, Government of India.

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 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.¹

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, 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 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.

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.² Inventories normally comprise raw materials including components, work-in-process, finished goods including by-products, maintenance supplies, stores and spare parts, and loose tools.³

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 jewellery.

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 inventories⁴:

(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 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 value of inventories rests with the management entity. It is therefore the responsibility of the management of the entity sure that the inventories included in the financial information are physical 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 (see Statement on Standard Auditing Practices 5, 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, x 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 issfie 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 maintained 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 stock-taking 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 pr4ction,

receiving, or despatch 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 pro forma 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 pro forma 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 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;
- 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. co.' 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 r -fitted. When the work of counting is completed you should hand over the rem- ming 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 insignificant value, such as bolts, nuts (state here any other items 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 to 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 auditors⁶, instructions issued for the removal of the tags and a suitable person should be in each department to detach the detachable portion of the tags, counterpart in the proper position. When they are collected, al should be brought back to a central location, placed in serial order 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 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 "stings 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.

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 - 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:

Description	Quantity
.....	
.....	

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. Paragraf 23]

[Letterhead of the entity]

{Date]

[Name and address of the 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:

Description	Quantity
-------------	----------

.....	
.....	

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 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)	Rs. _____
Work-in-Process	Rs. _____
Finished Goods (including by-products)	Rs. _____
Maintenance supplies and Stores and Spare Parts	Rs. _____
Loose Tools	Rs. _____
Others (specify each major head separately)	Rs. _____
Total	Rs. _____
	Rs. _____

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

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, slowmoving, 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:

Class of		Basis of Valuation	Effect of change in	Inventory
This year	Last year	Basis of Valuation		
...			...	
...			...	

Yours faithfully,

[Signature of responsible
official of the entity]

¹ With the formation of the Auditing Practices Committee in 1982, the Council of the has been issuing a series of Statements on Standard Auditing Practices (SAPs). Statements on Auditing Practices lay down the principles governing an audit. These principles apply when independent audit is carried out. Statements on Standard Auditing Practices become mandatory dates specified in the respective SAPs. Their mandatory status implies that, while discharging tl function, it will be the duty of the members of the Institute to ensure that the SAPs are following audit of financial information covered by their audit reports. If, for any reason, a member has able to perform an audit in accordance with the SAPs, his report should draw attention to the departures therefrom.

The Auditing Practices Committee has also been issuing, from time to time, guidance notes issues arising from SAPs. The Guidance Notes provide

guidance on procedures to be employed, auditor in order to comply with the principles laid down in SAPs. It is recognised that in deterrant nature, timing and extent of audit procedures to be employed in a specific situation, an auditor to exercise his professional judgment. The Guidance Notes, therefore, are recommendatory. A member should ordinarily follow the recommendations in a guidance note relating to an auditing mal where he is satisfied that, in the circumstances of the case, it may not be necessary to do so.

² Servicing equipment, stand-by equipment and specialised spares of machinery (which are in the nature of 'insurance spares') are normally capitalised.

³ 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 investment. Accordingly, this Guidance Note does not apply in respect of audit of shares, debentures and other securities held as stock-in-trade.

⁴ 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 controls in relation to inventories.

⁵ It may be mentioned that the Manufacturing and Other Companies (Auditor's Report) Order, 1989 uses the words "normally accepted accounting principles".

⁶ It is presumed that the auditors or their representatives are present at the time of stock-taking.

⁷ 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 Rs 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).

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 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

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 and to develop Statements on Standard Auditing Practices (SAPs) so that may be issued by the Council of the Institute. " Para 2.4 of the Preface states 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 viewing 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 then stand withdrawn.² 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.

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.³ 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 the date on which such investment is made. A long term investment is an investment other than a current investment.⁴

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.⁵

(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. There 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, matter of professional judgment of the auditor.

7. The investments of an entity may take various forms, e.g., they may be 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 right 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. Whenever 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 11 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 consists of shares, debentures and other securities have been sold at a price less than that at which they are purchased by the company.⁶

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, 1956.⁷

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.⁸

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.⁹ Appendix [1] 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 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 acknowledgement 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 presentation letter regarding investments is given in Appendix IV to this ice 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 2~2, 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 extent 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 dry 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(13) 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 concerned, whichever is less.

Further, an insurer cannot invest or keep invested any part of his assets in the shares of 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 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 in shares or debentures of any private company.

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]

[Date]

..... {Bank)

.....

.....

Dear Sirs,

For audit purpose, kindly send directly to our auditors (name and address 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)

APPENDIX III

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 V1 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, stock, 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 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 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 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)

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

(Letterhead of Entity)

[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)

¹ With the formation of the Auditing Practices Committee in 1982, the Council of the has been issuing a series of Statements on Standard Auditing Practices (SAPs). Statements on Auditing Practices lay down the principles governing an audit. These principles apply when independent audit is carried out. Statements on Standard Auditing Practices become mandatory from the dates specified in the respective SAPs. Their mandatory status implies that, while discharging the auditing function, it will be the duty of the members of the Institute to ensure that the SAPs are followed from audit of financial information covered by their audit reports. If, for any reason, a member has not been able to perform an audit in accordance with the SAPs, his report should draw attention to the departures therefrom. The Auditing Practices Committee has also been issuing, from time to time, guidance notes issues

arising from SAPs. The Guidance Notes provide guidance on procedures to be employed, auditor in order to comply with the principles laid down in SAPs. It is recognised that in deterrent nature, timing and extent of audit procedures to be employed in a specific situation, an auditor to exercise his professional judgment. The Guidance Notes, therefore, are recommendatory. A member should ordinarily follow the recommendations in a guidance note relating to an auditing matter where he is satisfied that, in the circumstances of the case, it may not be necessary to do so.

²This Guidance Note does not deal with special aspects of audit of investments of benefit plans, life insurance enterprises, mutual funds and/or the related asset management of banks and public financial institutions formed under a Central or State Government Act or s 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, Study on Audit of Companies Carrying on General Insurance Business. It may also be noted that 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 of entities insofar 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.

³ It may be clarified that the term 'investments' covers only to such securities as are beneficially owned by the entity and not those held by it on behalf of others.

⁴ 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 , Standard (AS) 10, Accounting for Fixed Assets, issued by the Institute, are also not investments.

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 in 1976 which contains, inter alia, an illustrative list of internal controls in relation to investments.

⁶ For a detailed discussion on this aspect, reference may be made to the Statement on Qualifications in an Auditor's Report, issued by the Institute of Chartered Accountants of India.

⁷For a detailed discussion on this aspect, reference may be made to the Statement on the Manufacturing and Other Companies (Auditor's Report) Order, 1988 (Issued under Section 227(4A) of the Companies Act, 1956), issued by the Institute of Chartered Accountants of India.

⁸Reference may be made in this regard to the Guidance Note on Audit of Fixed Assets issued by the Auditing Practices Committee of the Institute of Chartered Accountants of India.

⁹Reference may be made in this regard to Accounting Standard 13, Accounting for Investments, issued by the Institute of Chartered Accountants of India.

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 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.¹

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, 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.² In due course of time, the entire Statement on Auditing Practices shall be withdrawn.

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 Statement of Standard Auditing Practices 'Audit Evidence'). 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 auditors may also be particularly concerned with the valuation of cash and bank balances, e.g., in the case of (g) safe custody of cash, 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 cash and bank balances.³

- (a) 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;
- (b) proper authorisation of cash and banking transactions;
- (c) daily recording of cash transactions;
- (d) safeguards such as restrictive crossing of cheques, use of pre-printed, pre-numbered forms;
- (e) periodic reconciliation of bank balances;

(f) reconciliation of cash-on-hand with book balance on a daily basis or at other appropriate intervals, including surprise checks by higher authorities;

(g) safe custody of cash, cheque books, receipt books etc.; and

(h) 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 judgment of the auditor which is based, inter alia, on the auditor's evaluation of the effectiveness of the related internal controls.

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 balance 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 post dated 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 sizable 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. ⁴ 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]

[Date]

[Name and Address of Bank]

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.

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)

Date

Re: (Name of Client)

At the request of our client 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:	Amount
---------------------------------	--------

Designation of Account

2. Overdrawn Current Accounts, Overdraft	Amount
--	--------

Security Held (Give brief description. In the case of securities please list fully)

Accounts, Cash Credit Accounts

Designation of Account

3. Loan Accounts:	Amount	Security Held (Give brief description. In the case of securities please list fully)
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Designation of Account

4. Fixed, Call and Short Deposit Accounts:	Due Date	Particulars of any charges or liens
--	----------	-------------------------------------

Amount. Interest Accrued to the Closing Date

5. Investments and Other Documents of Title Held in Safe Custody:	Face Value or number of shares held
---	-------------------------------------

Designation

6. Margin against letters of credit, Guarantees Amount issued, etc:

Designation of Account

7. Bills for Collection:	Amount	Due Date
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Designation of Account

8. Bills Discounted or Purchased:	Amount	Due Date
-----------------------------------	--------	----------

Name of Drawee

9. Letters of Credit Open and Outstanding:	Amount utilised	not Valid up to
--	-----------------	-----------------

In favour of

10. Guarantees given on behalf of clients:	Amount	Date of expiry
--	--------	----------------

In favour of

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		

1. With the formation of the Auditing Practices Committee in 1982, the Council of the Institute has been issuing a series of Statements on Standard Auditing Practices (SAPs). Statements on Standard Auditing Practices lay down the principles governing an audit. These principles apply whenever an independent audit is carried out. Statements on Standard Auditing Practices become mandatory on the dates specified in the respective SAPs. Their mandatory status implies that, while discharging their attest function, it will be the duty of the members of the Institute to ensure that the SAPs are followed in the audit of financial information covered by their audit reports. If, for any reason, a member has not been able to perform an audit in accordance with the SAPs, his report should draw attention to the material departures therefrom. The Auditing Practices Committee has also been issuing, from time to time, guidance notes on issues arising from SAPs. The Guidance Notes provide guidance on procedures to be employed by an auditor in order to comply with the principles laid down in SAPs. It is recognised that in determining the nature, timing and extent of audit procedures to be employed in a specific situation, an auditor will have to exercise his professional judgment. The Guidance Notes, therefore, are recommendatory. A member should ordinarily follow the recommendations in a guidance note relating to an auditing matter except where he is satisfied that, in the circumstances of the case, it may not be necessary to do so.

2. 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 issued by the Auditing Practices Committee.

3. 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.

4. For valuation of foreign currency held as cash on 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

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 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.¹

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, 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 significant proportion of the total sources of funds of an entity. The audit of liabilities is primarily directed at ensuring that all known liabilities have been properly accounted for, since material omission or mis-statement 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 (see Statement on Standard Auditing Practices 5, *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 the internal control relating to liabilities.²

(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 duly 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, especially for those designated in foreign currencies.³

(b) In respect of trade creditors

- i) The procedure should ensure proper recording & 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 a procedure 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 from 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) 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 the internal control system of the entity provides for a procedure for identifying and estimating such liabilities and for periodic review of the same.

VERIFICATION

11. Verification of liabilities may be can 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 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

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 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 can not 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.

Provisions for Taxes and Duties

31. 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 a provision for taxation on the basis of the tax-effect accounting method, the auditor should examine whether the method has been applied properly.⁴

Provision for Gratuity

34. 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.⁵ 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.

Provision for Bonus

35. 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).

Provision for Dividends

36. 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.

Other Provisions

37. 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.⁶ 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 the 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 reconsider 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 amount 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 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 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 instalments 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 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 liabilities. The exact nature of analytical review 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

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 obtain 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 2930(d) of the Companies Act, 1956 are complied with.

(b) The auditor should examine the register of charges to ensure that charges 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 *prima facie* prejudicial to the interest of the company.⁷

(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.⁸

(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 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. There 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 acknowledgement 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 statements. 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 the confirmations received as well as any undelivered letters of request for confirmation. The management representation letter concerning 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]

[Date]

[Name and Address of Creditor]

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:⁹

<u>Invoice No.</u>	<u>Date</u>	<u>Order Reference</u>	<u>Amount</u>
		Total	_____
		Less: Payments made/other debits	_____
		Net amount due by 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)

(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:

<u>Invoice No.</u>	<u>Date</u>	<u>Order Reference</u>	<u>Amount</u>
		Total	_____
		Less: Payments made/other debits	_____
		Net amount due by us (Rs.)	_____

(Signature _____ of _____ creditor/
responsible official)

Date

APPENDIX II

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:¹⁰

<u>Invoice No.</u>	<u>Date</u>	<u>Order Reference</u>	<u>Amount</u>
		Total	_____
		Less: Payments made/other debits	_____
		Net amount due by us (Rs.)	_____

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

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 claim of material amounts.

Yours faithfully,

(Signature of responsible official of the entity)

1 With the formation of the Auditing Practices Committee in 1982, the Council of the Institute has been issuing a series of Statements on Standard Auditing Practices (SAPs). Statements on Standard Auditing Practices lay down the principles governing an audit. These principles apply whenever an independent audit is carried out. Statements on Standard Auditing Practices become mandatory on the dates specified in the respective SAPs. Their mandatory status implies that, while discharging their attest function, it will be the duty of the members of the Institute to ensure that the SAPs are followed in the audit of financial information covered by their audit reports. If, for any reason, a member has not been able to perform an audit in accordance with the SAPs, his report should draw attention to the material departures therefrom. The Auditing Practices Committee has also been issuing, from time to time, guidance notes on issues arising from SAPs. The Guidance Notes provide guidance on procedures to be employed by an auditor in order to comply with the principles laid down in SAPs. It is recognised that in determining the nature, timing and extent of audit procedures to be employed in a specific situation, an auditor will have to exercise his professional judgment. The Guidance Notes, therefore, are recommendatory. A member should ordinarily follow the recommendations in a guidance note relating to an auditing matter except where he is satisfied that, in the circumstances of the case, it may not be necessary to do so.

2 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.

3 Reference may be made in this regard to Accounting Standard 11, Accounting for the Effects of Changes in Foreign Exchange Rates, issued by the Institute of Chartered Accountants of India.

4 Reference may be made in this regard to the Guidance Note on *Accounting for Taxes on Income* issued by the Accounting Standards Board of the institute of Chartered Accountants of India.

5 Reference may be made in this regard to Accounting Standard (AS) 15, *Accounting for Retirement Benefits in the Financial Statements of Employers*, issued by the Institute of Chartered Accountants of India.

6 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.

7 Reference may also be made in this regard to the Statement on *the Manufacturing and Other Companies (Auditor's Report) Order, 1988* issued by the Institute of Chartered Accountants of India.

8 Reference may also be made in this regard to the Statement on *the Manufacturing and Other Companies (Auditor's Report) Order, 1988* issued by the institute of Chartered Accountants of India.

9 In case the list of invoices forming the balance is too large, these details may not be given.

10 In case the list of invoices forming the balance is too large, these details may not be given.

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. 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

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.¹ 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 SAP 5, *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:

Occurrence	that recorded expenses arose from transactions or events which took place 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: ²

- (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.

(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.³

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, *interalia*, 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 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.⁴

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.⁵

19. In respect of imports, the auditor should carryout 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 Eke 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.

(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 term 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 wage 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 ratio 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 employees⁶. If so, the auditor should examine whether the amount payable has been computed in accordance 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 entity⁷, 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 incurred⁸. 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.

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 depreciation⁹. 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.

Taxes on Income

38. The auditor should examine that tax expense or tax saving has been properly computed and disclosed in the financial statements¹⁰. 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.

(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, 1956.¹¹ 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 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 293J3 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.¹²

(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 goods, materials and services or the prices at which transaction for similar goods or service have been made with other parties.¹³

(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.

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.¹⁴

DOCUMENTATION

45. The auditor should maintain adequate working papers regarding audit of expenses. ¹⁵

1 Reference may be made in this regard to Guidance Note on Accrual Basis of Accounting.

2 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, inter alia, an illustrative list of internal controls in relation to petty cash, cash and bank payments, salaries and wages And purchases.

3 Refer to SAP-14, Analytical Procedures

4 Refer to AS-1 8, Related Party Disclosures.

5 Refer to SAP-21, Consideration of Laws and Regulations in an Audit of Financial Statements.

6 Attention is invited in this regard to AS 15, *Accounting for Retirement Benefits in the Financial Statements of Employers*.

7 Attention is also invited in this regard to SAP 9, *Using the Work of an Expert*.

8 Attention is invited AS-16, Borrowing Costs.

9 Attention is also drawn to Accounting Standard (AS) 6, *Depreciation Accounting*.

10 Attention is drawn to Accounting Standard (AS) 22, *Accounting for Taxes on Income*.

11 Reference may be made in this regard to the Guidance Note on Section 293A.of the Companies Act and the Auditor.

12 Reference may be made in this regard to the Statement on the Manufacturing and Other Companies (Auditor's Report) Order, 1988.

13 Reference may be made in this regard to the Statement on the Manufacturing and Other Companies (Auditor's Report) Order, 1988.

14 Reference may be made in this regard to SAP 11, Representation by Management.

15 Reference may be made in this regard to SAP-3, Documentation.

Guidance Note on Audit of Consolidated Financial Statements*

INTRODUCTION

1. The Council of the Institute of Chartered Accountants of India has issued Accounting Standard (AS) 21 'Consolidated Financial Statements' which lays down principles and procedures for preparation and presentation of consolidated financial statements. Consolidated financial statements are presented for a group of entities under the control of a parent. A 'parent' is an entity that has one or more subsidiaries. A group comprises a parent and its subsidiaries. Thus, consolidated financial statements are the financial statements of a group presented as those of a single entity. AS 21 is applicable to a parent that presents consolidated financial statements. In other words, whenever a parent decides to prepare and present consolidated financial statements, it should do so in accordance with the requirements of Accounting Standard (AS) 21, Consolidated Financial Statements.
2. Consolidated financial statements normally include consolidated balance sheet, consolidated statement of profit and loss, and notes, explanatory material that form an integral part thereof, and also consolidated cash flow statement (in case a parent presents its own cash flow statement). Consolidated financial statements are presented, to the extent possible, in the same format as adopted by the parent for its separate financial statements.
3. An entity which prepares the consolidated financial statements, either under any law or regulation governing the entity or *suo motu*, might be required to or otherwise engage a member for conducting the audit of consolidated financial statements¹. The auditor of the consolidated financial statements may not necessarily be the auditor of the separate financial statements of the parent or one or more of the components² included in the consolidated financial statements. However, a law or regulation governing the entity may require the consolidated financial statements to be audited by the statutory auditor of the entity. This Guidance Note provides guidance on the specific issues and audit procedures to be applied in an audit of consolidated financial statements.

DEFINITIONS

4. Various terms used in this Guidance Note, have the same meaning as in Accounting Standard (AS) 21, 'Consolidated Financial Statements', Accounting Standard (AS) 23, 'Accounting for Investments in Associates in Consolidated Financial Statements' and Accounting Standard (AS) 27, 'Financial Reporting of Interests in Joint Ventures' respectively.

RESPONSIBILITY OF PARENT

5. The responsibility for the preparation and presentation of consolidated financial statements, among other things, is that of the management of the parent. This includes:
 - (a) identifying components, and including the financial information of the components to be included in the, consolidated financial statements;
 - (b) where appropriate, identifying reportable segments for segmental reporting;
 - (c) identifying related parties and related party transactions for reporting;
 - (d) obtaining accurate and complete financial information from components; and
 - (e) making appropriate consolidation adjustments.
6. Apart from the above, the parent ordinarily issues instructions to the management of the component specifying the parent's requirements relating to financial information of the components to be included in the consolidated financial statements. The instructions ordinarily cover the accounting policies to be applied, statutory and other disclosure requirements applicable to the parent, including the identification of and reporting on reportable segments, and related parties and related party transactions, and a reporting timetable.

RESPONSIBILITY OF THE AUDITOR OF THE CONSOLIDATED FINANCIAL STATEMENTS

7. The auditor of the consolidated financial statements is responsible for expressing an opinion on whether the consolidated financial statements are prepared, in all material respects, in accordance with the financial reporting framework under which the parent prepares the consolidated financial statements.
8. Therefore, the auditor's objectives in an audit of consolidated financial statements are:
 - (a) to satisfy himself that the consolidated financial statements have been prepared in accordance with the requirements of Accounting Standard (AS) 21, Consolidated Financial Statements. Accounting Standard (AS) 23, Accounting for Investments in Associates in Consolidated Financial Statements and Accounting Standard (AS) 27, Financial Reporting of Interests in joint Ventures; and
 - (b) to enable himself to express an opinion on the true and fair view presented by the consolidated financial statements.

9. Auditing and Assurance Standards, Statements and Guidance Notes on auditing matters issued by the Institute of Chartered Accountants of India apply in the same manner to audit of consolidated financial statements as they apply to audit of separate financial statements. It means that the auditors, while conducting the audit of consolidated financial statements are, *inter alia*, expected to:
- (a) plan their work to enable them to conduct an effective audit in an efficient and timely manner;
 - (b) obtain an understanding of the accounting and internal control systems sufficient to plan the audit and determine the nature, timing and extent of his audit procedures. Such an understanding would help the auditors to develop an effective audit approach;
 - (c) use professional judgement to assess audit risk and to design audit procedures to ensure that the risk is reduced to an acceptable level; etc.

AUDIT CONSIDERATIONS

10. The following features of consolidated financial statements have an impact on the related audit procedures:
- (a) The consolidated financial statements are prepared on the basis of separate financial statements of the parent and its subsidiaries and associates and/or joint ventures, using the consolidation procedures prescribed by Accounting Standard (AS) 21, Consolidated Financial Statements, Accounting Standard (AS) 23, Accounting for Investments in Associates in Consolidated Financial Statements and Accounting Standard (AS) 27, Financial Reporting of Interests, in joint Ventures; and
 - (b) The auditor of the consolidated financial statements has to use the work of other auditors unless the auditor of consolidated financial statements is not the auditor of the other components of the group. This may, however, not be true in all cases.
11. The consolidated financial statements are prepared using the separate financial statements of the parent, subsidiaries, associates and joint ventures and also other financial information, which might not be covered by the separate financial statements of these entities. The 'other financial information' would include disclosures to be made in the consolidated financial statements about the subsidiaries associates and joint ventures, proportion of items included in the consolidated financial statements to which different

accounting policies have been applied, adjustments made for the effects of significant transactions or other events that occur between the financial statements of subsidiaries, associates or joint ventures and the parent, as the case may be, etc. Thus, this other financial information would be required to be additionally generated.

12. When an auditor accepts the audit of consolidated financial statements, the auditor should assess whether based on his work alone he would be able to express an opinion on the true and fair view presented by the consolidated financial statements. If the auditor is of the view that his own participation may not be enough or sufficient, he should consider using the work of 'other auditors'.
13. Such 'other auditors' might be the auditors of the separate financial statements of one or more of the components of the consolidated financial statements or the auditors appointed specifically for assisting the auditor of the consolidated financial statements (the principal auditor).
14. Where the statutory auditors of one or more of the components of the consolidated financial statements are also requested to assist the principal auditor, the work to be performed by such statutory auditors for use by the principal auditor would constitute an assignment separate from the assignment to conduct the statutory audit of the respective component.
15. The Auditing and Assurance Standard (AAS) 1 'Basic Principles Governing an Audit', states (paragraph 9):

"When the auditor delegates work to assistants or uses work performed by other auditors and experts, he will continue to be responsible for forming and expressing his opinion on the financial information. However, he will be entitled to rely on work performed by others, provided he exercises adequate skill and care and is not aware of any reason to believe that he should not have so relied. In the case of any independent statutory appointment to perform the work on which the auditor has to rely in forming his opinion, such as in the case of the work of branch auditors appointed under the Companies Act, 1956 the auditor's report should expressly state the fact of such reliance".

16. Auditing and Assurance Standard (AAS) 10, 'Using the Work of Another Auditor' establishes standards when an auditor, reporting on the financial statements of an entity (the group-in the case of consolidated financial statements), uses the work of another auditor on the financial information of one or more components included in the financial statements of the entity. The principal auditor, if he decides to use the work of another auditor in relation to the audit of consolidated financial statements, should comply with the requirements of AAS 10.

17. While complying with the requirements of AAS 10, 'Using the Work of Another Auditor', the principal auditor should keep the following under consideration:

- (a) When planning to use the work of another auditor, the principal auditor is not required to consider the professional competence of the other auditor if the other auditor is a member of the Institute of Chartered Accountants of India
- (b) The principal auditor should perform procedures to obtain sufficient appropriate audit evidence, that the work of the other auditor is adequate for the principal auditor's purposes, in the context of the audit of consolidated financial statements. When using the work of another auditor, the principal auditor should ordinarily perform the following procedures:
 - (i) The principal auditor should determine the information/assurance required by the other auditor; this emanates/precludes the principal auditor's determination of how the work of the other auditor would affect the audit of consolidated financial statements, for example, the information required from the auditor of a subsidiary would be different from that required from the auditor of a joint venture.
 - (ii) Advise the other auditor of the use that is to be made of the other auditor's work and report and make sufficient arrangements for co-ordination of their efforts at the planning stage of the audit. The principal auditor would inform the other auditor of matters such as areas requiring special consideration, procedures for the identification of inter-component transactions that may require disclosure and the timetable for completion of audit. It may, however, be noted that the principal auditor, if using the work of the auditors of one or more of the components unless such other auditors are specifically appointed for the purpose, should not enlarge the scope of the audit of the separate financial statements of the subsidiary or component to be included in the consolidated financial statements. Thus, the instructions that are to be issued should be confined to the other information required for consolidation.

- (iii) Advise the other auditor of the significant accounting, auditing and reporting requirements and obtain representation as to compliance with them.

AUDITING THE CONSOLIDATION

18. Before commencing an audit of consolidated financial statements, the auditor should plan his work to enable him to conduct an effective audit in an efficient and timely manner. The auditor should make plans, among other things, for the following:
 - (a) understanding of accounting policies of the parent, subsidiaries, associates and joint ventures;
 - (b) determining the extent of use of other auditor's work in the audit;
 - (c) determining and programming the nature, timing, and extent of the audit procedures to be performed., and
 - (d) coordinating the work to be performed.
19. A parent which presents consolidated financial statements is required to consolidate all subsidiaries include all associates and jointly controlled entities in the consolidated financial statements other than those for which exceptions have been provided in the relevant Accounting Standards.
20. The auditor should obtain a listing of subsidiaries, associates and joint ventures included in the consolidated financial statements. The auditor should review the information provided by the management of the parent identifying the subsidiaries, associates and joint ventures. The auditor should verify that all the subsidiaries, associates and joint ventures have been included in the consolidated financial statements unless a subsidiary, associate or joint venture meets a criterion for exclusion. In respect of completeness of this information, the auditor should perform the following procedures:
 - (a) review his working papers for the prior years for the known subsidiaries, associates and joint ventures;
 - (b) review the parent's procedures for identification of subsidiaries, associates and joint ventures;
 - (c) review the investments to determine the share holding in other entities;
 - (d) review the joint venture and other relevant agreements entered into by the parent;

- (e) review the statutory records maintained by the parent, for example registers under section 302, 372A of the Companies Act, 1956.

The auditor should also identify the changes in the shareholding that might have taken place since the last audit.

21. It is also important to note that ownership of voting power is not necessary for an entity to own more than one-half of the voting power of another to control the other enterprise. Control of the composition of the Board of Directors (in the case of a company) or corresponding governing body (in the case of any other enterprise), with a view to obtain economic benefits from its activities, ownership of voting power is not important. For example, an entity holds only 10 percent of the share capital of another entity but it has control over the composition of the Board of Directors/governing body of the second entity. In such a case, the first entity would be considered as a parent of the second entity and, therefore, it would consolidate the second entity in the consolidated financial statements as subsidiary. The auditor, therefore, apart from carrying out above procedures, should verify whether the parent controls the composition of the Board of Directors or corresponding governing body of any entity. There would be various means by which such kind of control can be obtained. In this regard, the auditor may verify the Board's minutes, shareholder agreements entered into by the parent, agreements with the entities to which the parent might have provided any technology or know how, enforcement of statute, as the case may be, etc. The auditor would have to use his professional judgement to determine whether the parent controls the composition of the Board of Directors of any other entity. If yes, whether that entity has been consolidated as a subsidiary in the consolidated financial statements.
22. Where a subsidiary or an associate or a jointly controlled entity is excluded from the consolidated financial statements, the auditor should examine the reasons for exclusion. There could be two reasons for exclusion of a subsidiary, associate or jointly controlled entity - one, that the relationship of parent with the subsidiary, associate or jointly controlled entity is intended to be temporary or the subsidiary, associate or joint venture operates under several long-term restrictions which significantly impair its ability to transfer funds to the parent. The auditor should satisfy himself that the exclusion made by the management falls within these two categories. The auditor should verify such long-term restrictions from the relevant laws and regulations, agreements entered by the parent with such entities which prohibit transfer of funds. In the case of an entity which is excluded from consolidation on the ground that the relationship of parent with the other entity as subsidiary, associate or joint venture is temporary, the auditor should verify that the intention of the parent, to dispose the subsidiary, investment in associate or interest in jointly controlled entity, in the near future, existed at the time of acquisition of the subsidiary, making investment in associate or jointly controlled entity. The auditor should also verify that the reasons for exclusion are given in the consolidated financial

statements. If an entity is excluded from the consolidated financial statements for reasons other than those allowed by the relevant accounting standards, the auditor should consider its effect on the report to be issued. The auditor should consider the need to issue a modified report on the consolidated financial statements. The auditor should also verify that in consolidated financial statements, investments in such subsidiaries, associates or jointly controlled entities should be accounted for in accordance with Accounting Standard (AS) 13, Accounting for Investments.

23. The auditor should also examine whether any subsidiary, associate or jointly controlled entity has ceased to be a subsidiary, associate or jointly controlled entity during the period under audit. It is also possible that a subsidiary might have become an associate or an associate might have become a subsidiary of the parent. The auditor, in such cases, should examine whether these changes have been appropriately accounted for in the consolidated financial statements as required by the respective accounting standards.
24. In preparing consolidated financial statements, the financial statements of the parent and its subsidiaries are combined on a line by line basis by adding together like items of assets, liabilities, income and expenses and then certain calculations like determination of goodwill or capital reserve, minorities interest and adjustments like elimination of intra group transactions, balances and unrealised profits etc. are made in accordance with the requirements of Accounting Standard (AS) 21, Consolidated Financial Statements. Investments in associates are accounted for using the Equity Method as prescribed in Accounting Standard (AS) 23, Accounting for Investments in Associates in Consolidated Financial Statements. A parent that has an interest in a jointly controlled entity, reports its interest in the consolidated financial statements using proportionate consolidation method in accordance with Accounting Standard (AS) 27, Financial Reporting of Interests in joint Ventures. Many of the procedures appropriate for the application of equity method and the proportionate consolidation are similar to the consolidation procedures set out in Accounting Standard (AS) 21, Consolidated Financial Statements.
25. The auditor should verify that the adjustments warranted by the relevant accounting standards have been made wherever required and have been properly authorised by the management of the parent. The preparation of consolidated financial statements gives rise to permanent consolidation adjustments and current period consolidation adjustments.

SPECIAL CONSIDERATIONS

Permanent Consolidation Adjustments³

26. Permanent consolidation adjustments are those adjustments that are made only on the first occasion of the preparation and presentation of consolidated financial statements. Permanent consolidation adjustments are:
- (a) determination of excess or deficit of the cost to the parent of its investment in a subsidiary over the parent's portion of equity of the subsidiary, at the date on which investment in the subsidiary is made (determination of goodwill or capital reserve);
 - (b) determination of the amount of equity attributable to minorities at the date on which investment in subsidiary is made; and
 - (c) determination of goodwill or capital reserve arising on application of equity method to account for investments in associates in consolidated financial statements.
27. The auditor should verify that the above calculations have been made appropriately. The auditor should pay particular attention to the determination of pre-acquisition reserves of the subsidiary and associates. Date(s) of investment in subsidiary and associates assumes importance in this regard. The auditor should also examine whether the pre-acquisition reserves have been allocated appropriately between the parent and the minorities of the subsidiary. The auditor should also verify the changes that might have taken place in these permanent adjustments on account of subsequent acquisition of shares in the subsidiary/associates, disposal of the subsidiary/ associate in the subsequent years. The auditor should also examine the joint venture agreements, to establish whether any change has taken place in the interest of the parent in the joint venture.
28. It may happen that in the case of one subsidiary, goodwill arises and in the case of another subsidiary a capital reserve arises. The parent may choose to net off these amounts to disclose a single amount in the consolidated balance sheet. In such cases, the auditor should verify that the gross amounts of goodwill and capital reserves arising on acquisition of various subsidiaries have been disclosed in the notes to the consolidated financial statements to reflect the excess/shortage over the parents' portion of the subsidiary's equity.

Current Period Consolidation Adjustments⁴

29. Current period adjustments are those adjustments that are made in the accounting period for which the consolidation of financial statements is done. Current period consolidation adjustments primarily relate to elimination of intra-group transactions and account balances including.

- (a) intra-group interest paid and received, or management fees, etc;
- (b) unrealised intra-group profits on assets acquired 1 from other subsidiaries;
- (c) intra-group indebtedness;
- (d) adjustments related to harmonising the different accounting policies being followed by the parent enterprise and its subsidiaries;
- (e) adjustments made for the effects of significant transactions or other events that occur between the date of the financial statements of the parent and one or more of the components, if the financial statements to be used for consolidation are not drawn upto the same reporting date; and
- (f) determination of movement in equity attributable to the minorities since the date of acquisition of the subsidiary.

30. The adjustments required for preparation of consolidated financial statements are made in memorandum records kept for the purpose by the parent. The auditor should review the memorandum records to verify the adjustment entries made in the preparation of consolidated financial statements. This would also help the auditor in ascertaining whether there is any difference in the elimination. Apart from reviewing the memorandum records, the auditor should:

- (a) verify that the inter-group transactions and account balances have been eliminated;
- (b) verify that the consolidated financial statements have been prepared using uniform accounting policies for like transactions and other events in similar circumstances;
- (c) verify that adequate disclosures have been made in the consolidated financial statements of application of different accounting policies in case, it was impracticable to do so;
- (d) verify the adjustments made to harmonise the different accounting policies; and

(e) verify that the calculation of minorities interest 'has been correctly done.

31. The auditor should gain an understanding of the procedures adopted by the management of the enterprise to make the above mentioned adjustments. This helps the auditor in reducing the audit risk to an acceptably low level.
32. One of the important adjustment that may be required in the current period is determination of impairment loss that might exist for goodwill arising on consolidation. Goodwill arising on consolidation is carried at the value determined at the date of acquisition of the subsidiary, and the same is to be tested for impairment at every balance sheet date. The auditor should examine whether any impairment loss has been determined by the parent. If yes, the auditor should examine the procedure followed for determination of impairment. The auditor should satisfy himself that the amount of impairment loss determined is fair.
33. The auditor should also verify that the disclosures required by Accounting Standard (AS) 21, Consolidated Financial Statements, Accounting Standard (AS) 23, Accounting for Investments in Associates in Consolidated Financial Statements and Accounting Standard (AS) 27, Financial Reporting of Interests in joint Ventures have been made in the consolidated financial statements.
34. Apart from verifying that the calculation and disclosures regarding minorities interest have been made appropriately, the auditor also determines, in cases where the minority interests' share of the losses exceed the minority interests' share of the equity, the excess, and any further losses applicable to the minority interest, have been accounted for in accordance with the relevant accounting standards. Where the minority interest has a binding obligation to make good losses, the auditor of the consolidated financial statements determines whether it is able to do so.
35. If the financial statements of one or more of the components are drawn upto different financial reporting dates, the auditor of the consolidated financial statements should review the component's results between its financial reporting date and that of the parent for significant transactions or other events that have taken place during the period and therefore, need to be reflected in the consolidated financial statements. For example, where a subsidiary has a different accounting period and after the end of its accounting period, the subsidiary has discontinued its one of the major operations, adjustments would be required to be made to reflect this in the consolidated financial statements.

36. The fundamental accounting assumption of "consistency" requires the auditor of the consolidated financial statements to consider whether the length of the reporting periods and any difference in financial year-ends are the same from period to period.
37. Notes to accounts and other explanatory material are an integral part of any financial statements since they provide information which *is* not reflected in the balance sheet and profit and loss account. Consolidated financial statements are not an exception to the need of notes to accounts and other explanatory material. In this regard paragraph 6 of Accounting Standard (AS) 21, Consolidated Financial Statement states as below:
- "6. Consolidated financial statements normally include consolidated balance sheet, consolidated statement of profit and loss, and notes, other statements and explanatory material that form an integral part thereof. Consolidated cash flow statement is presented in case a parent presents its own cash flow statement. The consolidated financial statements are presented, to the extent possible, in the same format as that adopted by the parent for its separate financial statements".
38. The Accounting Standards Board of the Institute has issued General Clarification (GC)-5/2002 on Notes to the Consolidated Financial Statements. The Clarification lays down certain principles that should be observed in respect of notes and other explanatory material that form integral part of the consolidated financial statements. The auditor should verify that the principles enunciated by the Clarification have been followed in preparation of notes to accounts. The auditor to verify, the compliance, should:
- (a) examine that the notes which are necessary for presenting a true and fair view of the consolidated financial statements have been included in the consolidated financial statements as an integral part thereof; and
 - (b) examine that additional statutory information disclosed in separate financial statements of the subsidiary and/or a parent having bearing on the true and fair view of the consolidated financial statements have been disclosed in the consolidated financial statements.
39. If as a result of the above examinations, the auditor is of the view that the consolidated financial statements do not disclose all the information which is necessary for presenting a true and fair view, the auditor should give a modified report.

MANAGEMENT REPRESENTATIONS

40. Auditing and Assurance Standard (AAS) 11, "Representations by Management" requires the auditor to obtain appropriate representations from management. The auditor of the consolidated financial statements should obtain evidence that the management of the parent acknowledges its responsibility for a true and fair presentation of the consolidated financial statements in accordance with the financial reporting framework applicable to the parent and that parent management has approved the consolidated financial statements. In addition, the auditor of the consolidated financial statements obtains written representations from parent management on matters material to the consolidated financial statements. Examples of such representations include:

- (a) Completeness of components included in the consolidated financial statements;
- (b) Identification of reportable segments for segmental reporting;
- (c) Identification of related parties and related party transactions for reporting;
- (d) Appropriateness and completeness of consolidation adjustments, including the elimination of intra-group transactions.

REPORTING*

41. There could be two situations in an audit of consolidated financial statements—when the parent's auditor is also the auditor of all the components to be included in the consolidated financial statements and when the parent's auditor is not the auditor of one or more subsidiaries and therefore, uses the work of other auditors in the audit. The auditor should, while preparing the report, should consider the requirements of Auditing and Assurance Standard (AAS) 28, The Auditor's Report on Financial Statements. Where, the auditor uses the work of other auditors in the audit of consolidated financial statements, the requirements of Auditing and Assurance Standard (AAS) 10, Using the Work of Another Auditor should also be considered.

WHEN THE PARENT'S AUDITOR IS ALSO THE AUDITOR OF ITS SUBSIDIARIES

42. While drafting the audit report, the auditor should report whether principles and procedures for preparation and presentation of consolidated financial statements as laid down in the relevant accounting standards have been followed. In case of any deviation, the auditor should make adequate disclosure in the audit report so that users of the consolidated financial statements are aware of such deviation.

43. Auditor should issue an audit report expressing opinion whether the consolidated financial statements give a true and fair view of the state of affairs of the Group as on balance sheet date and as to whether consolidated profit and loss statement gives true and fair view of the results of consolidated profit or losses of the Group for the period under audit. Where the consolidated financial statements also include a cash flow statement, the auditor should also give his opinion on the true and fair view of the cash flows presented by the consolidated cash flow statements. Suggested format of the audit report to be issued in such circumstance is given as Annexure I to this Guidance Note.

WHEN THE PARENT'S AUDITOR IS NOT THE AUDITOR OF ITS SUBSIDIARY(IES)

44. In a case where the parent's auditor is not the auditor of the components included in the consolidated financial statements, the auditor of the consolidated financial statements should also consider the requirement of AAS 10.
45. When the parent's auditor decides that he will make reference to the audit of the other auditors, the auditor's report on consolidated financial statements should disclose clearly the magnitude of the portion of the financial statements audited by the other auditor(s). This may be done by stating the rupee amounts or Percentages of total assets and total revenue of subsidiary(s) included in consolidated financial statements not audited by the parent's auditor. However, reference in the report of the auditor of consolidated financial statements to the fact that part of the audit of the group was made by other auditor(s) is not to be construed as a qualification of the opinion but rather as an indication of the divided responsibility between the auditors of the parent and its subsidiaries. Suggested format of the audit report to be issued by the auditor of consolidated financial statements in this circumstance is given in Annexure II to this Guidance Note.

Annexure I

Illustrative Auditor's Report on the Consolidated Financial Statements When the Parent's Auditor is also the Auditor of all the Components

Auditor's Report

The Board of Directors

_____ (Name of the Parent)⁵

We have audited the attached consolidated balance sheet of XYZ Group, as at 31st March 2XXX, and also the consolidated profit and loss account and the {consolidated cash flow statement}⁶ for the year ended on that date annexed thereto. These financial statements are the responsibility of the XYZ's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with the auditing standards generally accepted in India. Those Standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

We report that the consolidated financial statements have been prepared by the XYZ's management in accordance with the requirements of Accounting Standards (AS) 21, Consolidated financial statements, (Accounting Standards (AS) 23, Accounting for Investments in Associates in Consolidated Financial Statements and Accounting Standard (AS) 27, Financial Reporting of interests in joint Ventures}⁷ issued by the Institute of Chartered Accountants of India.

In our opinion and to the best of our information and according to the explanations given to us, the consolidated financial statements give a true and fair view in conformity with the accounting principles generally accepted in India:

- (a) in the case of the consolidated balance sheet, of the state of affairs of the XYZ Group as at 31st March 2XXX;
- (b) in the case of the consolidated profit and loss account, of the profit / loss ⁸ for the year ended on that date; and
- (c) in the case of the consolidated cash flow statement, of the cash flows for the year ended on that date.

For ABC and Co. Chartered Accountants

Signature
(Name of the Member Signing the Audit Report)
(Designation⁹)
Membership Number

Place of Signature

Date

Annexure II

Illustrative Auditor's Report on the Consolidated Financial Statements When the Parent's Auditor is Not the Auditor of All the Components

Auditor's Report

The Board of Directors

_____ (Name of the Parent)¹⁰

We have audited the attached consolidated balance sheet of XYZ Group, as at 31st March 2XXX, and also the consolidated profit and loss account and the {consolidated cash flow statement}¹¹ for the year ended on that date annexed thereto. These financial statements are the responsibility of the XYZ's management and have been prepared by the management on the basis of separate financial statements and other financial information regarding components. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with the auditing standards generally accepted in India. Those Standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

We did not audit the financial statements of certain subsidiaries, whose financial statements reflect total assets of Rs. _____ as at 31 st March 2XXX, the total revenue of Rs. _____ and cash flows amounting to Rs. _____ for the year then ended. These financial statements and other financial information have been audited by other auditors whose report(s) has (have) been furnished to us, and our opinion is based solely on the report of other auditors.

We report that the consolidated financial statements have been prepared by the XYZs management in accordance with the requirements of Accounting Standards (AS) 21, Consolidated financial statements, {Accounting Standards (AS) 23, Accounting for Investments in Associates in Consolidated Financial Statements and Accounting Standard (AS) 27, Financial Reporting of interests in joint Ventures}¹² issued by the Institute of Chartered Accountants of India.

Based on our audit and on consideration of reports of other auditors on separate financial statements and on the other financial information of the components, and to the best of our information and according to the explanations given to us, we are of the opinion that the attached consolidated financial statements give a true and fair view in conformity with the accounting principles generally accepted in India:

- (a) in the case of the consolidated balance sheet, of the state of affairs of the XYZ Group as at 31st March 2XXX;
- (b) in the case of the consolidated profit and loss account, of the profit/ loss¹³ for the year ended on that date; and
- (c) in the case of the consolidated cash flow statement, of the cash flows for the year ended on that date.

For ABC and Co. Chartered Accountants

Place of Signature:

Date:

Signature
(Name of the Member Signing the Audit Report)
(Designation¹⁴)
Membership Number

Appendix I

Consolidated Balance Sheet of a Group

The appendix is illustrative only and does not form part of the Guidance Note. The purpose of this appendix is to illustrate the application of Accounting Standard (AS) 21, Consolidated Financial Statements.

1. The example shows only current period amounts.
2. The amounts given in the brackets indicate deductions.
3. The working notes given towards the end of this appendix are intended to assist in understanding the manner in which the various figures appearing in the consolidated balance sheet have been derived. These working notes do not form part of the consolidated balance sheet and, accordingly, need not be published.
4. The following are the balance sheets as at 31st March, 2003 of X Limited (the holding company), Y limited and Z Limited (both subsidiaries of X Limited)

	(Rs.'000)		
Sources of Funds	X Limited	Y Limited	Z Limited
Share Capital	4,500.00	1,000.00	2,000.00
Reserves and Surplus	150.00	195.00	390.00
6% Debentures	--	250.00	---
Current Liabilities	420.00	210.00	300.00
Total	5,070.00	1,655.00	2,690.00
Application of Funds	X Limited	Y Limited	Z Limited
Fixed Assets	1,600.00	490.00	1,400.00
Investments in Subsidiaries	2,560.00	--	--
Inventories	520.00	650.00	850.00
Cash	200.00	230.00	160.00
Other Current Assets	190.00	285.00	280.00
Total	5,070.00	1,655.00	2,690.00

5. The following additional information is also relevant for the preparation of the consolidated balance sheet:

- (i) The break-up of investments of X Limited is as follows:

	Carrying Cost
(a) 80,000 equity shares of Rs.10 each of Y limited	880.00
(b) 1,35,000 equity shares of Rs.10 each of Z limited	1,200.00
(c) 4,000 preference shares of Rs.100 each of Z Limited	400.00
(d) 800 6% Debentures of Rs.100 each of Y Limited	80.00
Total	2,560.00

6. All the above investments were made on 30th September, 1998. The summarised balance sheets of Y Limited and Z Limited as on that date were as follows:

	(Rs.'000)	
Sources of Funds	Y Limited	Z Limited
Share Capital	1,000.00	2,000.00
Reserves and Surplus	152.50	350.00
6% Debentures	250.00	---
Current Liabilities	300.00	400.00
Total	1,702.50	2,705.00
Application of Funds	Y Limited	Z Limited
Fixed Assets	500.00	1450.00
Current Assets	1,202.50	1,255.00
Total	1,702.50	2,705.00

7. The Share Capital of Subsidiary consisted of

Sources of Funds	Y Limited	Z Limited
Equity Shares of Rs.10/- each	1,000.00	1,500.00
Pref. Shares of Rs.100/- each	Nil	500.00
Total	1,000.00	2,000.00

8. Current assets of Y Limited includes bills receivables for Rs.8,000 accepted by X Limited.

9. Current liabilities of Z Limited. Include Rs.2,000 due to X Limited.

10. Stock of X Limited include goods of Rs.10,000 purchased from Y Limited on which the latter company made a profit of Rs.2,000.

Consolidated Balance Sheet of X Limited and its Subsidiaries Y Limited and Z Limited as at 31st March, 2003

					(Rs.'000)
Sources of Funds	X Limited	Y Limited	Z Limited	Elimination Entries	Consolidation Amounts
Share Capital	4,500.00	1,000.00	2,000.00	(3,000.00) ¹	4,500.00
Reserves and Surplus	150.00	195.00	390.00	(476.50) ²	258.50
Capital Reserve	--	--	--	466.50 ³	466.50
6% Debentures	--	250.00	--	(80.00) ⁴	170.00
Current Liabilities	420.00	210.00	300.00	(28.00) ⁵	902.00
Minorities Interest	--	--	--	528.00 ⁶	528.00
Total	5,070.00	1,655.00	2,690.00	(2590.00)	6,825.00

Application of Funds	X Limited	Y Limited	Z Limited		
Fixed Assets	1,600.00	490.00	1,400.00	--	3,490.00
Investments	2,560.00	--	--	(2,560.00)	NIL
Cash	200.00	230.00	160.00	--	590.00
Inventories	520.00	650.00	850.00	(2.00) ⁷	2,018.00
Other Current Assets	190.00	285.00	280.00	(28.00) ⁵	727.00
	5,070.00	1,655.00	2,690.00	(2590.00)	6,825.00

WORKING NOTES

1. Elimination of share capital of subsidiaries ¹⁵

	Y Limited	Z Limited	Total
Equity Share Capital			
(i) Used in elimination of carrying cost of investment in each subsidiary	800.00	1,350.00	2,150.00
(ii) Included in the Minorities Interest	200.00	150.00	350.00
Preference Share Capital			
(i) Held within the Group (held by holding company)	Nil	400.00	400.00
(ii) Included in the Minorities Interest	Nil	100.00	100.00
Total share capital eliminated	1,000.00	2,000.00	3,000.00

2. Break-up of reserves and surplus eliminated:

	Y Limited	Z Limited	Total
(i) Reserves up to the date of investment; ¹⁶			
(a) Attributable to the holding company (utilised in eliminating carrying cost of investment) ¹⁷	122.00	274050	396.50
(b) Attributable to Minorities (included in minorities interest)	30.50	30.50	61.00
(ii) Movement in reserves and surplus after the date if investment:			
(a) Attributable to Minorities (included in minorities interest)	8.50	8.50	17.00
(b) Profit earned by the subsidiary Y Limited on account of sale of goods to X Limited	2.00	--	2.00
Total reserves and surplus eliminated	163.00	313.50	476.50

3. Elimination of carrying cost of investments in equity shares of each subsidiary:

	Y Limited	Z Limited
Carrying Cost	880.00	1,200.00
Less: Equity attributable to the holding company at the date at which investment was made (see working note 8 below)	(922.00)	(1,624.50)
Negative Goodwill (capital reserve)	(42.00)	(424.50)

4. The elimination of investment in Y Limited's 6% Debentures needs explanation. The holding company acquired debentures at face value of Rs.80,000. The consolidated amounts should represent debentures of the subsidiary Y Limited outside the group.

5. Bills payable of Rs.8,000 and debtors of Rs.20,000 are inter company owings and therefore eliminated.

6. Computation of Minorities Interest

	Y Limited	Z Limited	Total
(a) Amount of equity attributable to minorities at	230.50	180.50	411.00

the date at which investment in each subsidiary is made (as computed in working note 8 below)

(b) Minorities' share in movement in equity since the date of investment in each subsidiary (as computed in working note 9 below)

(c) Amount of Preference Share Capital held outside the Group

Total

8.50	8.50	17.00
Nil	100.00	100.00
239.00	289.00	528.00

7. The profit earned by Y Limited is reduced from the consolidated amount of inventories so that it can be valued at cost to the group as a whole.

8. Equity of the subsidiary companies Y Limited and Z Limited at the date at which investment is made:

	Y Limited	Z Limited
Fixed Assets	500.00	1,450.00
Current Assets	1,202.50	1,255.00
Debentures	(250.00)	--
Current Liabilities	(300.00)	(400.00)
Preference Share Capital	--	(500.00)
Equity on the date of investment	1,152.50	1,802.00
Equity attributable to the holding company {see para 13(a)}	922.22	1,624.50
Equity attributable to the minorities {see para 13(c)}	230.50	180.50
Total	1,152.50	1,805.00

9. Movement in equity of subsidiaries since the date of investment in each subsidiary:

	Y Limited	Z Limited
Equity as on 31 st March, 1999	1,195.00	1,890.00
Less: Equity on the date of Investment as compared in working note (8) above	(1,152.50)	(1,805.00)
Movement in equity	42.50	85.00
<i>Movement in Equity attributable to the holding company {see paragraph 13(a)}</i>	34.00	76.50
<i>Movement in Equity attributable to the minorities {see paragraph 13(c)}</i>	8.50	8.50
	42.50	85.00

Appendix II

Consolidated Profit and Loss Statement

The appendix is illustrative only and does not form part of the Guidance Note. The purpose of this appendix is to illustrate the application of the Accounting Standard (AS) 21, Consolidated Financial Statements.

1. The example shows only current period amounts.

2. The following additional information is also relevant for the preparation of the consolidated profit and loss statement (figures are in Rs.'000):

(a) The holding company A Limited purchased 2,70,000 equity shares of Rs.10 each (75% of the total equity share capital) and 9,000 9% preference shares of Rs.100 each (50% of the total preference share capital) of the subsidiary company B Limited on 1st November, 1998.

(b) A Limited proposes to pay a final dividend on equity shares @ 25%. A Limited paid an interim dividend Rs. 1,350 during the financial year 2002-2003.

(c) B Limited proposes to pay a final dividend on equity shares @ 20%. B Limited paid an interim dividend of Rs.720 on 1st October, 2002. An interim dividend of Rs.81 was paid on preference shares also. The holding company did not participate in the interim dividend.

(d) B Limited sold to A limited in March, 1999 material for Rs.750 at cost plus 25% of which A Limited unsold stock of Rs. 500 as on 31st March, 2003.

Consolidated Profit and Loss Statement of A Limited and its Subsidiary B Limited for the year ended 31st March, 2003

Income	A Limited	B Limited	Elimination Entries	Consolidated Amounts
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Sales	16,200.00	15,300.00	(750.00) ¹	30,750.00
Proposed Dividend from B Limited	540.00	--	(540.00) ²	NIL
Dividend on preference Shares of B Ltd.	40.50	--	(40.50) ²	NIL
Total Income (A)	16,780.50	15,300.00	(1,330.50)	30,750.00
Expenditure	A Limited	B Limited	Elimination Entries	Consolidated Amounts
Consumption of raw materials	8,280.00	8,820.00	(750.00) ¹	16,350.00
Overhead Expenses	2,070.00	945.00	--	3,015.00
Selling Expenses	810.00	1,215.00	--	2,025.00
Provision for Tax	2,700.00	1,944.00	--	4,644.00
Total Expenditure (B)	13,860.00	12,924.00	(750.00)	26,034.00
Net Profit for the year (A-B)	2,920.50	2,376.00	(580.50)	4,716.00

Consolidated Profit and Loss Appropriation Account of A Limited and its Subsidiary B Limited for the year ended 31st March, 2003

	A Limited	B Limited	Elimination Entries	Consolidated Amounts
Opening Balance	481.50	576.00	--	1,057.50
Add: Net Profit for the year	2,920.50	2,376.00	(580.50)	4,716.00
Less: Preference Dividend for the year		(162.00)	40.50 ²	(121.50)
Less: Equity dividend for the year	(2,700.00)	(1,440.00)	540.00 ²	(3,600.00)
Balance to be adjusted for consolidation	702.00	1,350.00	000.00	2,052.00
Amount credited to Investment Account	321.75 ³	--	--	321.75
Amount utilised in elimination of the Cost of Investment in Subsidiary	--	--	545.62 ⁴	545.62
Balance attributable to minorities	--	--	337.50 ⁵	337.50
Unrealised Profit on Stock (stock reserve)	--	--	100.00 ⁶	100.00
Amounts transferred to consolidated Balance Sheet	380.25	1,350.00	(983.12)	747.13
Total	702.00	1,350.00	000.00	2,052.00

Working Notes

For the purpose of the working notes, it is assumed that profits accrued evenly throughout the financial year 2003-04. Accordingly, the profits are apportioned as 'Profits upto the date of Investment' and 'Profits after the date of Investment' on the basis of months. An alternative

treatment calls for preparation of Profit and Loss Statement and Balance Sheet of the subsidiary company on the date at which investment is made by the Holding Company.

1. Since sales made by the subsidiary company B limited to A Limited in March, 2003 is an inter-company transaction, it is therefore, eliminated.

2. The holding company did not participate in the interim dividend declared by the subsidiary. The holding company is entitled to receive the final dividend as follows:

(a) Final dividend on equity shares $[72 \times 0.75]$	Rs.540.00
(b) Final dividend on preference share $[81 \times 0.51]$	Rs.40.50

3. Amount credited to Investment Account: The holding company A Limited credited to its Profit and Loss Statement the dividends received from the subsidiary B Limited. The dividends pertaining to pre-acquisition period represent recovery of cost and do not form part of income. Therefore, the same is required to be credited to the Investment Account.

Pre-acquisition period is for 7 months i.e., April 1998 to 1st November 1999

(a) Pre-acquisition equity dividend $[Rs.540 \times 7/12]$	Rs.31.50
(b) Pre-acquisition preference dividend $[Rs.40.50 \times 1/6]$	Rs.6.75

4. Holding company's share in the profit upto the date of investment in subsidiary forms part of equity on the date at which investment in subsidiary is made. Therefore, such profits are utilised in eliminating the cost of investments in subsidiary. Profits are computed as under:

(a) Opening Balance of the Profit and Loss Account	Rs.576.00
(b) Net Profit earned during the period 1.4.98 to 1. 11.98 i.e., $2376 \times 7/12$	Rs.1,386.00
(c) Interim dividend on equity shares	Rs.(720.00)
(d) Final dividend on equity shares for the period 2002-2003 (apportioned in the ratio of months 7:5) $[720 \times 7/12]$	Rs.(420.00)
(e) Interim dividend on preference shares	Rs.(81.00)
(f) Final dividend on preference shares (it relates to the last six months of the financial year, therefore, apportioned in the ratio of E5) $[Rs.81.00 \times 1/6]$	Rs.(13.50)
Total profits of the subsidiary upto the date of Investment	Rs.727.50
Holding Company's share in the profits computed (0.75×727.5)	Rs.545.62

5. Minorities have a share of 25% in the total profit of the subsidiary company. $[Rs.1,350 \times 0.25]$

6. Computation of Unrealised Profit on Stock

(i) Value of unsold stock	Rs.500.00
(ii) Profit included is 20% on cost Unrealised profit $[Rs.500.00 \times 0.20]$	Rs.100.00

* Issued in September, 2003. With the issuance of this Guidance Note, the Format of Auditor's Report to the Board of Directors on Consolidated Financial Statements which was published in March, 2002 issue of 'The Chartered Accountant' stands withdrawn.

¹ The Securities and Exchange Board of India, vide its circular SMI3RP/Policy/Cir.44/01 dated August 31, 2001 has amended clause 32 of the listing agreement which now requires the listed companies to publish consolidated financial statements in addition to the separate financial statements in its annual report. The amended clause further requires that the statutory auditors of the company should audit the consolidated financial statements. The filing of consolidated financial statements with stock exchanges has also been made mandatory. Similarly, the Reserve Bank of India, vide its circular no. DBOD No. BR13C. 72/21.04,018/2001-02 dated February 25,2003 have required the banks to prepare consolidated financial statements to facilitate consolidated financial supervision.

² Paragraph 8 of Auditing and Assurance Standard (AAS) 10, Using the Work of Another Auditor defines "components" as a division, branch, subsidiary, joint venture, associated enterprises or other entity whose financial information is included in the financial information audited by the principal auditor

³ Reference may be made to Appendix I Consolidated Balance Sheet of Group for an understanding of permanent consolidation adjustments.

⁴ Reference may be made to Appendices I and II for current period consolidation adjustments.

* With the issuance of the Guidance Note, the format of report on Consolidated Financial Statements issued in March, 2001 shall stand withdrawn,

⁵ As per paragraph 8 of AAS 28, "The Auditor's Report on Financial Statements", "The auditor's report should be appropriately addressed as required by the circumstances of the engagement and applicable laws and regulations. Ordinarily, the auditor's report is addressed to the authority appointing the auditor".

⁶ Where applicable.

⁷ *ibid.*

⁸ *ibid.*

⁹ Partner or proprietor, as the case may be

¹⁰ See Footnote 5.

¹¹ Where applicable.

¹² *ibid*

¹³ *ibid.*

¹⁴ Partner or proprietor, as the case may be.

¹⁵ Permanent consolidation adjustments.

¹⁶ *ibid.*

¹⁷ Current period consolidation adjustments.

Guidance Note on Audit of Miscellaneous Expenditure [2003]*

INTRODUCTION

1. The following is the text of the Guidance Note on Audit of Miscellaneous Expenditure. This Guidance Note provides guidance on audit procedures to be applied while auditing miscellaneous expenditure. This Guidance Note also provides guidance for audit of items that generally constitute miscellaneous expenditure when Accounting Standard (AS) 26, Intangible Assets comes into effect or is voluntarily applied by an enterprise in accounting for intangible assets. This Guidance Note, however, does not provide any guidance on audit of intangible assets that are recognised in accordance with AS 26. The guidance provided herein is restricted to only those items which were hitherto (before application of AS 26-whether mandatory or otherwise) being classified as items of miscellaneous expenditure, but because of application of AS 26, accounting treatment of such items would change.
2. 'Miscellaneous expenditure' shown in the balance sheet of companies (or shown under this or some other appropriate heading in the balance sheet of other enterprises) embraces within its fold a variety of items of expenditure which are not entirely charged to income in the year in which they are incurred, but are carried forward in the balance sheet to be written-off in subsequent periods. Unless some benefit from the expenditure can reasonably be expected to be received in future and unless the amount of such benefit is reasonably determinable, there is no justification for carrying forward the expenditure for being written-off in subsequent periods. Also, the amount of expenditure to be carried forward should not exceed the expected future revenue/other benefits related to the expenditure.
3. The Guidance Note deals with the audit considerations related to the following items that normally constitute 'miscellaneous expenditure':
 - (a) preliminary expenses;
 - (b) expenses including commission or brokerage on underwriting or subscription of shares or debentures including discount allowed on the issue of shares or debentures;
 - (c) research and development expenditure, etc.
4. The Council of the Institute of Chartered Accountants of India has issued Accounting Standard (AS) 26, 'Intangible Assets'. The objective of this AS 26 is to prescribe the accounting treatment for intangible assets that are not dealt with specifically in another Accounting Standard. AS 26 requires an enterprise to recognise an intangible asset if, and only if, certain criteria are met. The accounting standard also specifies how to measure the carrying amount of intangible assets and requires certain disclosures about intangible assets. Consequently, the accounting treatment of some of the items that generally constitute 'miscellaneous expenditure' would change as and when an enterprise adopts Accounting Standard 26 'Intangible Assets' to account for intangible assets.
5. Accounting Standard (AS) 26, 'Intangible Assets' comes into effect in respect of expenditure incurred on intangible items during accounting periods commencing on or after 1-4-2003 and is mandatory in nature from that date for the following:
 - (i) Enterprises whose equity or debt securities are listed on a recognised stock exchange in India, and enterprises that are in the process of issuing equity or debt securities that will be listed on a recognised stock exchange in India as evidenced by the board of directors' resolution in this regard.
 - (ii) All other commercial, industrial and business reporting enterprises, whose turnover for the accounting period exceeds Rs. 50 crores.

In respect of all other enterprises, the Accounting Standard comes into effect in respect of expenditure incurred on intangible items during accounting periods commencing on or after 1-4-2004 and is mandatory from that date. The Accounting Standard, how-

*Issued in September, 2003. The Guidance Note on Audit of Miscellaneous Expenditure shown in the Balance Sheet shall stand withdrawn in respect of audit of financial statements of enterprises for which AS 26, "Intangible Assets" has become mandatory and in respect of entity that has chosen to apply AS 26 to account for intangible assets.

ever, encourages earlier application.

6. In respect of intangible items appearing in the balance sheet as on the aforesaid date, i.e., 1-4-2003 or 1-4-2004, as the case may be, the Standard has limited its application as stated in paragraph 99 of AS 26. From the date of this Standard becoming mandatory for the concerned enterprises, the following stand withdrawn:
 - (i) Accounting Standard (AS) 8, Accounting for Research and Development;
 - (ii) Accounting Standard (AS) 6, Depreciation Accounting, with respect to the amortisation (depreciation) of intangible assets; and
 - (iii) Accounting Standard (AS) 10, Accounting for Fixed Assets - paragraphs 16.3 to 16.7, 37 and 38.
7. Since AS 26, applies to different entity from different dates, it may happen that certain enterprises, till the date the standard becomes mandatory for them may continue to defer the expenditure incurred on items that normally constitute "miscellaneous expenditure". Once an entity applies AS 26 to account for intangible assets, the expenditure incurred on items that normally constitute miscellaneous expenditure shall be governed by the Standard, except in the case of already appearing miscellaneous expenditure in the balance sheet which is to be accounted for using paragraph 99 of AS 26.
8. The following features of miscellaneous expenditure have an impact on the related audit procedures.
 - (a) The items of expenditure included under this heading do not represent any tangible asset.
 - (b) The expenditure on these items is usually of a non-recurring nature.
 - (c) There is a justification for deferring the expenditure on the basis that the benefits from the expenditure can reasonably be expected as flowing into the future the amount of such benefits is reasonably determinable, and the amount of deferred expenditure does not exceed the expected future benefits related thereto.
 - (d) Unless some fresh expenditure is incurred, the balance in these items reduces each year by the amount written-off in the year.
9. The auditor's primary objective in audit of items that generally constitute miscellaneous expenditure is to satisfy himself that -
 - (a) in case where some items are shown in the balance sheet under the head Miscellaneous Expenditure whether it is proper to defer the expenditure;
 - (b) in case where some items are shown in balance sheet under the head 'Miscellaneous

Expenditure', the period of amortisation of the expenditure is reasonable;

- (c) the expenditure shown to have been incurred during the year actually occurred during the year and there is proper authority for the expenditure and for its deferral;
- (d) the criteria which previously justified the deferral of the expenditure continue to be met and the expected future revenue/other benefits related to the expenditure continue to exceed the amount of unamortised expenditure;
- (e) where the entity has applied AS 26, for accounting for items that normally constitute miscellaneous expenditure, whether the same has been done in accordance with the Standard and the already appearing items under the head miscellaneous expenditure have been dealt with in accordance with paragraph 99 of AS 26.

INTERNAL CONTROL EVALUATION

10. The auditor should study and evaluate the system of internal control relating to the various items of miscellaneous expenditure to determine the nature, timing and extent of his other audit procedures. He should particularly review the following aspects.
 - (a) There should be a system of control over expenditure incurred on these items. An effective method of exercising such control is budgeting which, apart from ensuring proper authorisation of the expenditure incurred, also shows in general how effectively such expenditure is being controlled. This is accomplished through periodical comparisons of actual with budgeted figures.
 - (b) Accountability should be established over each item of such expenditure. This can be achieved, inter alia, by up-to-date maintenance of proper records.
 - (c) The system should ensure that reliable information (including reports of experts) is available for assessment of the results achieved against the objectives and estimates of the expenditure determined originally.

VERIFICATION

11. The nature, timing and extent of substantive procedures to be performed are matters of professional judgment of the auditor which is based, inter alia, on the auditor's evaluation of the effectiveness of the related internal controls.

12. While verifying an item of miscellaneous expenditure in the year in which the relevant expenditure is incurred, the auditor should satisfy himself regarding the amount of such expenditure and its deferral as also regarding the reasonableness of the period of amortisation of the expenditure. Till the amount is fully amortised, the auditor should examine every year that a proper amount is amortised during the year by way of a charge to income for the year (and not as its appropriation). The auditor should also examine every year that the criteria which previously justified the deferral of the expenditure continue to be met. If those criteria no longer apply, the auditor should examine whether the unamortised balance has been charged as expense immediately. Where the auditor finds that the criteria for deferral continue to be met but the amount of unamortised balance of the expenditure exceeds the expected future revenue/other benefits related thereto, the auditor should examine whether such excess has been charged as an expense immediately.
 13. The applicability of AS 26 on items that generally constitute miscellaneous expenditure and special considerations in audit of various items of miscellaneous expenditure when AS 26 is applied are discussed in subsequent paragraphs of this Guidance Note.
- Preliminary Expenses**
14. Preliminary expenses are the expenses relating to the formation of an enterprise. For example, in the case of a company, preliminary expenses would normally include the following.
 - (a) Legal cost in drafting the memorandum and articles of association.
 - (b) Fees for registration of the company.
 - (c) Cost of printing of the memorandum and articles of association and statutory books of the company.
 - (d) Any other expenses incurred to bring into existence the corporate structure of the company.
 15. Paragraph 55 of AS 26 requires that expenditure on an intangible item should be recognised as an expense when it is incurred unless:
 - (a) it forms part of the cost of an intangible asset that meets the recognition criteria laid down in paragraphs 19-54 of AS 26; or
 - (b) the item is acquired in an amalgamation in the nature of purchase and cannot be recognised as an intangible asset. If this is the case, this expenditure (included in the cost of acquisition) should form part of the amount attributed to goodwill (capital reserve) at the date of acquisition.
 16. Paragraph 56 of AS 26 provides some examples where the expenditure is recognised as an expense when it is incurred. The examples given include, expenditure on start-up of activities (start-up costs), unless this expenditure is included in the cost of an item of fixed asset under AS 10. Start-up costs may consist of preliminary expenses incurred in establishing a legal entity such as legal and secretarial costs, expenditure to open a new facility or business (pre-opening costs) or expenditures for commencing new operations or launching new products or processes (pre-operating costs).
 17. Preliminary expenses, therefore, incurred on or after the date on which the Standard becomes mandatory for an enterprise or the preliminary expenses incurred on or after the date on which the enterprise opts to apply the Standard in the preparation and presentation of financial statements would be written off in the year in which they are incurred. The expenditure on preliminary expenses shall not be carried forward in the balance sheet to be written off in subsequent accounting periods.
 18. Preliminary expenses already shown in the balance sheet on the date the Standard is first applied would be required to be accounted for in accordance with the requirements laid down by paragraph 99 of AS 26.
 19. The auditor should verify these expenses with reference to supporting documents such as invoices and contracts relating to these expenses. In the case of a company, the auditor should also examine that the reimbursement of such expenses to promoters is in accordance with the disclosures made in the prospectus. Compliance with legal provisions regarding reimbursement of the promoters' expenses should be specifically examined. In addition to the audit procedures mentioned above, the auditor should also apply the following audit procedures with regard to preliminary expenditure:
 - (a) The auditor should verify whether the preliminary expenses incurred on or after the date the Standard is applied by the enterprise are entirely charged to the profit and loss account in the year in which they are incurred.
 - (b) In the case of preliminary expenses already appearing in the balance sheet on the date the Standard is applied, the auditor should satisfy himself that the estimate made by the management of the enterprise of the useful life of the preliminary expenses is appropriate.
 - (c) The auditor should verify whether the carrying amount of the preliminary expenses already

appearing in the balance sheet is eliminated with a corresponding adjustment to the opening balance of the revenue reserve in case the amortisation period determined under paragraph 63 of AS 26 has already expired.

- (d) The auditor should satisfy himself that the preliminary expenses already appearing in the balance sheet are being amortised in accordance with the requirements of AS 26 in case the amortisation period determined under paragraph 63 of AS 26 has not expired.

Expenses Related to Subscription or Issue of Shares

20. Expenses related to subscription or issue of shares include commission or brokerage on underwriting or subscription of shares or debentures, discount allowed on issue of shares or debentures. AS 26 excludes from its scope certain activities or transactions which are so specialised that they give rise to accounting issues that may need to be dealt with in a different way. Such accounting issues, inter alia, are accounting for discount or premium relating to borrowings and ancillary costs incurred in connection with the arrangement of borrowings, share issue expenses and discount allowed on the issue of shares.
21. The auditor should examine whether the payment of brokerage, commission, etc., is authorised by articles of association or other rules/regulations and is in accordance with the provisions of the relevant statute.
22. The auditor should also examine whether the rates of commission paid or payable to brokers and underwriters are in accordance with the disclosures made in the prospectus. The auditor should verify the commission with reference to the agreements with brokers and underwriters.
23. The auditor should examine the certificate issued by the merchant bankers with regard to commission payable to underwriters, and ensure that the payment made to underwriters is in accordance with such certificate.
24. Other expenses on issue of shares or debentures, such as fees of the managers to the issue, fees of the registrars to the issue including mailing and handling charges, fees of the advisors to the issue, advertisement expenses, expenses on printing and supply of prospectus and application forms, expenses on printing of share/debenture certificates, etc., should be verified with reference to supporting documents such as invoices, agreements, etc. The auditor should also examine whether the limits on such expenses as laid down in the applicable statute have been complied with.

Research and Development Expenditure

25. Entities generally incur expenditure on research and development activities. Paragraph 41 of AS 26, Intangible Assets provides that no intangible asset arising from research or from the research phase of an internal project should be recognised and should therefore, be charged as an expenses, as and when incurred. According to AS 26, expenditure incurred in the development or during the development phase of an enterprise is required to be recognised as an intangible asset if, and only if, the requirements of paragraph 44 of AS 26 are met. It may be noted that the expenditure incurred on research or incurred during the research phase of an enterprise are required to be recognised as an expense when such expenses are incurred.
26. The expenditure, therefore, incurred in the development or during the development phase of an enterprise on or after the date on which the Standard becomes mandatory for an enterprise or the preliminary expenses incurred on or after the date on which the enterprise opts to apply the Standard in the preparation and presentation of financial statements would be recognised as an asset if the requirements of paragraph 44 of AS 26 are met. Where the expenditure qualifies to be recognised as an intangible asset then the requirements, related to carrying amount of the intangible asset, its amortisation and disclosures, laid down by AS 26 shall apply to the development expenditure.
27. The development expenditure shown in the balance sheet on the date on which the Standard is first applied shall be accounted for in accordance with the requirements of paragraph 99 of AS 26 from that date. If any expenditure incurred on the research or during the research phase of an enterprise already appears in the balance sheet, the same shall also be required to be accounted for in accordance with paragraph 99 of AS 26 from the date the Standard is first applied by the enterprise.
28. The auditor should perform the following audit procedures with regard to research and development expenditure:
 - (a) The auditor should verify the research expenditure and development expenditure with reference to supporting documents such as purchase invoices, agreements with third parties etc. A variety of expenses may be incurred by an enterprise during the research phase or development phase of an enterprise. The auditor should apply

the procedures mentioned in the Guidance Note on Audit of Expenses with regard to the items of expenditure covered therein.

- (b) The auditor should verify that the expenses incurred on research or incurred during the research phase of an internal project on or after the date the Standard is first applied by the enterprise are entirely charged to the profit and loss account in the year in which they are incurred;
- (c) In the case of research and development expenses already appearing in the balance sheet on the date the Standard is first applied, the auditor should satisfy himself that the estimate made by the management of the enterprise of the useful life of such expenses is appropriate;
- (d) The auditor should verify whether the carrying amount of the research and development expenses already appearing in the balance sheet is eliminated with a corresponding adjustment to the opening balance of the revenue reserve in case the amortisation period determined under paragraph 63 of AS 26 has already expired.
- (e) The auditor should satisfy himself that the research and development expenses already appearing in the balance sheet are being amortised in accordance with the requirements of AS 26 in case the amortisation period determined under paragraph 63 of AS 26 has not expired.
- (f) The auditor should also examine that the intangible asset recognised is accounted for in accordance with the requirements of AS 26.
- (g) Where an intangible asset has been recognised, the auditor should verify whether the asset so recognised is tested for impairment in accordance with Accounting Standard (AS) 28, Impairment of Assets. The auditor should examine whether the test of impairment is appropriate and where impairment has occurred, an impairment loss has been provided for in the financial statements.

OTHER ITEMS

- 29. Expenditure during construction period includes a variety of expenditure. Some of the expenditure during construction period may also constitute miscellaneous expenditure. Where an enterprise applies AS 26 to account for intangible assets, either voluntarily or is required to do so by operation of the accounting standard itself, the accounting treatment of some of the items of expenditure during construction period might

be governed by the principles enunciated in AS 26. The auditor, in such cases, should verify the expense incurred during the construction period with reference to the supporting documents, such as, invoices, contracts, etc., relating to those expenses. The auditor should also verify that the requirements of AS 26 have been complied with in accounting for such items.

- 30. In case where an enterprise does not apply AS 26 to account for intangible assets because it is not required to do so, the auditor apart from verifying the expense incurred during the construction period with reference to the supporting documents, such as, invoices, contracts, etc., relating to those expenses should also examine whether the deferral and the amortisation of expenditure incurred during the construction period are in accordance with recognised accounting policies and practices (see, for example, Guidance Note on Treatment of Expenditure During Construction Period, issued by the Institute of Chartered Accountants of India). Where the entity incurs heavy expenditure of a revenue nature during the year, the benefits of which are likely to extend beyond that year, the expenditure may sometimes be deferred and written-off over the number of years for which the benefits are expected to be derived by the entity. Some instances of such expenditure are removal of business from one location to another and massive advertisement in one year to introduce a product or develop a market. In such cases, the auditor should examine whether the deferred of the expenditure meets the relevant criteria and whether the amount of periodic write-off of the expenditure is appropriate.

DISCLOSURES

- 31. The auditor should examine whether the financial statements contain adequate disclosures as required by AS 26. The auditor should also examine that the financial statements disclose the accounting policy with regard to miscellaneous expenditure. On the first occasion when AS 26 is applied by an enterprise for accounting for items of miscellaneous expenditure, the financial statements should also disclose the change in accounting policy with regard to miscellaneous expenditure in accordance with the requirements of paragraph 32 of Accounting Standard (AS) 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies. ■

**Supplementary Guidance Note on
Tax Audit under section 44AB
of the Income-tax Act, 1961**

The Institute of Chartered Accountants of India

New Delhi.

Introduction

The Central Board of Direct Taxes has issued Notification No.208/2006 dated 10th August, 2006 containing the Income-tax (9th Amendment) Rules, 2006. These rules incorporate several significant amendments in Form No.3CD relating to tax audit. The Fifth Edition of the Guidance Note on Tax Audit under section 44AB of the Income-tax Act, 1961 incorporating the law as amended by the Finance Act, 2005 was published in September, 2005. This supplementary Guidance Note gives guidance on the amendments made by the above-mentioned Notification in Form No.3CD.

Furnishing of Form No.3CA/3CB with Form No.3CD

Every person who is required to get his accounts audited under section 44AB has to furnish the audit report along with the required particulars by the specified date mentioned in section 44AB namely 31st day of October of the Assessment Year (A.Y.) For the A.Y. 2006-2007 the tax audit report is to be furnished latest by 31st October, 2006. The Notification No.208/ 2006 has been issued on 10th August, 2006. All tax audit reports signed on or after 10th August, 2006 whether in respect of A.Y . 2006-07 or the earlier assessment years should be in the revised format. The tax auditor cannot use the old format merely because the tax audit is in respect of accounts for the financial years corresponding to the A.Y. 2006-07 and/or any of the earlier years. The relevant date is the date of signing of the tax audit report and not the financial year in respect of which such audit report is furnished. However, in respect of assessment years preceding A.Y. 2006-07 the tax auditor while giving his tax audit report in the revised format on or after 10th August, 2006 should indicate only those particulars as per the requirement based upon the relevant law applicable to the assessment year in relation to the financial year for which the report is being furnished. Further, the tax auditor need not give information, which is not relevant for the concerned earlier assessment year. This is necessary having regard to the fact that the tax audit report is to be used by the Assessing Officer for the purpose of completing the assessment of the concerned assessee for the relevant assessment year in accordance with the law applicable to that assessment year.

Tax audit report furnished prior to 10th August, 2006

If any person who is required to get his accounts audited in terms of section 44AB has got the audit done and furnished the audit report prior to 10th August, 2006 in the earlier Form No.3CD, he need not submit a revised audit report furnishing the particulars in the revised Form No.3CD. However, if such a person after getting the tax audit report prior to 10th August, 2006 approaches the tax auditor for a revised tax audit report along with the revised Form No.3CD with Annexure II, the tax auditor may furnish a revised report. Attention is invited to the following extracts from para 13.9 of the Guidance Note on Tax Audit.

"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.

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. [Reference may also be made to Guidance Note on Revision of the Audit Report (Handbook of Auditing Pronouncement Volume II, page 472)]

Amendments made by Notification No.208/2006

Notification No.208/2006 dated 10th August, 2006 has made significant amendments in Form No.3CD. It has also inserted Annexure – II for the computation of the value of fringe benefits in terms of section 115WC read with section 115WB. In the following pages the amendments made in various clauses of Form No.3CD, other than annexure II have been explained. Also the consequential impact of the Finance Act, 2006 and the Taxation Laws (Amendment) Act, 2006 have been discussed. This guidance note is a supplementary to and should therefore be read along with the Guidance Note on Tax Audit under section 44AB of the Income-tax Act, 1961 (September, 2005 Edition). The amendments made in different clauses of Form No.3CD have been given. The portions deleted are shown in a strikethrough form. The new insertions are given in bold.

Part B of Form No.3CD

Clause 7

7. (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/ members or their profit sharing ratios, the particulars of such change.~~

(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

There is no change in clause 7(a). The amendment in clause 7(b) is clarificatory that the change since the last date of the preceding year is required to be reported. If there is any change in the partners of the firm or members of the association of persons or their profit 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. Normally under the General Clauses Act, the word "year" refers to the calendar year. However, in this clause "preceding year" may be reckoned as the previous year ending before the commencement of the previous year for which tax audit is being conducted. Thus, for the audit of the year ended on 31st march, 2006, any change after 31st March, 2005 will have to be reported.

8. (a) ~~Nature of business or profession.~~

(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.

The amendment made in clause 8(a) is clarificatory in nature. In regard to the nature of business, the principal line of each business such as manufacturing of electronic goods, trading in chemicals, wholesale trade in foodgrains or a retail trade in grocery should be stated. In case of a person rendering services, the nature of each type of service should be broadly stated.

In regard to the nature of business or profession, Part 'B' of the annexure – I to Form 3CD needs to be referred to, which also requires to give nature of business. This Annexure provides details of various sector and sub-sector in which an assessee could be engaged. Information has to be furnished in respect of each business. An amendment similar to the one in sub-clause (b) of clause 8 has been carried out in Part B of Annexure I. Information provided under this clause should be in consonance with the information provided in Part B of Annexure – I.

12A. 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.**

This is a new clause inserted by the notification. For furnishing the particulars required by clause 12A, the provisions of section 2(47), 45(2), 47(iv) and (v) and 47A have to be kept in mind.

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.

Section 47 of the Act enumerates the transactions which will not be regarded as transfer. Under sub-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.

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.

The particulars to be stated under new clause 12A 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.

Under clause (a) description of the capital asset is required to be mentioned for example shares, security, land, building, plant, machinery etc.

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.

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).

Under clause (d) the amount at which the asset converted into stock-in-trade should be stated. Such an amount may not be the fair market value 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 such a value. The valuation of stock-in-trade is to be examined with reference to AS-2 – Valuation of Inventories. Non-compliance of AS-2 is to be properly qualified in the main audit report.

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.

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 section 49 of the Act. Under such circumstances the auditor may have to verify the cost of acquisition. The following broad principles need to be kept in mind.

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. Thus, in this case, the evidence would be provided by documents such as board resolutions and minutes. In case of a company, engineer's certificate on stages of completion, communication with the regulating agency, if any, payment made to the contractor, payments made for purchase of raw materials etc. and entries recorded in the fixed assets register may be verified. In the 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). While relying upon the valuer's report, the auditor should also bear in mind the principles outlined in Auditing and Assurance Standard (AAS) 9 - Using the Work of an 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 Fixed Assets issued by the Institute.

13. Amounts not credited to the profit and loss account, being,-

(b) the proforma credits, drawbacks, ~~refund of duty of customs or excise, or refund of sales tax,~~ **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

The two items included by the amendment in sub-clause (b) of clause 13 are refund of service-tax and refund of value added tax. All the observations made in paragraph 24.3 are *mutatis mutandis* applicable in respect of refund of service tax and refund of value added tax.

15. ~~Amounts admissible under section 33AB, 33ABA, 33AC, 35, 35ABB, 35AC, 35CCA, 35CCB, 35D, 35E:-~~

Amounts admissible under sections –

- (a) 33AB***
- (b) 33ABA***
- (c) 33AC (wherever applicable)***
- (d) 35***
- (e) 35ABB***
- (f) 35AC***
- (g) 35CCA***
- (h) 35CCB***
- (i) 35D***
- (j) 35DD***
- (k) 35DDA***
- (l) 35E***

(a) debited to the profit and loss account (showing the amount debited and deduction allowable under each section separately);

(b) not debited to the profit and loss account.

This is an amendment to the existing clause 15. References to sections 35DD being amortisation of expenditure in case of amalgamation or demerger and section 35DDA being

amortisation of expenditure incurred under voluntary retirement scheme have been added by the amendment.

All the observations made in paragraph 26.1 are mutatis mutandis applicable in respect of sections 35DD and 35DDA.

17(f) amounts inadmissible under section 40(a)

Notification No.208/2006 has not made any amendments to clause 17(f). However, the Taxation Laws (Amendment) Act, 2006 has come into force on 13th July, 2006 made amendment in sections 40(a) and section 194J which have a bearing on the responsibilities of a tax auditor. Therefore, the following additional guidance has been given to guide the tax auditor to discharge his responsibility in the context of the above mentioned amendments.

The Taxation Laws (Amendment) Act, 2006 has amended sub-clause (ia) of clause (a) of section 40 w.e.f. the 1st day of April, 2006. The scope of inadmissible amounts mentioned in the sub-clause has been expanded to include rent and royalty. Accordingly, where tax has not been deducted in respect of rent and royalty 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, the same shall not be deducted in computing the income chargeable under the head "profits and gains or business or profession".

It may be noted that section 194-I has also amended by Taxation Laws (Amendment) Act, 2006. However, this amendment is with effect from 13th July, 2006. Therefore, for the purpose of computing the inadmissible amount under section 40(a)(ia) for the assessment year 2006-07 rent will have the meaning as

per the Explanation (1) under section 194-I prior to its substitution by the Taxation Laws (Amendment) Act, 2006.

It is possible that an assessee may contend that the inadmissibility under section 40(a)(ia) with respect to the amended definition of rent and royalty does not apply in relation to assessment year 2006-07. In such a case the tax auditor should state the view point of the assessee and also provide the relevant information as mentioned above in order to enable the tax authority to take a decision in the matter.

17 (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];*

This is an amendment to the existing clause 17. The Taxation Laws (Amendment) Act, 2006 has amended section 40A(3) w.e.f. 13th July, 2006 to provide that the payment for expenditure is made only by account payee cheque or account payee bank draft. The present provision of allowing the expenditure in case the payment has been made by crossed cheque/bank draft has been discontinued.

The amended provisions of section 40A(3) are not applicable for the A.Y. 2006-07. They are applicable from 13th July, 2006. The certificate required under Item (A) of sub-clause (h) is based upon the amended provisions of section 40A(3). So far as A.Y. 2006-07 is concerned the tax auditor may state that clause (A) is not applicable.

However, the tax auditor has to verify whether the law contained in section 40A(3) as applicable for A.Y. 2006-07 has been complied with by the assessee. Although the reporting requirement is not strictly applicable for the previous year 2005-06 and also for the period from 1.4.2006 to 12th July, 2006, it is always desirable that the tax auditor should obtain suitable certificate as per the applicable law and keep it in his audit working papers file.

In respect of A.Y. 2007-08 the reporting requirements under sub-clause (h) can be divided into two parts. In respect of the period commencing from 1st April, 2006 and ending on 12th July, 2006 the amended provisions of section 40A(3) are not applicable. Therefore, in respect of that period there is no reporting requirement under item (A) of sub-clause (h). In respect of the period commencing from 13th July, 2006 and ending on 31st March, 2007 and the subsequent financial year the reporting requirements of item (A) have to be complied with.

There may be practical difficulties in verifying the payments made through crossed/account payee cheque or bank drafts.

If no proper evidence for the verification of the payment by the crossed/account payee cheque or draft is available, such a fact could be brought out by appropriate comments in the following manner applicable to the relevant assessment year.

In respect of A.Y . 2006-07.

"It is not possible for me/us to verify whether the payments in excess of Rs.20,000 have been made otherwise than by crossed cheque or bank draft as the necessary evidence is not in the possession of the assessee".

In respect of A.Y . 2007-08

For the period commencing from 1st April, 2006 and ending with 12th July, 2006, it is not possible for me/us to verify whether the payments in excess of Rs.20,000 have been made otherwise than by crossed cheque or bank draft as the necessary evidence is not in the possession of the assessee and for the period commencing from 13th July, 2006 and ending on 31st March, 2007, it is not possible for me/us to verify whether the payments in excess of Rs.20,000 have been made otherwise than by account payee cheque or account payee bank draft, as the necessary evidence is not in the possession of the assessee.

The earlier sub-clause (h) required furnishing of the amount inadmissible under section 40A(3) read with rule 6DD along with computation. The amended sub-clause requires disclosure of amount inadmissible under section 40A(3) read with rule 6DD with the break-up of inadmissible amount.

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.

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 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.

(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,

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 increase in the liability of the assessee under section 154, for any assessment year beginning on or before the first day of April, 2001.

The Finance Act, 2006 has inserted sub-sections (2) and (3) w.e.f. A.Y. 2007-08. Under 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 such 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.

Sub-section (3) provides that the provisions of sub-section (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.

It is primarily the responsibility of the assessee to furnish the details of amounts 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. The method of ascertaining the inadmissible expenditure as and when prescribed should be followed. The tax auditor has to verify the details furnished by the assessee and should satisfy himself that the inadmissible amounts have been worked out correctly. 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 the Act and does not furnish the necessary particulars for the purpose of ascertaining the inadmissible expenditure under section 14A, the tax auditor has to make a proper disclaimer/qualification. Attention is invited to para 5 of AAS-11, Representation by Management which is as under:-

During the course of an audit, management makes many representation to the auditor, either unsolicited or in response to specific enquiries. When such representations relate to matters which are material to the financial information, the auditor should;

- (a) seek corroborative audit evidence from sources inside or outside the entity;
 - (b) value whether the representations made by management appear reasonable and consistent with other audit evidence obtained, including other representations; and
 - (c) consider whether the individuals making the representation can be expected to be well informed on the matter.
- (m) amount inadmissible under the proviso to section 36(1)(iii).**

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.

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.

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).

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.

The requirements of sub-clause (m) 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.

21.* (i) In respect of any sum referred to in ~~clause (a), (c), (d) or (e) of section 43B,~~ **clauses (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.

~~(ii) — In respect of any sum referred to in clause (b) 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:~~

~~(a) — nature of liability;~~

~~(b) — due date of payment under second proviso to section 43B;~~

~~(c) — actual date of payment;~~

~~(d) — if paid otherwise than in cash, whether the sum has been realised within fifteen days of the aforesaid due date;~~

~~(B) — was incurred in the previous year:~~

~~————— (a) — nature of liability;~~

~~(b) — due date of payment under second proviso to section 43B;~~

~~————— (c) — actual date of payment;~~

~~(d) — if paid otherwise than in cash, whether the sum has been realised within fifteen days of the aforesaid due 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.~~

Section 43B has been amended by the Finance Act, 2001 and Finance Act, 2003.

Consequent to the above amendments a uniform treatment is being given in respect of all sums specified in clauses (a) to (f) of section 43B.

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 tax, etc.), cess or fee, by whatever name called, payable by the assessee under any law for the time being in force.

(b) employer's 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.

(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.

In the case of an assessee maintaining its accounts on the mercantile system, the tax auditor should verify the aforesaid particulars, referred to in clauses (a) to (f) above 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 so that the information about the aforesaid payments made in the subsequent year can be furnished.

All the payments referred to in clauses (a) to (f) above incurred in the previous year are to be reckoned. They will be allowable to the extent they are paid by the assessee on or before the due date for furnishing the return of income under section 139(1). It may be noted that the requirement for disclosing of such sums is covered by clause 21(i)(B). It may be noted that the effect of the amendment to the said clause is only for the amount of employer's contribution and the employees contribution would still be governed by the provisions of section 2(24)(x) read with section 36(1)(va) and as such information required to be provided in respect of employees contribution under clause 16(b) of Form No.3CD shall continue to be on the basis of due date under the relevant law.

While the deduction for liability in respect of the specified sums incurred during the previous year is available for payments actually made till the due date of filing the tax return for the said year, deduction for payments made against liability that pre-existed on the first day of the relevant previous year is restricted to only those payments made up to the close of the relevant previous year. The requirement for disclosure of such sums is covered by clause 21(i)(A). 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 so that allowable deduction u/s 43B is capable of being verified .

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.

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 upto the date of signing of the tax audit report. This fact should be stated under this clause by way of note as follows:

Note: Information given under clause 21(i)(B) is only up to..... and does not include any payment which the assessee may make subsequently before the due date of filing of the return under section 139(1).

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. Hence the tax auditor should advise the assessee to include necessary evidence of payments made after the signing of the tax audit report but before the due date of filing. This evidence may also be in the form of a certificate from a chartered accountant obtained specifically for this purpose - Circular No.601 dated 4.6.1991 vide Appendix XVII.

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).

Payments made in lieu of leave standing to the employees' credit is covered under clause (f) of Section 43B. This clause was introduced by the Finance Act, 2001 effective assessment year 2002-03. Earlier, the Supreme Court in the case of *Bharat Earth Movers Ltd. v CIT [2000] 245 ITR 428* ruled that provision made by an assessee company for meeting the liability towards leave encashment proportionate to entitlement earned by the employees of the company (subject to ceiling on accumulation as applicable on the relevant date) is fully deductible in view of the said liability being a certainty and not a contingent liability. In view of the aforesaid decision many assessees who had provided for leave encashment liability were given the benefit of deduction without actual payment or discharge of such liability till the previous year 2000-01. Effective A.Y. 2002-03, with the introduction of clause (f) in section 43B, leave encashment liability is allowable as deduction only upon payment. The tax auditor has to check and satisfy himself whether the payments for leave encashment made during or after the previous year 2001-02 have been already claimed by or allowed to the assessee in an earlier year in terms of the above decision of the Supreme Court. The tax auditor, while reporting on payment covered by clause (f) should proper distinguish the leave encashment payments made by the assessee during the previous year that were earlier allowed from the payments that were disallowed in the earlier years.

The above particulars are required 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.

The tax auditor is not required to determine any admissible or inadmissible amount(s).

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/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 fact of payment along with the amount paid should also be disclosed.

Format (to be prepared and typed)

As suggested under clause 16(b), given herein before, here also, in view of the voluminous nature of the information the tax auditor can apply test checks and compliance tests to satisfy himself.

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 in his report so that the assessee, while preparing his return of income may exclude such items.

The Finance Act, 2006 has added Explanation 3C to section 43B w.r.e.f A.Y. 1989-90 and Explanation 3D w.r.e.f. A.Y. 1997-98. The Explanations 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.

24.(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,

The tax auditor has to state 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. The mere obtaining of such certificate from the assessee does not reduce the scope of the responsibility of the tax auditor to verify the compliance with the provisions of sections 269SS & 269T.

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 24 and also the certificate mentioned above need not be given.

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.

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

<i>Serial Number</i>	<i>Assessment year</i>	<i>Nature of loss/ allowance (in rupees)</i>	<i>Amount returned (in rupees)</i>	<i>Amount as assessed (in rupees) reference to relevant order)</i>	<i>as (give reference to relevant order)</i>	Remarks

(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.

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.

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.

Section 79 applies to all losses, including losses under the head Capital gains. 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)*.

Sub-clause (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.

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.

The above comparison of the shareholding can be done by referring to the Register of Members. In this connection reference may be made to paragraph 11.2 dealing

with making the necessary records available for examination by the tax auditor. The company concerned should make the relevant records available to the tax auditor.

27. (a) Whether the assessee has deducted tax at source and paid the amount so deducted to the credit of the Central Government in accordance with the provisions of Chapter XVII-B.

(b) If the answer to (a) above is in the negative, then give the following details:

<i>Serial Number</i>	<i>Particulars</i>	<i>Amount</i>	<i>Due date</i>	<i>Details</i>	<i>Remarks</i>
	<i>of head of tax for of under deducted remittance payment which tax at source to Govt. Date is (in rupees) deducted at source</i>			<i>Amount (in rupees)</i>	

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>Amount</i>
(i)	<i>Tax deductible and not deducted at all</i>	<i>.....</i>
(ii)	<i>Shortfall on account of lesser deduction than required to be deducted</i>	<i>.....</i>
(iii)	<i>Tax deducted late</i>	<i>.....</i>
(iv)	<i>Tax deducted but not paid to the credit of the Central Government</i>	<i>.....</i>

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

Clause 27 (a)

The newly inserted clause 27 is different from the earlier clause. In the earlier clause the requirement was with reference to the tax deducted at source but not paid to the credit of the Central Government in accordance with the provisions of Chapter XVII-B. The new clause requires reporting on the compliance with the provisions of Chapter XVII-B regarding deduction of tax at source and payment thereof to the credit of the Central Government. Thus, the scope of reporting under the new clause is much wider. This reporting requirement is to be read with the specific non-compliances stated under clause (b).

It may be noted that in the context of reporting on the inadmissible amounts under section 40(a)(ia) where the assessee submits that the tax is not required to be deducted on any payment covered under clause (ia), 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 view points. Further, in view of the voluminous nature of the transactions, the tax auditor can apply tests checks and compliance tests for verifying the information required to be provided under this clause. These principles equally apply here.

It is essential to note that it is the primary responsibility of the assessee to prepare the information in such manner so 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 tests 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. In the case of large organizations it is in their own interest to get a separate and independent audit conducted in respect of tax deducted at source and remitted to the credit of the Central Government.

From the above it is clear that while answering the issue of compliance with the provisions of Chapter XVII-B, a number of debatable issues will arise before the assessee as well as the tax auditor. Therefore, it may not be possible to say yes/no in many of the tax audits. The answer to the question may have to be qualified depending upon the facts and circumstances of each case. Where the tax auditor is satisfied regarding the compliance with the provisions of the Chapter XVII-B he may consider bringing out such compliance by appropriate comments in the following manner:

"We have verified the compliance with the provisions of Chapter XVII-B regarding the deduction of tax at source and regarding the payment thereof to the credit of the Central Government in accordance with the Auditing Standards generally accepted in India which include test checks and the concept of materiality. Such audit procedures did not reveal any significant non-compliance with the provisions of Chapter XVII-B."

In case the tax auditor is not satisfied regarding the compliance with the provisions of Chapter XVII-B he may consider bringing out such non-compliance by appropriate comments in the following manner:

"We have verified the compliance with the provisions of Chapter XVII-B regarding the deduction of tax at source and regarding the payment thereof to the credit of the Central Government in accordance with the Auditing Standards generally accepted in India which include test checks and the concept of materiality. The non-compliance as revealed during such audit procedures are as mentioned in clause (b) hereunder."

Clause 27(b)

The reporting requirement in clause (b) arises where the tax auditor is not satisfied as to the compliance by the auditee with the provisions of the Chapter XVII-B regarding deduction of tax at source and the payment thereof to the credit of the Central Government. Such non-compliance is required to be reported under sub-clause (i), (ii), (iii) and (iv).

In regard to sub-clause (i) the tax auditor has to verify the particulars regarding tax deductible and not deducted at all from the information furnished by the assessee. The various provisions of Chapter XVII-B requires different classes of assesseees to deduct 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. There may be occasions when the tax auditor may not agree with the interpretation/ view taken by the auditee. In such cases it will be advisable to report both the views. The tax auditor may give the information under this sub-clause in the following format:

S.No.	Particulars of payment	Tax deductible but not deducted	Remarks

The shortfall on account of lesser deduction is required to be reported in sub-clause (ii). This will include deduction at a lower rate than what is prescribed, application of wrong rate of deduction of tax at source, non-inclusion of surcharge and education cess etc.

Further, as per the provisions of sections 195 and 197 the deductee can obtain a certificate of no deduction or lower deduction. 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 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. The tax auditor may give the information under this sub-clause in the following format:

S.No.	Particulars of payment	Tax deductible	Tax deducted	Remarks

Sub-clause (iii) requires the tax auditor to verify and report on tax deducted late. The due dates of deduction have been prescribed under the various provisions of the Act and the rules framed thereunder. The auditor should verify the date of actual deduction with reference to the due date of deduction as per the Act, rules/circulars/notifications for reporting under this clause. The tax auditor may give the information under this sub-clause in the following format:

S.No.	Particulars of payment	Tax deductible	Due date of deduction	Date of deduction	Remarks

Sub-clause (iv) requires information regarding cases where tax has been deducted at source but the same has not been deposited. As such the tax auditor should verify the cases where the tax has been deducted at source but not paid before the last date of the previous year under audit. Only those cases where tax has not been deposited before that date are to be reported under this clause. For example, in respect of previous year ending 31st March, 2006 details of tax deducted but not remitted to the Government before 31st March, 2006 should be furnished. The tax auditor may give the information under this sub-clause in the following format:

S.No.	Particulars payment	Tax deducted	Tax not paid	Remarks

In the case of items which are also covered under clause 17(f) the information provided in clause (i), (ii) and (iv) should agree with the information provided in clause 17(f).

Annexure – I

Part B

<i>Nature of business or profession in respect of every business or profession carried on during the previous year</i>	Code*				
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The information required under Part B regarding the nature of business or profession in respect of every business or profession carried on during the previous year is the same as required to be given under clause 8(a). However, under this clause code of the nature of business is to be selected from the list of various nature of businesses given in the Annexure itself. The relevant code numbers in respect of each class of business or profession is to be given. The tax auditor should further verify that there is no contradiction between the particulars given in clause 8(a) and this item. Reference may also be made to paragraph 19.1 for this item.

<i>Sl. No.</i>	<i>Parameters</i>	<i>Current year</i>	<i>Preceding year</i>
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1. ***Paid up share capital/ capital of partner/ proprietor***
 2. ***Share Application Money/ Current Account or Partner or Proprietor, if any***
 3. ***Reserves and Surplus/ Profit and Loss Account***
 4. Secured loans
 5. Unsecured loans
 6. Current liabilities and provisions
 7. Total of Balance Sheet
 8. ***Gross turnover/Gross receipts***
 9. Gross profit
 10. Commission received
 11. Commission paid
 12. Interest received
 13. Interest paid
 14. Depreciation as per books of account
 15. ***Net Profit (or loss) before tax as per Profit and Loss Account***
 16. Taxes on income paid/provided for the books
-

(b) *Parameters*

The statement of particulars contains 16 parameters. This information is to be given by all assesseees though the nomenclature of some of the parameters does not match with the nomenclature used in the case of non-corporate assesseees. For such assesseees, such information is to be given with suitable modification/clarification by way of footnote. Information on these parameters has to be given both in respect of the current year as well as the preceding year. These parameters are discussed below:

1. *Paid-up share capital/capital of partner/proprietor*

The Guidance Note on terms used in financial statements defines "paid-up share capital" as that part of the subscribed share capital for which consideration in cash or otherwise has been received. This includes bonus shares allotted by the corporate enterprises. There is no difficulty in giving information regarding "paid-up share capital" for a corporate assessee. In respect of non-corporate assessees like sole proprietorship or partnership firm the term "capital" has to be understood in terms of the capital contribution made by the sole proprietor or the partners as the case may be. In practice assessees follow two types of accounting policies for maintaining capital account. One policy is to maintain the capital in a fixed manner and to make all the adjustments regarding share of profit or loss, drawings, interest, remuneration payable to the sole proprietor or the partners in the drawings/current account. In such a case the amount of fixed capital is to be stated as capital. Alternatively, where the floating capital concept is followed, i.e. all the above-mentioned adjustments are made in the capital account itself, then the net capital is to be stated.

2. *Share application money/ current account of partner or proprietor, if any*

The information regarding share applicable money is applicable for corporate assessees. Particulars about the amount received as share application money should be furnished under this clause. *Regarding partner or sole proprietor, the net balance in the current account is to be shown. The tax auditor should verify the amount received in regard to application and ensure proper disclosure under this clause. In regard to current account of partner or proprietor he has to verify the correctness of the particulars of the current account.*

3. *Reserves and surplus/ Profit and loss account*

The Guidance Note on terms used in financial statements defines "reserves" as 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. The reserves are primarily of two types: capital reserves and revenue reserves. Further, surplus is the credit balance in the profit and loss statement after providing for proposed appropriations, e.g., dividend or reserves. Part III of Schedule VI of the Companies Act, 1956 contains interpretation of the terms "provision", "reserve" and "capital reserve". The tax auditor should have due regard to these definitions and ensure that proper information is given in regard to reserves and surplus. In the case of non-corporate assessee besides reserves, surplus in the profit and loss account not appropriated to the capital accounts of partners or proprietor is to be disclosed under this item.

8. *Gross turnover/gross receipts*

The term sales, turnover or gross receipts has been explained in paragraph 5 of this Guidance Note. The term "gross turnover" is a commercial term and it should be construed in accordance with the method of accounting regularly employed by the assessee. Further, the Guidance Note defines "sales turnover" as 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 same aggregate before and after deduction of returns and trade discounts. The information to be provided under this item accordingly shall be the gross turnover/ *gross receipts* as per the method of accounting being followed by the assessee. The tax auditor should have due regard to the method of accounting while verifying the particulars regarding "gross turnover/ *gross receipts*".

15. *Net profit (or loss) before tax as per profit and loss account*

The net profit or loss as per the books of account before tax is to be furnished under this item. The Guidance Note defines net profit as 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 tax auditor should verify the figure of net profit or net loss with the profit and loss account and the balance sheet. The net profit to be stated here should be the same as considered for working out/turnover ratio under sub-clause (b) of clause 32. For this, attention is invited to para 56.3

For the kind attention of members

Guidance Note on Tax Audit Under
Section 44AB of the Income-tax Act, 1961

Changes approved subsequent to the publication of the Supplementary Guidance Note.

1. Form No.3CD was extensively amended by Notification No.208/2006 dated 10th August, 2006. The Supplementary Guidance Note on Tax Audit under section 44AB of the Income-tax Act, 1961 was published in 2006 as a part of the Guidance Note on Audit of Fringe Benefits under the Income-tax Act, 1961.
2. Subsequent to the publishing of the Supplementary Guidance Note, the Finance Act, 2007 has made amendments in section 40A(3). New Rule 6DD was inserted in the Income-tax Rules by Notification No.208/2007 dated 27.6.2007 w.e.f. A.Y. 2008-09.
3. It was also necessary to give guidance in respect of valuation of purchases, sales and inventory under section 145A of the Income-tax Act in the context of Value Added Tax introduced by the State Government.
4. The Finance Act, 2007 has also amended the provisions relating to the fringe benefit tax.
5. Consequent changes have been made in the Guidance Note on Tax Audit under section 44AB of the Income-tax Act, 1961 which have been approved by the Council.
6. The following changes be read in the Guidance Note on Tax Audit [2005 Edition], the Guidance Note on Audit of Fringe Benefit under the Income-tax Act and the Supplementary Guidance Note on Tax Audit [2006 Edition]

1. Clause No.12(a) and (b) – Para No.23 of the Guidance Note (2005 Edition)

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

This clause requires the details regarding method of valuation of closing stock employed in the previous year and the details of deviation, if any, from the method of valuation prescribed under section 145A and the effect thereof on the profit or loss.

There is no change from paragraphs from 23.1 to 23.17. After that, the following paragraphs are being added.

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” issued by the ICAI 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 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 are to be used for making taxable sales as well as for making exempt sales. In such a case, the dealer, on the date of purchase, should estimate inputs expected to be used for making taxable sales and for making exempts sales. The dealer should recognize VAT credit only in respect of those inputs which are

expected to be used for making taxable sales and no VAT credit should be recognized in respect of inputs expected to be used for making exempt sales. Subsequently, in case the actual use is different from the estimated use, the dealer should pass an appropriate adjustment entry for the same. Similarly, 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, the dealer should make an estimate of the expected stocks transfers/ consignment sales and account for accordingly.

- 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:

Trading Concern

Three items purchased @ Rs.3.00 lakhs per item. VAT on purchase @ 10%. There is no opening stock.

Two items sold @ Rs.4.50 lakhs per item. VAT on sales @ 10%

The Trading Account on “EXCLUSIVE METHOD”

Particulars	Quantity	Rate	Amount	Particulars	Quantity	Rate	Amount
To Opening Stock			-	By Sales	2	4,50,000	9,00,000
To Purchases	3	3,00,000	9,00,000	By Closing Stock	1	3,00,000	<u>3,00,000</u>
To GP			<u>3,00,000</u>				
			<u>12,00,000</u>				<u>12,00,000</u>

The Trading Account on "INCLUSIVE METHOD"

Particulars	Quantity	Rate	Amount	Particulars	Quantity	Rate	Amount
To Opening Stock			-	By Sales	2	4,95,000	9,90,000
To Purchases	3	3,30,000	9,90,000	By Closing Stock	1	3,30,000	3,30,000
Less: VAT credit availed on cost of goods sold			<u>60,000</u>				
			9,30,000				
VAT paid on sales			90,000				
Gross Profit			<u>3,00,000</u>				_____
			<u>13,20,000</u>				<u>13,20,000</u>

The statutory adjustments required under section 145A can be explained by the following example:

Sl. No.	Particulars	Increase in profit (Rs.)	Decrease in profit (Rs.)
1.	VAT on Purchase		90,000
2.	VAT on Sales	90,000	
3.	VAT on Closing Stock	30,000	
4.	VAT paid on sales		90,000
5	VAT credit availed on cost of goods sold		_____
		<u>60,000</u>	
		<u>1,80,000</u>	<u>1,80,000</u>

The net impact on Profit & Loss Account is NIL.

The computation of total income would appear as under:-

Profit as per Profit & Loss account as per books of account	Rs.300,000
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Add: Adjustments required under section 145A

1.	VAT on Sales	Rs. 90,000	
2.	VAT on Closing stock	Rs. 30,000	Rs.1,20,000
	Total		4,20,000

Less:

1.	VAT credit Receivables (Input) A/c	<u>Rs.90,000</u> 3, 30,000
2.	Deductions under section 43B on the assumption that the amount is paid on or before the due date of filing of the return of income in respect of :-	
	a) VAT on closing stock of raw material	Rs.30,000
	Profit	3,00,000

In the above example ,assuming that the assessee has opening stock of Rs.3,30,000 on which input tax rebate of Rs.30,000/- is available and the VAT has become applicable for the first time, then the comparative position will be as under:-

The Trading Account on "EXCLUSIVE METHOD"

Particulars	Quantity	Rate	Amount	Particulars	Quantity	Rate	Amount
To Opening Stock	1	3,30,000	3,30,000	By Sales	2	4,50,000	9,00,000
Less Input tax rebate			30,000				
			3,00,000				
To Purchases	3	3,00,000	9,00,000	By Closing Stock	2	3,00,000	6,00,000
To Gross Profit			<u>3,00,000</u>				
Total			<u>15,00,000</u>				15,00,000

The Trading Account on “INCLUSIVE METHOD”

Particulars	Quantity	Rate	Amount	Particulars	Quantity	Rate	Amount
To Opening Stock	1	3,30,000	3,30,000	By Sales	2	4,95,000	9,90,000
To Purchases	3	3,30,000	9,90,000	By Closing Stock	2	3,30,000	6,60,000
			<u>13,20,000</u>				
Less: VAT credit availed on cost of goods sold			60,000				
			12,60,000				
VAT paid on sales			90,000				
Gross Profit			3,00,000				
			16,50,000				16,50,000

The statutory adjustments required under section 145A can be explained by the following example:

Sl. No.	Particulars	Increase in profit (Rs.)	Decrease in profit (Rs.)
1.	VAT Recovered on Opening Stock		30,000
2	VAT on Purchase		90,000
3.	VAT on Sales	90,000	
4.	VAT on Closing Stock	60,000	
5.	VAT paid on sales		90,000
6.	VAT credit availed on cost of goods sold	60,000	
		2,10,000	2,10,000

The net impact on 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.3,00,000

Add: Adjustments required under section 145A

1.	VAT on sales	Rs. 90,000	
2.	VAT on closing stock	Rs. 60,000	Rs.1,50,000
		Total	4,50,000

Less:

1.	VAT credit Receivables (Input) A/c	<u>Rs. 90,000</u>
		3,60,000
2.	Deductions under section 43B on the assumption that the amount is paid on or before the due date of filing of the return of income in respect of :-	
	a) VAT on closing stock of goods	Rs. 60,000
	Profit	<u>3,00,000</u>

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
Purchases of raw material 300 units	@ Rs.100 per unit
Sales 250 units	@ Rs.150 per unit
Manufacturing expenses	Rs.3,000
Closing stock of raw material	50 units
Closing stock of finished goods	50 units
VAT rate on purchases and sales	4%

Manufacturing Account on “EXCLUSIVE METHOD”

Particulars	Qty	Rate	Amount	Amount	Particulars	Qty	Rate	Amount
Opening Stock	50	100	5,000		By Sales	250	150	37,500
Purchase of raw materials	300	100	30,000		By closing stock of finished goods	50	110	5,500
Total	350	100	35,000					
Less: Closing Stock of raw material	50	100	5,000					
Raw material Consumed (C) = (A) – (B)	300			30,000				
To manufacturing expenses	300	10		3,000				
To VAT on finished goods sold				0				
To gross profit				10,000				
Total				43,000	Total			43,000

Manufacturing Account on “INCLUSIVE METHOD”

Particulars	Qty	Rate	Amount	Amount	Particulars	Qty	Rate	Amount
Opening Stock	50	104	5,200		By Sales	250	156	39,000
Purchase of raw materials	300	104	31,200		By closing stock of finished goods	50	114	5700
Total	350	104	36,400					
Less: Closing Stock of raw material	50	104	5,200					
Less; VAT on Raw Material Consumed	300	4	1200					
Raw material Consumed (C) = (A) – (B)	300	100		30,000				
To manufacturing expenses	300	10		3,000				
To VAT on finished goods sold	250	6		1,500				
To VAT included in finished goods on account of inclusion of VAT in the raw material value	50	4		200				
To gross profit				10,000				
Total				44,700	Total			44,700

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.

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:

Sl.No.	Particulars	Increase in Profit (Rupees)	Decrease in Profit (Rupees)
1.	Increase in cost of opening stock of raw material on inclusion of VAT		200
2.	Increase in purchase on account of inclusion of VAT.		1,200
3.	Increase in sales of finished goods on inclusion of VAT.	1,500	
4.	VAT paid on sale of finished goods as a result of its inclusion in sales		1,500
5.	Increase in closing stock of raw material on inclusion of VAT	200	
6.	Accounting of VAT credit availed and utilized on raw material consumed in payment of VAT on finished goods, accounted on the basis of raw material consumed.	1,200	
7.	Increase on account of VAT included in finished goods on account of inclusion of VAT in the raw material value	200	
8.	Increase in VAT on closing stock of finished goods on account of inclusion of VAT in the raw material value		200
Total		3,100	3,100

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
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Add: Adjustments required under section 145A

1.	VAT on sales	Rs. 1,500	
2.	VAT on closing stock of raw material	Rs. 200	
3.	VAT included in finished goods on account of inclusion of VAT in the raw material value	<u>Rs. 200</u>	Rs.1,900
	Total		11,900

Less:

1.	VAT credit receivables (Input) A/c		<u>Rs.1,200</u>
			10,700
2.	Deductions under section 43B on the assumption that the amount is paid on or before the due date of filing of the return of income in respect of :-		
	a) VAT on sales (1500-1200)	Rs. 300	
	b) VAT on closing stock of raw material	Rs. 200	
	c) VAT included in finished goods on account of inclusion of VAT in the raw material value	<u>Rs. 200</u>	<u>700</u>
	Profit		10,000

The following paragraph 35 in the existing guidance note will be renumbered appropriately at the time of printing.

35. (h) amount inadmissible under section 40A(3) read with rule 6DD and computation thereof;

(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];
- [Clause 17(h)]

Following is the full guidance for clause 17(h)

Statutory provision upto A.Y. 2007-08

- 35.1 Section 40A(3) as amended by the Taxation Laws (Amendment) Act, 2006 w.e.f. 13th July, 2006 provides that where the assessee incurs any expenditure in respect of which payment is made in a sum exceeding Rs.20,000 otherwise than by an account payee cheque drawn on a bank or account payee bank draft 20% of such expenditure shall not be allowed as deduction except in certain cases and circumstances. The cases and circumstances in which payment of a sum exceeding Rs.20,000/- in cash or otherwise than an account payee cheque drawn on a bank or account payee bank draft is allowable are specified in Rule 6DD. The details regarding the payments made in cash or otherwise than by account payee cheques drawn on a bank or by account payee bank drafts are to be stated under this clause.

Statutory provision w.e.f. A.Y. 2008-09

- 35.2 The Finance Act, 2007 has substituted sub-section (3) for the existing sub-section (3) of section 40A w.e.f. A.Y. 2008-09.
- 35.3 The provisions of the newly substituted sub-section (3) of section 40A have three limbs. In the first limb, where the assessee incurs any expenditure in respect of which he makes a payment in a sum exceeding rupees twenty thousand otherwise than by an account payee cheque drawn on a bank or account payee bank draft no deduction would be allowed in respect of such expenditure. This is in contrast to the last applicable up to A.Y. 2007-08 where under only 20% of such expenditure would be disallowed. Under the second limb, where the assessee claims the expenditure as a deduction on the basis of the principle of accrual

and in the subsequent year he makes payment in respect of such expenditure otherwise than by an account payee cheque drawn on a bank or account payee bank draft, such payment shall be deemed to be the profits and gains of business or profession chargeable income-tax as income of the subsequent year if the amount of payment exceeds rupees twenty thousand. However, the third limb provides that no disallowance would be made if the payment is made even otherwise than by an account payee cheque drawn on a bank or account bank draft in respect of cases prescribed under rule 6DD. Notification No.208/2007 dated 27.6.2007 has inserted new rule 6DD w.e.f. A.Y. 2008-09.

- 35.4 The auditor will now have to verify the payments made otherwise than by an account payee cheque drawn on a bank or an account payee bank draft regarding expenditure allowed for any earlier year. Such amount will be required to be reported in sub-para (B) of para 17(h)
- 35.5 The provisions of section 40A(3) as amended by the Taxation Laws (Amendment) Act, 2006 are not applicable for the A.Y. 2006-07. They are applicable from 13th July, 2006. The certificate required under Item (A) of sub-clause (h) is based upon the amended provisions of section 40A(3). So far as A.Y. 2006-07 is concerned the tax auditor may state that clause (A) is not applicable. However, the tax auditor has to verify whether the law contained in section 40A(3) as applicable for A.Y. 2006-07 has been complied with by the assessee. Although the reporting requirement is not strictly applicable for the previous year 2005-06 and also for the period from 1.4.2006 to 12th July, 2006, it is always desirable that the tax auditor should obtain suitable certificate as per the applicable law and keep it in his audit working papers file.
- 35.6 In respect of A.Y. 2007-08 the reporting requirements under sub-clause (h) can be divided into two parts. In respect of the period commencing from 1st April, 2006 and ending on 12th July, 2006 the amended provisions of section 40A(3) are not applicable. Therefore, in respect of that period there is no reporting requirement under item (A) of sub-clause (h). In respect of the period commencing from 13th July, 2006 and ending on 31st March, 2007 and the subsequent financial years the reporting requirements of item (A) have to be complied with.

35.7 The particulars may be furnished in the following form:

Sl. No.	Nature and particulars of expenditure	Date of Payment	Amount paid otherwise than by an account payee cheque drawn on a bank or account payee bank draft	Total amount of expenditure	Remarks

35.8 There may be practical difficulties in verifying the payments made through crossed/account payee cheque or bank drafts. If no proper evidence for the verification of the payment by the crossed/account payee cheque or draft is available, such a fact could be brought out by appropriate comments in the following manner applicable to the relevant assessment year.

In respect of A.Y. 2006-07.

“It is not possible for me/us to verify whether the payments in excess of Rs.20,000 have been made otherwise than by crossed cheque or bank draft as the necessary evidence is not in the possession of the assessee”.

In respect of A.Y. 2007-08

For the period commencing from 1st April, 2006 and ending with 12th July, 2006, it is not possible for me/us to verify whether the payments in excess of Rs.20,000 have been made otherwise than by crossed cheque or bank draft as the necessary evidence is not in the possession of the assessee and for the period commencing from 13th July, 2006 and ending on 31st March, 2007, it is not possible for me/us to verify whether the payments in excess of Rs.20,000 have been made otherwise than by account payee cheque or account payee bank draft, as the necessary evidence is not in the possession of the assessee.

In respect of A.Y. 2008-09 and onwards.

“It is not possible for me/us to verify whether the payments in excess of Rs.20,000 have been made otherwise than by account payee cheque or account payee bank draft as the necessary evidence is not in the possession of the assessee”.

- 35.9 The earlier sub-clause (h) required furnishing of the amount inadmissible under section 40A(3) read with rule 6DD along with computation. The amended sub-clause requires disclosure of amount inadmissible under section 40A(3) read with rule 6DD with the break-up of inadmissible amount.
- 35.10 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.
- 35.11 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 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.
- 35.12 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.

INCOME-TAX ON FRINGE BENEFITS

Amendments made by the Finance Act, 2007

The Finance Act, 2007 now excludes any expenditure on distribution of samples free of cost or at a concessional rate from "Sales promotion including publicity". Therefore, the exemption is now not restricted to only distribution of free medical samples but is extended to distribution of all samples. Further, expenditure on advertisement by way of display of products have also been excluded from "Sales promotion including publicity" and hence exempt from levy of FBT. These amendments are effective from A.Y. 2008-09.

The Finance Act, 2007 has extended the liability to fringe benefit tax to stock options also.

Accordingly, a new clause (d) has been inserted in section 115WB(1) to provide for levy of FBT on the value of any specified security or sweat equity shares allotted or transferred, directly or indirectly, by the employer free of cost or at concessional rate to his employees, including former employees. Specified security means "securities" as defined in section 2(h) of the Securities Contracts (Regulation) Act, 1956 and includes employees' stock option. Sweat equity shares means equity shares issued by a company to its employees or 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. A new clause (ba) has been inserted in section 115WC(1), in order to prescribe the value of such specified security or sweat equity shares. The value of specified security or sweat equity shares, for the purpose of levy of FBT, shall be the fair market value of such security or shares on the date on which the option vests with the employee, as reduced by any amount actually paid by, or recovered from, the employee in respect of such security or shares. The fair market value means the value determined in accordance with the method as may be prescribed by the CBDT. "Option" means a right but not an obligation granted to an employee to apply for the specified security or sweat equity shares at a pre-determined price. Consequently, the proviso to section 17(2)(iii) has been omitted. So far, the value of any benefit provided by a company free of cost or at a concessional rate to its employees by way of allotment of shares, debentures or warrants,

directly or indirectly under any Employees' Stock Option Plan or Scheme of the company offered to such employees was an exempt perquisite. Now, it is a taxable fringe benefit.

A new section 115WKA has been inserted for the purpose of enabling the employer to recover the FBT in respect of any specified security or sweat equity shares from the employees. If sweat equity shares are allotted or transferred, directly or indirectly, by an employer on or after 1.4.2007, it shall be lawful for the employer to vary the agreement or scheme under which such specified security or sweat equity shares has been allotted or transferred. The agreement or scheme can be modified so as to recover from the employee, the FBT, to the extent to which such employer is liable to pay the FBT in relation to the value of fringe benefits provided to the employee and determined in the specified manner. This amendment is effective from A.Y. 2008-09.

Advance tax liability in respect of fringe benefits [Section 115WJ(2) to (5)]

- (i) Under section 115WJ(2), quarterly payment of advance fringe benefits tax, equal to 30% of the value of fringe benefits paid or payable during each quarter, is required to be made by an assessee, on or before the 15th day of the month following such quarter. The advance tax payable for the quarter ending on 31st March is payable by 15th of March. This was causing genuine hardship to the assessees since specific computations were required to be made for each quarter. Further, the FBT return also required information on a quarterly basis.
- (ii) The existing sub-section (2) of section 115WJ has been substituted to remove this difficulty. The new sub-section (2) requires payment of advance tax on the value of fringe benefits paid or payable in a financial year in the same manner as payment of advance income-tax. Accordingly, advance FBT will be payable in four installments in the case of companies in the following manner:

Due date of installment	Advance tax payable
On or before 15 th June	Not less than 15% of such advance tax.
On or before 15 th	Not less than 45% of such advance tax, as reduced

September	by the amount, if any, paid in the earlier installment.
On or before 15 th December	Not less than 75% of such advance tax, as reduced by the amount or amounts, if any, paid in the earlier installment or installments.
On or before the 15 th March	The whole amount of such advance tax as reduced by the amount or amounts, if any, paid in the earlier installment or installments.

Similarly, non-corporate assesseees shall be liable to pay advance tax on the value of fringe benefits paid or payable in a financial year in three installments in the following manner –

Due date of installment	Advance tax payable
On or before the 15 th September	Not less than 30% of such advance tax.
On or before the 15 th December	Not less than 60% of such advance tax, as reduced by the amount, if any, paid in the earlier installment.
On or before the 15 th March	The whole amount of such advance tax as reduced by the amount or amounts, if any, paid in the earlier installment or installments.

Therefore, computation of value of fringe benefits on a quarterly basis is no longer required for payment of advance FBT.

- (iii) Interest for deferment of advance FBT in the case of corporate assesseees [Section 115WJ(3)]

In case of corporate assesseees, simple interest (calculated as per the table given below) is payable in case of failure to pay advance tax before the due date of any installment or shortfall in the advance tax paid vis-à-vis advance tax due in any installment –

	Rate of Interest	Amount on which interest is payable
(1)	1% per month for 3 months	15% of advance tax payable minus advance tax paid on or before 15 th June.
(2)	1% per month for 3 months	45% of advance tax payable minus advance tax paid on or before 15 th September.
(3)	1% per month for 3 months	75% of advance tax payable minus advance tax paid on or before 15 th December.
(4)	1%	100% of advance tax payable minus advance tax paid on or before 15 th March.

- (iv) Interest for deferment of advance FBT in the case of non-corporate assessees [Section 115WJ(4)]

In the case of non-corporate assesses, simple interest (calculated as per the table given below) is payable in case of failure to pay advance tax before the due date of any installment or shortfall in the advance tax paid vis-à-vis advance tax due in any installment –

	Rate of Interest	Amount on which interest is payable
(1)	1% per month for 3 months	30% of advance tax payable minus advance tax paid on or before 15 th September.
(3)	1% per month for 3 months	60% of advance tax payable minus advance tax paid on or before 15 th December.
(4)	1%	100% of advance tax payable minus advance tax paid on or before 15 th March.

- (v) Where an assessee has failed to pay the advance tax payable by him during a financial year or where the advance tax paid by him is less than 90% of the tax assessed under sections 115WE, 115WF or 115WG, the assessee shall be liable to pay simple interest @1% per month for every month or part of a month, from 1st April next following such financial year to

the date of assessment of tax under sections 115WE or 115WF or 115WG [Section 115WJ (5)]. (Effective from 1.6.2007)

Guidance for audit: The tax auditor has to verify whether the value of the fringe benefit in respect of sweat equity shares and specified securities allotted by the employer to its employees including former employees has been computed in accordance with the provisions of section 115WC(1)(ba).

SELECT ISSUES IN ACCOUNTING FOR STATE-LEVEL VAT

“The views expressed in these issues do not represent the views of the Council of the ICAI. These issues have been collected, classified and analyzed by the Fiscal Laws Committee based on the original draft prepared by Indore Branch of the Central India Regional Council of the Institute.”

1. How should the Value Added Tax (VAT) be accounted for?

The Institute of Chartered Accountants of India (ICAI) has issued Guidance Note on Accounting for State- level Value Added Tax – GN(A) 19 (Issued 2005). The objective of this Guidance Note is to provide guidance in respect of accounting for various aspects of State-level Value Added Tax, including accounting for credit/set-off available for input- tax paid on purchases and accounting for VAT payable on sales.

2. To which class of the assesseees is this guidance note applicable?

The accounting treatment recommended in this guidance note is applicable in case of all the assesseees who are required to account for the VAT. The accounting treatment regarding the VAT credit is recommended only in situation where the VAT credit is available. Accordingly the recommended VAT credit treatment is not applicable in cases where no VAT credit is available such as for:-

- (i) Dealers (assesseees) not registered under VAT, or
- (ii) Dealers having turnover below the threshold limit as fixed under the State law no VAT, and opting for composition scheme, or
- (iii) Dealers engaged in the works contract and opting to pay tax by way of composition, or
- (iv) Purchase of goods from unregistered dealers.

3. Can the Input Tax paid on purchases be included in the cost of purchases?

No. 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” issued by the ICAI deals with “cost of inventories” and “cost of purchases”. As per para 6 and 7 of the said AS2 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 of purchases.

4. How should the input tax on purchases be accounted for?

The amount of tax paid on purchase of inputs/ supplies and available for VAT credit should be debited to a separate account, say, VAT Credit Receivable (Inputs) Account. As and when VAT credit is actually utilized against VAT payable on sales, appropriate accounting entries will be required to record the adjustment, i.e. VAT Credit Receivable (Inputs) Account should be credited with a corresponding debit to the account maintained for the tax payable on the sales. The debit balance in VAT Credit Receivable (Inputs) Account at the year- end, should be shown on the “Assets’ side of the balance sheet under the head “Loans and Advances”.

5. What is the accounting treatment for the input tax on purchases which are to be used for making taxable sales as well as exempt sales?

An assessee may purchase certain common inputs which are to be used for making taxable sales as well as for making exempt sales. In such a case, the assessee, on the date of the purchase, should estimate inputs expected to be used for making taxable sales and for making exempt sales. The assessee should recognize VAT Credit only in respect of those inputs which are expected to be used for making taxable sales and no VAT credit should be recognized in respect of inputs expected to be used for making exempt sales. Subsequently, in case the actual use is different from the estimated use, the assessee should pass an appropriate adjustment entry for the same. Such an adjustment will not be a prior period item.

6. Can the tax paid on purchases of capital goods, which is refundable in nature be included in the cost of purchases of such capital goods?

As per para 9.1 of the Accounting Standard (AS) 10, Accounting for Fixed Assets, issued by the ICAI, provides that the cost of the fixed assets should include the non- refundable taxes or levies. Since the VAT tax is in the nature of a refundable tax, it cannot be included in the cost of the capital goods.

7. What is the Accounting Treatment for VAT credit on capital goods?

The VAT credit on capital goods may or may not be available immediately. To the extent VAT Credit is available immediately, the amount in respect of thereof should be debited to an appropriate account, say, "VAT Credit Receivable (Capital Goods Account)" and the balance which is not available immediately should be debited to another appropriate account, say "VAT Credit Deferred (Capital Goods) Account". Subsequently, when the balance credit or a part thereof becomes available, the appropriate adjustment for the same should be made, i.e. the amount of credit becoming available should be credited to 'VAT Credit Deferred (Capital Goods) Account' with a corresponding debit to "VAT Credit Receivable (Capital Goods) Account". Depreciation should be charged on the original cost of the fixed asset excluding the VAT Credit.

8. What is the accounting treatment for liabilities adjusted from VAT credit receivable balance?

All liabilities adjusted out of the VAT credit receivable balance should be credited to the VAT Credit Receivable (Inputs) Account or VAT Credit Receivable (Capital Goods) Account. The corresponding debit for the same should be given to the account maintained for recording VAT liability on sale, say. "VAT Payable Account", if the liability of VAT payable on sales has been met by using the balance in the said account.

9. What is the treatment if the amount utilized pertains to disallowance / withdrawal of VAT?

If the amount utilized pertains to disallowance/ withdrawal of VAT credit taken on purchase of inputs made during the year, the same should be

added to the cost of inputs. Appropriate adjustments in that case should be while valuing inventory of the inputs. If the amount adjusted pertains to disallowance / withdrawal of credit in respect of purchases made in earlier years, the accounting treatment would depend on whether the said inputs/ supplies are available in stock or not. If they are not available i.e. , these have already been sold, the disallowance/ withdrawal should be debited to profit and loss account and treated as expense of the current year., If these are still lying in stock the amount should be added to the cost of inputs.

10. What is the treatment if the amount utilized pertains to disallowance / withdrawal of VAT Credit on capital goods?

If the amount utilized pertains to disallowance / withdrawal of VAT Credit on capital goods, the same should be added to the cost of the relevant fixed asset. For accounting purposes, depreciation on the revised unamortized depreciable amount should be provided prospectively over the residual useful life of the asset. In case the fixed asset no longer exists, the relevant amount should be written-off in the profit and loss account with an appropriate disclosure. If the amount of VAT credit disallowed on capital goods is standing to the debit of VAT Credit Deferred (Capital Goods) Account and has not been transferred to VAT Credit Receivable (Capital Goods) Account, the account to be credited would be the VAT Credit Deferred (Capital Goods) Account.

11. What is the treatment for refund of Input Tax?

Any refund of input tax received in what so ever manner, should be credited to the VAT Credit Receivable (Inputs) Account or VAT Credit Receivable (Capital Goods) Account.

12. What is the impact of Input Tax for Valuation of inventory?

The Input tax 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.

13. What is the treatment for VAT Credit on Goods lying in stock at the inception of the VAT Scheme?

VAT Credit is available in respect of tax-paid goods lying in stock at the inception of the VAT Scheme. The amount of VAT credit available in respect of opening stock should be credited to "VAT Credit Available on Opening Stock Account" at the inception of the VAT Scheme. The corresponding debit of this amount should be given to 'VAT Credit Receivable (Inputs) Account' if the VAT credit is available immediately. In the Profit and Loss Account the amount of 'VAT Credit Available on Opening Stock' should be shown as a deduction from the value of opening stock.

14. What is the accounting treatment for Output Tax i.e. VAT on Sales?

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 enterprises. 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 the should be reflected as a long term liability.

15. Will the treatment mentioned above result in non-compliance with the provisions of section 145A of the Income Tax Act?

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 can 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.

16. Please explain by way of illustration how the adjustments for accounting are to be done and how the exclusive method will be tax neutral.

The examples given in the Guidance Note (Revised 2007) on tax audit under section 44AB of the Income-tax Act, 1961 are reproduced hereunder:

CASE I

The position of a trading concern is as under:-

1.	Opening stock of goods	NIL
2.	Purchases	Rs. 9,00,000
	VAT on purchases	10%
3.	Sales	Rs.9,00,000
	VAT on sales	10%
4.	Closing stock	Rs.3,00,000
5.	VAT unpaid at the end of the year	Rs.30,000

The recording of the above transactions in the books of accounts will be as under:

(i)	Purchases A/c	Dr.	9,00,000
	VAT Credit Receivable (Input) A/c	Dr.	90,000
	To Sundry Creditors		9,90,000
(ii)	Sundry Debtors A/c	Dr.	9,90,000
	To Sales A/c		9,00,000
	To VAT on Sales A/c		90,000
(iii)	VAT on Sales A/c	Dr.	90,000
	To VAT Credit Receivable (Input) A/c		90,000

Based on the above transactions the trading account on "Exclusive basis" will appear as under as per the books of account:

The Trading Account on "EXCLUSIVE METHOD"

Particulars	Quantity	Rate	Amount	Particulars	Quantity	Rate	Amount
To Opening Stock			-	By Sales	2	4,50,000	9,00,000
To Purchases	3	3,00,000	9,00,000	By Closing Stock	1	3,00,000	<u>3,00,000</u>
To GP			<u>3,00,000</u>				
			<u>12,00,000</u>				<u>12,00,000</u>

Upon making adjustments as required under section 145A of the Income-tax Act, 1961 the trading account on inclusive basis will appear as under:-

The Trading Account on "INCLUSIVE METHOD"

Particulars	Quantity	Rate	Amount	Particulars	Quantity	Rate	Amount
To Opening Stock			-	By Sales	2	4,95,000	9,90,000
To Purchases	3	3,30,000	9,90,000	By Closing Stock	1	3,30,000	3,30,000
Less: VAT credit availed on cost of goods sold			<u>60,000</u>				
			9,30,000				
VAT paid on sales			90,000				
Gross Profit			<u>3,00,000</u>				_____
			<u>13,20,000</u>				<u>13,20,000</u>

It will be seen from the above that the gross profit is the same both under the inclusive and the exclusive method.

The tax auditor should explain the deviations as required by clause 12(b) of Form No.3CD as under :-

	(Rupees) Increase in Profit	(Rupees) Decrease in Profit
VAT on Purchase		90,000
VAT on Sales	90,000	
VAT on Closing Stock	30,000	
VAT paid on sales		90,000

VAT credit availed on cost of goods sold	60,000	
	1,80,000	1,80,000

The net impact on profit and loss account is NIL.

CASE II

The following position of a trading concern (with opening stock) is as under:-

1.	Opening stock of raw material	Rs. 3,00,000
	VAT on opening stock	Rs. 30,000
2.	Purchases	Rs. 9,00,000
	VAT on purchases	10%
3.	Sales	Rs. 9,00,000
	VAT on sales	10%
4.	Closing stock	Rs. 6,00,000
	VAT on closing stock	Rs. 60,000

The recording of the above transactions in the books of account will be as under:

(i)	Purchases A/c	Dr.	9,00,000	
	VAT Credit Receivable (Input) A/c	Dr.	90,000	
	To Sundry Creditors			9,90,000
(ii)	Sundry Debtors A/c	Dr.	9,90,000	
	To Sales A/c			9,00,000
	To VAT on Sales A/c			90,000
(iii)	VAT on Sales A/c	Dr.	90,000	
	To VAT Credit receivable (Input) A/c			90,000

Based on the above transactions the trading account on "Exclusive basis" will appear as under:

The Trading Account on "EXCLUSIVE METHOD"

Particulars	Quantity	Rate	Amount	Particulars	Quantity	Rate	Amount
To Opening Stock	1	3,30,000	3,30,000	By Sales	2	4,50,000	9,00,000
Less Input tax rebate			30,000				
			3,00,000				
To	3	3,00,000	9,00,000	By	2	3,00,000	6,00,000

Purchases				Closing Stock			
To Gross Profit			3,00,000				
Total			15,00,000				15,00,000

Upon making adjustments as required under section 145A of the Income-tax Act, 1961 the trading account on inclusive basis will appear as under:-

The Trading Account on "INCLUSIVE METHOD"

Particulars	Quantity	Rate	Amount	Particulars	Quantity	Rate	Amount
To Opening Stock	1	3,30,000	3,30,000	By Sales	2	4,95,000	9,90,000
To Purchases	3	3,30,000	9,90,000	By Closing Stock	2	3,30,000	6,60,000
			13,20,000				
Less: VAT credit availed on cost of goods sold			60,000				
			12,60,000				
VAT paid on sales			90,000				
Gross Profit			3,00,000				
			16,50,000				16,50,000

It will be seen from the above that the gross profit is the same both under the inclusive and the exclusive method.

The tax auditor should explain the deviations as required by clause 12(b) of Form No.3CD as under :-

Sl. No.	Particulars	Increase in profit (Rs.)	Decrease in profit (Rs.)
1.	VAT Recovered on Opening Stock		30,000
2	VAT on Purchase		90,000
3.	VAT on Sales	90,000	
4.	VAT on Closing Stock	60,000	
5.	VAT paid on sales		90,000
6.	VAT credit availed on cost of goods sold	60,000	
		2,10,000	2,10,000

The net impact on Profit & Loss Account is NIL.

CASE III

The following position of a manufacturing concern is as under:-

Opening stock of raw material 50 units	@ Rs.100 per unit
Purchases of raw material 300 units	@ Rs.100 per unit
Sales 250 units	@ Rs.150 per unit
Manufacturing expenses	Rs.3,000
Closing stock of raw material	50 units
Closing stock of finished goods	50 units
VAT rate on purchases and sales	4%

The recording of the above transactions in the books of accounts will be as under:

(i)	Purchases A/c	Dr.	30,000	
	VAT Credit Receivable (Input) A/c	Dr.	1,200	
	To Sundry Creditors			31,200
(ii)	Sundry Debtors A/c	Dr.	39,000	
	To Sales A/c			37,500
	To VAT on Sales A/c			1,500
(iii)	VAT on sales A/c	Dr.	1,500	
	To VAT Credit receivable (Input) A/c			1,200
	To VAT payable A/c			300

(Assuming the balance of Rs. 300 (1500-1200) is unpaid)

Based on the above transactions the trading account on "Exclusive basis" will appear as under:

Manufacturing concern
The Trading Account on "EXCLUSIVE METHOD"

Particulars	Qty	Rate	Amount	Amount	Particulars	Qty	Rate	Amount
Opening Stock	50	100	5,000		By Sales	250	150	37,500
Purchase of raw materials	300	100	30,000		By closing stock of finished goods	50	110	5,500
Total	350	100	35,000					
Less: Closing Stock of raw material	50	100	5,000					
Raw material Consumed (C) = (A) – (B)	300			30,000				
To manufacturing expenses	300	10		3,000				
To VAT on finished goods sold				0				
To gross profit				10,000				
Total				43,000	Total			43,000

Upon making adjustments as required under section 145A of the Income-tax Act, 1961 the trading account on inclusive basis will appear as under:-

The Trading Account on “INCLUSIVE METHOD”

Particulars	Qty	Rate	Amount	Amount	Particulars	Qty	Rate	Amount
Opening Stock	50	104	5,200		By Sales	250	156	39,000
Purchase of raw materials	300	104	31,200		By closing stock of finished goods	50	114	5700
Total	350	104	36,400					
Less: Closing Stock of raw material	50	104	5,200					
Less; VAT on Raw Material Consumed	300	4	1200					
Raw material Consumed (C) = (A) – (B)	300	100		30,000				
To manufacturing expenses	300	10		3,000				
To VAT on finished goods sold	250	6		1,500				
To VAT included in finished goods on account of inclusion of VAT in the raw material value	50	4		200				
To gross profit				10,000				
Total				44,700	Total			44,700

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 tax auditor should explain the deviations as required by clause 12(b) of Form No.3CD as under :-

Sl.No.	Particulars	(Rupees) Increase in Profit	(Rupees) Decrease in Profit
1.	Increase in cost of opening stock of raw material on inclusion of VAT		200
2.	Increase in purchase on account of inclusion of VAT.		1,200
3.	Increase in sales of finished goods on inclusion of VAT.	1,500	
4.	VAT paid on sale of finished goods as a result of its inclusion in sales		1,500
5.	Increase in closing stock of raw material on inclusion of VAT	200	
6.	Accounting of VAT credit availed and utilized on raw material consumed in payment of VAT on finished goods accounted on the basis of raw material consumed.	1,200	
7.	Increase on account of VAT included in finished goods on account of inclusion of VAT in the raw material value	200	
8.	Increase in VAT on closing stock of finished goods on account of inclusion of VAT in the raw material value		200
Total		3,100	3,100

The net impact on the Profit & Loss Account is NIL.

GUIDANCE NOTE ON AUDIT OF DEBTORS, LOANS AND ADVANCES*

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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** 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 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, AASs 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.

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 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

** Now known as the Auditing and Assurance Standards Board (AASB).

++ Now known as the Auditing and Assurance Standards (AASs).

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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.¹

(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.

¹ 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 discussion on internal controls in relation to debtors and loans and advances.

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- (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.

(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 Statement on Standard Auditing Practices (SAP) 5, *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 practices and relevant statutory requirements, if any. |

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

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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.

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- (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.²

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.

² 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.

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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.³ The competence of the borrower to receive the loan may also 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

³ 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 the relevant publication(s) 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*, *Guide to Audit of Cooperative Societies*, etc.

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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 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

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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

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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

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

Audit of Debtors, Loans and Advances

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:⁴

<i>Invoice No.</i>	<i>Date</i>	Order Reference or Tender No. etc. (To be used Particularly for Government Customers)	Acceptance or Amount
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

⁴ In case the list of invoices forming the balance is too large, these details may not be given.

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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)

.....

(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:

Invoice No.	Date	Order Reference	Amount
		Total	_____
		Less: Advanced paid	_____
		Net Amount due from us (Rs.)	_____
		Net Amount due from us (Rs.)	_____

Date

(Signature of debtor/responsible official)

Audit of Debtors, Loans and Advances

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:⁵

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

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)

⁵ In case the list of invoices forming the balance is too large, these details may not be given.

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 Advances⁶ Rs.

Yours faithfully,

(Signature of responsible official of the entity)

⁶ 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.

REVISED GUIDANCE NOTE ON INDEPENDENCE OF AUDITORS

The following is the text of the revised Guidance Note on Independence of Auditors issued by the Council of the Institute of Chartered Accountants of India.

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 judgment 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 con-

fused 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

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 objective 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, Objec-

tivity, 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 judgment 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 appears 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 Rs. 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 Rs. 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-subsi-diary 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 is 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 Rs. 1000/- irrespective of the nature of the purchase or period of credit allowed to other customers the provisions concerning disqualifi-

cation 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 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.

3.4.10A 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 emphasise 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.

3.4.15A 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 indebted-

ness 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 Rs. 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 Rs. 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

SECTION 227(3)(e) AND (f) OF THE COMPANIES ACT, 1956 [REVISED]¹

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 (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”
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 Issued in August 2004. This version of the Guidance Note also incorporates the amendment to Appendix II of the Guidance Note as approved by the Council in January 2005.

² Inserted by the Companies (Second Amendment) Act, 2002.

- tion (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 management³. 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 does not intend to change the basic objective and the concept of audit of financial statements of a company, which is to examine the financial statements with a view to express an opinion thereon.
9. The scope of the audit and auditor's role remains as contemplated under the Auditing and Assurance Standards (AASs) 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. AAS 2, “Objective and Scope of the Audit of Financial Statements” spec-

³ Reference may be made to paragraphs 31 through 47 of Auditing and Assurance Standard (AAS) 28, “The Auditor's Report on Financial Statements.”

ifies, “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 judgment, for example, in deciding the extent of audit procedures and in assessing the reasonableness of the judgments 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 judgment 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 Affairs⁴ (“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, 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

⁴ Now “Ministry of Company Affairs”.

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 (1) 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 of the Rules 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 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. 2/5/2001-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 date 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 of the Rules requires that the statutory auditors of both the appointing as well as the disqualifying company to:

- (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, resig-

nation 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 appointment, 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 of a private company. In such cases, the auditor 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 of the Rules 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.
- (2) These rules shall come into force from the date of their notification in the Official Gazette.
- (3) 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

FOR YOUR INFORMATION

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:

Name of the Company	Date of Appointment	Date of Cessation
1.....		
2.....		

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.

Name of the Company	Date of Appointment	Date of Cessation
1.....		
2.....		

Signature
(Full Name)

Dated this _____ day of _____

FOR YOUR INFORMATION

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 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, I/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 on the said date⁵.

Date:

Address:

For XYZ & Co.,
Chartered Accountants

.....
(Signature)

(Name of the Member Signing the Certificate)
(Designation⁶)

.....
(Membership Number)

⁵ Emphasis supplied – words added pursuant to the amendment approved by the Council in January 2005.

⁶ 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.
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. Auditing and Assurance Standard (AAS) 29, “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 CAATs 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 organization'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

<i>Techniques</i>	<i>Description</i>	<i>Advantages</i>	<i>Disadvantages</i>
Audit Automation	?? Expert Systems ?? Tools to evaluate a client's risk management procedures ?? Electronic working papers, which provide for the direct extraction of data from clients computer records ?? Corporate and financial modeling programs for use as predictive audit test	?? These techniques are more useful when auditors are using laptops which can be directly linked with the entity's system.	?? Not applicable in the case of mainframe computers.
Audit Software	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.	?? 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

Core Image Comparison	Software used by the auditor to compare the executable version of a program with a secure master copy	?? 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
Database Analysers	Software used by the auditor to examine the rights associated with terminals and the ability of users to access information on a database	?? 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

Embedded Code	Software used by the auditor to examine transactions passing through the system by placing his own program in the suite of programs used for processing	?? Performs a wide variety of audit tasks ?? Examines each transaction as it passes through the system ?? Operates continuously ?? Capable of identifying unusual transactions passing through the system	?? There is a processing overhead involved because of the extra programs ?? Definition of what constitutes an unusual transaction needs to be very precise ?? Precautions need to be taken over the output from the programs to ensure is security ?? Precautions need to be taken to ensure that the program cannot be suppressed or tampered with ?? Requires some degree of skill to use and to interpret the results
Log Analysers	Software used by the auditor to read and analyse records of machine activity	?? Provides detailed information on machine usage ?? Long term economics ?? Effective when testing integrity controls	?? Requires a high degree of skill to use and to interpret the results ?? Limited availability as regards machine types ?? 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 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	?? Can be a very powerful analytical tool ?? Can enable the auditor to examine provisions on a number of different bases ?? Very flexible in use ?? Can provide the auditor with useful information on trends and patterns	?? A high volume of data may need to be entered initially ?? Results require careful interpretation
On-line Testing	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	?? Very widely applicable ?? Easy to use ?? Can be targetted for specific functions carried out by programs	?? Each use satisfies only one particular objective ?? Care must be taken to ensure that "live" data does not impact actual results
Program Code Analysis	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	?? Gives a reasonable degree of comfort about the program logic ?? The auditor can examine every function of the program code	?? The auditor must understand the program language ?? The auditor needs to check that the source code represents the version in the source library, and that this version equates to the executable version
Program Library Analysers	Software used by the auditor to examine dates of changes made to the executable library and the use of utilities to amend programs	?? Provides the auditor with useful information concerning the program library ?? Identifies abnormal changes to the library ?? Useful when testing program security	?? Requires a high degree of skill to use and to interpret the results ?? Availability restricted to certain machine types ?? Only relevant when testing integrity controls

Snapshots	Software used by the auditor to take a "picture" of a file of data or a transaction passing through the system at a particular point in time	?? Permits the auditor to examine processing at a specific point in time to carry out tests, or to confirm the way a particular aspect of the system operates	?? Can be expensive to set up
Source Comparison	Software used by the auditor to compare the source version of a program with a secure master copy	?? Compares 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	Fictitious data applied against the client's programs either whilst they are running or in an entirely separate operation. The results of processing the fictitious data are compared with the expected results based on the auditor's understanding of the programs involved	?? Performs a wide variety of tasks ?? Gives considerable comfort about the operation of programs ?? Can be precisely targetted for specific procedures within programs ?? Long term economies	?? "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-seated fraud
Tracing	Software used by the auditor to identify which instructions were used in a program and in what order	?? Helps to analyse the way in which a program operates	?? There may be less costly ways to achieve the same objectives,

			although not in the same detail ?? Requires a high degree of skill to use and to interpret the results ?? Adaptation needed from machine to machine
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GUIDANCE NOTE ON TAX AUDIT UNDER SECTION 44AB OF THE INCOME-TAX ACT

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.

(a) Act

The Income-tax Act, 1961.

(b) AS

Accounting Standards issued, prescribed and made mandatory by the Institute of Chartered Accountants of India.

(c) AS(IT)

Accounting Standards notified by the Central Government under section 145(2).

(d) Assessee

As defined in section 2(7).

(e) Audit report

Any report submitted in Form No. 3CA/3CB along with the statement of particulars in Form No. 3CD.

(f) Board

The Central Board of Direct Taxes constituted under the Central Boards of Revenue Act, 1963.

(g) Circular

A circular or instructions issued by the Board under section 119(1).

(h) Form or Forms

Collectively refer to Forms 3CA, 3CB and 3CD.

(i) ICAI

The Institute of Chartered Accountants of India.

(j) Person

As defined in section 2(31).

(k) Previous year

As defined in section 3.

(l) Rules

The Income-tax Rules, 1962.

(m) Specified date

"Specified date", in relation to the accounts of the previous year relevant to an assessment year means, in the case of a company, the 30th day of November of the relevant assessment year and in any other case, the 31st day of October of the relevant assessment year.

(n) Tax audit

The audit carried out under the provisions of section 44AB.

(o) 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 :-

- (i) Public charitable or religious trusts or institutions under section 12A(b).

(Form No.10B)

- (ii) Assessee carrying on the business of growing and manufacturing tea claiming deduction under section 33AB.

(Form No.3AC)

- (iii) Assessee 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 Site Restoration Account under section 33ABA.

(Form No.3AD)

- (iv) Assesseees other than companies or co-operative societies claiming amortisation of certain preliminary expenses under section 35D and deduction for expenditure on prospecting etc. for certain minerals under section 35E.

(Form No.3B)

- (v) Assesseees incurring any expenditure on or after 1.4.1999 wholly and exclusively in respect of a non-Y2K compliant computer system under section 36 (1)(xi).

(Form No.3BA)

- (vi) Assesseees carrying on business or profession whose sales, turnover or gross receipts exceed Rs.40 lakhs (Rs.10 lakhs in the case of profession), and assesseees 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 or 44AF.

(Forms No.3CA/3CB/ and 3CD)

- (vii) Assesseees who have been ordered by the Assessing Officer with the previous approval of the Chief Commissioner or Commissioner under section 142(2A) to get their books of account audited having regard to the nature and complexity of the accounts of the assessee and the interests of the revenue.

(Form No. 6B)

- (viii) Assesseees other than companies or co-operative societies claiming deduction under section 80HH in respect of profits from newly established industrial undertakings or hotel business in backward areas.

(Form No.10C)

- (ix) Assesseees other than companies or co-operative societies claiming deduction under section 80HHA in respect of profits from newly established small scale industrial undertakings in rural areas.

(Form No.10C)

- (x) Assessee other than companies or co-operative societies claiming deduction under section 80HHB in respect of profits from projects outside India.
(Form No.10CCA)
- (xi) Assessee claiming deduction under section 80HHBA in respect of profits and gains from housing projects.
(Form No.10CCAA)
- (xii) Assessee being supporting manufacturers claiming deduction under section 80HHC in respect of profits on sale of goods and the merchandise to the recognised Export House/Trading House.
(Form No.10CCAB)
- (xiii) Assessee claiming deduction under section 80HHC in respect of export profits.
(Form No.10CCAC)
- (xiv) Assessee claiming deduction under section 80HHD in respect of profits from services provided to foreign tourists.
(Form No.10CCAD)
- (xv) Assessee claiming deduction under section 80HHE in respect of profits from the export of computer software.
(Form No.10CCAF)
- (xvi) Assessee being supporting software developers claiming deduction under section 80HHE in respect of profits on sale of computer software to exporting company.
(Form No.10CCAG)
- (xvii) Assessee being Indian companies, claiming deduction under section 80HHF in respect of profits derived from the business of export or transfer out of India of film software etc.
(Form No.10CCAI)
- (xviii) Assessee other than companies or co-operative societies claiming deduction under section 80-I in respect of profits and gains from newly established industrial undertakings, ships or hotel business set up after 31st March, 1981.
(Form No. 10CCB)

- (xix) Assesseees other than companies or co-operative societies claiming deduction under section 80-IA in respect of profits and gains derived from industrial undertakings etc.

(Form No. 10CCB)

- (xx) Assesseees claiming deduction under sub-section (7A) of section 80-IA in respect of profits and gains of business of housing or other activities which are an integral part of a highway project.

(Form No. 10CCC)

- (xxi) Assesseees, being Indian companies, claiming deduction under section 80JJAA, in respect of employment of new workers.

(Form No. 10DA)

- 2.2 The Guidance Note relating to the audit under section 44AB was first published in the year 1985 and revised in the years 1989 and 1998. The Government has 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. Hence, any tax audit report signed after 4th June, 1999 for any assessment year should be issued in the revised Form Nos. 3CA or 3CB along with the statement of particulars in Form No. 3CD, as the case may be. Since the requirements under the revised forms are quite different and enlarged as compared to the earlier forms, it has now become necessary to revise the Guidance Note. The revised 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 special information, the same has to be given separately along with Form No. 6B.
- 2.3 The Institute has published separate Guidance Notes for audit of Public Trusts under section 12A(b) and for audits required for claiming deduction under sections 80HBB/80HHC.
- 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 Rs.40 lakhs. For a professional, the provisions of tax audit become applicable, if his gross receipts in profession exceed Rs.10 lakhs. 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 by the Finance Act, 1997 to provide, w.e.f. Assessment Year 1998-99, 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, if such person claims that his income is lower than the amount of income deemed under these sections as presumptive income.

- 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 assesseees."

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 or exceeds forty lakh rupees in any previous year; or*
- (b) *carrying on profession shall, if his gross receipts in profession exceed ten 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 44AD or section 44AE or section 44AF, 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,*

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 44BB or section 44BBA or section 44BBB, 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 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 previous year relevant to an assessment year means, -*
 - (a) *where the assessee is a company, the 30th day of November of the assessment year;*
 - (b) *in any other case, the 31st day of October of the assessment year."*

- 3.2. 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 Rs.40 lakhs in the case of business and gross receipts exceed Rs.10 lakhs in the case of profession - vide clauses (a) and (b) of section 44AB.
- 3.3. Clause (c) of section 44AB, inserted by the Finance Act 1997 w.e.f. assessment year 1998-99, provides that in the case of an assessee carrying on a business of the nature specified in sections 44AD, 44AE or 44AF, tax audit will be required, if he claims his income to be lower than the presumptive income deemed under the said sections. Therefore, an assessee will be required to get his accounts audited even if his turnover does not exceed Rs.40 lakhs.
- 3.4. Under the provisions of sections 44AD and 44AF, an assessee can opt to be assessed on presumptive basis, so long as the gross receipts/total turnover from any of the business(es) do not exceed Rs.40 lakhs. Once the total turnover/gross receipts from any such business(es) exceed Rs.40 lakhs, 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 the business of civil construction, etc. as referred to in section 44AD(1), the business of plying, hiring or leasing goods carriages as referred to in section 44AE(1) and retail business as referred to in section 44AF(1). In computing the monetary limits under sections 44AA and 44AB, the turnover/gross receipts, or, as the case may be, the income from the said business shall be excluded.

- 3.5. If a person is carrying on business(es), coming within the scope of sections 44AD, 44AE or 44AF, 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 Rs.40 lakhs. In the case of a person carrying on businesses covered by section 44AD, 44AE or 44AF 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 Rs.40 lakhs.
- 3.6. The first proviso to section 44AB stipulates that the provisions of that section will not be applicable to a person who derives income of the nature referred to in sections 44B, 44BB, 44BBA or 44BBB. Where the assessee is carrying on any one or more of the businesses specified in section 44B or section 44BB or section 44BBA or section 44BBB 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.
- 3.7. 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.
- 3.8. A question may arise in the case of an assessee who is eligible to claim deductions under sections 80HH, 80HHA, 80HHC, 80HHD, 80HHE, 80HHF, 80-I or 80-IA 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 80HH, 80HHA 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 Roy 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. - *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. Manmohan Das (Deceased) [1966] 59 ITR 699 (SC)*.

The following have been listed out as professions in section 44AA and notified thereunder (Notifications No. SO-17(E) dated 12.1.77 and No. SO 2675 dated 25.9.1992):

- (i) Accountancy
- (ii) Architectural
- (iii) Authorised Representative
- (iv) Company Secretary

- (v) Engineering
- (vi) Film Artists/Actors, Cameraman, Director, Singer, Story-writer, etc.
- (vii) Interior Decoration
- (viii) Legal
- (ix) Medical
- (x) Technical Consultancy

4.4. The following activities have been held to be business :-

- (i) Advertising agent
- (ii) Clearing, forwarding and shipping agents - *CIT v. Jeevanlal Lallubhai & Co. [1994] 206 ITR 548 (Bom).*
- (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 Rs.40 lakhs and to a person carrying on a profession, if his gross receipts from profession exceed Rs.10 lakhs 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 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".

- 5.3 The Guide to Company Audit issued by the Institute, while discussing "sales", states as follows : (Page 53 of 4th Edition, 1980)

"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."

- 5.4 The "Statement on the Amendments to Schedule VI to the Companies Act, 1956" issued by the Institute, (Page 14, 1976 edition) while discussing the disclosure requirements relating to 'turnover' states 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."

- 5.5. The Statement on the Manufacturing and Other Companies (Auditors' Report) Order, 1988 issued by the Institute in May 1989, while discussing the term 'turnover' in paragraph 41(c) states as follows:

"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 discount can be deducted from sales but not the commission allowed to third parties. If however, the Excise duty and/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".

- 5.6. 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.
- 5.7. 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.

5.8. 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 consignee, as the case may be, the sale price received/receivable by him shall form part of his sales/turnover.

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.

5.9. 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.

5.10. 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) Profits on sale of a licence granted under the Imports (Control) Order, 1955 made under the Imports and Exports (Control) Act, 1947;
- ii) Cash assistance (by whatever name called) received or receivable by any person against exports under any scheme of the Government of India;
- iii) Any duty of customs or excise re-paid or repayable as drawback to any person against exports under the Customs and Central Excise Duties Drawback Rules, 1995;
- iv) The aggregate of gross income by way of interest received by the money lender;
- v) Commission, brokerage, service and other incidental charges received in the business of chit funds;
- vi) 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;
- vii) The net exchange rate difference on export sales during the year on the basis of the guiding principle explained in (vi) above will have to be added.
- viii) Hire charges of cold storage;
- ix) Liquidated damages;
- x) Insurance claims - except for fixed assets;
- xi) Sale proceeds of scrap, wastage etc. unless treated as part of sale or turnover, whether or not credited to miscellaneous income account;

- xii) Gross receipts including lease rent in the business of operating lease;
- xiii) Lease rent or interest on financing in the business of finance lease ; and
- xiv) Hire charges and instalments received in the course of hire purchase.

5.11. The following items would not form part of "gross receipts in business" for purposes of section 44AB.

- i) Sale proceeds of fixed assets;
- 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, and
- 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.

- 5.12. 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.
- 5.13. 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.
- 5.14. 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 twelve lakhs but his total sales, turnover or gross receipts in business are, say, rupees twenty 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 ten lakhs. If however, the

professional receipts are, say, rupees seven lakhs and total sales turnover or gross receipts from business are, say, rupees thirty four 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.

- 5.15. 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 limit of Rs.40 lakhs as laid down in this section has been exceeded or not. However, where the business is covered by section 44B or 44BB or 44BBA or 44BBB, turnover of such business shall be excluded. Similarly when the business is covered by sections 44AD, 44AE and 44AF 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.
- 5.16. It must also be understood that the issue whether the turnover exceeds Rs.40 lakhs in the case of business or the gross receipts exceed Rs.10 lakhs 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 particular 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 assesseees 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 charitable trust carrying on business may enjoy exemption under sections 10(21), 10(23), 10(23B) or section 10(23BB) or section 10(23C) and a research association carrying on business may enjoy exemptions under section 10(21) and section 11. A co-operative society carrying on business may enjoy exemption 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 Rs.40 lakhs. 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 Rs.40 lakhs. 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 Rs.40 lakhs.

- 6.2. 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 exceeds the prescribed limits. This audit, however, would be confined only to the Indian operations carried out by the non-resident assessee since he is not chargeable to income-tax in India in respect of income accruing or arising or received outside India.

7. Specified date and tax audit

A question may arise whether a tax auditor appointed under section 44AB can be held responsible if he does not complete the audit and give his audit report 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 the 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. In view of the fact that section 44AB does not give any discretion to the tax authorities to extend the time limit for completion of audit, the audit has to be completed within the time limit provided in this section. 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 271-B 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 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 lakh whichever is less. However, in view of the specific provisions contained in section 273B, no penalty is

impossible 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 term "accountant" has been defined in sub-clause (i) of Explanation to section 44AB as under:-

"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".

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 tax auditor of companies registered in that State."

The proviso to section 44AB also 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 of the audit as required under section 44AB. It may be noted that with the deletion of the words "by an accountant" in the proviso to section 44AB by the Finance Act, 1985 with effect from 1st April, 1985, in the case of any assessee like a co-operative society where the accounts under the relevant law are allowed to be audited by a person other than a chartered accountant, the tax audit may also be conducted by the statutory auditor who may not be a chartered accountant.

- 9.2. 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 below his name.
- 9.3. Section 44AB does not stipulate that only the statutory auditor appointed under the Companies Act or other similar statute should perform the tax audit. The tax audit can, therefore, be conducted either by the statutory auditor or by any other chartered accountant in practice.
- 9.4. 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.

- 9.5 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. 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 Conduct" under clause (8) of Part I of the First Schedule to the Chartered Accountants Act, 1949 vide Appendix II.
- 9.6 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. The tax auditor should get the statement of particulars, as required in the annexure to the audit report, authenticated by the assessee before he proceeds to verify the same.
- 9.7. The tax auditor is required to submit his report to the person appointing him viz. the assessee.
- 9.8. 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 paragraph 15 of the Statement on the Responsibility of Joint Auditors reproduced below:

“No problem arises if the joint auditors are able to arrive at an agreed report. But, where joint auditors are in disagreement with regard to the report, each one of them would be justified in expressing his own opinion through a separate report. Even where more than two joint auditors are appointed, there is no question of majority or minority with regard to the joint audit report. Each auditor is entitled to express his own separate opinion and, in fact, it is his duty to do so.”

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 "Statement on the Responsibility of Joint Auditors" issued by ICAI. The same is reproduced in Appendix III.

- 9.9. 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.
- 9.10. 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 a decision of the Council (reported in the Code of Conduct under clause(4) of Part I of Second Schedule), a chartered accountant who is in employment of a concern or in any other concern under the same management cannot be appointed as tax auditor of that concern. 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. It may also be noted that under the Second Schedule to the Chartered Accountants Act, if a member gives an audit report under section 44AB in the case of a concern in which he and/or his relatives have substantial interest, it will be necessary for him to disclose his interest in the audit report. Relevant extracts from the Code of Conduct published by ICAI relating to disclosure of substantial interest by a chartered accountant are given in Appendix IV.

- 9.11. A chartered accountant who is responsible for writing or the 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 the 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.
- 9.12. 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.
- 9.13. 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. If the internal auditor is working in a professional capacity (as an independent chartered accountant not being an employee of the assessee), he can conduct the tax audit.
- 9.14. 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. There is no specific procedure for removal of a tax auditor appointed under section 44AB. It is, however, possible for the management to remove a tax auditor where there are any 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 before the specified date. In such cases, the assessee 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 concerned committee constituted by the Institute 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.
- 9.15. Before accepting a tax audit, the chartered accountant should take into consideration the ceiling on tax audit assignments fixed under the Notification dated 13th January, 1989, issued by the ICAI. A copy of this Notification is appended as Appendix V.

- 9.16. In view of the said Notification, a member of the Institute in practice, shall be deemed to be guilty of professional misconduct if he accepts in a financial year more than 30 tax audit assignments 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. Further, as per a Council decision, audits of accounts of persons carrying on business covered by sections 44AD, 44AE or 44AF, is not included in the aforesaid limit. In case the member is a partner of a firm of chartered accountants in practice, the ceiling of 30 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 30 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 30 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.
- 9.17. No separate guidelines have been prescribed for tax audit fees under section 44AB. 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 will 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 scale of fees effective from 1.4.1995 recommended by the Institute for professional services is given in Appendix VII (published in 'The Chartered Accountant', April, 1995 p.1402). The Council has also clarified that the scale does not include fees chargeable in respect of non-qualified assistants and that the chartered accountants are free to negotiate the terms in respect of such assistants with the clients.

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.

9.18. Attention is also invited to Notification No.1-CA/(7)/29/95 dated 1st March, 1995 of the Institute (published in 'The Chartered Accountant', April, 1995 p.1394) which prescribes minimum fees to be charged by certain specified categories of firms. The Notification is reproduced as Appendix - VIII. The notification does not apply to certification or audit under Income-tax Act by the statutory auditor. The limits specified in the notification will therefore apply only if tax audit is conducted by a firm other than that of statutory auditors. Also, where tax audit and statutory audit are done by the same firm, the total fee for both assignments shall be reckoned for the purpose.

9.19 As mentioned in Paragraph 9.16 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. Recognising the need to harmonise 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 AS.

- 10.2. AS are formulated by the Accounting Standards Board and issued by the Council of the Institute. Such Standards are issued 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 and other statements and explanatory notes which form part thereof, issued for the use of shareholders/members, creditors, employees and public at large.
- 10.3. The Institute has so far issued fifteen definitive standards as follows:
- AS-1 Disclosure of Accounting Policies
 - AS-2 (Revised) Valuation of Inventories
 - AS-3 (Revised) Cash Flow Statements
 - AS-4 (Revised) Contingencies and Events Occurring After the Balance Sheet Date.
 - AS-5 (Revised) Net Profit or Loss for the period, Prior Period items and changes in Accounting policies
 - AS-6 (Revised) Depreciation Accounting
 - AS-7 Accounting for Construction Contracts
 - AS-8 Accounting for Research and Development
 - AS-9 Revenue Recognition
 - AS-10 Accounting for Fixed Assets
 - AS-11 (Revised) Accounting for 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 Accounting for Retirement Benefits in the Financial Statements of Employers

Out of the 15 Standards issued so far, 14 have been made mandatory except AS-3 Cash Flow Statements (Revised). It may be noted that AS-2 (Revised) Valuation of Inventories has been made mandatory from accounting year starting from 1.4.1999. The mandatory 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.

- 10.4. 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.
- 10.5 The Companies Act, 1956, 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, 1956, 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.

In this connection, it may be noted that sub-section (3A) of section 211 of the Companies Act, 1956, newly inserted by the Companies (Amendment) Act, 1999 w.e.f. 31.10.1998 provides that every profit and loss account and balance sheet of a company shall comply with the accounting standards. Sub-section (3B) thereof, also newly inserted, provides that where the profit and loss account and the balance sheet of

the company do not comply with the accounting standards, such companies shall disclose in its profit and loss account and balance sheet, the following namely:-

- (i) the deviation from the accounting standards;
- (ii) the reasons for such deviation; and
- (iii) the financial effect, if any, arising due to such deviation.

Sub-section (3C) provides that for the purposes of section 211, the expression "accounting standards" means the standards of accounting recommended by the Institute of Chartered Accountants of India as may be prescribed by the Central Government in consultation with the National Advisory Committee on Accounting Standards established under sub-section (1) of section 210A. The proviso under sub-section (3C) provides that the standards of accounting specified by the Institute of Chartered Accountants of India shall be deemed to be the Accounting Standards until the accounting standards are prescribed by the Central Government under sub-section (3C).

Further, sub-clause (d) has been inserted in sub-section (3) of section 227 to provide that the auditors' report shall also state 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.

- 10.6. The 'Preface to the Statements of Accounting Standards', issued by the Institute, *inter alia*, states:

"While discharging their attest function, it will be the duty of the members of the Institute to ensure that the Accounting Standards are implemented in the presentation of financial statements covered by their audit reports. In the event of any deviation from the Standards, it will be also their duty to make adequate disclosures in their reports so that the users of such statements may be aware of such deviations."

- 10.7. 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 Policies-AS 1.

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.

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.

- 10.8 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.

10.9 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 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.

10.10. **Accounting Standards under Taxation Law:**

The Finance Act, 1995 substituted a new section 145 w.e.f. assessment year 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 assesseees 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."

10.11 **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.

These AS(IT) are given below:

Accounting Standards to be followed by all assesseees 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:

7. 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.
8. Extraordinary items of the enterprise during the previous year shall be disclosed in the profit and loss account as part of 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.
9. 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.
10. 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.
11. 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.
12. 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.

13. For the purposes of paragraphs (7) to (12), 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.

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.

10.12. 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 assessees 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. Now, the revised 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 can apply the technique of test audit depending on the type of internal control procedures followed by the assessee. The tax auditor will also have to keep in mind the concept of materiality depending upon the circumstances of each case. He would be well advised to refer to the Statements on Standard Auditing Practices (SAPs) issued by ICAI, the "Statement on Auditing Practices" as well as the "Guidance Note on Audit Reports and Certificates for Special Purposes" while determining the extent of test checks and materiality in each particular case. 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 of the Companies Act 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. However, since the appointment of the tax auditor is made by 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, the assessee refuses to produce any particular record or to give any specific information or explanation, the tax auditor will be required to report the same and qualify his report.
- 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 detailed notes about the evidence on which he has relied upon while conducting the audit and also maintain all his 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.

Attention is also invited to the Statement on Standard Auditing Practices: Documentation (SAP-3) which provides that the tax auditor should document matters which are important in providing evidence that the audit was carried out in accordance with the basic principles.

- 11.4. 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 accounts to his report and verify the particulars in the prescribed form for expressing his opinion as to whether these are true and correct.
- 11.5. While test checks may suffice in the conduct of a statutory audit for the expression of the auditor's opinion as to whether the accounts depict a 'true and fair' view, the tax auditor may be required to apply reasonable tests on the total information to be prepared by the assessee in respect of certain items in the prescribed form, e.g., in verification of payments for purchases/expenses exceeding Rs.20,000/-in cash. While the entity may have to prepare the details for the entire year, the tax auditor may have to ensure that no items have been omitted in the information furnished and a reasonable test check 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.

- 11.6. The tax auditor may rely upon the audit conducted by an internal auditor or by an outside professional firm appointed as internal auditor, by using his own judgement as to the degree of reliance which he wishes to place on the work of the internal auditor relevant to tax audit. The degree of reliance would depend on the areas of work covered by the internal auditor and relevant for purposes of tax audit, particularly by reference to working papers/documents of the internal auditor and ensuring that reasonable checks/tests have been applied to transactions covered by the internal auditor, to satisfy himself about the authenticity of the ultimate information. It would be in the interest of the tax auditor to obtain and scrutinise the programme of work and procedures adopted and the relevant working papers and documents obtained by the internal auditor in evidence of the work carried out by him. Reference may be made to the Statement on Standard Auditing Practices: Relying upon the Work of an Internal Auditor (SAP-7) - vide Appendix IX. Primarily, however, it would, be necessary for the tax auditor to ensure that in expressing his opinion, he has adequately satisfied himself as to the authenticity of the information contained in the relevant form and that, his working papers and documents are adequate to enable him to certify the particulars. Reference may be made to Statement on Standard Auditing Practices: Study and Evaluation of the Accounting System and Related Internal Controls in Connection with an Audit (SAP-6) and Analytical Procedures (SAP-14).
- 11.7. 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 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.

12. Professional misconduct

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 earlier there were three forms of audit report.

Form No. 3CA - Audit report under section 44AB of the Income-tax Act, 1961, in a case where the accounts of business of a person have been audited under any other law.

Form No. 3CB - Audit report under section 44AB of the Income-tax Act, 1961 in the case of a person carrying on business.

Form No. 3CC - Audit report under section 44AB of the Income-tax Act, 1961, in the case of a person carrying on profession.

The revised Form No. 3CA is applicable to a person whose accounts of the business or profession have been audited under any other law carrying on either business or profession while Form No. 3CB is applicable 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.

Earlier the required particulars in the case of a person carrying on profession were to be furnished in Form No. 3CE. However, the new Form No. 3CD is applicable in respect of persons carrying on business and/or profession.

- 13.4. It may thus be noted that the audit report 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.

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.

- 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. The requirement in paragraph 3 of Form No.3CA and paragraph 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 by the Companies Act, 1956. 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 ensure factual accuracy relating to these particulars.

- 13.6. 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.
- 13.7 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. Even where separate sets of accounts are maintained in respect of business and professional activities Form No. 3CB and Form No. 3CD should be used.
- 13.8. 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, proper books of account have not been prescribed generally for a person who carries on business or profession but who is not required by or under any other law to get his accounts audited (except under Section 44AA for certain categories of persons), the tax auditor should ensure that such books are maintained as would give the information required to prepare balance sheet and profit and loss account in the formats recommended in Appendices X and XI of this Guidance Note. Reference in this connection may also be made to the publication of the Institute entitled "Monograph on Compulsory Maintenance of Accounts", which provides the necessary guidance in the matter.

- 13.9. In case the accounts 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, are being audited for the first time, it is recommended that a disclosure be made to the effect that corresponding comparative figures of the previous year, if given, are not audited.
- 13.10. 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 Department of Company Affairs have affirmed this position. In case of revision, the audit report should be given in the manner suggested by the Institute. (Published in the Chartered Accountant, pp.655, February, 1985. Also refer to Revision/Rectification of Financial Statements, published in Compendium of Guidance Notes - Volume I). The Department of Company 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.

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. [Reference may also be made to the Guidance Note on auditor's Report on Revised Accounts of Companies Before Circulation to shareholders, published in Compendium of Guidance Notes, Volume-I] - vide Appendix XII.

- 13.11. 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 XIII.

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.
- 14.2. The next paragraph states that the statement of particulars required to be furnished under section 44AB is annexed with the report in Form No. 3CD. The tax auditor has to state further that, in his opinion and to the best of his information and according to the explanations given to him, the particulars given in the said annexure are true and correct.
- 14.3. Where any of the requirements in this form is answered in negative or with qualification, the report shall state the reasons therefor. 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 realise the impact of such qualifications. In this regard the tax auditor should follow the "Statement on Qualifications in Auditors' Reports" - vide Appendix XV.
- 14.4. It is possible that in the case of a 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 SAP-10 '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 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".

- 14.5 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 and the status such as proprietor or partner under which he has signed the report.
- 14.6 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 in his audit report as under:-

"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.

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 four paragraphs.

The tax auditor has to state whether he has examined the balance sheet as at 31st March of the relevant previous year and the profit and loss account/income and expenditure account for the year ended on the date. **Further, such a balance sheet and the profit and loss account must be attached with the audit report.**

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 accounts maintained at the head office and branches. He has also to mention the total number of branches.

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.

- 15.2 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, the following portion of paragraph 3 may be deleted:

"3(a) *I/We report the following observations/comments/discrepancies/ inconsistencies, if any:

Subject to above,-"

The tax auditor may then give his report as required by sub-paragraphs (A), (B), and (C) of paragraph 3 and paragraph 4.

- 15.3 Paragraph 4 of Form No.3CB provides that the prescribed particulars are furnished in Form No.3CD annexed to the report and whether in his opinion and to the best of his information and according to the explanations given to him, they are true and correct. 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.

- 15.4. 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.
- 15.5 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. 3CA/3CB.

16. Form No. 3CD

- 16.1 The statement of particulars given in Form No. 3CD as annexure to the audit report contains thirty two 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 Accounting Standards (AS), Guidance Notes, Statements of Auditing Practices (SAP) 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.

17. Particulars to be furnished in Form No.3CD.

PART – A

1. **Name of the assessee** : _____
2. **Address** : _____
3. **Permanent Account Number** : _____
4. **Status** : _____
5. **Previous year ended** : **31st March** _____
6. **Assessment year** : _____

[Clauses 1 to 6]

The requirements of clauses 1 to 6 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. If the assessee has not been allotted the permanent account number as on the date of signing of the report, that fact should be indicated. Where PAN is not known but the general index register number (GIR) is available, the same may be given.

- 17.4 Under clause (4) the status of the assessee is to be mentioned. Obviously this refers to the different classes of assesseees 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. In case of dispute regarding status the full facts should be mentioned.
- 17.5 Under clause (5), since the previous year under the Act uniformly ends on 31st March, the relevant previous year should be mentioned.
- 17.6 Under clause (6) the assessment year relevant to the previous year for which the accounts are being audited should be mentioned.

PART - B

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/members or their profit sharing ratios, the particulars of such change.**

[Clause 7(a) and (b)]

- 18.1 Where the assessee is a firm or association of persons (AOP), the names of partners of the firm or members of the association of persons and their profit sharing ratios have to be stated. In case where the partner of a firm or the member of AOP 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 25.9.1996 issued by the Board reproduced in Appendix XIV.
- 18.2 If there is any change in the partners of the firm or members of the association of persons or their profit or loss sharing ratio, 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) whether the relevant documents, if required, 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.

18.5 In certain cases of association of persons 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.

19. (a) **Nature of business or profession.**

(b) **If there is any change in the nature of business or profession, the particulars of such change.**

[Clause 8 (a) and (b)]

19.1 In regard to the nature of business, the principal line of business such as manufacturing of electronic goods, trading in chemicals, wholesale trade in foodgrains or a retail trade in grocery should be stated. In the case of a person rendering services, the nature of services should be broadly stated. This information is similar to the information required in the return of income "Part IV, Information relevant to the business or profession", where an assessee is required to state the nature of business or profession.

19.2 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.

- 19.3 A review of business report or the minutes of meetings would enable the tax auditor to 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.
- 19.4 In the case of amalgamation, if there is a similar line of activity, no reference need be made. However, if a new line of activity emerges because of amalgamation, the same may be stated. In the case of restructuring, if any line of activity is being hived off, the same may also be stated.
20. (a) **Whether books of account are prescribed under section 44AA, if yes, list of books so prescribed.**
- (b) **Books of account maintained.**
(In case books of account are maintained in a computer system, mention the books of account generated by such computer system.)
- (c) **List of books of account examined.**

[Clause 9 (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 3 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 and skill 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 Whereas the CBDT has prescribed the books of account and other documents to be kept and maintained by the specified professional persons in Rule 6F, it has not yet prescribed the books of account to be maintained by those falling under sub-section (2) 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 sixty thousand rupees (eighty thousand rupees in the case of a person who, in the course of his medical profession, dispenses drugs and medicines) in any one of 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:

1. Cash book.
2. Journal, if the accounts are maintained according to the mercantile system of 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.

No books of accounts have been prescribed so far in respect of any other class of persons.

20.3. If books of account have been prescribed under rule 6F, the list of books so prescribed have to be stated under clause 9(a). It may be noted that the daily case register and the inventory under broad heads do not constitute books of account and hence they need not be mentioned under clause 9(a). Sometimes an assessee may carry on a combination of 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 this clause.
- 20.5. Attention is invited to the Institute's publication titled "Monograph on Compulsory Maintenance of Accounts" dealing with the requirements of provisions of section 44AA relating to the books of account to be maintained by the tax payers falling within the said section. 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 have to verify that the assessee has maintained such books of accounts and documents as prescribed under sub-section (3).
- 20.6. For a person whose accounts of the business or profession have been audited under any other laws, the requirement for maintenance of books of account is contained in the relevant statutes. In the case of other assessees, normal books of account to be maintained will be cash book/bank book, sales/purchase journal or register and ledger. Assessee 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.
- 20.7. As to the requirement regarding the mentioning of the books of accounts generated by the computer system, only such books of account and other records which properly come within the scope of the expression "proper books of account" should be mentioned. The tax auditor should insist on proper print-outs of books of account being taken out.

20.8. Books of account examined would constitute the books of original entry and the other books of account. While the assessee is required to maintain proper evidence in the form of bills, vouchers, receipts, documents, etc., it may be noted that these are essential to support the entries in the books of account and no reference to such supporting evidence need be made under this clause.

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 (44 AD, 44AE, 44AF, 44B, 44BB, 44BBA, 44BBB or any other relevant section).

[Clause 10]

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.

Sr. No.	Section	Business Covered
1	44AD	Civil construction business
2	44AE	Transport business
3	44AF	Retail trade
4	44B	Shipping business of a non-resident
5	44BB	Exploration etc. of mineral oil by a non-resident
6	44BBA	Operation of aircraft by non-resident
7	44BBB	Civil construction etc. in certain turnkey power project by non-residents.
8	Any other relevant section	This refers to the sections not listed above under which income may be assessable on presumptive basis like section 44D and will include any other section that may be enacted in future for presumptive taxation.

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. However, the tax auditor may clarify by way of a note that the amount mentioned under this clause is not necessarily the actual amount of profits and gains chargeable to tax under the relevant section.

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.

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 correctness of such apportionment, he should indicate such fact under this clause by a suitable note and the exact tenor and nature of such remarks has to be formulated on the basis of "Statement on Qualifications in Auditors' Report" issued by the ICAI - vide Appendix XV.

- 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.

- 21.4 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 Rs.40 lakhs. 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 40 lakhs. 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.

- 21.5 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.
22. (a) **Method of accounting employed in the previous year.**
- (b) **Whether there has been any change in the method of accounting employed 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.**
- (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 11 (a) to (d)]

- 22.1. The Finance Act, 1995 has 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 assessee 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 is not permitted from assessment year 1997-98. 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, 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. The provisions of section 209 (3) of the Companies Act, 1956 are, however, not applicable to entities other than companies.

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.

- 22.3 If there is any change, the effect thereof has to be stated under this clause. Insofar 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.
- 22.4 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.
- 22.5 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.

- 22.6 The Calcutta High Court in *Snow White Food Products v CIT* [1983] 141 ITR 861, and Madras High Court in *CIT v Carborandum Universal Limited* [1966] 149 ITR 759 and several other decisions like *CIT v. Mopeds India Ltd.* [1998] 173 ITR 347, *Triveni Engg. Works Ltd. v. CIT* [1987] 167 ITR 742 (All), *CIT v. Ganga Trust Fund* [1986] 162 ITR 612 (Guj) have held that it is open to an assessee to change the method of accounting provided the changed method is the regular method of accounting and the assessee has not merely abandoned or changed it for a casual period to suit his own purposes. Any such change which is followed consistently has to be accepted by the Department, even if it results in reduction of tax liability
- 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 11(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 on 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 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 11(d). He may rely on the various pronouncements and clarifications made by the ICAI.

- 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.**

[Clause 12 (a) and (b)]

- 23.1 The method of valuation of closing stock is to be stated under this clause. It is the normal practice to disclose the same as a part of 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 realisable value whichever is lower.
- 23.3 In clause 3(i) of the old Form No. 3CD reference was to "opening and closing stock-in-trade". In sub-clause (a) of clause 12 of revised Form No.3CD, the reference is 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 Hon'ble 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) (mandatory 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 23.7, 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 12(b).
- 23.8 Section 145A has been enacted by the Finance (No.2) Act, 1998 and has come into force from the accounting year 1.4.1998 to 31.3.1999 (assessment year 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.

Particulars	Qty	Rate excluding excise duty	Rate of excise duty
Opening stock	10	10	2
Raw material purchased	90	10	2
Other manufacturing cost	80	10	-
Finished goods manufactured	80	-	-
Sales of finished goods	60	25	3
Closing stock of raw material	20	10	2
Closing stock of finished goods	20	20	3

The input output ratio of raw material to finished goods is 1: 1

23.10 It may be stated that the MODVAT 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 MODVAT credit in the accounts are permissible.

- I. Duty paid on inputs may be debited to a separate account, e.g. MODVAT credit receivable account. As and when the MODVAT 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 "MODVAT 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 MODVAT credit is utilised for payment of excise duty on final products, the amount could be credited to a separate account, i.e. MODVAT credit availed account. Out of the MODVAT credit availed account, the amount of MODVAT 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:

Item	Particulars	Unit	Rate	Amount	Amount	Item	Particulars	Unit	Rate	Amount
(a)	Opening Stock	10	10	100		(h)	By sales	60	25	1,500
(b)	Purchase of raw material	90	10	900		(i)	By closing stock of finished goods	20	20	400
	Total	100	10	1000						
(c)	Less closing stock of raw material	20	10	200						
(d)	Raw material consumed	80	10		800					
(e)	To manufacturing cost	80	10		800					
(f)	To excise duty on finished goods sold				0					
(g)	To gross profit				300					
	TOTAL				1900		TOTAL			1900

The profit & loss account on “inclusive method” which is also in accordance with the provisions of section 145A would be as under:

Item	Particulars	Unit	Rate	Amount	Amount	Item	Particulars	Unit	Rate	Amount
(j)	Opening stock	10	12	120						
(k)	Purchase of raw material	90	12	1080		(s)	By sales	60	28	1680
	Total	100	12	1200		(t)	By closing stock of finished goods	20	23	460
(l)	Less closing stock	20	12	240						
(m)	Less MODVAT credit	80	2	160						
(n)	Raw material consumed	80	10		800					
(o)	To manufacturing cost	80	10		800					
(p)	To excise duty on finished goods	60	3		180					
(q)	To excise duty on closing stock of finished goods	20	3		60					
(r)	To gross profit				300					
	TOTAL				2140		TOTAL			2140

23.11 It may be pointed out that the "inclusive method" is not permitted by AS2 which is made mandatory from accounting year beginning on or after 01.04.1999. Further, in the Guidance Note on Accounting for MODVAT 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]”

(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 is required to be reported under clause 12(b).

Sl. No.	Particulars	(Rupees) Increase in Profit	(Rupees) Decrease in Profit
1.	Increase in cost of opening stock on inclusion of excise duty on which MODVAT credit is available/availed (j - a)		20
2.	Increase in purchase cost of raw material on inclusion of excise duty on which MODVAT credit is available/availed (k - b)		180
3.	Increase in sales of finished goods on inclusion of excise duty (s - h)	180	
4.	Excise duty paid on sale of finished goods as a result of its inclusion in sales (p-f)	-	180
5.	Increase in closing stock of raw material on inclusion of excise duty (l - c)	40	-
6.	Increase in closing stock of finished goods on inclusion of excise duty (t - i)	60	-
7.	Increase in excise duty on closing stock of finished goods as a result of its inclusion in closing stock of finished goods (q)	-	60
8.	Accounting of MODVAT credit availed and utilised on raw materials consumed in	160	-

	payment of excise duty on finished goods accounted on the basis of raw material consumed (m)		
	TOTAL	440	440

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 23.11 above.
- Note 2.: The MODVAT 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 MODVAT credit set off availed and utilised 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 MODVAT 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 MODVAT 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 MODVAT 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 MODVAT 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 that sections are satisfied.

- 23.17 The computation of total income would appear as under :

	Rs.	Rs.	Rs.
Profit as per Profit and Loss account			
On the basis of exclusive method			
(see paragraph 23.10)			300
Add: Adjustments required			
under section 145A:			
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) MODVAT credit utilised			
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

24. Amounts not credited to the profit and loss account, being,-

- (a) the items falling within the scope of section 28;
- (b) the pro forma credits, drawbacks, refunds of duty of customs or excise, or refunds of sales 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 13 (a) to (e)]

- 24.1 Under this clause various incomes 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 (13) 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. Section 28 refers to (a) profits and gains of business or profession, (b) compensation received on termination of employment, agency etc (c) income of trade or professional or similar

association from specific services to members, (d) export incentives, (e) perquisite received during the course of business or profession, (f) interest, salary, bonus, remuneration, etc. received by a partner of a firm which is allowable under section 40(b) and (g) amount received under Keyman Insurance policy. It will now be necessary to ascertain from the assessee about any receipts under these heads which have not been credited to profit and loss account and state such amounts in this clause. Clause 13 (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 13 (a). However, those items which are reported in clauses 13(b), (c) and (d) need not be reported in clause 13 (a). The tax auditor may obtain a management representation in writing from the assessee in respect of all items falling under this clause.

24.2. 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).

- a) Pro forma credits
- b) Drawback
- c) Refund of duty of custom
- d) Refund of excise duty
- e) Refund of sales 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.

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.

The words 'admitted by the concerned authorities' would mean 'admitted by the authorities within the relevant previous year'.

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.

- 24.3 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.

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.

- 24.4 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 had to AS-9 - Revenue Recognition.

The tax auditor should scrutinise all the items including casual and non-recurring 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.

- 24.5 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 also indicate various judicial pronouncements on which he has relied.

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) Compensation received for agreeing not to compete.
- e) Profit on sale of fixed assets/investments to the extent not credited to the profit and loss account.

- 24.6 Loans and borrowings are not required to be stated under this sub-clause.

25. 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) **Modified Value Added Tax credit 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 14 (a) to (f)]

- 25.1 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
 - f) The additions / deductions and dates thereof.
 - g) Adjustments required – specified as well as on account of sale, etc.
- 25.2 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.
- 25.3 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 view point of one class of assessee, yet it may not be plant or machinery from the view point of another class of assessee. 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

- 25.4 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.

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.

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. and 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.

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 upto 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.”

- 25.5 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 publications of the ICAI such as AS, Guidance Notes, Statement on Expenditure during Construction Period etc. Due to the amendments made by the Finance (No.2) Act, 1998, depreciation is allowable on intangible assets like know-how, patents, copyrights, trademarks, licences, 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.
- 25.6 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. As per Explanation 8 to section 43(1) of the Act, so much of interest as is relateable to any period after such asset is first put to use shall not form part of actual cost. 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/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.

- 25.7 Details have to be given in respect of adjustments on account of three factors.

The first adjustment relates to Modified Value Added Tax credit 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 leviable under section 3 of the Customs Tariff Act, 1974 (51 of 1975) in respect of which a claim of credit has been made and allowed under the Central Excise Rules, 1944. 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 MODVAT credit claimed and allowed in respect of those assets.

- 25.8 Under the Central Excise rule relating to MODVAT credit on capital goods, the assessee is entitled to avail MODVAT and utilise the same in payment of duty of excise leviable on final products, but subject to the condition that the assessee shall not claim depreciation under the Income-tax Act on an amount equivalent to the amount of MODVAT credit and therefore, it is necessary for the tax auditor to check the amount of MODVAT credit which has been claimed by the assessee. It is very relevant to note here that only that portion of MODVAT credit is to be deducted from the cost of fixed assets which has been claimed and allowed. If in a given case, the claim of MODVAT credit has not been allowed by the Central Excise Department or the same is under any dispute pending adjudication, the adjustment may not be made till the final decision and depreciation may be claimed on the amount of actual cost. However, if in the succeeding year the claim is settled and allowed by the Department, the same has to be adjusted from the written down value of the related asset/block of assets in that year. The tax auditor may also rely on the excise records for the purpose of verifying the details regarding MODVAT credit

- 25.9 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. AS-11 (Revised) issued by the ICAI deals with accounting for effects of changes in foreign exchange rates. Therefore, the tax auditor should refer to them and arrive at a judgement as to whether the adjustment as contemplated in the said provisions of law and AS-11 has been made properly.
- 25.10 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 relateable 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 relateable 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.
- 25.11 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.
- 25.12 There are judicial pronouncements to the affect that depreciation which is not claimed by the assessee should not be thrust on him. *Shri Sahakari Sakhar Karkhana Ltd.* 177 ITR 443 (Bom.), *Beco Engineering Co. Ltd.* 148 ITR 478 (P & H) , *Premier Automobiles Ltd.* 206 ITR 1

(Bom.) *Machine Tools Corp. of India Ltd.* 201 ITR 101 (Kar), and *Andhra Cotton Mills Ltd.* 209 ITR 404 (A.P.) However, there are certain other judicial pronouncements to the effect that allowance of depreciation is mandatory whether the assessee has claimed the same or not. *Allahabad Glass Works* [1961] 42 ITR 439 (All), *Dasaprakash Bottling Company v. CIT* [1980] 122 ITR 9 (Mad) *CIT v. Southern Petro Chemical Industries Corporation Limited (No.2)* [1998] 233 ITR 400 (Mad).

25.13 However, if other relevant details are made available by the assessee, they would have to be mentioned under the relevant sub-clauses.

26. Amounts admissible under section 33AB, 33ABA, 33AC, 35, 35ABB, 35AC, 35CCA, 35CCB, 35D, 35E:-

- (a) debited to the profit & loss account (showing the amount debited and deduction allowable under each section separately);
- (b) not debited to the profit and loss account.

[Clause 15 (a) and (b)]

26.1 The assessee can claim deduction under the following sections subject to the terms and conditions mentioned in these sections.

- i) Section 33AB: Tea Development Account
- ii) Section 33ABA: Site Restoration Fund
- iii) Section 33AC: Reserve for Shipping Business
- iv) Section 35 : Expenditure on Scientific Research
- v) Section 35ABB: Expenditure for obtaining licence to operate telecom services
- vi) Section 35AC: Expenditure on eligible projects/schemes
- vii) Section 35CCA: Expenditure by way of payments to associations and institutions for carrying out rural development programmes.
- viii) Section 35CCB: Expenditure by way of payments to associations and institutions for carrying out programmes of conservation of natural resources.
- ix) Section 35D: Amortisation of certain preliminary expenses

- x) Section 35E: Deduction for expenditure on prospecting etc. for certain minerals

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.

- 26.2 The tax auditor should indicate the amount debited in the profit and loss account and the amount actually admissible in accordance with the concerned provisions of law.
- 26.3 The amount not debited to the profit and loss account but admissible under any of the sections mentioned in the clause have to be stated. 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 and 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 thereunder and report the same.
- 26.4 Where the assessee is eligible for deduction under one or more of the above sections, the tax auditor has to state the deduction allowable under each section separately.
- 26.5 In many cases, capital expenditure may have been incurred which is allowable as deduction while computing the profits and gains of the assessee under these heads and such expenditure may have been capitalised and shown as fixed assets in the books. The tax auditor should ascertain such expenditure and state the same under sub-clause (b).
27. (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) **Any sum received from employees towards contributions to any provident fund or superannuation fund or any other fund mentioned in section 2(24)(x); and due date for payment and the actual date of payment to the concerned authorities under section 36(1)(va).**

[Clause 16 (a) and (b)]

- 27.1. 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 Nana & Sons v. CIT* [1977] 108 ITR 358 (SC)]. In the case of *Loyal Motor Service Company Ltd. v. CIT* [1946] 14 ITR 647, (Bom) the assessee company paid bonus at the rate of 2 months' salary to its employees who were also shareholders in the company. The tax authorities contended that the bonus paid was not allowable as it would have been payable to the employees as profit or dividend. It was held by the court that it was not in the nature of profit or dividend and accordingly it was held to be allowable.
- 27.2 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 contract with the employees so as to ascertain the nature of payments.
- 27.3 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").
- 27.4 Section 36(i)(va) of the Act permits deduction of such sum if it is credited by the assessee to the account of the employees in the relevant statutory fund on or before the due date, 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 Act provides for 5 days of grace period for payment of contribution. This can be taken into consideration for determining the due date of payment. Similar grace period is available under ESI fund and other funds and the same treatment can be given.
- 27.5 Section 36(1)(va) read with section 2(24)(x) does not give much latitude about the due date of payment. However, the Appellate Tribunal has held that this provision should be liberally construed - vide *Madras Radiators Pressing Ltd, v. DCIT* – 59 ITD 515 (Mad), *Fluid Air (India) Ltd. v. DCIT* [1997] 63 ITD 182 (Bom.).

- 27.6 The tax auditor should get a list of various contributions recovered from the employees which come within the scope of this clause. 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 of the amount deducted, due date for payment and actual date of payment in respect of provident fund, ESI fund or other staff welfare fund have to be stated. However, in case of big assesseees such as public sector undertakings, banks etc. where information to be stated is voluminous, the tax auditor may exercise his professional judgement and state only those cases under this clause where actual date of payment to the concerned authorities is beyond the due date of payment and state this fact by way of a suitable note.

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

28. (a) expenditure of capital nature;
[Clause 17(a)]
29. (b) expenditure of personal nature;
[Clause 17 (b)]
30. (c) expenditure on advertisement in any souvenir, brochure, tract, pamphlet or the like, published by a political party;
[Clause 17(c)]
31. (d) expenditure incurred at clubs,—
(i) as entrance fees and subscription;
(ii) as cost for club services and facilities used;
[Clause 17(d)]
32. (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;

[Clause 17 (e)]

33. (f) amounts inadmissible under section 40(a);

[Clause 17 (f)]

34. (g) interest, salary, bonus, commission or remuneration inadmissible under section 40(b)/40(ba) and computation thereof;

[Clause 17(g)]

35. (h) amount inadmissible under section 40A(3) read with rule 6DD and computation thereof;

[Clause 17(h)]

36. (i) provision for payment of gratuity not allowable under section 40A(7);

[Clause 17 (i)]

37. (j) any sum paid by the assessee as an employer not allowable under section 40A(9);

[Clause 17 (j)]

38. (k) particulars of any liability of a contingent nature;

[Clause 17 (k)]

28. Clause 17(a)

- 28.1 This clause requires the tax auditor to state the amount of expenditure incurred by the assessee in respect of various items listed therein. 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 may necessitate review of books of account, basis of classification, groups under which such expenses have been debited, and so on.

28.2 Capital expenditure is not allowable in computing business income unless specifically provided in any sections of the Act. The words “capital expenditure” are 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.

28.3. 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 very framework of the assessee's business.
- (iv) Whether it is an initial expenditure or an expenditure incurred in setting the profit earning machinery into motion.
- (v) Whether it is an expenditure to acquire a concern or goodwill.

The nature of receipt in the hands of the recipient is not a determining factor to determine 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.

28.4. 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 capital expenditure on certain assets like energy saving devices. Similarly, capital expenditure on preliminary expenses, etc. is deductible over a period of years.

It is, however, suggested that those items of capital expenditure which are otherwise fully deductible in computing the total income of the assessee under the Act should be separately indicated under this clause so that the assessee can claim proper deduction in the computation of his total income.

- 28.5. The capital expenditure, if any, debited to the profit and loss account should be disclosed in a classified manner stating the amount on various heads separately. Since part of this capital expenditure may be allowable as deduction in the computation of total income, it is necessary to specify the nature of expenditure, the amount of expenditure incurred, and the relevant provision under which the expenditure is admissible, so that proper deduction can be allowed in the computation of total income.

29. Clause 17(b)

- 29.1. 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.
- 29.2. Section 227(1A) and the Manufacturing and Other Companies (Auditor’s Report) Order, 1988 issued by the Central Government in terms of section 227 (4A) of the Companies Act require the auditor to state in his report whether personal expenses have been charged to revenue account.

In this context, a reference may be made to paragraph 45(b) of the Statement on the Manufacturing and Other Companies (Auditors’ Report) Order, 1988, which states as follows:

“Whether an item of expenditure is of the nature of personal expenses or is a legitimate business expenditure depends upon the facts and circumstances of each case. The practice of meeting certain types of personal expenses (such as provision of rent-free accommodation, conveyance for private use, medical expenses, leave travel concession, maternity benefits, canteen facilities, etc.) of the employees and/or directors is normal and is recognised by the Department of Company Affairs and

other authorities. The charging of such expenses to the revenue account either on the basis of contractual obligations or in accordance with the generally accepted business practice is normal and does not call for any comment by the tax auditor. Where, however, such expenses are not covered by contractual obligations or by generally accepted business practice and are charged to revenue account, the tax auditor should report thereon”.

Similar views have been expressed in para 2.28 of the ‘Statement on Qualifications in Auditors’ Reports’ (Edition 1985) vide Appendix

Thus, 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.

29.3 The particulars may be furnished in the following form:

Sl.No.	Nature and particulars of expenditure	Account head under which debited	Amount of expenditure	Remarks

30. Clause 17(c)

- 30.1. 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.
- 30.2. 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 17(c) 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.

31. Clause 17(d)

- 31.1. The amount of payments made to clubs by the assessee during the year 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 17(b) referred to earlier.
- 31.2. 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. Likewise, payments made to service organisations such as Rotary, Lions, Jaycees, Giants etc., would not necessarily be covered by this clause.

31.3 The particulars may be stated in the following form:

Sr. No.	Name of the club	Nature of amount paid			Remarks
		Entrance fees	Subscri-ption	Cost of club services	
(1)	(2)	(3)	(4)	(5)	(6)

32. Clause 17(e)

- 32.1 In this clause, sub-clause (i) covers only penalty or fine for violation of any law for the time being in force, while sub-clause (ii) covers 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 law as have been made and paid or incurred during the relevant previous year and how such amounts have been dealt with in the books of account produced for audit. The tax auditor may not be aware of the intricacies of all the laws of the land. 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 to give the details of such items as have been charged in the account. This clause covers only penalty or fine and not the payment for contractual breach or for redressal of contractual wrongs. While stating the particulars under this clause, the tax auditor should take into consideration the concept of materiality.
- 32.2 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, if yes, the same has to be disclosed.

- 32.3 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 17 (e)(i) is to be answered.
- 32.4 Any expenditure in consequence of violation of law like penalty or fine levied for evading provisions of the Act, FERA, 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 Shekooor 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. Some of the other cases where it has been held that penalty for violation of law is not an allowable expenditure are cited below:

Penalty paid in lieu of confiscation of goods by customs authorities

[CIT v. Mihir Textiles Ltd. [1976] 104 ITR 167 (Guj)]

Penalty paid for delayed payment of cess tax and purchase tax -

[CIT v. Upper Doad Sugar Mills Ltd [1972] 85 ITR 489 (Del)]

Penalty payable under section 3(5) of Sugarcane Cess Act

[Upper Doad Sugar Mills Ltd v. [CIT [1979] 116 ITR 928 (All)]

- 32.5 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 a 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. 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.

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.

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.

- 32.6 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.
- 32.7 If in an illegal business, income arises, expenses/losses incurred in earning such income are deductible. However, fine or penalty imposed thereon is not deductible while computing taxable income-*Mam vs. Nash* [1932] 1 KB 752.

- 32.8 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".

The above said Explanation appears to have been enacted in order to nullify the effect of the decisions, such as *Pranav Construction Co v. Asst. CIT [1998] 61 TTJ (ITAT, Mumbai) 145*, where a sum of Rs.20 lakhs paid as protection money to certain persons by the assessee, a builder, engaged in the construction activities in areas which were vulnerable to such dangers as extortion, haftas etc. has been held as an allowable expenditure. Hence, any expenditure incurred by an assessee for any purpose which is an offence or which is prohibited by law is to be stated under this sub-clause.

33. Clause 17(f)

- 33.1 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". They are as follows:

- i) Any interest, royalty, fees for technical services or other sum chargeable under the Income-tax Act on which tax has not been paid or deducted under Chapter XVII-B.
- ii) Any sum paid on account of any rate or tax levied on the profits or gains of any business or profession or assessed at a proportion of, or otherwise on the basis of, any such profits or gains.
- iii) Any sum paid on account of wealth tax.
- iv) Any payment which is chargeable under the head "salaries", if it is payable outside India and if the tax has not been paid thereon nor deducted therefrom under Chapter XVII-B.

- v) 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 had "Salaries".

33.2 In respect of items (i) and (iv) the tax auditor should obtain in writing from the assessee the details of all payments of the nature referred to in paragraph 33.1 and 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 needs to report under this clause only if he has a different opinion on the issue. Where no remittances have been made during the relevant year, the tax auditor may examine the relevant provisions vis-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.

34. Clause 17(g)

34.1 As per earlier Form No.3CD, only particulars of interest and remuneration paid to a partner were required to be furnished. The scope of information has been enlarged and now the tax auditor is required to state the inadmissible amount 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). 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.

- 34.2 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
- 34.3 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).
- 34.4 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 of eighteen per cent simple interest per annum will not be admissible as a deduction.
- 34.5 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;

34.6 In order to determine the amounts inadmissible under section 40(b), the tax auditor should obtain the computation of total income from the assessee.

34.7 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 XIV.

35. Clause 17(h)

35.1 Section 40A(3) provides that where the assessee incurs any expenditure in respect of which payment is made in a sum exceeding Rs.20,000 (present limit) otherwise than by a crossed cheque or a crossed bank draft, 20% of such expenditure shall not be allowed as deduction except in certain cases and circumstances. The cases and circumstances in which payment of a sum exceeding Rs.20,000/- in cash or otherwise than by crossed cheque or draft is allowable are specified in Rule 6DD. The details regarding the payments made in cash or otherwise than by crossed cheque or bank draft are to be stated under this clause.

35.2 The particulars may be furnished in the following form:

<i>Sl. No</i>	<i>Nature and particulars of expenditure</i>	<i>Date of Payment</i>	<i>Amount paid otherwise than by account payee cheque/ draft</i>	<i>20% of such expenditure</i>	<i>Remarks</i>

35.3. There may be practical difficulties in verifying of payments made through crossed cheques or bank drafts. If no proper evidence for verification of the payment by crossed cheque or draft is available, such a fact could be brought out by appropriate comments in the following manner:-

"It is not possible for me/us to verify whether the payments in excess of Rs.20,000 have been made otherwise than by crossed cheque or bank draft, as the necessary evidence is not in the possession of the assessee".

35.4. 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 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.

35.5 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.

36. Clause 17(i)

36.1. As per Section 40A(7), the deduction of any provision for gratuity made after 1.4.1976 is allowable only if an approved gratuity fund is created

and the provision is made for contribution due to such fund.

- 36.2. 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.
- 36.3. 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.

37. Clause 17(j)

- 37.1. 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) is not allowable. The tax auditor should furnish the details of payments which are not allowable under this section.

38. Clause 17(k)

- 38.1. 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. 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.
- 38.2. Reference may be made to AS-4, 'Contingencies and Events occurring after the Balance Sheet Date' to determine what should normally be

treated as a contingent liability.

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

[Clause 18]

- 39.1. 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 XVI) 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.
- 39.2. 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 a 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 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. Amounts deemed to be profits and gains under section 33AB or 33ABA or 33AC.

[Clause 19]

- 40.1 Sections 33AB and 33ABA lay down the circumstances under which amount withdrawn from such deposit account covered thereby for purposes other than specified purposes is to be deemed income chargeable as profit and gains of business. The tax auditor is required to report such amounts. Likewise, section 33AC allows deduction in respect of reserve created out of the profit of the assessee engaged in shipping business to be utilised in accordance with the provision of sub

section (2) of section 33AC. Sub section (3) thereof lays down the circumstances in which the amount of reserve account shall be deemed to be the profit and gains chargeable to tax. The tax auditor should verify the amount withdrawn from the deposit account for purposes other than specified purposes. Similarly, he should verify whether the reserve created under section 33AC and utilised not in accordance with the provisions of sub-section (2) of section 33AC has been properly disclosed.

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

[Clause 20]

- 41.1 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.

Where the assessee to whom the trading liability may have been allowed is succeeded in his business either because of amalgamation of two companies or on account of the constitution of new firm or the business is continued by some other person when the assessee ceases to carry on the business, then the person succeeding will be chargeable to tax on any amount received in relation to which deduction or allowance has been made.

Explanation (1) to section 41(1) provides to tax the remission or cessation of liability in the hands of the taxpayer and for this purpose the expression "loss or expenditure or some benefit in respect of any such trading liability by way of remission or cessation thereof" shall include the remission or cessation of any liability by a unilateral act of the assessee by way of writing off such liability in his accounts.

- 41.2 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. 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.

- 41.3 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.
- 41.4 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 41(1) would apply.
- 41.5 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 during the previous year in which recovery is made.

From the assessment year 1998-99, section 41(4A) has been inserted which 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.

- 41.6 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.
- 41.7 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. However, if the amount has already been credited to the profit and loss account, the tax auditor should mention the fact. The computation of the profit chargeable under this clause is also to be stated.
- 42. * (i) In respect of any sum referred to in clause (a), (c), (d) or (e) 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.**
- (ii) In respect of any sum referred to in clause (b) 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:**
 - (a) nature of liability;**
 - (b) due date of payment under second proviso to section 43B;**
 - (c) actual date of payment;**
 - (d) if paid otherwise than in cash, whether the sum has been realised within fifteen days of the aforesaid due date;**
- (B) was incurred in the previous year:**
 - (a) nature of liability;**
 - (b) due date of payment under second proviso to section 43B;**
 - (c) actual date of payment;**
 - (d) if paid otherwise than in cash, whether the sum has been realised within fifteen days of the aforesaid due 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 21]

42.1 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:

- i) Any tax, duty (sales tax, excise duty, municipal tax, etc.), cess or fee payable by the assessee under any law for the time being in force.**
- ii) Employer's contribution to any provident fund or superannuation fund or gratuity fund or any other fund for the welfare of**

employees.

- iii) Any bonus or commission payable by the assessee to its employees.
- iv) 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.
- v) Any sum payable by the assessee as interest on any term loan from a scheduled bank in accordance with the terms and conditions of the agreement governing such loan.

- 42.2 In the case of an assessee maintaining its accounts on the mercantile system, the tax auditor should verify the aforesaid particulars, referred to in clause (i), (iii) (iv) and (v) 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 so that the information about the aforesaid payments made in the subsequent year can be furnished.
- 42.3 In case of contribution to provident fund, superannuation fund, gratuity fund or any other fund for the welfare of employees, the restriction for allowance contained in second proviso should be noted. The said proviso, *inter alia*, states that no deduction shall be allowed unless such sum has actually been paid on or before due date as defined in the Explanation below section 36(1)(va) and where such payment has been made otherwise than in cash, the sum has been realised within 15 days from due date. Regarding grace period and lenient treatment of reasonable delays in payment, reference may also be made to paragraphs 27.4 and 27.5 of this Guidance Note.
- 42.4 If the assessee is following the cash basis of accounting, sums referred to in clause (a), (c), (d) and (e) 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.
- 42.5 Under the first proviso to section 43B, deduction is available in respect of any sum referred to in clause (a), (c), (d) or (e) 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 upto the date of signing of the tax audit report. This fact should be stated under this clause by way of note as follows:

NOTE: Information given under clause 21(i) (B) is only up to and does not include any payment which the assessee may make subsequently before the due date of filing of the return of income under section 139(1).

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. Hence the tax auditor should advise the assessee to include necessary evidence of payments made after the signing of the tax audit report but before the due date of filing. This evidence may also be in the form of a certificate from a chartered accountant obtained specifically for this purpose - Circular No.601 dated 4.6.1991 vide Appendix XVII.

- 42.6 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 MODVAT credits before the due date applicable in his case for furnishing the return of income under section 139 (1).
- 42.7 The information required under clause 21(i)(B) is for the purpose of allowing the deduction of such sum as per the first proviso to section 43B in respect of payments made after the end of the previous year but before the due date of filing return of income. As such, reporting under clause 21(i)(B) is required only in respect of the amounts referred to in clauses (a), (c), (d) or (e) of section 43B which were incurred in the previous year but were outstanding as at the end of the relevant previous year.
- 42.8 The above particulars are required 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.
- 42.9 The tax auditor is not required to determine any admissible or inadmissible amount(s).

42.10 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/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 fact of payment along with the amount paid should also be disclosed.

42.11 In respect of the expenditure covered by clauses (a), (c), (d) and (e) of section 43B, the particulars may be furnished in the following form:

(A) Liability pre-existing on the first day of the previous year :

Sl. No.	Nature of liability	Outstanding opening balance not allowed in any earlier previous year(s)	Amount paid/set off during the year against column 3
(1)	(2)	(3)	(4)

Amount written back to the profit and loss account	Amount remaining unpaid as at the end of the year	Whether passed through profit & loss account	Remarks
(5)	(3-4-5)=(6)	(7)	(8)

(B) Liability incurred during the previous year :

Sl No.	Nature of liability	Amount incurred during the previous year but remaining outstanding as on the last day of the previous year	Amount paid/set off before the due date of filing return/date upto which reported in the tax audit report, whichever is earlier against column (3)
(1)	(2)	(3)	(4)
			Date Amount

Amount unpaid on the due date of filing the return/date upto which reported in the tax audit report whichever is earlier	Whether passed through the profit & loss account	Remarks
(5)	(6)	(7)

42.12 In respect of contributions covered by clause (b) of section 43B, the particulars may be furnished in the following form:

(A) Liability pre-existing on the first day of the previous year:

Sl No.	Nature of liability	Outstanding opening balance not allowed in any earlier previous year(s)	Due date for payment
(1)	(2)	(3)	(4)

Amount paid during the previous year		If not paid in cash, whether realised within 15 days	Outstanding balance as at the end of the year	Remarks
(5)		(6)	(3 - 5) = (7)	(8)
Date	Amount			

(B) Liability incurred during the previous year :

Sl No.	Nature of liability	Due date of Payment	Amount incurred during the previous year
(1)	(2)	(3)	(4)

Amount paid before the due date		If not paid in cash, whether realised within 15 days	Closing balance as at the end of the year	Remarks
Date	Amount			
(5)		(6)	(4-5) = (7)	(8)

- 42.13 As suggested under clause 16(b), given herein before, here also, in view of the voluminous nature of the information the tax auditor can apply test checks and compliance tests to satisfy himself. It may be mentioned that under clause 21(ii), complete details of amounts due, amounts paid, due date of payment and actual date of payment are to be given. In the case of big assessees such as public sector undertakings, banks etc., where information to be stated is voluminous, the tax auditor may exercise his professional judgement and state only those cases under this clause where actual date of payment to the concerned authorities is beyond the due date of payment and indicate this fact by way of a suitable note.
- 42.14 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 in his report so that the assessee, while preparing his return of income may exclude such items.
43. (a) **Amount of Modified 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 Modified Value Added Tax credits in the accounts.**
44. (b) **Particulars of income or expenditure of prior period credited or debited to the profit and loss account.**

[Clause 22 (a) and (b)]

43. Clause 22(a)

- 43.1 This clause requires the factual reporting about the amount of MODVAT credit availed of and utilised during the year as well as its treatment in profit and loss account and treatment of outstanding MODVAT credits in the accounts. Accordingly the tax auditor should check relevant statutory records viz. RG-23 (both parts) maintained under the Central Excise Rules 1944 and ascertain therefrom the amount of credit on inputs availed and utilised during the previous year. The tax auditor should verify that there is a proper reconciliation between balance of MODVAT credit in the accounts and RG-23. The tax auditor should report the amount of MODVAT availed and utilised under this sub-clause. In a given case MODVAT availed may be lesser than the MODVAT credit utilised during the year on account of opening balance in MODVAT 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 MODVAT also.
- 43.2 In so far as the reporting of accounting treatment of MODVAT credit is concerned the clause requires that its treatment in profit and loss account and the treatment of outstanding MODVAT credit in the account have to be reported upon.

The tax auditor may consider reporting under this clause in the following manner:

	Capital Goods	Others
Balance representing MODVAT credits as at the beginning of the year		
MODVAT credit available during the year		
Less amount of MODVAT credit utilised during the year		
Balance representing outstanding amount as at the end of the year		

Where the assessee follows exclusive method by accounting the excise duty paid on purchase of raw material to the MODVAT credit receivable account and not as part of the purchase cost of raw material and adjusts the excise paid against the MODVAT receivable account, the tax auditor should state the facts under this clause.

- 43.3 The reporting requirement under clause 12(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 12(b).

44. Clause 22(b)

- 44.1. 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 readily 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.
- 44.2 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 thought related to previous periods but determined in the current period, will not be considered as prior period items. In such cases, though the expenditure may related 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.

44.3. In AS –5 as also in AS (IT) – 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. 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 23]

45.1. 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 issued by Board explaining the provisions of section 69D - vide Appendix XVIII.

45.2. 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.

45.3. 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, he should make a suitable comment in his report as suggested below which is exactly similar to the one suggested in respect of expenditure paid otherwise than through an account payee cheque [Section 40A(3)].

“It is not possible for me/us to verify whether the amounts borrowed on hundi or any amount due thereon (including interest on the amount borrowed) were repaid

otherwise than by crossed cheque or bank draft, as the necessary evidence is not in the possession of the assessee”.

46. (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.)

47. (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.

[Clause 24 (a) and (b)]

46. Clause 24(a)

46.1 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.

46.2 For the purposes of section 269SS "loan or deposit" means loan or deposit of money.

46.3 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.

46.4 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.

46.5 If the total of all loans/deposits in a year 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.

- 46.6 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 and in the absence of conclusive or satisfactory evidence, he should 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".

- 46.7 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 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 / deposits only 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 repayment of 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.
- (viii) Loans and deposits taken or accepted by means of transfer entries 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 will not be treated as loans or deposits accepted.

46.8 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 617 of the Companies Act, 1956 (1 of 1956);
- (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.

The footnote in clause 24(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.

47. Clause 24(b)

47.1 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 is attracted where

repayment of the deposit is made to a person, where the aggregate amount of 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. Section 269T does not cover repayment of loans. Explanation (ii) contains a definition of the term 'deposit' for the purposes of section 269T. Accordingly, "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 deposit of any nature. As such, all repayments made to any person where the 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.

- 47.2 Clause 24(b) does not exclude Government companies, banking companies from the scope of its applicability. As such, details of repayment are to be shown in the case of these entities also. But considering the voluminous nature of information to be provided in the case of these entities, only those cases may be reported where such repayments have been made otherwise than by way of account payee cheque or account payee bank draft and the auditor should indicate this fact by way of a suitable note.
- 47.3 In the case of company assessee deposit is defined to mean deposit repayable after notice or deposit repayable after a period. Therefore, deposit repayable on demand will not be considered as deposit. However, in the case of non-company assessee deposit is defined to mean deposit of any nature. This distinction will have to be kept in mind while giving information under this sub-clause.
- 47.4 Deposits discharged by means of transfer entries constitute repayment of deposits otherwise than by account payee cheques or account payee bank drafts. Hence, such entries have to be reported under this clause. The entries that relate to transactions with a supplier and customer will not be treated as loans or deposits repaid.
- 47.5 As pointed out in paragraph 47.1, section 269T prescribes the mode of repayment only in respect of deposits. However, this sub-clause requires the relevant particulars in respect of each "loan or deposit". Hence the particulars required under this sub-clause are to be given in

respect of both loan and deposit but in view of applicability of section 269T to deposits only, the particulars of loan and deposit may be given separately.

- 47.6 Clause 24(b) does not exclude repayment of deposits to Government company, banking company etc. from its scope. Hence, details of repayments of deposits falling within the scope of section 269T as mentioned in clause 47.1 have to be stated. Section 269T also does not exclude Government company, banking company or a corporation established by a Central, State or Provincial Act. As such, repayment of deposits by banking companies falling within the scope of section 269T are also to be stated. However, both in the case of repayment to banking companies etc. and repayment by banking companies etc. considering the voluminous nature of information to be provided, the tax auditor can exercise his professional judgment and state only those cases of repayment of deposits which are made otherwise than by account payee cheque or account payee bank draft and should state this fact by way of a suitable note.

48. Details of brought forward loss or depreciation allowance, in the following manner, to the extent available:

Serial Number	Assessment Year	Nature of loss / allowance (in rupees)	Amount as returned (in rupees)	Amount as assessed (give reference to relevant order)	Remarks

[Clause 25]

- 48.1 The amount is required to be quantified as per return and assessment orders.
- 48.2 A format has been given which could be used for reporting. To the extent necessary, modification can be made provided basic information is furnished. For example in the 5th column two requirements have been clubbed, namely, amount assessed and reference to relevant order. These two requirements may be split up into two columns and the reference to the relevant order may be given opposite to the amount assessed. In a given case, appeal(s) may have been decided; but effect might not have been given. While giving particulars, appropriate

adjustment may be made, with suitable disclosure. Where the relevant particulars are not available, the necessary disclosure may be made in that behalf.

- 48.3 While giving information under this head it will be necessary to ascertain whether the figures of unabsorbed loss or depreciation are likely to be modified as a result of any assessment or appellate proceedings which are pending for the earlier years. If that is the position, the fact relating to the pending assessment or appellate proceedings should be clearly stated and it should be mentioned that the figures of unabsorbed loss or depreciation are likely to be modified as a result of the assessment or appellate proceedings.
- 48.4 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 78 of the Income-tax Act with regard to loss/depreciation under different heads. Therefore, the information should be separately given under each head of income under which the loss/ depreciation has remained unabsorbed. 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.

49. Section-wise details of deductions, if any, admissible under Chapter VIA.

[Clause 26]

- 49.1 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.
- 49.2 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 26 relating to the deductions admissible under Chapter VIA will have to be restricted to the items appearing in the books of accounts audited by the tax auditor. If the tax auditor is giving tax audit report in respect of the accounts of a particular branch or a particular unit he will have to examine the particulars relating to deduction admissible under Chapter VIA with reference to the books of account of that branch or that unit which is audited by him. Similarly when the tax auditor is giving report on 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 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.

- 49.3 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 only with reference to the items appearing in the books of accounts of the business/profession which is subject to audit under section 44AB.
- 49.4 Section 80A(2) provides that the aggregate amount of deductions under Chapter VIA shall not, in any case exceed the gross total income of the assessee. It is possible that the tax auditor may not be aware about the gross income of the assessee because the income-tax return has not been prepared before the tax audit report is given or because the tax auditor is auditing only the particular branch or a unit. In such circumstances the tax auditor should put a note while giving the above particulars under clause 26 that the figure of deductions mentioned under clause 26 is subject to the determination of the gross total income of the assessee.
- 49.5 The admissibility of the aforesaid deductions is dependent upon

various conditions precedent laid down in the section under which deduction 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 on his record which would enable him to express the opinion on 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. For example under section 80HHC the quantum of deduction in respect of export profit is on the basis of convertible foreign exchange having been received within a period of 6 months from the end of accounting year or extended period. In this context tax auditor has to verify that all export proceeds have been received by the assessee by 30th September and for this he has to ask the client to produce necessary bank certificate etc. There may be cases where there is difference between the amount claimed by the assessee and the amount worked 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 and the amount claimed and the background behind and the basis of the claim of the assessee. 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 clarify that admissible amount has been reported on the basis of judicial pronouncement.

- 49.6 It may be noted that there are certain sections under Chapter VIA where separate audit report or certificate is required to be given. Under section 80-HH, 80-HHA, 80I, 80IA, 80IB a non-corporate assessee who has income from industrial undertaking covered under the above sections has to obtain audit report with reference to the accounts of these undertakings. Section 80HHB, 80HHC, 80HHD, 80HHE, 80HHF and 80O while relate to profits of foreign projects, profit from export of goods as well as foreign export earning etc. require separate audit report. While giving information with regard to the deduction allowable under these section 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.
- 49.7 Some sections in Chapter VIA such as section 80G (donations), section 80JJAA (wages of new workmen) etc. which relate to the expenditure incurred by a assessee. There are other sections such as 80HHBA (specified housing project), section 80P (income of co-operative societies), 80JJA (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 26.
50. (a) **Whether the assessee has deducted tax at source and paid the amount so deducted to the credit of the Central Government in accordance with the provisions of Chapter XVII-B.**

- (b) If the answer to (a) above is in the negative, then give the following details:

Serial Number.	Particulars of head under which tax is deducted at source	Amount of tax deducted at source (in rupees)	Due date for remittance to Government	Details of Payment: Date Amount (in rupees)	Remarks

[Clause 27 (a) and (b)]

- 50.1. Under this clause, the tax auditor is expected to verify from the records whether the tax deducted at source has been paid to the credit of the Central Government in accordance with the time stipulated under Chapter XVII-B of the Act. The details about the delay in payment of tax deducted at source may be given under this clause in the form prescribed.
- 50.2. Normally the tax auditor should clarify in the report whether there is a delay in payment of tax deducted at source. It is not expected under this clause from a tax auditor to verify whether the tax deductible has been properly deducted or not. There is no requirement of giving information under this clause about the delay in filing the return relating to tax deducted at source.
- 50.3. The tax auditor should obtain the details of tax deducted at source and paid to the credit of the Central Government from the assessee. A copy of the tax deducted at source account and the certified details of evidence relating to payment should be retained by the tax auditor.
51. (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.
52. (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;
 - (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.

[Clause 28 (a) and (b)]

51. Clause 28(a)

- 51.1 This information was required by old Form 3CD, pursuant to a Note inserted below Clause 3 and the information requirement more or less corresponds to information to be submitted in case of a manufacturing concern.

51.2 Accordingly, a reference may be made to the subsequent paragraph - paragraph 52, for compliance, etc.

51.3 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.

52. Clause 28(b)

52.1. 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. In other cases, the tax auditor may indicate in his report that the relevant records were either not maintained or were inadequate for the purpose of furnishing the requisite information.

52.2. 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. In this connection a reference may be made to the ICAI's 'Statement on Amendments to Schedule VI to the Companies Act, 1956.'

52.3. The information about 'yield', 'percentage of yield', and 'shortages/excess' is required to be given only to the extent such information is available in the records of the business.

52.4 In respect of assesseees 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.

- 52.5 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 at 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.

53. 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) total tax paid thereon;**
- (c) dates of payment with amounts.**

[Clause 29]

- 53.1 Section 115-O provides for a special levy to the extent of 10% plus surcharge, if any, 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 @ 10% on such distributed profit has to be reported against this clause.
- 53.2 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 the tax auditor need not go into the question of how the total amount of distributed profits has been arrived at.
- 53.3 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.
- 53.4 In this clause, the total amount of profits distributed in the previous year , tax paid thereon and the date of payment is required to be given. Information about the date of declaration/distribution of dividend or

payment of dividend is not required to be given. However, it will be advisable to give the above information of distribution because the company is required to deposit the tax due under section 115-O within 14 days of the date of declaration/distribution or payment whichever is earlier.

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

[Clause 30]

- 54.1 The tax auditor should ascertain from the management whether cost audit was carried out and if yes enclose the copy of the report of such audit. Even though the tax auditor is not required to make any detailed study of such report, he has to take note of any material observation made in such cost audit report which may have relevance to the tax audit conducted by him. 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.
- 54.2 In cases where cost audit which might have been ordered is not completed by the time the tax auditor gives his report, he has to state the same in this report.
- 54.3 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.

55. Whether any audit was conducted under the Central Excise Act, 1944, if yes, enclose a copy of the report of such audit.

[Clause 31]

- 55.1 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 the report, if available and enclose the copy of the report of such audit. Even though the tax auditor is not required to make any detailed study of such report, he has to take note of any material observation made in such excise audit report which may have relevance to the tax audit conducted by him. 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.

- 55.2 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 state the same in this report.
- 55.3 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.
56. **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.**

[Clause 32]

- 56.1 These ratios have to be calculated only for assesseees who are engaged in manufacturing or trading activities. This clause is not applicable to assesseees carrying on profession. 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 sub-clause (d) need not be given for trading concern.
- 56.2 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 the this clause are to be calculated in terms of value only.
- 56.3 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.

(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.

56.4 For the purpose of calculating the ratio mentioned in sub-clause (c), 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.

56.5 Material consumed would, apart from raw material consumed, include stores, spare parts and loose tools.

56.6 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 -

56.7 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.

56.8 There should be consistency between the numerator and the denominator while calculating the above ratios. Any significant deviation thereof should be pointed out.

57. **Signature :**

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, place and date. It may be noted

that in the earlier Form No. 3CD there was no requirement of signature by the person competent to sign the audit report.

58. Code of Conduct and other matters

58.1 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.

58.2 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.

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.

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.

58.3 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 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.

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.

- 58.4 A tax auditor can accept the assignment of tax representation.
- 58.5 Under the Code of Conduct, no tax auditor can charge professional fees by way of percentage of turnover or percentage of profits. 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 43 of the Code of Conduct (1988 Edition). Certain exceptions are made in Regulation 168, but these exceptions do not apply for charging of fees for tax audit.
- 58.6 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.
- 58.7 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.

59. Format of Financial Statements

- 59.1 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.

- 59.2 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 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.)
- 59.3 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 XI 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 X gives the recommended format of the balance sheet and the requirements of the profit & 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 from 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.