How to Conduct Tax Audit – Part 1
Analysis of Certain Clauses

Audit under Section 44AB of the Income Tax Act
By Raman Jokhakar, Chartered Accountant
Objective

- To understand the purposes of this Form
- To learn nuances of the clauses
- To understand audit risk
- To effectively carry out attestation
- To document adequately
- To disclose standard notes, limitations and stands
- To know inter links between clauses
- To be aware of important stands taken by Courts
- To understand the objective of the tax department
Tax Audit is an Audit

- It’s a process – there are systematic steps and discipline involved
- To crack it you have to know –
  - Goal of audit and its components and situations
  - Gathering reliable data and evidence
  - Analysis of data
  - Arriving at the conclusions as per regulation/standards
- Cover your RISKS as an auditor
  - Management to prepare and own responsibility
  - Certified by management
Tax Audit is an Audit

- Review what is done by team to get high quality result – Prepared by – Reviewed by – 4 eye approach
- Remember People and Process are the key – Their rigour, focus on the objectives, imagination to visualise issues, ability to ask right questions, backing up conclusions with evidence, and above all agility to close issues with the client.

- Qualifications / Comments in audit report?
  - Quantities not matching
  - Records not maintained, Books not closed
  - Stat. Auditors have reported adversely
Remember

NOT DOCUMENTED

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NOT AUDITED
Audit Approach

- Number of questions – 34

- Overall view
  - There is no logical sequence – likes not together
  - Appears to be outsourcing by IT department of data before the days of outsourcing started
  - Irrelevant / redundant clauses
  - Relationships between certain clauses

- Risk based approach
Let's start - High Level Analysis

- 34 Clauses - 1 to 32 + 12A + 17A

- 10 Clauses – Static Information, Reproduction, Prior year information, not so critical [1-6, 11, 29,30,31]

- 11 Clauses – Rarely applicable or require little work on them [7-10, 12,12A, 16, 17A, 19, 23, 28]

- 13 Clauses – Important, require verification, high risk [13,14,15,17,18,20,21, 22, 24, 25,26,27,32]
Introduction

- 1\textsuperscript{st} April 1985 – AY 1985-86 – Celebrating 37 years
- Revised 10\textsuperscript{th} August 2006 –
- Rationale – *Proper Books to reflect true income for proper administration of tax laws*
- Only CAs “who form a class by themselves” (SC Judgment in GN) are privileged to carry out TA

**Applicability**
- Business
- Profession
- Presumptive basis
- 1\textsuperscript{st} Proviso to 44AB
- 2\textsuperscript{nd} Proviso to 44AB
- AY 11-12 – TA applies in spite of assessee claims non applicability of Sec 44AD – then books to be kept as per 44AA+ Audit under 44AB
Terms used

- Accountant
- Specified Date
- Business – Section 2(13)
- Profession – Section 2 (36)
- Difference explained in Manmohandas Case 59 ITR 699
- Professions - 44AA read with Notification SO – 17E, SO 2675, SO 385 (E)
  - Accountancy, Architectural, ....
Turnover

- Extra Charges – Packing charges, Freight charges,
- Sales Tax
- Excise Duty
- Sale of Scrap in Miscellaneous income
- Goods Returned
- Sale of Fixed Assets
- Sales of Shares – Business vs. Capital Gain
- For Proprietor – total turnover of each business
- Sale of Capital Asset
Gross Receipts

- All receipts arising in cash or in kind which normally will be assessable as business income
- Profit on Sale of Import Licenses
- Cash Assistance received against export
- Customs / Excise Duty Drawback
- Net Exchange rate difference on export sale
- LD
- Insurance Claims except for fixed assets
- Sale proceeds of scrap, wastage, etc..
- Advance received and forfeited from customers
- Reimbursement of expenses – packing, forwarding, on net basis
Gross Receipts (GR)

- Whether OPE recovered by professional firm part of GR? ---- (treated as BS item then out of GR, but accounted as expenditure then include in GR)
- Advance Fees received part of GR --- (No)
- When assesseee carrying both business and profession – what is the threshold - Audit of both? – Say Professional fee of 12 Lacs and Turnover of 49 lacs ----- (separate limits can still apply)
- What if assesseee has income below taxable limit? ---- GR to be considered for
Turnover

- Includes income assessible on presumptive basis
- Say:
  - Turnover of Presumptive basis Rs. 52 Lacs and Normal Business 9 Lacs
  - If assessee opts for presumptive taxation – No TA
  - If assessee does not opt – entire business subject to TA
Applicability for TA

- Whether Purchase be treated as Turnover –
- Sales by Commission Agents or Consignment Agents -
- Turnover of Transactions by Share Brokers –
- Speculative transactions –
- Derivative, Options, Futures -
- Non Residents -
- Reimbursement of customs duty collected by clearing agent –
- Interest income assessed as income from other sources and not business income --
- Travel Agents – Tickets, Railways fares collected
Which Limits to Apply

- 60 Lacs or 15 Lacs
  - Nursing Home -
  - Interior Decorators -
  - Management Consultants
  - Coaching Classes
  - Dealers in Shares / Securities (not broker) –
  - Gain on sale of investments – CG vs. stock
  - Insurance Agents, Financial Planning Advisors --
Failure to get TA done

- Section 271B - 0.5% of Turnover
- Section 273B – Penalty not to be imposed in certain cases – Reasonable Cause
- Reasonable Cause
  - Bona fide Cause
  - Bona Fide interpretation of turnover based on expert advice
  - Death or physical disability of partner in charge of accounts
  - Labour Problems
  - Fire, Theft, etc.
  - Non availability of accounts due to seizure
  - Natural Calamity
Clauses 1 to 6

- **Trade name** of the assessee along with the fact that Individual or HUF is the proprietor should be clearly mentioned.

- **Address** Same as communicated to IT as on the date of signing report- mainly Principal place of business or Branch

- If Tax audit in respect of Branch- the name and address of the branch should be given.

- In case of company, also provide address of Registered office.
Verification and Disclosure

- Partnership Deed, MOA
- Supplementary Deeds, RoF Filings
- Disclosure can be in tabular form with CY and PY ratios
Clauses No. 7 & 8

- Firm or AOP - Name of Members to be stated along with Profit sharing Ratio
- If the partner in representative capacity, the name of the beneficial partner should be stated
- Profit Sharing including loss sharing ratio to be stated.
- Payment of remuneration or interest to partners is not to be shown here
- Change in the Partner/Member or profit sharing ratio should be disclosed – even if several times
- In case share of Member in AOP is indeterminate, the same should be stated
Clauses No. 7 & 8 (Contd...)

- Principal line of business or nature of services should be stated – Activity to be stated
- Activities that constitute major activities
- While stating the nature of business – consistent with Part 'B' of the annexure to Form 3CD + ITR
- Any material change in the nature of business should be clearly brought out
- Whether Temporary suspension amount to change in business? – generally no
Verification Procedures

- Nature of Business – Matter of fact
- New Activities to be mentioned
- Refer Quantitative details for evidence
- Prefer to include rather than exclude, examine implications

Disclosure:
- Under broad heads viz., manufacturing, trading services and services
- Nature of each business/profession should be disclosed,
- Nature of product/ services under each broad head.
9.(a) Whether the books of Accounts are prescribed under section 44AA, if yes, list of books prescribed

Books of account maintained
Elaborating clause 9(a)

Books and other documents prescribed by CBDT under rule 6F carrying on certain profession:

I. Cash Book
II. Journal (If the accounts are kept on mercantile basis)
III. Ledger
IV. Serial numbered carbon copies of bills and receipts issued
V. Original purchase bills/ payment vouchers
VI. Person carrying on medical profession shall In addition to above maintain;

- Daily case register In form 3C
- Inventory of Drugs and Medicines
Elaborating Clause 9(a) (Contd…)

- Business & profession other than specified profession also required to maintain the books of accounts based on the specified limit
  - Income exceeds Rs. 1,20,000 or Turnover / Gross receipts exceeds Rs. 10,00,000 In any one of the three years immediately preceding previous year. – Section 44AA(2) read with Rule 6F
  - In case of business / profession set up during the previous year, the above limit applies for the previous year.
  - No Books of accounts, have been prescribed for other than specified profession but the one which enable the assessing officer to compute his total Income.
  - In case audit under any other law, books of accounts as prescribed under that law.
  - Assessee engaged in trading / manufacturing activities should preferably maintain quantitative details of principal Item of stores, RM and FG.
  - Bills, vouchers, receipts, documents etc. do not constitute books of accounts under this clause.
Statement of particulars to be furnished under section 44AB of Income Tax Act, 1961

9 (b) Books of accounts maintained (in case books of accounts are maintained in a computer system, mention the books of accounts generated by such computer system)

9 (c) List of books of accounts examined
Elaborating Clause 9(b)

Steps to be taken by the Tax Auditor:

I. Obtaining a **complete list of books of accounts** maintained by the assessee

II. To ensure that the assessee has **complied with the provisions of section 44AA(2)**

III. To check whether the assessee has opted **for/against presumptive taxation**

IV. Obtaining a complete list of **computer generated books of accounts**

V. **Branches** to be included

VI. **Reporting** to be based on facts

VII. **Report** any limitation placed on your audit
Clause 9(b): Practical issue

(1) In case where stock records are not properly maintained by the assessee due to big volume of operations e.g. particularly in case of retail trade how should the tax auditor report on such imperfect records maintained by the assessee?
Clause 9(b): Practical Issue

While giving the particulars in Form No.3CD the concept of materiality has to be kept in mind. If the value of inventories constitutes a very significant portion of the total assets and even then the assessee does not maintain proper stock records, the tax auditor will have to exercise his professional judgment whether the absence of such records would affect his reporting requirements.
Clause 9(b): Practical Issue

- The requirement of sub-clause (b), the books of account generated by such computer system are required to be mentioned. Paragraph 20.7 GN on TA clarifies that only such books of account and other records which properly come within the scope of the expression "proper books of account" should be mentioned.

- Further, the paragraph advises that the tax auditor should insist on proper printout of books of account being taken out (this maybe impossible in digital day and age – refer clause 12A of section 2 where definition of books of account amended)
10. Whether profit and loss includes any profits and gains assessable on presumptive basis, if yes, indicate the amount and the relevant sections (44AD, 44AE, 44AF, 44B, 44BB, 44BBA, 44BBB or other relevant sections)
Elaborating Clause 10

- Section 44AD: Presumptive Basis
- Section 44AE: Transport business
- Section 44AF: Retail trade
- Section 44B: Shipping business of a non resident
- Section 44BB: Providing services and faculties in connection with or supplying plant and machinery on hire used or to be used in the prospecting for or extraction or production of mineral oils
- Section 44BBA: Operation of aircraft by non resident
- Section 44BBB: Civil construction etc, in certain turnkey power project by non resident
- Any other section not listed above under which Income may be ' assessable on Relevant presumptive basis may also be reported here
Elaborating clause 10

- **Tax Auditor may come across three situations, viz — Page 57 Guidance Note:**
  
a) Where the assessee has more than one business and maintains single books of accounts for all businesses which includes income from presumptive business. - Problem of apportionment of common expenditure - Fair and reasonable basis and proper disclosure for the same.

b) Where the assessee has more than one business and maintains separate books of accounts for each such businesses - No issue.

c) Where the assessee has more than one business and only the net income from the business as specified in the aforesaid sections is credited to the Profit & Loss account and no books of accounts maintained in respect of such business. - Auditor can not satisfy about the correctness of the data and that fact should be disclosed. This requires qualification and the same needs to be mentioned even In 3CB.
Clause 10 : Practical Issue

- **Whether only the gross presumptive income is to be reported or the income arrived at after considering all expenses is also required to be reported**

- The amount to be mentioned under this clause means the net amount included in the profit and loss account computed in accordance with the paragraph 21.3. 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 furnished.
Verification and Disclosure

- To confirm whether any of the businesses fall under this Category
- If amount included in P & L a/c does not match the amount assessable under the presumptive section, note maybe added to that effect
- Confirm whether common or separate books maintained for such businesses
- Verify allocation if common books maintained
- The auditor has to just mention the amount included in the profit & loss account and is not required to indicate whether such amount corresponds to the amount assessable to tax as presumptive income
Reporting on Clause 10

- The auditor has to just mention the amount included in the profit & loss account and is not required to indicate whether such amount corresponds to the amount assessable to tax as presumptive income.

- Consider Disclaimer: The computation of this profit has not been verified by us.
Statement of particulars to be furnished under section 44AB of Income Tax Act, 1961

11. (a) Method of accounting employed in the previous year
Elaborating clause 11(a)

- **Method of accounting:**
  - Finance act has amended section 145 with effect from assessment year 1997-98 to provide that the income chargeable under the head 'income from business or profession' and 'income from other sources' must be computed in accordance with either **cash or mercantile system of accounting regularly followed** by the assessee. Even after such amendment the option as regard to choice of method rests with assessee. Once the choice of accounting has been decided, the assessee must follow consistently the method of accounting employed.
Clause 11(a): Practical Issue

1. A non-corporate assessee having more than one businesses may adopt cash system of accounting for one business and mercantile system for other. (94 ITR 107)*

2. AO cannot impose his own method of accounting:
   a) Manilal kher Ambalal & Co. v ITO (176 ITR 253)
   b) CIT v K. Sankarapandia Asari & Sons (130 ITR 541)

  So long as consistent and its not grossly wrong then accounting method cannot be rejected. (Example: AO cannot impose what should be included in say overhead valuation.)
Audit Procedures

- Mixed system not allowed
- Cash basis not permitted to companies
- Deviation from AS as well as Income Tax AS
- State Accounting Policies
- Materiality
- Change in policy if any should be stated
- Effect on Profit / Loss to be stated
- Compare with PY reports for consistency
Statement of particulars to be furnished under section 44AB of Income Tax Act, 1961

11. (b) whether there has been any change in the method of accounting employed vis-a-vis method employed in the immediately preceding year
Elaborating clause 11 (b)

- The Tax auditor is required only to mention whether there has been any change in the method of accounting employed in relation to the method employed in the preceding year, from Cash to Mercantile or vice-a-versa.

- It is important to note that the Tax Auditor is required to mention a change in the "method of accounting" and not change in an "accounting policy"
Clause 11(b): Practical Issue

- A change in method of accounting need not have the approval of I.T. authorities (CIT v. Carborandum universal limited 149 ITR 759), If there is any change in method of accounting followed then such disclosure is required to be made in this clause.

- If a regular method is changed for a permanent period and which is to be followed consistently has to be accepted by the department, even if it results in a reduction of tax liability (Snow white Food Products Limited 141 ITR 861) and (CTI v. Carborandum Universal Limited 149 ITR 759).
Clause 11(b): Practical Issue

- Whether a change in an accounting policy be considered as a change in the method of accounting employed?
  - No. Paragraph 22.7 clarifies that a change in an accounting policy will not amount to 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.
Statement of particulars to be furnished under section 44AB of Income Tax Act, 1961

11. (c) if answer to (b) above is in the affirmative, give details of such change, and the effect thereof on the profit or loss
Elaborating clause 11 (c)

- If there is any change in the accounting method the effect thereof has to be stated under this clause. So far as effect of such change on the profit or loss is concerned, the concept of materiality should be considered.

- 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.

- An assessee has to follow method of accounting consistently. It is open to an assessee to change the method of accounting provided the change 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 purpose.
FORM 3CD
[See Rule 6(G)2]

Statement of particulars to be furnished under section 44AB of Income Tax Act, 1961

11. (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
Presently there are two standards which are prescribed u/s 145 viz; 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 accounting policies".

It may be noted that these accounting standards do not prescribe the method of accounting. These accounting standards relate to disclosure of accounting policies and disclosure of prior period and extraordinary items and changes in accounting policies, it appears that the method of accounting explained here, refers to accounting policies and hence a suitable disclosure is required here.

The tax auditor has to report the details of the deviation in the method of accounting in the previous year from the AS (IT) and the effect there on the profit or loss
FORM 3CD
[See Rule 6(G)2]

Statement of particulars to be furnished under Section 44AB of Income Tax Act, 1961

12.(a) Method of valuation of closing stock employed in the previous year
Closing Stock

- RM, PM, FG, WIP and Stores
- Valuation Principles
  - Lower of Cost of NRV
  - Absorption Costing
  - Include all costs including Excise duties (sec 145A)
  - Mention determination of cost
- Change in method covered by previous clause 11
Elaborating clause 12(a)

- It is the normal practice to disclose the method of valuation of the closing stock 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.

- The method of valuation followed by the assessee having regard to the articles or goods dealt or manufactured by the assessee, should be clearly indicated.
Clause 12(a): Practical Issue

- Is it necessary to ensure that the method which is consistently followed for valuation of stock results in disclosure of correct profit and gains?
- The Supreme Court in case of CIT v. British Paints Ltd. [1991] 188 ITR 44 (SC) has held that the method of valuation of stock at actual cost of raw materials and not taking into account overhead charges was not the correct method of valuation even though the said method has been consistently followed.
- AS-2 would be relevant for this clause
FORM 3CD
[See Rule 6(G)2]

Statement of particulars to be furnished under Section 44AB of Income Tax Act, 1961

12. (b) Details of deviation, if any, from the method of valuation prescribed u/s 145A, and the effect thereof on the profit or loss
When tax department became a standard setter

- Background
- No progress in standard setting stopped at 2
- Last year they gave a few drafts again
- Idea to gross up – Inputs, Sales and Inventories
- INCLUSIVE METHOD - All taxes, duties, cess,
- This standard opposed to AS 2 and C(AS) Rules, 2006
- Normally impact on profits will be NIL
- Disclosure to be made as per format suggested in GN of ICAI
Elaborating clause 12(b)

- Section 145A has been enacted by the Finance (No. 2) Act, 1998 and has come into force from A.Y. 1999-2000. This section provides that the valuation of purchase and sale of goods and inventory for the purpose of computation of income from business or profession shall be made on the basis of the method 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.

- If the assessee follows inclusive method, no adjustment in the computation of income are required. If assessee follows exclusive method of accounting, adjustments are to be made in computation of total income. The auditor should report the same as a deviation from section 145A under this clause 12(b) of form No. 3CD and also the effect on profit / loss.
Clause 12(b): Practical Issue

3(a) While giving effect of deviation from section 145A, as per the Guidance Note, excise duty payable on finished goods has to be included in the information related to section 43B i.e., it is allowable as deduction on payment basis.

(b) Subsequent to the year end but before furnishing of return, excise duty of an amount which is more than the payable amount, has been paid.
Clause 12(b): Practical issue

a) The component of excise duty on finished goods forms part of value of stock in trade. This is because the moment the manufacture of the goods is completed in all respects and ready for dispatch the liability of excise duty arises. The deduction for excise duty is allowed only when the excise duty on such goods is paid on the finished stocks cleared and/or dispatched. The information relating to section 43B is only to see that claim is not made on the basis of advance payments made without clearance and/or dispatch of goods.

b) Section 43B is a provision intended to disallow certain items of expenditure which are otherwise admissible on account of non-payment within the stipulated date. It cannot be used to allow an item of expenditure which is not relating to the year merely on account payment made. Hence, excise duty paid in excess of amount payable cannot be claimed as deduction.

c) Gopikrishna Granites India Ltd v. DCIT {251 ITR 337}(AP)

d) Hindustan Liver limited v.V.K. Pandey, JCIT, (251 ITR 209} (Bom)
Verification and Disclosure

- The effect on the profit and loss account of deviation from method of valuation prescribed under Section 145A should be given individually on the opening and closing stocks. Both the effects should be disclosed separately and not netted off. In case of netting off, there should be proper disclosure.
- Refer GN which has excellent example
FORM 3CD

22 (a) Amount of Modified Value Added Tax credits availed of or utilised during the previous year and its treatment in the Profit & Loss Account and treatment of outstanding Modified Value Added Tax* credits in the accounts.

*Modified Value Added Tax (MODVAT) has been replace with Central Value Added Tax (CENVAT)
Clause 22

What is CENVAT?

- One can utilise credit for input taxes against taxes payable on the final products.
- The EXCISE DUTY on the inputs and capital goods is eligible to be set off against the EXCISE DUTY payable on the final products.
- The SERVICE TAX paid on input services can be set off against the SERVICE TAX on output service.
Clause 22 Reporting

- Reporting under 12(b) is different from this clause
- OPENING BALANCE – AVAILED – UTILISED – CLOSING BALANCE
- Treatment in Profit and Loss Account
- Treatment of Outstanding CENVAT credit in the accounts
- Method of Accounting followed
Clause 22

- Exclusive Method
- Input Duty to be debited to a separate account
- Purchases A/c - ...Dr
- CENVAT Credit Receivable A/c ...Dr
- To Creditors A/c ....Cr
Clause 22 - Practical Issues

- MODVAT on fixed assets purchased is credited to the respective assets account. What should be reported under clause 22(a) as treatment in P& L Account of MODVAT availed?

- The MODVAT credit on fixed assets would not be credited to P&L account but would be credited to Fixed Assets account. So to that extent actual cost of asset will reduce and depreciation will not be available.
Clause 22 - Practical Issues (Contd...)

- Which entries are to be considered, whether CENVAT as per books or as per excise record?
- CENVAT credit figures must be reported as per books of account and not as per excise record. However, it is important that there is a proper reconciliation between books and excise records. If any entries are necessary to be passed in the books, they should be made before certifying the financial statements.-p.103
Clause 22 - RG 23 Register

- Reconciliation between the balance of CENVAT Credit
  - as per books of account of assessee
  - as per relevant Central Excise records
- Information furnished under this clause should be compatible with the information furnished under sub clause 12(b).
Clause 22(b)

- Clause 22(b) Particulars of income or expenditure of prior period credited or debited to the Profit and Loss Account.
What is Prior Period Item?
- Prior period item are those *incomes* or *expenses* which arise in the current period as a result of the error or *omission* in the preparation of the financial statement of one or mere prior periods.
- Prior period items are generally infrequent in nature

Example:
Mr. Amit is an employee of M/s. XYZ Co. Ltd. During the year 2009-10, he has gone on leave from December to March, 10. No provision of salary has been made by the company. He has rejoined on 1st of April, 10. He was paid the salary in April for the previous months of Dec to March.

In this situation the company has committed the mistake in preparation of account by not making the provision of the salary for the period of Dec to March. So this is treated at prior period item occurred due to the error or omission in accounts of prior periods.
Clause 22 - Reporting

- AS 5 – Change in estimates is not a prior period item
- Examine whether expenditure of earlier year or current year
- The tax auditor has to report the prior period items under clause 22(b); as such expenses are not allowed to be deducted from current year's income
- Applicability

This clause is applicable only where the mercantile accounting system follows, in the case of non-corporate entity maintaining accounts on cash basis, this clause is not applicable.
Clause 22 – Reporting

- The expenditure which arises in the current year as a result of error or omission in the preparation of accounts of earlier year.

- The expenditure relating to any earlier year, which has crystallized during the year cannot be considered as prior period item.

- There was some dispute in wages for the year ended 31st March 2005. The dispute was settled during the year ended 31st March 2006 and wages are accounted during the year.

- This is not an error or omission in preparation of account of earlier year. But this is the liability which though related to previous year but crystallized in current year, which can not be regarded as prior period item.

- Kalinga Tubes Ltd Vs. CIT 218 ITR 164 (SC)
- Hajilal Mohd. Biri works 224 ITR 591 (SC)

As a tax auditor one has to be very careful in deciding the prior period items.
Clause 22 - Prior Period Exps

- State Electricity Board bills the fuel surcharge at provisional rates. Final bill for fuel surcharge for Rs.53 lakhs for the period Oct, 1990 to Sept. 1994 has been received and paid in February 1995. Is it a prior period Item?

- As it is not a result of an error or omission in preparation of account of earlier periods, It is NOT treated as a prior period item.

- Whether the provision made In the earlier year which Is no longer required. Is a prior period Item?

- No, it is just a revision of the estimate and not an error or omission, hence it is not treated as a prior period item.
Clause 23

23 Details of any amount borrowed on hundi or any amount due thereon (Including Interest on the amount borrowed) repaid, otherwise than through an account payee cheque [Sec 63D].

- What is a HUNDI?
  
  Hundi is not defined by the Income Tax Act anywhere. But a couple of circulars issued by the CBDT try to throw some light on the same.

- A gist of the understanding of Hundi as given In such circulars is as under:

  A Hundi in common parlance denotes, the indigenous form of Bill of Exchange, by & large in vernacular language, which is being used by the mercantile community in India.
Clause 23

- There are certain special features of Hundi as given by the Andhra Pradesh High Court in case of CIT v. Dexan Pharmaceuticals (P) Ltd. (1995) 214 ITR 576
- Three parties - Drawer, Drawee (Borrower) and Owner/Holder(Payee)
- Negotiable without endorsement by payee.
- Normally in the vernacular language.
- If lost, duplicate and triplicate can be claimed by the owner from the Drawer
- This clause basically requires the tax auditor to report on contraventions of provisions of section 69D

Section 69D

‘Where any amount is borrowed on a hundi from, or any amount due thereon is repaid to, any person otherwise than through an account payee cheque drawn on a bank, the amount so borrowed or repaid shall be deemed to be the income of the person borrowing or repaying the amount aforesaid for the previous year in which the amount is so borrowed of repaid as the case may be’
One important issue in this regards is that, as per the decision given by the Madras Tribunal in case of AK KHADER SONS reported in 6 ITD 65 (Madras)

A Promissory Note is not hit by provisions of Section 69D. This clause applies to Hundies only

Hence the tax auditor needs to differentiate between a Hundi and a Promissory Note

If the borrowal or repayment on hundi is done through cross account payee draft it should also be treated as “account payee cheque” and the provisions of section 69D cannot be involved.

There might arise some practical difficulties in the verifications of requisite details, in such circumstances a suitable disclaimer may be made in the report.
Clause 24(a) - Form 3CD

- Particulars of each loan or deposit in an amount exceeding the limit specified in section 269SS (Rs. 20,000) taken or accepted during the previous year
- The loan / deposit taken /accepted from Govt. / banking company, co-op. bank, post office saving bank, Govt. company would not be considered for this clause.
Clause 24(a) - Form 3CD

- Limit of Rs 20,000 inserted in 1984
- Limit of Rs 20,000 is the aggregate limit
- Aggregation is made on per lender basis and not on global basis
- Whether opening balances of loans / deposits are to be considered?
Clause 24(a) - Form 3CD

- Payments made through third parties is covered e.g. payment made by financer to supplier
- Conversion of creditors' balance into Unsecured loans is covered
- Current Account transactions are also covered
- Advances received is not loan or deposit
- Renewal of deposit is treated as repayment of loan and acceptance of a fresh loan
- In absence of clarity whether an advance is against sales or a loan, auditor should see the trade practices and the conduct of the parties
- Loan or Deposit through Book Entry or Journal Entry.
Particulars of each repayment of loan or deposit
In an amount exceeding the limit specified in section 269T (Rs 20,000) made during the previous year
Clause 24(b)

- Interest on loan / deposit is to be reported if the same forms part of the loan / deposit
- Renewal of deposits is treated as repayment and needs to be reported
- Repayment of loan by issue of equity shares is covered
- Settlement amount of a partner of a firm by treating the same as loan covered
- Clause applicable to Government Companies, banking companies.
- In case of Company assessee, loan or deposit payable on demand will not be considered as deposit.
- How ca you verify payment by account payee cheque?
Clause 24 (c)

- Obtain a certificate from the assessee covering all loans and deposits.
Clause 28 (a) and (b) – Quantitative Details

- For Trading Concerns – Principal items of goods traded
- For Manufacturing Concerns – Principal items RM, FG, By Products
Clause 28(a) - Form 3CD

- Factual Clause
- Services company fall out of this clause
- Quantitative information is to be disclosed only for principal items
- Should be as per books of Account
- Report whether stock records maintained properly as your reporting dependent on that
- Certificate on shortage, damage, etc.
- Principal items are those which constitute more than 10% - 20% of the aggregate of purchases, consumption or turnover.
- Materiality is to be considered
- Sometimes not possible at all to provide this - Projects company with numerous small items
Clause 28(a) - Form 3CD

- Following details are to be given in respect of a trading concern
  - Opening Stock
  - Purchases
  - Sales
  - Closing Stock
  - Shortage / excess, if any
Clause 28(b) - Form 3CD

Following details are to be given in respect of raw materials for a manufacturing concern:

- Opening Stock
- Purchases
- Consumption
- Sales
- Closing Stock
- Yield of Finished products
- Percentage of yield
- Shortage / excess, if any
Clause 28(b) - Form 3CD

- Following details are to be given in respect of finished goods / by-products for a manufacturing concern
  - Opening Stock
  - Purchases
  - Quantity manufactured
  - Sales
  - Closing Stock
  - Shortage / excess, if any
Clause 28(b) - Form 3CD

- Yield of finished product indicates quantity
- Percentage of yield indicates the actual percentage
- These requirements do not apply to a construction contractor (construction not manufacturing)
  - N.C.Budharaja and Co (2041 ITR 412)
- Where the input and output is recorded in different units, effort should be made to relate the output to the input to compute the percentage of yield.
- Where the percentage cannot be computed, the fact should be stated
Clause 29-Form 3CD

- Following information relating to tax on distributed profits
- Deemed dividend excluded

**Under section 115-0:**
- Total amount of distributed profits during the financial year.
- Total tax paid thereon
- Dates of payment of tax with amount
- 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 as the tax is required to be deposited within 14 days.- P120
Where Cost Audit under section 233B of the Companies Act, 1956 is carried out, a copy of the cost audit report is to be enclosed, (refer section 139(9))

Cost Audit Rules have changed – only cost audit report under 233B covered. Compliance report is not covered,

Where audit is conducted under Central Excise Act, 1944, a copy of the audit report is to be enclosed.

Take note of material observations, but not required to be reported

Reports refer to those pertain to this year (cost audits) or done within this year (excise)
Clause 32 - Form 3CD

- Applicable to Manufacturing or Trading entities only
- Ratios as a whole not business wise
- Consistency between Numerator and Denominator
- **Accounting ratios with calculation**
  - Gross profit / Turnover
  - Net Profit / Turnover
  - Stock-in-trade / Turnover
  - Material consumed / Finished goods produced
- **Calculation in terms of value only**
Issues

- Accounting / Tax figure? --- PBT/Turnover
- Combined / Individual business? --- Combined
- Whether apply to construction company? --- NO, construction not manufacturing
  - N C Budharaja & Co case (204 ITR 412)
- Interest and remuneration to partners? – 40B yes should be considered
- Average stock or opening stock or closing stock? ----- only closing of FG
- Closing Stock should be as per books and not adjusted as per 145A
Resources on Tax Audit by ICAI & BCAS

- GN on Audit under 44AB – 134 Pages
- Issues on Tax Audit – 138 Pages
- Supplementary GN on Tax Audit under Section 44AB of the Income Tax Act, 1961 – 37 Pages
- Revision of GN on Tax Audit – 8 Pages
- GN on Terms used in Financial Statements
- BCAS Referencer – Tax Audit Checklist
THANK YOU