

'Tax Audit u/s 44AB'

AY 2014-15

by

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Recent focus on Tax Auditors and CAs

- Increased focus on role of tax auditors due to:
 - Reports signed under dummy or non-existent names
 - Reports signed exceeding permissible limits
 - Reports issued without undertaking an 'audit'
 - Reports issued by charging very low fees
- Mandatory e-filing of TAR mainly due to overcome above concerns
- ITAT decision – Vijay V Meghani vs DCIT (Mum) 20/8/2014
 - *Serious doubts cast on conduct of concerned CA firm*
 - *Has doubted the methodology of training and CPE of ICAI*

Introduction

- For AY 2014-15: 29 instances in IT Act, 1961 where audit or attestation necessary
- Audit required vide section 44AB of IT Act as under:

Sales / Gross Turnover or Gross Receipts exceed	AY 1985-86 to AY 2010-11	AY 2011-12 to AY 2012-13	AY 2013-14 onwards
In case of Business	40 lakhs	60 lakhs	1 crore
In case of Profession	10 lakhs	15 lakhs	25 lakhs

- From AY 2011-12 onwards, audit u/s 44AB also necessary where assessee claims non-applicability of sec 44AD
- **ICAI has issued revised 'GN on Audit u/s 44AB' in 2013**
- **A further revised GN is expected from ICAI**

Introduction ...

- Audit in case of non corporate entities
 - Entire audit to be conducted
 - True and Fair view of FS
- Tax Audit in case of Companies
 - Only particulars in Form 3CD to be certified
 - Reliance to be placed on report of Statutory Auditor
 - SA 600 “Using the work of another auditor”
 - Some additional verification maybe necessary
 - Co-relation of particulars given in Form 3CD with disclosures in FS (e.g. AS 18, CARO report, etc.)

Introduction ...

- Format for FS (non corporate Entities)
 - Recommended by ICAI – (follows old schedule VI format)
 - BS in horizontal format – PL in vertical format
 - For firms to also state whether registered or not
 - Format also mentions previous years' figures
- Format for FS (Corporate Entities)
 - In Revised Schedule VI (incl companies having year-end different from 31 March)

Compliance with ICAI Code of Ethics

- Appointment and NOC procedures
- Same person cannot conduct Internal Audit & Tax Audit
- The auditor should not be indebted for more than Rs. 10,000
- Ceiling on number of tax audit assignments
 - *60 per partner (for audits during AY 2014-15 onwards) (earlier 45)*
 - HO and branch considered as 1 assignment
 - audits conducted under section 44AD, 44AE and 44AF or under state VAT laws **not to be included** in the limits
- Minimum Fees to be charged:
 - Council decision for minimum fees (notified in 2009) **repealed** with effect from 7th June 2011
 - preferable to follow ICAI recommended scale of fees
- Record of tax audit assignments in prescribed format

Applicability of Accounting Standards

- Corporate entities
 - **Mandatory as per Companies (AS) Rules, 2006 as also sec 133 of Companies Act, 2013**
 - Concessions to SMCs from some AS
- Non-corporate entities
 - Compliance not given by any statute (except for IT-AS 1 & IT-AS 2 issued under section 145 of Income Tax Act)
 - As per ICAI guidelines – mandatory for auditors while reporting – exemptions for SMEs from some AS
 - AS 1, AS 2, AS 7, AS 9, AS 10, AS 11, etc. need to be followed as otherwise the FS may not give “True and Fair” view
 - Consider implications u/s 145 if AS not followed

Business vs. Profession

- Business defined "*Business includes any trade, commerce, or manufacture or any adventure or concern in the nature of trade, commerce or manufacture*" [sec 2(13)]
- SC has in *Barendra Prasad Roy v ITO [1981] 129 ITR 295 (SC)* mentions that '*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 -

Business vs. Profession ...

- Sec 2(36) defines profession to include vocation.
- SC has stated *“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)*,
 - *CIT v. Ram Kripal Tripathi [1980] 125 ITR 408 (All)*.
- Whether a particular activity can be classified as ‘business’ or ‘profession’ will depend on the facts and circumstances of each case

Business vs. Profession ...

- CBDT has vide Notification No. SO-18(E) dated 12.1.77, No. SO 2675 dated 25.9.1992 and No. SO 385(E), dated 4.5.2001 notified professions u/s 44AA. These are:
 - Accountancy
 - Architectural, Interior Decoration
 - Authorised Representative
 - Company Secretary
 - Engineering
 - Film Artists/Actors, Cameraman, Director, Singer, Story-writer, editor, Singer, lyricist, dress designer etc.
 - Legal, Medical
 - Technical Consultancy
 - Information Technology

Whether Business or Profession?

- Insurance Agent
- Nursing home
- Management consultants
- Coaching classes
- Stock broking
- Dealer in shares/securities
- Gain on sale on investments
- Clearing, forwarding and shipping agents
- Financial Planning Advisors,
- Dentist having individual practicing
- Group of Dentists practicing jointly as partners of a partnership firm

What is Turnover?

- Sec 2(91) of Companies Act, 2013 defines Turnover as:
 - “turnover” means the aggregate value of the **realisation of amount made** from the sale, supply or distribution of goods or on account of services rendered, or both, by the company during a financial year; (wef 12-9-2013)
- CST Act, 1956 defines Turnover as:
 - “turnover” used in relation to any dealer liable to tax under this Act means **the aggregate of the sale prices received and receivable by him in respect of sales of any goods** in the course of inter-State trade or commerce made during any prescribed period and determined in accordance with the provisions of the Act and rules made there under.
 - Sec 8A(1) of the said Act provides that in determining turnover, **deduction of sales tax should be made from the aggregate of sales price.**
- Turnover also defined by ICAI in:
 - Guide to Company Audit
 - Statement on CARO

What is Turnover?

- ICAI GN on sec 44AB defines in para 5.8 'turnover' as under:
 - “the aggregate amount for which sales are effected or services rendered by an enterprise”.
- As per the GN:
 - If sales tax and excise duty are **included** in the sale price, no adjustment in respect thereof should be made for considering the quantum of turnover. Trade discounts can be deducted from sales but not the commission allowed to third parties.
 - If, however, the Excise duty 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 be excluded from turnover.
- For Companies, in view of definition in sec 2(91) of the Companies Act, 2013, maybe difficult to follow above GN.

What is Turnover? ...

- Para 5.9 of the GN further states “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”
- As per sec 145(1) income chargeable under "Profits and gains of business or profession" or "Income from other sources" is to be computed in accordance with either cash or mercantile system of accounting regularly employed by the assessee. This method of accounting followed would also be relevant to determine sales, turnover or gross receipts.
- Whether the transaction is made on “principal to principal’ basis of ‘principal to agent’ basis is also relevant.

What is Turnover? ...

In case of speculative transactions

- Transaction in which a contract for the purchase or sale of any commodity, including stocks and shares, is periodically or ultimately settled otherwise than by the actual delivery or transfer of the commodity or scrips
- The contract is settled otherwise and squared up by paying out the difference which may be positive or negative.
- As per the ICAI GN, **the aggregate of both positive and negative differences is to be considered as the turnover of such transactions**

What is Turnover? ...

In case of derivatives, futures and options

- **The total of favourable and unfavourable differences is taken as turnover.**
- **Premium received on sale of options is also to be included in turnover.**

In case of delivery based transactions

- **Depends on whether transaction undertaken in the course of business or as investment.** Answer also depends on the facts and circumstances of each case taking into consideration the nature of the transaction, frequency and volume of transactions etc.

What is Turnover? ...

Whether the following is part of turnover?

- Trade discount
- Cash discount
- Sale proceeds of fixed assets
- Sale of scrap (included in 'Other Income')
- Sale proceeds of shares/property held as 'Investments'
- Sale proceeds of shares/property held as 'Stock-in-trade'
- Sales by commission agents / share brokers
- Rent received
- Dividend received

What are Gross Receipts?

Para 5.14 of GN states:

- Gross Receipts includes 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.**
- Are the following include in “Gross Receipts”?
 - Export benefits received
 - Interest received by money lender
 - Exchange difference (net)
 - Insurance claims (other than fixed assets)
 - Package Tour charges recovered by a travel agent
 - Share of profit of a partner from a firm
 - Write back of amounts payable to creditors (*GN says ‘no’*)

What are Gross Receipts ...

In case of Reimbursements, the GN states 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.
- In case of professionals, may also depend on whether 'service tax' is recovered on such reimbursements

FORM 3CA, 3CB

- When to use 3CA and 3CB?
- Form 3CA is applicable to persons specified in section 44AB, who carry on business or profession, and who are required by or under any other law to get their accounts audited.
- Form 3CB is applicable to persons applicable to persons specified in section 44AB, who carry on business or profession, other than those who are required by or under any other law to get their accounts audited.

Audit Procedures

- Letter of appointment (by management)
- SA 210 – Agreeing to the terms of Audit Engagement
 - Engagement letter to be issued
- SA 230 – Audit Documentation
- SA 610 – relying on work of Internal Auditors
- SA 315 – Identifying and Assessing risk of material misstatement through understanding the entity
- SA 330 – Auditors’ responses to assessed risks
- SA 520 – Analytical Procedures

Applicability of SA 700 while issuing Form 3CB

- SA 700(R) is applicable for all reports on audits of General Purpose Financial Statements (GPFS) in view of Footnote 9 to SA 800 states that *“In India, financial statements prepared for filing with income tax authorities are considered to be general purpose financial statements.”*
- **Clarification issued by ICAI on July 5, 2013:**
Considering the fact that all tax audit reports are now mandatorily required to be filed online and that the format of the report is prescribed by the CG, it is decided to defer the applicability of SA-700 (Revised) on the tax audit report under section 44AB of the IT Act by one year i.e. the requirements of SA-700(Revised) are not applicable for tax audit reports filed up to 31st March, 2014

Applicability of SA 700 while issuing Form 3CB ...

ICAI Announcement – Council meeting 326 of 27-29 July 2013

- The Council noted that in many cases such prescribed auditor's report were required to be filed online in a preset form and, hence, it was not possible for the auditors to make necessary changes in these reports to bring them in line with the SA 700. ...
- On a perusal of a cross section of the formats of the auditor's report prescribed under various laws, specially, the Income-tax Act, 1961 and the Value Added Tax Acts of various States, it is clear that these prescribed formats do not contain all the elements of the auditor's report as required in paragraph 43 of SA 700.
- *Accordingly, it would not per se be possible for the auditors to state in their audit reports that the audit has been carried out in accordance with the Standards on Auditing. However, the auditors would be required to carry out the audits in accordance with the Standards on Auditing issued by the ICAI.*

Form 3CA, 3CB ...

- **Notes to Accounts to normally specify:**
 - Method of accounting followed – accrual or cash
 - Revenue Recognition
 - Inventory valuation
 - Fixed Assets and Depreciation
 - Investments
 - Accounting of Forex fluctuations
- **Items that may require qualification:**
 - Mandatory AS not followed (esp. for Companies)
 - Non provision of Income Tax
 - Non provision of Employee bonus and retirement benefits
 - Confirmations for balances
 - Inventory valuation on estimated basis

Form 3CA, 3CB, 3CD ...

- For a proprietor having 2-3 different business – whether same or different Form 3CD?
- Primary responsibility of management
- To be certified by management

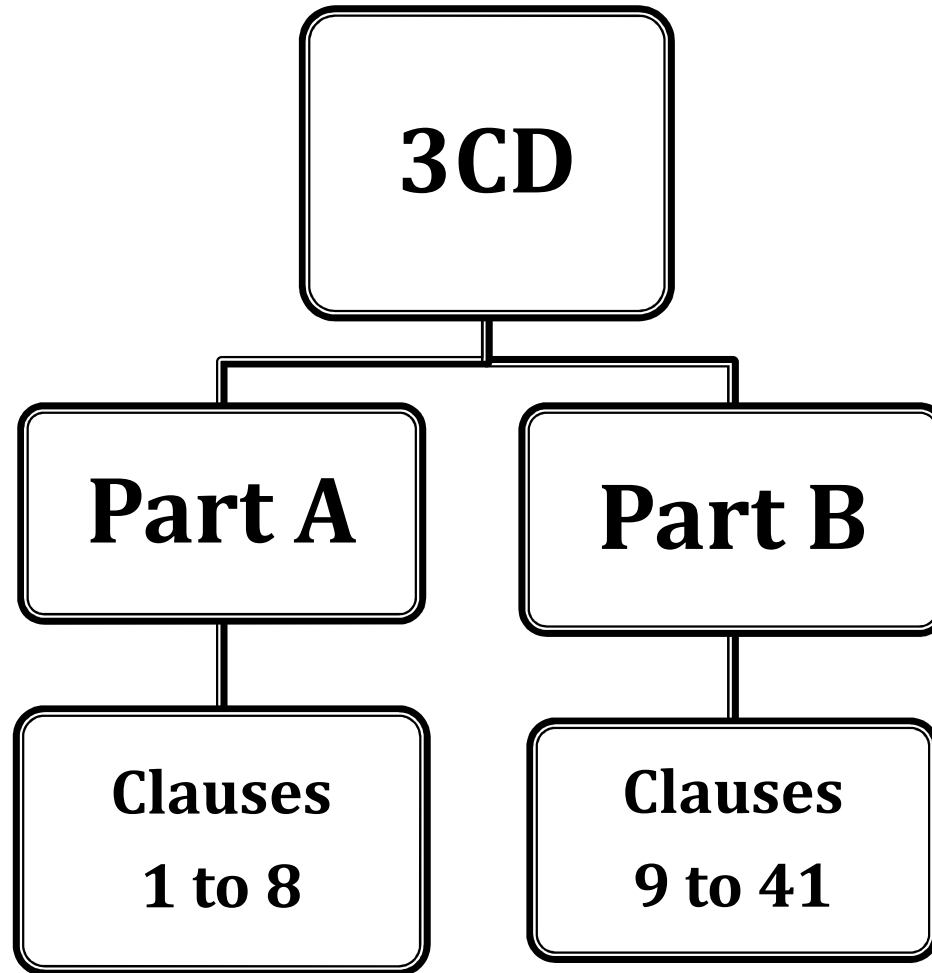
Signatures

- Form 3CA / 3CB to be signed by Chartered Accountant
- Mention of Firm Registration Number (FRN)
- Mention of membership number
- Form 3CD also to be signed by assessee?
- Preferable for CA to put initials / stamp on each page / annexure of 3CD

Form 3CD – Revised

- **Form 3CD revised by notification dated 25th July 2014**
- **Issues arose about:**
 - Applicable date?
 - What happens to reports issued earlier?
- **CBDT has issued order u/s 119 dated 20th August 2014:**
 - **Due date for obtaining / furnishing report extended to 30 Nov 2014**
 - **Reports filed from 1st April 2014 to 24th July 2014 in pre-revised forms shall be treated as valid**
- **Issues still remaining:**
 - *Due date of filing return u/s 139 not extended beyond 30 Sept 2014*
 - *Reports obtained prior to 25th July 2014, but not filed not covered in above order – these will need to be obtained in new format*

Form 3CD ...



Form 3CD – whether comments necessary in following cases?

- No interest charged on loans to relatives
- Insufficient household withdrawals
- Books not closed
- Investments, assets (like car, flat) held in names of partners and not name of firm
- No quantity records are maintained
- Stocks not tallying with bank

Clause 10(a), 10(b): Nature of Business or Profession, ...

- To give broad nature of **each** business/profession
- To give principal line of each business/profession
 - Main sector to be given with sub-sector
 - *e.g. Manufacturing – aromatic chemicals*
 - Details as per Part B of annexure to Form 3CD
- E-filing portal requires details as:
 - Sector, sub-sector, code
- Mention of any **material** change like:
 - New business started
 - Some business discontinued – (if only temporary not to mention)
- In practice, activities that constitute > 10 % are given

Clause 11(a), 11(b), 11(c): Whether books prescribed u/s 44AA, ...

- To give list of books prescribed, maintained *and address of each location where books are maintained*
- Books for certain professionals mentioned in sec 44AA(1)
- Books constitute books of original entry and maybe prescribed under some other statute
- Sec 2(12A) of the Act defines “books or books of account” – can be in written form or print-outs or other form of electro magnetic data
- Though books not prescribed in sec 44AA(2), such books are required to be maintained to enable the AO to compute the income as per the IT Act
- To give the list for all locations (incl stock registers)
- If maintained in a computer system – to mention so
- *List of books of account and nature of relevant documents examined*

Clause 13(a), (b), (c), (d): Method of Accounting

- Method of accounting followed
 - Accrual vs. Cash method (mixed or hybrid method not allowed)
 - Method to be consistently followed
 - Allowability of remuneration in case of professional firm following Cash basis
 - Cash basis not possible for companies (in view of sec 209 of Cos Act 1956 / sec 128 of Companies Act 2013)
- Deviation from accounting standards prescribed u/s 145 – sec 145 has notified 2 AS:
 - AS 1 (IT) – similar to AS 1 of ICAI / notified AS for Cos
 - AS 2(IT) – similar to AS 5 of ICAI / notified AS for Cos

Clause 13(a), (b), (c), (d): Method of Accounting ...

- AS 1(IT) requires disclosure of all significant accounting policies
- Change in method of accounting
 - Allowed as per para 9 of AS 2(IT) in 2 cases
 - Adoption required by statute
 - Change would result in more appropriate presentation of FS
 - Materiality to be considered
 - Effect on profit/loss to be stated (*in columnar format*)
 - Changed policy to be followed consistently
 - Change in policy is not to be reported as 'change of method of accounting' – impact thereof is however disclosed in FS

Clause 14(a), (b): Method of Valuation of closing stock

- Closing stock consists of RM, WIP, FG, Stores, etc.
- Normal valuation principles to be followed:
 - At lower of Cost or NRV;
 - To follow Absorption Costing;
 - To include all costs incl. excise duty (sec 145A)
 - To mention how cost is determined
 - If cost arrived at as SP less GP margin – whether ok?
 - Allowed at SP in certain cases
 - SC decision of British Paints (188 ITR 44)
- To also value stores, packing items
- Change in method of valuation covered in Clause 13

Clause 14(a), (b): Method of Valuation of closing stock ...

- To mention effect of 145A on
 - Any tax, duty, cess ,etc. paid/incurred on inputs to be added to the cost of the inputs, if not already added;
 - Any tax, duty, cess ,etc. paid/incurred on sale of goods to be added in sales, if not already added;
 - Any tax, duty, cess ,etc. paid/incurred on inventory to be added to inventory valuation, if not already added;
- Section 145A thus requires “Inclusive method” as against “Exclusive method” mandated by AS 2
- ICAI GN on “Tax Audit u/s 44AB” mentions (with an illustration) that in both methods, impact on profit/loss is Nil
- For an entity following “Exclusive method” ICAI GN has suggested disclosure in the following table (see next slide)

Clause 14(a), (b): Method of Valuation of closing stock ...

	Particulars	Increase in Profit (Rs.)	Decrease in Profit (Rs.)
1	Increase in cost of opening stock on inclusion of excise duty on which Cenvat available/availed	Xxx	Xxx
2	Increase in purchase cost of RM on inclusion of excise duty on which Cenvat available/availed	Xxx	Xxx
3	Increase in sales of finished goods on inclusion of ED	Xxx	Xxx
4	ED paid on Sale of FG due to inclusion in Sales	Xxx	Xxx
5	Increase in closing stock of RM on inclusion of ED	Xxx	Xxx
6	Increase in closing stock of FG on inclusion of ED	xxx	Xxx
7	Increase in ED on closing stock of FG as a result of its inclusion in closing stock of FG	xxx	Xxx
8	Accounting of Cenvat credit availed and utilised on RM consumed in payment of ED on FG accounted on basis of RM consumed	Xxx	Xxx

Clause 14(a), (b): Method of Valuation of closing stock ...

- Get list of Closing Inventory;
- Confirm whether all items like RM, WIP, FG, Stores, Packing materials, consumables, etc. are valued
- Confirm method of valuation (incl. determination of cost, etc.)
- Tally inventory list with that submitted to the bank –
- quantity should match – value may differ due to different valuation method applied
- Disclosure as per ICAI GN, if 145A not followed

Clause 18(a) to (f): Fixed Assets & Depreciation

- Particulars of Block of Assets and depreciation
 - a. Description
 - b. Rate of depreciation
 - c. Actual cost or WDV
 - d. Additions/Deductions with dates of acquisition/put to use – whether net of Cenvat credit, Foreign exchange fluctuations, subsidies
 - e. Depreciation **allowable**
 - f. WDV at end of the year
- Additions normally bifurcated into:
 - Used for more than 180 days and others
 - **Cut-off date would be 2nd October (not 30th Sept)**
- If list of additions very voluminous, summary information maybe given

Clause 18(a) to (f): Fixed Assets & Depreciation ...

- Date when Asset put to use – can differ with date of start of commercial production
- Capital assets claimed as deduction
 - R & D assets (also refer clause 15)
 - Assets less than Rs. 5,000?
- Computer Software: whether asset?
- Adjustments for currency fluctuations (as per sec 43A)
- Adjustments for subsidies received (as per expl 10 to sec 43)
- Provisions of section 36(1)(iii) to be considered
- In case of disputes (which are under litigation) regarding depreciation claim in earlier years – to clearly mention the same

Clause 26 (A) / (B): Disallowances u/s. 43B (a) to (f)

- Disallowances for the following:
 - Any tax, duty, cess, fee, etc.;
 - Employers' contribution to Provident Fund or other funds;
 - Bonus of commission payable to employees;
 - Interest on loan from financial institutions or scheduled banks;
 - Leave encashment
- **(A): Liability pre-existing as on 1st day of PY and not allowed in any preceding year**
 - Paid / Unpaid during the PY
- **(B) Liability incurred in PY**
 - Paid / Unpaid before due date of filing return u/s 139(1)
- To also state whether Sales Tax, Excise, etc. passed through PL

Clause 26 (A) / (B)

Disallowances u/s. 43B (a) to (f) ...

- Some typical reporting issues:
 - Borrowings from NBFCs not covered
 - Treatment of funded interest (to refer circular 7/2006)
 - Sales Tax Deferral Loans
 - Provision for Excise Duty on closing stock of finished goods
 - Payments made after signing of Form 3CD, but before filing of return – to attach proof or separate certificate
 - Assumptions for making provision for taxation
- List of items disallowed to be cross tallied with Deferred Tax calculations (which would qualify for DTA)
- If certain items disallowed in earlier year and now written back in books (since no longer payable), not to include the same for tax computation

Clause 27(a), (b): Treatment of CENVAT, Income / Exp. of Prior period

- **27(a) – Reporting of CENVAT credits availed, treatment in PL and outstanding Balance**
- Ensure proper reconciliation of data as derived from excise and service tax records
- Consider various circulars in regard to Excise / Service Tax for availment and utilisation of cenvat credit
- Obtain details on SCN or other correspondence with the Excise / Service Tax dept
- In some industries (say., textiles) claiming cenvat credit is optional – in such cases consider whether o/s balance can be utilised in future

Clause 27(a), (b): Treatment of CENVAT, Income / Exp. of Prior period ...

- **27(b) - Reporting of income or expenditure of prior period included in PL**
- Definition of 'Prior Period Items': errors or omissions that arise due to errors or omissions in earlier periods
- As per AS 5 [*and AS (IT) 2*], revision of estimates does not result in a Prior Period Item
- Materiality to be considered while reporting the same
- Reporting not relevant in case 'Cash Basis' is being followed

Clause 31(a), 31(b), 31(c): Loans or Deposits accepted/repaid

Loans / deposits exceeding limits u/s 269SS / 269T

- To give name, address, PAN, amount accepted, whether squared up during the year, maximum amount, whether taken otherwise than by A/c Payee cheque / draft
- If total amount of loan/deposit exceeds Rs. 20,000, to report even if each transaction is less than Rs. 20,000
- Though, applies only to amounts accepted/repaid during the year, preferable to disclose movement of even existing loans
- If accounts are utilised as current accounts, to segregate loan and other transactions
- Security Deposits, loans from NBFCs also to be reported
- If data voluminous (say company accepting FDs), to test check and mention the fact

Clause 31(a), 31(b), 31(c): Loans or Deposits accepted/repaid ...

- Repayments by book/transfer entries to be reported
- Whether repayments by cheque on behalf of depositor to be reported? (e.g. direct payments for PPF, tax, LIP, etc.)
- Share Application money advance supported by appropriate documentation not to be reported
- Disclaimer Note normally given if evidence of paid cheques, etc. not available
- NA for loans from banks, government companies

31(c) - whether the accepting or repayment of loan / deposits was made by A/c payee cheque / draft based on examination of books of account and other relevant factors

Clause 35: Quantitative Details

- Information to be given as per books of accounts
- Details about trading as well as manufacturing activities for all principal items
- Materiality can be kept in mind –
 - Items constituting more than 10 % of aggregate value of purchases/consumption/turnover (as per Revised Schedule VI)
- To reconcile with stock details given to banks
- Reporting of Yield, Shortage/Excess – to compare the same with earlier years or with industry norms

Documentation

- Documentation for 3CD should be separate
- Check list for 3CD
- For debatable issues, separate management representations, if required
- Important for Peer Review since tax audit is also an attest function.
- To follow SA 230
- Golden principle for Documentation:

**WRITE what you do
and
DO what you write**



Thank you!

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