A HANDBOOK ON AUDIT
Preface

After the issue of detailed CBDT Instructions on Receipt and Internal Audit in 2006 and 2007, the procedural aspects of Internal Audit have been clearly delineated. Role of Internal audit as a mechanism to place check on tax manipulations by professionals and those dealing with taxation matters, and taxpayers returns cannot be emphasized enough. The recent expose of the 2G-Spectrum scam by the CAG is a telling case in point.

This compendium, relies heavily on the compendium of the DTRTI, Lucknow compiled in 2008 by Sh. O.P. Aggarwal, then DDIT (Training). An effort has been made by DTRTI Chandigarh to reorganize the chapters and proved the officers/officials with the latest updated check sheet items, nature of common mistakes and types of mistakes covered in the C & AG Review on implementation of the Supreme Court judgments and update the auditing and accounting standards.

While instances of good practices are many, what is lacking in most offices is Institutional memory, an here a Handy Ready-Reference, suitably updated can act as an effective aide to those discharging duties pertaining to Audit. Hence this Handbook on Audit for the Workshops for Audit Officers being organized all over India.

The Departmental Audit Manual is also under Compilation and should be released shortly by CBDT. In the meanwhile there may be scope for further improvement and possibly some unintended errors might have crept into this handbook. Corrections and suggestions can be e-mailed to richandigarh@gmail.com or faxed at 0172-262056.

G.G. Shukla
Director General, NADT, Nagpur
# A Handbook on Audit

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Regarding Internal Audit

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CHAPTER-I

OBJECTS AND SCOPE OF INTERNAL AUDIT

Internal Audit was introduced in 1954 and after the audit of receipt was entrusted with Comptroller & Auditor General of India in the year 1960, the scope of duties of Internal Audit were made co-extensive with that of statutory Audit.

The Central Board of Direct Taxes, New Delhi has now introduced the new internal audit set up, procedure for working and dealing with the internal audit objections, responsibilities of the officers and staff and procedure for settlement of internal audit objections with special reference to different views expressed by the courts. The Instruction now introduced is Instruction No.03 of 2007 dated 16-04-2007 circulated vide F.No. 246/109/2004-A&PAC -I dated 17-04-2008. This Instruction supersedes the old Instructions, which is now broad based, has wider scope and is more comprehensive.

OBJECTIVES OF INTERNAL AUDIT

The three fold objectives were laid down by the Central Board of Direct Taxes in the Year 1972

(i) To have a preventive and reforming effect in direction of avoiding mistakes.
(ii) To play the corrective role by pointing out mistakes and ensuring remedies without loss of time.
(iii) To improve quality of assessments so as to reduce the criticism of the working of department by statutory audit and the Public Accounts Committee.

The main objective of Internal audit is to detect the mistake and errors committed during the assessment work, TROs and Administrative Officers/Superintendents, so that a suitable/appropriate remedial action is taken to retrieve the loss caused to the revenue not to allow relief to the assessee in case of overcharge /over assessment. The other objective of internal audit is to find out whether the procedure and laws laid down are properly followed or not and whether there is any violation of CBDT Guidelines, Instructions and Circulars. Internal audit shall also exercise vigilance for prevention of mistake having both deterrent as well as reformative effect. Ultimate aim is to improve quality of assessments by reducing the errors and omissions which are subsequently detected by receipt audit.

SCOPE OF INTERNAL AUDIT

The scope of scrutiny by Internal Audit has been continuously enlarged and in 1969 it was made coterminous with that the Receipt Audit. The scope of scrutiny by the Receipt Audit is discussed in Chapter II. However, the scope of checking by internal audit is broadly laid down as under:-
i) Whether the return has been filed in time: or it is delayed and whether the assessee is liable for payment of interest for late filing of returns and has the assessing officer charged interest correctly and initiated the relevant penal provisions.

ii) Whether the returns is correctly signed and verified by the authorized person.

iii) Arithmetical mistake in the computation of income/tax in the return of income filled by the assessee and also in the processing / assessment order passed by the Assessing Officer.

iv) Correct application of rate of tax and surcharge, if any. Also whether the credit of advance tax paid, TDS deducted and self assessment tax paid is properly allowed.

v) Whether the interest under different provisions of Act for the defaults committed by the assessee has been properly charged and correctly calculated.

vi) Checking of correct dates of payment of advance tax and tax deducted at source and the defaults committed by the assessee which remained undetected by the assessing officer.

vii) Looking into missing of certain additions in the final computation which were discussed in the body of the assessment order.

viii) Incorrect computation of depreciation, investment allowance, export allowance, incorrect allowance of provisions of bad and doubtful debts, incorrect computation and deduction of other allowances, incorrect carry forward set off of unabsorbed depreciation, business losses and any other allowances.

ix) That the claims of tax payers are perused with due diligence and are not abandoned or reduced except with adequate justification or proper authority.

x) To point out apparent mistake of law including the mistake of law arising as a result of subsequent ruling by the Supreme Court. Other example of apparent mistake of law would be a case where mandatory provisions of Act have not been applied or where deduction is allowed for an item which is patently chargeable to tax, or where the interpretation of law in the assessment order is in conflict with the decision of the Jurisdictional High Court and that of the Supreme Court.[ Also see Instruction No 03 of 2007-Annexure-3 to this Handbook]

xi) To bring out cases of general departure from the order of, or procedures prescribed by CBDT /Directorate/ CCsIT/CCsIT

xii) To check whether the AOs have recorded in the body of the assessment order the fact of having waived or reduced the interest chargeable under various sections of the Act.
xiii) To check whether the procedures and terms prescribed by the Income Tax Department are adequate, the instructions issued and procedures prescribed by the Board are being duly implemented.

xiv) To check whether Board's Instruction No. 598 dated 25-08-73 and 646 dated 10-01-74 regarding checking of tax calculations by Sr TAs Supervisory staff and A.Os are being complied with. Failure to follow these instructions should be reported to the Commissioner of Income Tax through Addl.CIT1JCIT each month. It is necessary to find out in how many cases which have not been checked by the AOs, and Office Superintendents, mistakes in calculation of tax have been detected by the Auditing Officers.

xv) The Auditing Officer should further check the points as mentioned in the check sheet given in Chapter XII. The check sheet is not exhaustive and the scope of scrutiny/enquiry can go beyond points mentioned in the check sheet and the Auditing Officer is free to comment on any law and interesting points that come to light during their scrutiny. However, the Auditing Officer should not raise vague and ambiguous objections. Cogent reasons should be given by the Auditing Officer while expressing his views or pointing out mistakes in the Audit Memo. There must be mention of under assessment / over assessment amount as well as tax effect in the Audit Memo.

[Source: Manual of Office Procedure Vol-III-issued by DI(O&MS)

For further details on Internal Audit:

1. For Auditors - Check Sheets liven in Chapter XII of this Handbook
2. For Instruction No 03/2007 -See Annexure -3
3. For Ledger Cards and other details -See -Overview -Chapter IV of this Handbook.
4. For AOs & Auditors Common Mistakes -See Chapter XII! of this Handbook]
CHAPTER-II

OVERVIEW OF AUDIT IN I.T. DEPARTMENT
(With reference to the CBDT Instructions & with Flow Charts)

1. Internal Audit was introduced in 1954

2. Scope of duties of Internal Audit were made co-extensive with statutory Audit after audit of Receipts introduced by Comptroller & Auditor General of India in the year 1960.

3. The three fold objectives were laid down by the Central Board of Direct Taxes in the Year 1972
   (i) To have a preventive and reforming effect in direction of avoiding mistakes.
   (ii) To play the corrective role by pointing out mistakes and ensuring remedies without loss of time.
   (iii) To improve quality of assessments so as to reduce the criticism of the working of department by statutory audit and the Public Accounts Committee.

4. Types of Mistakes- Committed by the AOs
   1. Legal Mistakes.
   2. Arithmetical Mistakes
   3. Mistakes offacts
   4. General Mistakes

5. Organizational Set up:

   ![Organization Chart]

Compiled for DTRTI, Chandigarh’s Workshop on Audit; 22nd and 23rd November 2010 at Delhi and Chandigarh
Posts of 22 - CIT (Audit), 22 Addl. CIT (Audit), 22 DCIT/ACIT SAPs & 88 IAPs as per CBDT Instruction No. 03/2007 were created.

There were a number of old instructions on Audit in the Income-tax Department and after the scrapping of chain audit, the structure of Audit has gone through a change. The introduction of Instruction No. 09 of 2006 did. 21-11-2006 - w e f 01-12-2006 and introduction of Instruction No. 03 of 2007 on Internal Audit dtd 17-04-2007 we .f 01.06.2007 a number of difficulties faced by the officers /staff of the department are sought to be addressed by the Central Board of Direct Taxes. Earlier Instructions issued by CBDT/DIT (Audit) which have been since been superseded are given at the end of this chapter.

The salient features of the changes brought about by the two instructions as referred to the above are discussed as under:-

A. Receipt Audit -

(See Instruction No. 09 of 2006 as Annexure of this handbook in detail)

(i) The receipt audit done by the C & AG has undergone changes by introduction of System Review of the cases in different types of businesses, professions, industries and trades. Focus of receipt audit has, now shifted from individual cases to block of cases under particular provisions of the Income-tax Act, 1961. Accordingly changes have been brought about by the CBDT in the Instructions issued. Now, replies are to be sent by the CCIT (CCA) office to CBDT and role of CIT (Audit) has become very important as he assists the CCIT (CCA) and also coordinates with the concerned CCIT/ DG and jurisdictional administrative CIT. The time limits of sending report from the initial level of AO to the CCIT (CCA) have now been fixed in cases of LAR's and Draft Para Reports to the office of Accountant General of the State.

(ii) In Half Margin Cases reply should be given by the AO within 3 days accepting or not accepting the audit observation.

(iii) On Local Audit Report (LAR) - Part - I Part -II- Reply should reach from AO through Addl./JCIT within 30 days. Addl./JCIT must send reply within a fortnight to CIT. Therefore, time available with AO is only for 15 days. In cases where the tax' effect involved is Rs 1,00,000 and above in IT/CT cases and Rs. 30,000 and more in other taxes cases, the appropriate remedial action must be taken within one month. The AOs must be prompt in sending replies.

(iv) On Local Audit Report (LAR)-Part-III-A.0. may not reply but appropriate remedial action should be taken within three months. The AOs must immediately start the process of collecting records & taking steps for remedial action.

(v) On Statement of Fact (SOF), the reply from CIT from should reach the AG within 15 days.
(vi) If AG Office intimate about proposed Draft Para, the reply must be immediately sent

(vii) In DP cases, Proforma Reports in Part A and Part B has to reach C & AG within 4 weeks to CIT; Therefore, AOs should not wait for last days and must send their reply within a week preferably.

(a) The AO’s should follow instruction No. 09/2006 on Receipt /Revenue Audit of CBDT

The AO's should follow Instruction No. 9/2006 of Receipt /Revenue Audit of CBDT in the manner, the salient features of the same are detailed below:

(i) Reasons for not providing relevant records to the RAP have to be given to them in writing. Failure to do so may attract action against the defaulter officer/staff.

(ii) Prescribed registers be maintained accurately.

(iii) Reply is to be filed within three days of receiving half margin note clearly indicating agreement/disagreement with the objection.

(iv) The AO is to send report regarding part-I & II within 30 days of receipt of LAR and to take appropriate action regarding part-II within 3 months. The Addl. CIT will forward the report to CIT within a fortnight with comments.

(v) Addl. CIT to order remedial action to A.O. within a month of receipt of LAR cases where revenue involved is less that Rs. 1,00,000/- in I.T./C.T cases or less than Rs. 30,000/- in order cases after carefully considering remedial action u/s' 154/147/263 in view of the legal provisions and sustainability in appeal.

(vi) Whether or not the audit objection is accepted remedial action should be taken within 2 months of receipt of LAR, as a precautionary measure.

Remedial action should invariably be initiated where:-

(a) Audit's interpretation of law/fact is conflicts with that of a non jurisdictional High Court.

(b) There are conflicting decisions of High Court (other than jurisdictional High Court)

(c) There is no decision of any High Court on the matter involving interpretation of statute.

To drop remedial action intimated as above, Board's prior approval is necessary.

Therefore, the AOs should identify such cases at the earliest possible so that time taken at the level of higher authorities is available to them sufficiently.

(vii) Remedial action should also invariably be initiated where an assessment u/s 143(2) was made and the audit objection could not have been considered under the provisions of section 143(1)

(viii) Remedial action need not be initiated where CPI’ is of the view that:-

a) Audit’s interpretations conflicts with Supreme Court decision.

b) Audit’s interpretations conflicts with jurisdictional- High Court’s decision

c) A.O. acted in conformity with Board’s circular /instruction

d) Audit objection is factually incorrect


In case defaults accountability must be fixed and action be taken against defaulting /erring Officers and staff.
Some of earlier Instructions have been superseded by Instruction No. 09 of 2006. Brief details of such Instructions are given in Annexure-S of this Handbook for ready reference. ‘Performance Audit’ of Union of India made by the C & AG is the System Review and other cases of audit observations of C & AG are published every year which have to be replied.[Briefs of the same are given from the year 2002 to 2008 are given in chapter VIII of this Handbook and for details please see the Reference material on, CD enclosed with this Handbook].

The CCsIT (CCA) CITs are required to give replies not only in illustrative cases but also on the key cases. Where details of key of cases are not available, the AOs/Addl CITs /Officers in the office of the CCII (CCA)ICITs dealing with Audit should immediately contact the concerned AGIDAG of the State. The details of the C & AG reports from 2002 to 2008 can also be uploaded from C & AG website www.cag.gov.in. The manner in which replies to Half- Margin Notes, LARs and draft para reports are to be sent to AG are given in Flow Chart at the end of chapter and Frequently Asked Questions in Chapter-VII to this Handbook

(11). The CBDT Central Action Plan 2008-09 for Audit is as under:-

<table>
<thead>
<tr>
<th>SL. No.</th>
<th>Key Result</th>
<th>Target</th>
</tr>
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<tr>
<td>1.</td>
<td>Disposal of Audit Objections</td>
<td>The targets for settlements of Receipt Audit Objections are as under:</td>
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<tr>
<td>A.</td>
<td>Proforma replies to draft Audit paras</td>
<td>A. 100% by 31.12.08</td>
</tr>
<tr>
<td>B.</td>
<td>Receipt Audit Major Objections (Arrear)</td>
<td>B. 90% of pendency</td>
</tr>
<tr>
<td>C.</td>
<td>Receipt Audit Major Objections (Current)</td>
<td>C. 80% of pendency</td>
</tr>
<tr>
<td>D.</td>
<td>Receipt Audit Minor objections (Arrear &amp; Current)</td>
<td>D. 100% of pendency</td>
</tr>
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**B. Internal Audit**

The Internal Audit set up has undergone changes after the issue of CBDT Instruction no. 03 of 2007. Salient features are given as under :-

1. The CBDT vide Instruction No. 03 of 2007 has scrapped the chain Audit System involving audit by assessing officers.
2. Quality Audit introduced in the year 2005 has also been scrapped.
3. Now, newly sanctioned posts of 22 CITs (Audit), 22 Addl. CsIT (Audit), 22 Dy/ACIT (SAP), 88 ITOs, 176 ITIs, 66 PAs/Stenographer, 176 Sr. TAs/TAs have created for the Internal Audit wing throughout the country. Now, Special pay is to be given to the auditing staff posted in audit wing and normal tenure will be of two years.
4. In the new field organizational set up of Internal Audit, there are two CsIT (Audit) at Metros in Mumbai, Delhi, Chennai and Kolkata. under respective CCsIT (CCA) and there is only one CIT (Audit) at Non-Metro Stations under CCIT (CCA). New set ups are given as under:-

Compiled for DTRTI, Chandigarh’s Workshop on Audit ; 22rd and 23rd November 2010 at Delhi and Chandigarh
INTERNAL AUDIT SETUP - METRO

CCIT (CCA)

CCIT CCA

CIT (Audit)-I
(PA/STENOGRAPHER-I)

CIT (Audit)-II
(PA/STENOGRAPHER-II)

ADDITIONAL CIT (AUDIT)
(PA/STENOGRAPHER-I)

ADDITIONAL CIT (AUDIT)
(PA/STENOGRAPHER-I)

SAP-I

SAP II (ONLY DELHI/MUMBAI IAP(HQ))

IAP-IAP-2

IAP-M

INTERNAL AUDIT SETUP - NON METRO

CCIT (CCA)

CIT (AUDIT)
(PA/STENOGRAPHER-I)

ADDITIONAL CIT (AUDIT)
(PA/STENOGRAPHER-I)

SAP

IAP(HQ)

IAP-I

IAP-2

IAP-X

(Excep't:
GUWAHATI,
NAGPUR,
LUCKNOW
AND KOCHI)
(5) The norms for selection of auditable cases and number of cases to be audited by Addl. CIT JCIT(Audit), SAPs headed by DC/ACIT(Audit) /IAPs headed by ITO for corporate and non-corporate cases have been fixed.

(6) Now, other Metros (apart from Delhi and Mumbai) include Chennai, Kolkata Banglore, Ahmedabad, Pune and Hyderabad for the purpose of Selection Norms of Auditable Cases.

(7) The SAPs have not been given to CCIT (CCA), Guwahati, Nagpur, Lucknow and Kochi Regions.

(8) For TAP (Central), TAP will audit cases in Central charges not taken up by Addl. CIT (Audit) and SAP (Audit).

(9) The responsibilities and roles are now fixed at different levels from AOs to CCIT (CCA) and DI (Audit) for dealing with the Internal Audit.

10. Targets laid down for number of auditable cases for each audit unit are as under:

**Targets-Auditable cases have been laid down**

<table>
<thead>
<tr>
<th>Workload</th>
<th>Description</th>
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<tr>
<td>Addl. CIT-50</td>
<td>The CCIT (CCA) and CsIT (Audit) shall draw</td>
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<td>IAP-600 (corporate cases)</td>
<td>Action Plan for the year taking into account</td>
</tr>
<tr>
<td>-700 (Non-corporate cases)</td>
<td>Case selected by the CCIT and depending up the manpower available</td>
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</table>

11. The distribution of newly sanctioned ITOs, ITIs and Sr.TAs/TAs at the headquarters of CIT (Audit) shall be as under:

<table>
<thead>
<tr>
<th>Sl.No.</th>
<th>Designation</th>
<th>ITO’s</th>
<th>ITIs</th>
<th>PA/Steno</th>
<th>Sr. TAs/TAs</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>CIT (Audit)</td>
<td>2</td>
<td>2</td>
<td>1</td>
<td>4</td>
</tr>
<tr>
<td>2</td>
<td>Addl. CIT (Audit)</td>
<td>1</td>
<td>2</td>
<td>1</td>
<td>2</td>
</tr>
<tr>
<td>3</td>
<td>Dy. Asst. CIT (SAP)</td>
<td>Nil</td>
<td>2</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>4</td>
<td>ITOs (IAP)</td>
<td>1</td>
<td>2</td>
<td>-</td>
<td>1</td>
</tr>
</tbody>
</table>

The distribution of posts of officers and staff, station wise Special Audit Parties / Internal Audit Parties have been given in detail in Instruction No.03/2007

12. Norms for Selection of Auditable Cases-Norm of auditable cases have been separately fixed for corporate and non-corporate cases

(A) For Additional CIT/Joint CIT (Audit)
The accounts fixed for different categories vary from 25 Lakhs to 25 crores. [For details see Para III- (A) to D - Ins. No. 03 of 2007-ANNEXIJRE-3 to this Handbook]

13. Roles of various authorities have now been fixed. The role of CCIT (CCA) have been increased and each of the officer, has to ensure timely compliance from the officers under them. Though separate responsibilities have been fixed but the combined effect is to

(i) To ensure settlement of audit objections at the earliest possible.
(ii) To ensure that remedial action is taken within the time limits prescribed
(iii) To maintain accountability at different levels from staff to CIT level

**Salient features of Role of DIT(Audit)**

- To Monitor the functioning of Internal Audit and settlement of their objections
- To carry out Inspection of Internal Audit work of CCIT (CCA) with the approval of DGIT (Admn.)
- To co-ordinate with CIT(Audit) under CCIT (CCA) & administration CIT regarding maintenance of various registers ledgers cases
- Submission of Annual Report to CBDT
- To monitor the settlement of major Internal Audit objections
- Collection and collection of information regarding critical areas where mistakes have been deleted by Internal Audit & Revenue Audit
- To monitor implementation of Instructions of the CBDT.

**Role of authorities in Field Stations**

(a) Role CCIT (CCA)- Salient features

- To review the performance of Internal Audit wing quarterly.
- To monitoring functioning and performance of Internal Audit wing under CIT (Audit)
- To provide requisite infrastructure to officers and staff to Internal Audit wing.
- To co-orderate for training imparted to officers and staff in Internal Audit wing with NADT/RTIIMSTUs To provide updated material on case laws, circulars etc to CIT (Audit), Ranges and AOs
- To ensure that norms or targets, laid down are followed for Internal & Receipt audit.
- To ensure that necessary reports or statistics are sent to Board / Directorates.

(b) Role of CCIT (having administrative control over CIT/DIT) -Salient features

- To exercise authority to decide difference of opinion is between concerned CIT (Admn.)
and
CIT (Audit) in cases under his charge where audit objection has been raised whether an
audit objection raised by an LAP is to be accepted or not

(c) Role of CIT (Audit)-Salient features

- To hold jurisdiction for Internal Audit - cases assessed under CsIT assigned to him
- To hold Administrative control over Addl. CsIT (Audit), SAPS & IAPs
- To regularly review the work of LAPs & SAPs
- To co-ordinate with Administrative CCsIT/DGsIT and CsITIDsIT

(a) for preparation of lists of auditable cases
(b) Timely production of records/ reports to Internal /Receipt Audit teams within scheduled link
(c) Smooth conduct of audit
(d) Settlement of Internal as well as receipt audit objections
(e) Action to be taken against officers /staff in respect of Internal Audit

Other functions of CIT

- Maintenance of ledger cards and register in receipt of Internal receipt audit.
- Draw action plan for Internal Audit for the year in consultation with CCIT/DGI- with to approval of
  the CCIT (CCA completion of Internal Audit completed with 30 days
- Prepare and send necessary reports and statistics to Board, Directorates and AGs.
- Settle with Administrative CIT concerned

(a) Upto Rs. 1,00,000 in IT/CT cases
(b) Upto Rs. 30,000 in other direct taxes cases
(c) Also ensure that Addl. CIT (Audit) settled IAP cases involving tax effect below / above
  limits within 4 months of sending Audit memos to CsIT.

(d) Role of Addl./J.CIT (Audit)
To ensure settlement of IAP cases involving tax effect below /above limits within 4 months of sending Audit
memos to CsIT/Addl./Jt. CIT i.e.

(a) Below Rs. 1,00,000 in I.T./C.T. Cases.
(b) Below Rs. 30,000 in other Direct Taxes Cases.

(e) Role of administrative CsJT/DsIT ; The administrative CsIT /DsIT shall:

(i) To extend all cooperation to the CIT(Audit) for preparation of the list of auditable cases, production
    of records / registers to the Internal Audit within the scheduled time frame, conduct of audit by the
    Internal Audit and settlement of internals as well as Receipt of internal audit;
(ii) To ensure maintenance of ledger Cards and the Registers, manual as well as in electronic media,
     as per guidelines given in the Internal Audit Manual, 200’, as amended from time to time;
(iii) To prepare and send the necessary reports and statistics to the CIT(Audit);
(iv) To ensure that the list of auditable cases (category wise) of a particulars month are sent to the
CIT(Audit) concerned by the 10th of the following month:

(v) To ensure that the relevant records / registers are produced before the Internal Audit along with the list of auditable cases, and wherever records etc are not given to Internal Audit without adequate reasons, to watch that suitable action against the officers / staff concerned under intimation to the CIT(Audit);

(vi) To ensure that the internal audit objections are examined in accordance with parameters laid down in paras V and VI of Instruction No 3/2007, and that remedial action in accepted cases are initiated accordingly within a month of the receipt of the internal audit memos:

(vii) To ensure that acceptance / non-acceptance of the internal audit objection is done with appropriate reasons and the details of remedial action initiated in accepted cases, is communicated to the CIT(Audit) within 3 months of receipt of the internal audit memos;

(viii) To settle, with the CIT(Audit) concerned, the major internal audit objections having tax effect above Rs 1,00,000/- and Rs.30,000/- in Other Taxes, and ensure that the Addl/Jt. CIT Range settles the internal audit objections involving tax effect below these limits with the Addl.CIT (Audit), within 4 months of the receipt of the Internal Audit memos:

(ix) In a case where there is dispute between the administrative CIT and the CIT (Audit) with regards to the settlement of the internal audit objection, and t or the remedial action taken, the administrative CIT shall report the matter, with full facts and reasons, to his / her jurisdictional CCITs, who shall take up the matter with the CIT (Audit), and the decision of the CCIT shall be final.

(f) Role of Addl. CsIT/JCsIT (Assessment Range): The Addl./Jt.CsIT (Assessment Range)

(i) To ensure that remedial action is taken within the prescribed time limits, and shall facilitate prompt recovery of tax;

(ii) To ensure that records requisitioned by the IAP/SAP are made available expeditiously;

(iii) To ensure that the AOs maintain the relevant records and registers with regards to Internal/Receipt audit objections;

(iv) To ensure timely submission of reports relevant to the Audit set up;

(v) To ensure that cases selected for internal audit are audited by Internal audit before relevant case records are given to Receipt Audit;

(i) To conduct Seminars / Workshops every year for the officers / staff posted in the Internal Audit Wing in co-ordination with the CCs(CCA) / CsIT(Audit), and ensure that similar training programmes are organized by the CCs(CCA)/1 Cs1T (Audit) every year;

(ii) To devise necessary reporting mechanism, and to prescribe the forms and register in consultation with DIT (System) and DOMS;

(iii) To prepare Annual Report of Internal Audit Functions of the Departments, incorporating the highlights gathered through Inspections and Performance Audit, and submit the Annual Report to the Board by 30" June every year.

(g) The AO 's should follow instruction No. 0312007 on Internal Audit o CBDT

The AO's should follow Instruction No.03/2007 of Receipt /Revenue Audit of CBDT in the manner, the
salient features of the same are detailed below:-

1. That relevant record to the LAP/SAP is made available expeditiously.
2. The prescribed registers are maintained accurately.
3. Remedial action is taken within prescribed limits.
4. The AO is to send report regarding timely submission of reports to the Addl.CIT.
5. To expeditiously send reports for taking remedial action within a month of receipt of audit objection, where revenue involved is more than Rs. 1,00,000/- in T.T./C.T cases or less than Rs. 30,000/- in order cases after carefully considering remedial action u/s 154/147/263 in view of the legal provisions and sustainability in appeal whenever called for.

6. Remedial action should invariably be initiated where:-
   (a) Audit's interpretation of law/fact is conflicts with that of a non-jurisdictional High Court.
   (b) There are conflicting decisions of High Court (other than jurisdictional High Court)
   (c) There is no decision of any High Court on the matter involving interpretation of statute

To drop remedial action intimated as above, higher authorities prior approval is necessary. Therefore, the AOs should identify such cases-at the earliest possible so that time taken at various higher authorities levels is sufficient available to them.

The details of the Roles of various authorities can be referred to Annexure -3 of Handbook.

1. Role of CCIT (CCA) [Para IV 1 Annexure -3 of this Handbook]
2. Role of Jurisdiction CCIT/DGIT [Para IV-2 Annexure -3 of this Handbook]
3. Role of CsIT (Audit) [Para IV -3 Annexure -3 of this Handbook]
4. Role of Administrative CsIT/DsIT [Para IV -4 Annexure -3 of this Handbook]
5. Role of Addl. CsIT (Audit) [Para IV -5 Annexure -3 of this Handbook]
6. Role of Addl. CsIT/JCsIT (Assessment Range) [Para IV -6 Annexure -3 of this Handbook]
7. Role of DIT (Audit) [Para IV-7 Annexure -3 of this Handbook]

14. Timely and appropriate action on remedial action on the internal audit objection

(i) in respect of audit objections involving revenue of Rs.1, 00,000/- or more in Income Tax/Corporate Tax cases and Rs.30, 00/- or other Direct Taxes cases, the Commissioners concerned shall be personally responsible for careful examination of such objections and issues of instructions to the AOs on the appropriate remedial action to be taken within a month of the receipt of Internal Audit objection memo.
(ii) in respect of audit objections involving revenue below the limits Prescribed in (i) above, the Commissioners should ensure that the Addl. / A. CsIT Ranges issue similar instructions to the AOs within said period of one month; and,
(iii) the choice of such remedial action, whether under 154 or 147 or 263, should be carefully
considered in the light of existing legal provisions and its sustainability in appeal.

15. Remedial action:

(i) An Audit objection should be accepted and remedial action should be taken in a case where the audit objection relating to an error of facts or an issue of law is found to be correct;

(ii) Even if objection is not accepted by the CIT, remedial action should be initiated, as a precautionary measure, in respect of such audit objections pending final settlement with the CIT(Audit) / the decision of the CCIT concerned, except where,

(a) the CIT of the view that the interpretation of fact or law by the Internal Audit is in conflict with a decision of the Supreme Court and the decision squarely applies to the facts of the case, or,

(b) the CIT of the view that the interpretation of fact or law by the Internal Audit is in conflict with a decision of jurisdictional High Court, which is squarely applicable to the facts of the case and the operation of which has not been stayed by the Supreme Court, or

(c) the CIT is of the view that the Assessing Officer has acted in conformity with Board's Instructions / Circular, or

(d) the audit objection raised is on facts, and CIT, after necessary verification, is of the opinion that the audit objection is factually incorrect.

(iii) Appropriate remedial action should invariably be initiated within one month of the receipt of the internal audit memo except for in circumstances mentioned in sub-paras (ii) a, b, c, & d above.

16. Calling of Explanation & Action thereon:

Explanation of the office and staff concerned should be invariably be obtained where the Internal Audit objection, involving revenue of Rs. 1,00,000/- or more in Income Tax / Corporate Tax and Rs. 30,000/- or more in other Direct Taxes, have been accepted, or the mistakes, inter alia, arise from any one more or more of the following reasons:

- failure to follow departmental instructions / circulars;
- failure to follow binding judicial decision; and;

Where palpable mistake on fact or law, or mistake arising from gross negligence or malafide action; explanation of the officer and staff concerned should be obtained, in a case of default in adhering to the time limit prescribed or other defaults in complying with requirements mentioned in para 17 Where failure to take timely and appropriate remedial action in respect of objections raised by Internal Audit leads to irretrievable loss of revenue.

17. Accountability. Further, in cases of objections involving arithmetical inaccuracy in calculation or computation, the accountability of the dealing staff, besides that of the assessing officer, cannot be overemphasized. Hence, if the mistake is, inter alia, on account of any one or more of the following reasons, the explanation of the staff responsible for the mistake should invariably be obtained,

- Where an issue is considered / discussed in the body of assessment order, and necessary addition on the issue is directed to be made, or where a deduction is directed to be allowed by the assessing officer, but such directions are not taken into account at the time of calculation of tax, interest and surcharge;
- Where there is totaling mistake in the computation of income;
- Where an income disclosed in the return is not included in the computation in the assessment order, except where the assessing officer has discussed in the body of assessment order and directed not to include it;
- Where there is wrong calculation of tax including application of wrong rate of tax;
- Where there is wrong calculation of including application of wrong rate of interest or wrong calculation of period for which interest is leviable;
- Where any income is added in the computation of income more than once;
- Where wrong set off brought forward losses, unabsorbed depreciate, loss on long/short term capital gain etc. in the scrutiny 1 search assessment, not commented by the assessing officer in the assessment order, has been allowed;
- Where wrong verification of, or failure to verify the arrear demand before the issue of refund results in wrongful issue of refund;
- Where credit of pre-paid taxes is wrongly allowed;
MAINTENANCE OF LEDGER CARD

The proper maintenance of Ledger Card is an essential step to enforce accountability of both the Assessing Officer and the Auditing Officer. It is also necessary in order to reverse the existing trend of increase in the detection of major irregularities by the C&AG and Internal Audit Parties from year to year. Ledger Cards will be maintained in respect of both Internal as well as Receipt audit where objections have been accepted by the Department.

Further, Ledger Card will be maintained in cases where objections have been accepted by the Department. It will be maintained in respect of both Internal as well as Receipt Audit Objections accepted by the Department. Ledger Cards will be maintained in respect of both the Assessing Officer and Auditing Officer who failed to detect the mistakes point out by the Receipt Audit. **Now, it is essential to maintain Ledger Cards in such cases, where the tax effect involved is above Rs. One lac in Income-tax/corporate tax cases and where the tax effect involved is above Rs. Twenty thousand in other Direct Tax cases. The Ledger Cards will be maintained in the office of the CIT (Audit) as well as in fice of Administrative CIT in fice formats Riven in the Annexure -- I and Annexure - II**

Annexure - I (Chapter IV of the Hand Book)

**RECORD OF MISTAKES I MAINTENANCE OF LEDGER CARD**

*(to be maintained in the CIT Office)*

**Applicable to all Assessing Officers i.e the Auditee Officers**

<table>
<thead>
<tr>
<th>Sl.No.</th>
<th>LAR No. &amp; Date</th>
<th>Para No.</th>
<th>Internal Audit Objection No. &amp; Date</th>
<th>Gist of Objection</th>
<th>Tax effect (in Rs. Lakhs)</th>
<th>Remedial action taken u/s 147/154/263</th>
<th>Official's explanation if called for</th>
<th>Remarks</th>
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<td>1</td>
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Compiled for DTRTI, Chandigarh’s Workshop on Audit ; 22nd and 23rd November 2010 at Delhi and Chandigarh
### Annexure-II (Chapter IV of the Hand Book)

#### RECORD OF MISTAKES / MAINTENANCE OF LEDGER CARD

*(to be maintained in the CIT Office)*

**Applicable to all the Auditing Officers including Addl. CIT/JCIT Ranges**

Name of the Official / Officer :  
Designation :  
CIT Charge :  
CCIT Region :  
S.No. of the AO in the Seniority list :  
Date of Birth of the AO :  

<table>
<thead>
<tr>
<th>Sl.No.</th>
<th>LAR No. &amp; Date</th>
<th>Para No.</th>
<th>Internal Audit Objection No. &amp; Date</th>
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**Note:**

[]Ledger Cards given in Internal Audit Manual -2003 is as per Para 4(ii) of Instruction No 03 of 2007] FLOW CHARTS are given on next page.
FLOW CHART FOR DEALING WITH HALF MARGIN NOTES, L.A.Rs, SOFs AND DRAFT PARAS

**RAP- Audit Memo – Half Margin Note**

Any Irregularity or Mistake in Individual Cases

- Including Cases where the Validity of Objection needs future consideration

- AO- Agrees with Audit Memo or Not must reply

  Within three days of date of its receipt reply must be given

**Local Audit Report (LAR)**

- DAG

- A.O must reply on

  AO- Part- I (Introductory and Outstanding objections of the previous report) - Copy to CIT

  +

  AO- Part-II (Major irregularities and Important Points)

- AO shall send report (excepting Part-III) To CTT through Addl/Jt.CIT-Range within 30 days of Receipt of LAR

- AO has to take

  Appropriate remedial action

  must be taken by AO within three months.
AO’s report on Part-I & Part II of LAR

Jt/ Addl. CIT after examination of AO’s Comments

within a fortnight → sent a reply to CIT

Decision is taken by CIT - App. Reply to AG/DAG within fortnight

Statements of facts-SOF

AG does not accept the views of CIT on LAR or

AG is not prepared to drop - Audit Objection.

AG Conveys its view to CIT

Through Statements of FACT (SOF)

On AGs SOF - CIT should send appropriate reply to AG

Within a fortnight of the receipt of "SOF"
DRAFT PARA REPORT

ON " SOF"

AG

Does not accept the views of CIT or is not prepared to drop the audit Objection

Audit Objection is converted into

"Draft Para" - Proposed to be included in the "Audit Report" of the C & AG of India

CIT should send Report Also DIT (AUDIT)

Through CCIT in Proforma of one copy of Proforma Report ATN (Action Take Notes)

Board should send Report Within Six weeks (Scheduled) (Acceptance or Non Acceptance)

To C & AG of India

Endorsing a copy to CCIT/CIT! DIT (Audit)
After `Audit Report' presented to the parliament

DIT (Audit) gives concluding shape to the ATNS on Audit Paras
(Performance Audit) included in Audit Report now
Renumbered as, 7 or 8 from 2006
{Earlier Audit Report No. 12, 12A or 13}

DGIT (Adorn.)

CBDT
(After vetting and consideration in the Board

TO
C & AG of India
FLOW CHART AND TIME LIMITS FOR DEALING WITH INTERNAL AUDIT OBJECTIONS

I- INTERNAL AUDIT OF A PARTICULAR MONTH

CIT (Admn) to ensure that the list of auditable cases (category wise) of a particular month are sent to CIT (Audit) concerned by 10th of the following month. Auditors after audit must

Hand over Records/ Registers and the list of the audited cases to Addl./ Jt CIT Range (Assessment) or AO as the case may be

TIME PERIOD - within one week of audit of cases.

II- AUDIT OBJECTION MEMOS ARE SENT

ACTION - CIT (Admn) - ensure that internal audit objections are examined in accordance with parameters laid down in Para V & VI of Inst. No. 03 of 2007 by the Addl/ Jt CIT Range/ AO
Overview of Audit in I.T. Department

III- REMEDIAL ACTION
(Acceptance or non-acceptance of Internal Audit objection)

Remedial action must be taken within one month of receipt of Audit Objection Memo.

Where revenue involved in Income tax/corporate tax cases is more than Rs. 1,00,000/- and/or more than Rs. 30,000 in other Direct Tax cases.

To be ensured by the CIT (Admn.)

Where revenue involved in Income tax/corporate tax cases is less than Rs. 1,00,000/- and/or less than Rs. 30,000 in other Direct Tax cases.

To be ensured by the Addi/Jt CIT (Range)

IV- Other Important points for settlement of Internal Audit objections

1- Choice of remedial action
U/s 154 or 147 or 263 be carefully examined in the light of its sustainability in appeal
Remedial action must be taken within 4 months of receipt of Audit memo to CIT

2- Where audit objection of IAP related to an error of facts or an issue of law is found to be correct
Remedial action must be taken within one month of receipt of audit memo.

3- Remedial action must be taken as a precautionary measure

Even if objection is not accepted by the CIT

Even if Audit objection is pending final settlement with CIT (Audit)/CCIT concerned - decision is pending
4-

**Exceptions**

Where the CIT is of the view that the interpretation of fact or law by internal Audit

- Is in conflict with a decision of Supreme Court & High Court & decision squarely applies to the facts of the case and operation of which has not been stayed by the Supreme Court, or
- Is in conflict with a decision of Jurisdictional decision squarely applies to the facts of the case.
- The CIT is of the view that the Assessing Officer has acted in conformity with the Board’s Instructions/ Circular, or
- The audit objection raised is on facts, and CIT, after necessary verification, is of the opinion that the audit objection is factually incorrect.

**Settlement of Internal audit objection must be done within four month of sending audit memo to CIT.**
CHAPTER III
How To Deal With Internal Audit Objections

There are six authorities as per Instruction No 03 of 2007 in hierarchy, who in Internal Audit set up are dealt by the assessing officer.

Assessing Officer to Co-ordinate with

- CIT (Admn)
- CIT (Audit)
- Addl./Jt CIT (Audit)
- Range or DC (SAP)
- or ITO (IAP)
- IAP (ITI) etc.

Assessing Officer to deal with Corporate and Non-corporate cases

- Pending arrear
- Major Audit
- Minor Audit
- Objections

- Pending arrear
- Major Audit
- Objections

- Pending Current
- Major Audit
- Objections

- Pending Current
- Minor Audit
- Objections

- Current Cases

Internal audit matters are now settled by CIT (Audit), Addl./Jt CTT (AUDIT) and CIT (Admn) & Range Addl./Jt CIT offices with almost similar lines as in case of Receipt Audit Objections. But, the responsibilities and roles has been laid down separately by CBDT Instruction No 03/2007 as discussed in Chapter 4 Chapter 5 of the handbook. Functioning of these functionaries is illustrated as under:-

i. **CIT Audit office under CCIT CCA deals with**

Major Internal audit Objections arrear and Current where the tax effect is Rs 1,00,000/- & above in Income-tax and Corporate tax cases and Rs 30,000/- & above in Other Taxes cases.
ii  
**CIT (Audit) office Co-ordinates with**

- CCIT (CCA)
- DI(Audit)
- CIT(Admn)

iii  
**CIT (Admn) office deals with**

Major Internal audit Objections arrear and Current where the tax effect is Rs 1,00,000/- and above in
Income-tax and Corporate tax cases and Rs 30,000/- in Other Taxes cases

- Pending arrear
- Pending Current
- Major Audit Objections
- Major Audit Objections

iv.  
**CIT (Admn) Co-ordinates with**

- DI (Audit) Range
- CCIT (CCA)
- CIT (Audit)
- Addl. Jt. CIT

V.  
**Addl./Jt. CIT (Audit)) in coordination with**

**CIT(Audit) deals with**

Major Internal audit Objections arrear and Current where the tax effect is less than Rs 1,00,000/- in Income-tax and Corporate tax cases and less than Rs 30,000/- in Other Taxes cases

vi  
**Addl./Jt CIT Range in co-ordination with**

**CIT(Admn) deals with**

Major Internal audit Objections arrear and Current where the tax effect is less than Rs 1,00,000/- in Income-tax and Corporate tax cases and less than Rs 30,000/- in Other Taxes cases
2. **Suggested tips to liquidate pendency of Internal Audit Objections for the staff and officials working in audit**

   In CIT(Audit)/CIT(Admn) office verification of pendency and sorting out cases relating to pending audit objections which are likely to be settled be taken up on priority (Corporate and Non-corporate cases)

   In Addl/JtCIT(Audit)/Addl/JtCIT, range office verification of pendency and sorting out cases relating audit objections which are likely to be settled early be done to speed up reduction;

   AOs should also conduct the similar exercise.

   Cases which are likely to be struck off be separated category wise in Major Audit Objection Cases and Minor Audit Objection Cases.

   Only then, Minor Audit Objection cases shall be taken up. But where the limitation is involved with the Ranges and AOs, these cases must be taken on priority. Thereafter; other pending cases shall be taken up to meet action plan targets of audit.

   Replies sent to the higher authorities must clearly state whether the objection is accepted/acceptable or not. In case of vague replies received, where the time period is short records from the AOs may be directly called for.

   Detailed reply must be given with reasons where objection is not acceptable For support enclosures of documents filed by the assessee and other supporting case laws and CBDT Circulars may also be enclosed.

   Targets be completed as per action plan or as fixed by the CCIT (CCA) must be strictly adhered with.

   Action for the recovery of taxes after taking remedial action by the AOs shall also be watched.

3. **Other important points for dealing with Internal Audit Objections:**

   Internal Audit organization serves two purposes. Firstly, it has a deterrent and reforming effect in the direction of prevention of mistakes, and secondly, it serves a corrective role by putting a check on the mistakes and having them remedied without loss of time. It was also expected to improve the quality of our assessments and thus substantially reducing, if not eliminating, criticism in the hands of Receipt Audit.

   The Field officers are expected to send the lists of auditable cases divided into the categories of Corporate and Non Corporate cases to the Internal Audit Party every month. In addition, the Internal Auditing Officers are also supposed to go through the Demand & Collection Registers and note down the cases requiring checking immediately. Recently, the CBDT have decided that irrespective of the total income assessed, cases completed under Summary Assessment Scheme under AST may not to be included in the lists of auditable cases Now, there are three categories of auditable cases at audit parties at the level of Addl/Jt CIT (Audit), DCJACIT.
3. The procedure for dealing with Internal objections is on the same lines as for Receipt Audit Objections. As soon as an objection has been raised, the member of the Audit Party has to bring it to the notice of the officer concerned, who has to go through it and give his comments at Half Margin stage itself. After discussion, if there is no agreement between the Audit Party and the Assessing Officer, the Audit Party forwards the objection to the Addl/JtCIT (Audit), the C1T(Audit) through DCIT/ACIT (SAP)Income-tax Officer (Internal Audit), who is required to vet the objection and then send the Internal Audit Report for the month to the AO for his final comments. However, for paucity of time and particularly in mofussil charges, it is not possible to have this vetting and the objections are passed on to the officers as they have been received from the party. At the headquarters of the CIT (Audit)/CIT, objections are bifurcated into different categories of Major and Minor objections keeping in view the tax effect pointed out by the Audit. Cases having effect of more than revenue of Rs. 1, 00,000/- in Income-tax Corporate tax and Rs. 30,000/- in other direct taxes are classified as major and other as minor. The Assessing Officer is expected to send reply to the said audit objection within a period of 30 days to the Addl/JtCIT(Audit), the DCIT/ACIT(SAP) Income-tax Officer (Internal Audit) in the office of CIT (Audit) & CIT (Administration) respectively, where the reply of the AO is processed. Where the AO accepts the audit objection, the mistake has to be rectified within a period of 30 days. In case of any disagreement between the Internal Audit and the Field officer, the objection is further processed by CIT(Admn)/CIT(Audit) and where the revenue effect is more than 1, 00,000/- in IT/CT cases & Rs. 30,000/- in Other direct tax cases, it is placed before the CCIT(CCA) in case of difference of opinion for final settlement.

4. The Range Officers and Assessing Officer should now be more actively associated with the settlement of the objections particularly because the Instructions for remedial action in case involving revenue effect of less than Rs. 1, 00,000/- in income tax/CT cases and less than Rs. 30,000/- in other taxes have to be taken on directions of Addl/JtCIT (Audit) and where the tax effect is as given above, in such cases reports have to be sent to CIT (Audit).

Responsibility on AOs and their Staff has also been fixed in certain circumstances as given in the Instruction No 03/2007 and also enumerated in Annexure -3 (in Para 17 of II-Internal Audit) enclosed to this Handbook.

5. When a mistake pointed out by Audit is accepted as correct, remedial action for rectification can be taken under any of the following sections:-Section 154/155 Section 1, r147 and Section 263 of the Income-Tax Act 1961. The section u/s 154 or 155 can be applied in the cases where mistake pointed out...
out by the Audit is apparent from record. Under this category, cases can be covered for mistakes in calculation of tax, like applying wrong rates, allowing basic exemption twice or when it is not due. Where there is any doubt or the point is debatable, it is advisable not to resort to the provision of section 154, because there is likelihood of the remedial action being knocked down in appeal on the preliminary ground that the mistake admitted to be, rectified was not a mistake apparent from record at all.

6. Most appropriate section for remedial action is sec.263 under the income-tax and Sections 25 (2) and 24(2) of Wealth Tax Act 1957. These sections give very wide powers to CIT and as far as possible action should be taken under this section to remedy the mistake pointed out by Audit. One major difficulty for taking action under section 263(1) of the Income Tax Act, 1961 for CIT is the time limit of 2 years i.e. from the end of the financial year in which the order sought to be revised was passed.

7. Action u/s 147 can be taken only where there is any non-disclosure on the part of the assessee. But in most of the cases where mistakes are pointed out by the Audit, action is possible only of u/s 147 of the I.T. Act. While on the subject of remedial action, a reference may also be made to the Supreme Court decision in the case of Indian and Eastern News Paper Society Vs. CIT reported in 1979 ITR Vol.119, 996.

8. The information furnished by the Audit should be utilized but no reference should be made to the Audit objection in the reasons recorded by the AO. The AO should process the information furnished by the Audit and then should satisfy himself about the same and should mention this fact in the reasons recorded by him.

9. A reference may also be made to the old instructions of Board regarding remedial action. Like the objection raised by the Receipt Audit Parties, the Board have observed that even in Internal Audit Objections, remedial action should be taken in all cases as a protective measure even where in the first instance the audit objection is not acceptable. It is for the AO to approach the CIT or his ADDL./3T CIT for getting the instructions regarding appropriate action. But now in case involving revenue effect of less than Rs. 1,00,000/- in income tax/CT cases and less than Rs: 30,00W- in other taxes have to be taken on directions of Addi/3t CIT(Audit) and in cases above these limits, the CIT(Audit) has to ensure that timely remedial action is taken by the concerned Assessing Officer.
### 2. Regarding Revenue Audit

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<td>Chapter V-A:- System Reviews of Comptroller and Auditor General of India</td>
<td>50-53</td>
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Chapter IV

OBJECTS AND SCOPE OF REVENUE AUDIT

Article 149 of the Constitution and the C&AG (Duties, Powers and Conditions of Service Act, 1971), empowers the C&AG of India to audit receipts from various direct taxes. The Public Accounts Committee lays its report before the Parliament. The main object of this audit is to satisfy itself that the Income-tax department has provided sufficient checks against errors and fraud and that the procedures prescribed give effect to the requirements of law. Receipt Audit constitutes an effective check for ensuring proper assessment, collection and allocation of taxes. Besides scrutinizing individual cases, it also scrutinizes whether procedures have been adequately provided to secure:-

i. collection and utilization of data necessary for the computation of demand or refunds under the law;
ii. prompt raising of demands on taxpayers in the manner required by law;
iii. regular accounting of demands, collections and refunds;
iv. correct accounting and allocation of collections and their credit to the Consolidated Fund;
v. proper safeguards against willful omission or negligence in the levy or collection of taxes or issue of refunds;
vi. due diligence in the pursuit of claims on taxpayers and their abandonment, reduction or waiver with adequate justification and proper authority; and
vii. prompt reporting and subsequent investigation of cases of double, fraudulent or forged refunds or other cases of loss of revenue.

2. Receipt Audit also covers-

i. Examination of the Board's general circulars, instructions, notifications and orders in specific cases so as to check whether these are in accordance with law and have been issued under proper authority.
ii. Checking of the CIT's orders under sections 263, 264 and 273 and orders under the corresponding provisions of the other direct tax laws so as to identify cases involving any deviation from law.
iii. Checking the penalty orders passed by the JCTs/Addl. CITs and other instructions issued by them to the A.O.s so as to ensure that they are in conformity with the provisions of law and the instructions of the Board.
iv. Checking the orders of the CITs (Appeals) so as to ensure that they are not against the law or against the procedure that has been laid down.
v. With reference to assessment work, seeing whether
   a. the assessment made is in accordance with the provisions of the relevant Act and the Rules;
   b. the block assessments are correctly made.
   c. the procedure laid down by the CBDT (the CCIT has been followed; and the instructions or orders issued by the higher authorities have been complied with. It may be noted that Receipt Audit will not call into question the exercise of discretionary powers vested with various
authorities under the statute, but it is competent to see whether the departmental interpretation of law and facts is not contrary to any decision of the jurisdictional High Court or that of the Supreme Court.

vi. Scrutinizing orders of reassessment, rectification, penalty, refunds and relief u/s 89 of the I.T. Act, and also giving orders giving effect to appellate orders.

vii. Checking whether recovery has been credited under the proper head of account. Audit may also point out cases of undue delay in recovery to pinpoint faults in the procedure.

viii. Test checking entries in the registers of the Assessing Officer with a view to seeing that no irregularities occur in assessment, collection and adjustment of taxes due to improper maintenance of the prescribed registers and that the statistical reports of the department truly reflect the figures shown in the registers.

ix. Examining the cases checked by the Internal Audit to verify its effectiveness.

X. Point out cases of over-assessment.

Xi. Specially checking the classification of revenue receipts and refunds under various heads of account.

xii. Scrutinizing orders of write off to see if they are passed by the competent authority after following the prescribed procedure, rules and statutory provisions.

xiii. Checking whether arrears have been correctly carried forward.

1.3 Consistent with their objectives, RAPs are free to enlarge the area of scrutiny even beyond the points listed above and to report uncommon issues to the C&AG. The mistakes/irregularities pointed out by the RAPS in individual cases of assessment, etc., find place in the local audit reports (LARs) pertaining to the ward/circle. Some of the more serious mistakes / irregularities might be converted into Draft Paras; which eventually might be incorporated as Audit Paras in the C&AG Report placed before Parliament and examined by its Public Accounts Committee. Likewise, the C&AG orders ‘Systems Reviews’ by selecting a special area or areas for audit each year. While conducting ‘Systems Review’ on a subject, the RAPS would follow the same procedure as in the case of regular audit but instead of issuing a LAR, the mistakes / irregularities, are aggregated, and are incorporated in the ‘Systems Review’ on the subject. The manner of replies as also the importance that has to be assigned to the mistakes/irregularities pointed out either in the course of a regular audit or ‘Systems Review’ is from the department's point of view generally the same. Monthly and quarterly reports on important irregularities are sent by Receipt Audit to Director (Audit). The latter, in turn, circulates them to the field formations for necessary action. [Also see - Reviews of C&AG of India Chapter VIII]

2. **Organizational Arrangement**

In order to obviate adverse criticism of the department by the C&AG and the PAC, the Assessing Officers and their supervisory authorities have to ensure that the assessments made are error-free and that there are sufficient safeguards provided against any leakage of the revenue. Internal Audit has to complete the audit of the wards/circles before the RAP commences auditing them. Infernal Audit has the onerous responsibility of ensuring that mistakes are detected early and that final orders are error-free. Wherever mistakes are
pointed out, the department has to ensure that remedial action is taken and the lost revenue is retrieved promptly.

2.1 Role of Assessing Officer

I. Presently, Receipt Audit is required to intimate its programme of audit to the concerned Assessing Officer at least one month in advance. The Assessing Officer has to ensure that the internal audit of the circle/ward is concluded before the commencement of Revenue Audit. If for any reason, internal audit has not been completed prior to receiving the intimation of the programme of audit from the Receipt Audit; the notice period of one month has to be utilized for completion of internal audit. The Assessing Officers and the audit wing are also have to watch the recovery of demand raised /refunds ordered as a result of the objections raised by Receipt Audit in the preceding audits. This is important especially since the objections are treated as settled by the department only on completion of remedial action, raising of demand or ordering of refund and quoting DCR No. in the reply furnished to Receipt Audit.

II. The assessment records requisitioned by the Receipt Audit parties should be supplied promptly. Reasons for not supplying any records may be required in writing by higher authorities.

III. Wherever the Receipt Audit Party notices a mistake, it issues a ‘Half-margin Note’; to the Assessing Officer. This contains the details of the mistake. The Assessing Officer should attend to the mistake at this stage itself, and, in any case, before the Receipt Audit Party winds up audit of the circle/ward. The need to furnish a complete reply, unless the issue raised is complicated and calls for extensive study, is obvious, since the file is available before the Assessing Officer, the facts are fresh and the Officer in-charge of the RAP is available for an effective discussion. This is especially relevant in regard to the objections raised by the Receipt Audit Party which are factually incorrect. Attending to the ‘Half-margin Notes’ in this manner would obviate the chances of an unacceptable objection being incorporated in the Local Audit Report (LAR). The Receipt Audit Party issues this after the audit is concluded: This procedure normally ensures that the LAR contains a minimum number of objections. It also has the advantage of ensuring that the time of the department is not wasted in attending to unacceptable objections at various levels. Towards the achievement of his objective, the Assessing Officer should also set aside sufficient time for discussion at the end of audit, with the officer-in-charge of the Receipt Audit Party.

IV. Whenever Receipt Audit points out a mistake which has already been detected by the Internal Audit or by the A.O. himself, the RAP should be appraised of this fact in reply to the Half Margin Note. This will ensure that the RAP would not include the mistake as an objection in the LAR. Further, all the important objections involving mistakes likely to have been committed in other cases /other A.O.s or are repetitive in nature should be promptly brought to the notice of the higher authorities so that corrective remedial action is taken in all the cases without loss of time. The AO shall furnish a reply to the Audit Memo, in all cases, stating clearly, whether he agrees with the Audit Memo within 3 days of receipt of Half Margin Note.

The Assessing Officers will also be responsible for -

a. keeping a proper record of Receipt Audit objections.

b. initiation and completion of remedial action against the mistakes promptly within the prescribed time.
c. maintenance of proper records and registers to ensure accurate and timely submission of the prescribed statistical reports

2.2 **CIT (Audit)/Addl./Jt. Commissioners of Income Tax (Audit) are also ensure for:-**

I. settlement of Receipt Audit objections

II. maintenance of registers pertaining to receipt audit and timely disposal of receipt audit objections.

III. ensuring that compliance reports are sent in all cases where Receipt Audit objections have been settled after taking appropriate remedial action.

IV. discussions with the Audit Officers of the rank of the AG/ Senior DAG regarding major disputes relating to objections raised by Receipt Audit; and

V. assisting the CIT in matters relating to Receipt Audit

2.3 **The Commissioners of Income Tax (Audit) and Commissioners of Income Tax (Administration):**

The CIT (Audit) is now nodal officer for coordination with Revenue audit, administrative CsIT, CCs1T and CCIT (CCA). In the metropolitan charges of Mumbai, Chennai, Delhi and Kolkata two CIT (Audits) have been posted and in non-metropolitan charges, one CIT (Audit) performs this function in respect of CCIT(CCA) Region. Instruction No 9 of 2006 dtd 07-11-2006 and Instruction No.0 3 of 2007 dated 16-04-2007 give in detail the responsibility of planning of work; maintenance of the record of receipt audit objections; ensuring prompt remedial action, maintenance of ledger cards and furnishing of reports to the CCIT (CCA) and the CBDT/ DIT (Audit) on the Draft Paras and the Action Plan. The Commissioner of income-tax (Administration) has to ensure expeditious settlement of audit objections. Some of the responsibilities of the CIT (Audit) are detailed below:-

i. sending Proforma reports on the Draft Para (Part A and B) received as per CBDT Instruction No 9 of 2006 to the CBDT and DIT Audit within the specified due dates after personally verifying the correctness and completeness of the data contained in the reports,

ii. maintaining liaison with the Accountant

iii. holding discussions’ on important questions of law and facts arising out of the Receipt Audit objections with CCIT/DGIT, DIT(Audit), CBDT, etc..

iv. monitoring and supervising the work of the TCsIT/Adcll.CsIT(Audit) in such a manner that the objections are attended to promptly within the prescribed time limits and that replies are furnished expeditiously to Receipt Audit and to the CBDT/DIT(Audit) through CCIT(CCA) with regard to the queries raised;

v. examining the cases of mistakes of a serious nature from the vigilance angle, maintaining a record of the same and informing the CCIT(CCA) for review and appropriate action;

vi. identifying mistakes of general and/or repetitive nature, devising ways and means of taking immediate remedial action and ensuring issue of appropriate circulars in order to ensure that these mistakes does not recur;
vii. test checking the registers maintained in field offices to ensure that they are properly kept and that the statistical reports furnished are correct and complete;

viii. over-all supervision, collation and maintenance of statistical data of CCIT(CCA) for:
   a. submission of reports and information to the PAC and the C&AG;
   b. planning performance targets;
   c. sending monthly MIS Report to the CCIT/DGIT;
   d. transmitting quarterly reports and statements to the DIT(Audit) through CCIT/ DGIT;

ix. maintaining ledger cards, in the prescribed form, for each Assessing Officer recording therein mistakes accepted by the department involving a tax-effect of Rs. 1,00,000 and above in income tax and company cases and Rs.20000 or more in respect of other taxes. The ledger cards have to be maintained both for the Internal and Receipt Audit objections and should contain details of both the Assessing Officer and the Auditing Officer who failed to detect the mistakes pointed out.

2.4 **Role of the Director of Income Tax (Audit):** With a view to expediting settlement of the Receipt Audit objections, DIT (A) is required to bring to the notice of the Board all those irregularities which are not settled within four months. Further, for each audit Para finally included in the C&AG's report, the DIT (A) has to ensure that a correct and complete book and brief is prepared for Board much before the PAC meeting.

3. **Assistance to Receipt Audit**

3.1 For proper conduct of audit by the Receipt Audit Parties, all relevant records and registers should be made available to them in time. Besides, the Sr.DAG/DAG is also entitled to requisition files.

3.2 The register for cases requisitioned by the Receipt Audit should contain the following details:
   a. Cases requisitioned for test-check by RAPs.
   b. Files actually made available to Receipt Audit for checking.
   c. Particulars of Major Objections, i.e., the name of the assessee and the assessment year, raised at the half margin stage
   d. Similar particulars relating to minor objections raised at the half margin stage.

3.3 A rubber stamp ought to be affixed on the outer cover of the relevant files supplied to Receipt Audit Party indicating "Issued to Receipt Audit on ... .".

3.4 In a foot note below the order of assessment, the Assessing Officer should record a gist of the objection raised in the audit memo and his own comments on the validity of the objection.

3.5 A reply to an audit memo should be issued within 3 days of its receipt, retaining the original memo or a copy thereof on the permanent record.

3.6 For proper maintenance of such registers, the JCITs/Addl. CITs are required to obtain statements
from the Assessing Officers (Please refer to Annexure-I for the proforma). Failure on the part of an Assessing Officer to maintain these registers or their incorrect or incomplete maintenance should be brought to the notice of the CIT.

4. **Procedure of handling audit objections**

Upon detection of a mistake, the RAP issues audit memos (half margin notes) for each mistake. The Assessing Officer is required to furnish replies to each memo to the Receipt Audit Party within three days, clarifying facts and figures. At this stage, the Assessing Officer should avail this opportunity to furnish a complete reply rather than routinely replying that the objection would be looked into. On the last day of audit, the Accounts Officer in-charge of RAP will discuss the draft local audit report, that is, the half margin memos and the replies thereto, with the Assessing Officer. The mistakes indicated in the half margin memos are dropped if the RAP is convinced that the premise on which the mistake was pointed out was incorrect. The mistakes that are not dropped at this stage are treated as objections and are included in the LAR. The discussion with the RAP before the audit is wound up would prove fruitful in thrashing out contentious issues. It is, therefore, essential that the Assessing Officer should familiarize himself with the facts of each case and ensure that the objections that are incorrect and unacceptable are not incorporated in the LAR. Failure on the part of the Assessing Officer to avail this opportunity might lead to avoidable involvement of other authorities at higher levels, including the Board, thus resulting in unproductive use of the scanty resources of the department.

4.1 Half-margin notes, which are not dropped by the Receipt Audit Party, are edited by the Sr.DAG. After editing, a copy each of the report, called as the Local Audit Report (LAR) is sent to the Assessing Officer, the range JCIT/Addl.CIT, JCIT/Addl.CIT (Audit) O/o CCIT and the CIT.

**The LAR Comprises three parts:**

**Part-I:**

This gives introductory information like the names of the officers who held the charge of the circle/ward and the objections outstanding and carried from the earlier LARs.

**Part II:** This part has two sections

a. **Section A** contains major irregularities, otherwise known as the major revenue audit objections, involving tax effect of Rs. 1,00,000 and above relating to the cases under the IT Act, and Rs. 30,000 and above in relation to the other direct taxes cases.

b. **Section B** contains details of the objections involving tax effect of at least Rs. 2500 but below the monetary limits applicable to the major objections. These are known as the minor revenue audit objections.
Part III:-

This contains other irregularities and objections involving tax effect below Rs.2500

Regarding Part III of LAR, there is no need for the Assessing Officer to send a separate report. Nevertheless the Assessing Officer has to take remedial action within three months against these objections as well. The AG reviews the progress in this regard through the RAP in the following audit cycle.

4.2 The AG selects some important objections in Part IIA (Section A of Part II) of the LAR as potential cases for inclusion as draft paras in the report of the C&AG. The AG refers such cases, known as proposed draft para (PDP) cases, to the CIT for verification of facts. The AG issues this reference terming it as 'Statement of Facts' (S.F.) to the CIT. This reference has to be replied to within a period of four weeks. This affords yet another opportunity for the department to ensure that incorrect and unacceptable objections are not converted into draft paras. It is, therefore, necessary that replies to the S.F. are furnished to the A.G. within the stipulated period lest an unacceptable objection is converted into a draft para by sheer default, on account of the failure of the department to furnish a reply in time.

4.3 In the light of the reply to the S.F., the AG makes his recommendations on the draft audit paras to the C&AG. The C&AG consider such recommendations. He then sends the C&AG's 'Select List' of draft audit paras to Ministry of Finance for their comments. The P&AC Section of the C&AG calls for a report from CITs on these select draft audit paras. The CIT has to furnish the report on the draft para in the proforma report. This comprises two parts - Part A and Part B (Please refer to Annexure-2 of this Handbook for the proformae). The CIT has to send the proforma report to the A&PAC Section of the Board within the time limit specified in the Board's reference. The proforma reports received from the CITs are p, %, ssed in the Board and the Ministry's replies are then sent to the C&AG. After obtaining the Ministry's comments, the C&AG finalize the audit paras. The paras, unless dropped at this stage, forms part of the C&AG's audit paras. These may eventually find place in the C&AG's Report for the year.' Thereafter the Report of the C&AG is placed before Parliament. The Public Accounts Committee (PAC), examines the Report. The PAC convenes meetings with the Finance Ministry for discussing the findings and the observations contained in the C&AG's Audit Report.

4.4 The Assessing Officer's reply to 'half margin notes' issued by Receipt Audit should be sent to the party within three days through CIT clarifying the facts and figures involved in the objection raised. Half Margin note should be retained in the permanent folder of the assessment record and a note detailing the summary of the objection should be left at the foot of assessment order and also in the register of requisitions. [Also see the flow chart in Chapter IV]

4.5 The Assessing Officer should send his report on the objections contained in the LAR (Part IIA &B) to the JCIT/Addl.CIT, in duplicate, within 15 days of its receipt in his office. One copy of this report should also be sent to the CIT. The Joint/Addl.CIT of the Range will forward one copy of the Assessing Officer's report together with his comments to the CIT and the CIT will send report to Sr. DAG/DAG concerned within a fortnight of its receipt. Objections for which the Department does not have an arguable case should be accepted. In cases where a difference of opinion persists between the Sr.DAG and the department, the CIT should report the facts of the case to, specifically mentioning, the
dates by which the limitation for remedial action expires to Sr.DAG within a fortnight finally informing him whether the objection is acceptable or not the. In any case, the time limits should be adhered to so that the final reply of the department reaches the Sr.DAG/DAG within 8 weeks of the receipt of the LAR by the Assessing Officer. The CIT, in turn, may refer important cases of unacceptable objections to the CBDT. He, however, has to ensure that adequate time is available for taking remedial action, in case the objection is accepted by the department.

4.6 As soon as an important mistake which is likely to have been committed elsewhere is detected, the Assessing Officer should immediately bring the same to the notice of his higher authorities so that steps are taken at the appropriate time to correct the same and pre-empt the RAP from pointing out the same lapses in other field offices.

4.7 Remedial action against the major and minor revenue audit objections which appear in Part IIA of the LAR should be completed within 3 months from the date of the receipt of the LAR.

4.8 The choice of proper remedial action and the procedure to be followed is contained in Instruction No. 09 of 2006. As regards the Audit objections raised against the Board's instructions/circulars; the said Instruction No 9 of 2006 should be referred to. There is always a possibility that the instructions/circulars might be amended. Thus, even in such cases, remedial action should be initiated but-concluded only after receipt of the Board's decision. The registers to be maintained in connection with the above instructions of the Board are indicated in Annexure -1 of this Handbook.

5. **Settlement of objections**

For statistical purposes, the department treats an objection as settled on completion of remedial action after a final reply has been sent to the Sr. DAG.

The reply to the Sr.DAG against the objections must be self-contained. It should state the para No., part/section and no. of LAR, the name of the assessee and the assessment year (for example Major Revenue Audit Objection in Para... Of Part IIA of LAR No... In the case of M/s... For the Assessment Year...). The body of the reply should contain the following details:

i. the objection in brief;
ii. acceptance or rejection of the objection; and
iii. reasons for non-acceptance.

If the objection is accepted, the following further details have to be furnished:

i. date and section under which remedial action has been taken;
ii. demand raised;
iii. D&CR No. where demand has been entered; and
iv. reasons for variation, if there is a variation, between the tax effect indicated in the

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objection and the tax effect on account of remedial action.

Unless, the replies contain all the aforesaid details, the objections cannot be settled. The Assessing Officers, therefore, should not only take appropriate remedial action but also ensure full and complete reporting of the same so as to enable quick settlement.

5.1 Objections on procedural lapses raised by the Receipt Audit are not uncommon. Usually, such objections are accepted by the department in principle but the revenue effect pointed out, being merely hypothetical, is not. Such cases include those relating to non-recording of reasons for not initiating penalty proceedings u/s 271(1) (c) of the I.T. Act, 18(l)(c) of the W.T. Act, etc. In terms of Board's letter No.DI (Audit)-9/77/781DI dt. 18-8-77, such objections, which are accepted in principle, but where no remedial action can be initiated and where the revenue effect is hypothetical, can be treated as settled, even if the same have not been withdrawn by the Receipt Audit, once a reply has gone to the Sr.DAG.

5.2 Treating objections as settled within the department after the issue of a final reply will not ipso facto constitute settlement of the objection with the AG. It will still have to be pursued with the AG till he also treats the objections as settled and rounds them off in his registers. It would be, therefore, advantageous for the CIT/CIT (Audit) to hold personal discussions with the AG from time to time in order to coordinate and expedite settlement of objections.

6. Handling of draft audit paras

a. The CIT has to send a proforma report: (Part A and Part B) through CCIT to the Board(A&PAC Section) immediately on receipt of the draft para. The time limit for furnishing this has to be rigidly adhered to, so as to enable the Ministry to send their report to the C&AG within the stipulated period of 6 weeks. Simultaneously, a copy should also be endorsed to the Director (Audit). Now, the Proforma reports have been revised by Instruction No 09 of 2006 and therefore the report must be sent in revised Proforma given in Annexure 2 of this Handbook.

b. Even when some part of the information required to be incorporated in the proforma report is not readily available, the report should not be held up. Instead, soon after submission of the report to the A&PAC Section of the CBDT, a correction slip should be sent to the Board, for affixing the same to the report already sent.

c. The factual data in the report should be correct and complete. It should be personally verified by CIT who would be ultimately responsible for its accuracy and completeness.

d. The Director (Audit) will send a draft brief-cum-paper book to the Board on each case figuring as an audit para in C&AG's Report.

e. Information called for by the Board on any draft para must be supplied expeditiously.

CHAPTER V

HOW TO DEAL WITH RECEIPT AUDIT

1. Receipt audit matters are now mainly dealt by CIT (Audit) and CIT (Admn) offices with almost similar functions in nature but the responsibilities and roles have been laid down separately by CBDT vide Instructions 08/2006 and 03/2007 as discussed in Chapter II and Chapter IV of this handbook. Roles and responsibilities of these functionaries are illustrated in brief as under :-

i. **CIT (Audit) office under CCIT CCA deals with**

   - DP Cases
   - Major and Minor Systems Reviews
   - Receipt audit objections
   - Major and Minor Internal audit objections

ii. **CIT (Audit) office Co-ordinates with**

   - CCIT (CCA)
   - AG Office
   - DI (Audit)
   - PAC – Section
   - CIT (Admn)

iii. **CIT (Admn) office deals with**

   - DP Cases
   - Major and Minor Systems Reviews of C&AG
   - Receipt audit objections
   - Major and Minor Internal audit objections

iv. **CIT (Admn) Co-ordinates with**

   - DI (Audit)
   - CCIT (CCA)
   - CIT (Audit)
   - AG
   - Addl. /Jt. CIT
2. **Suggested lips to liquidate pendency Draft Para cases**

- In CIT(Audit) office verification of pendency and sorting of cases which are likely to be settled earlier be done.

- Registers maintained shall be updated so that where replies have already been sent may be struck off.

- Co-ordination with higher authorities DIT (Audit) and CBDT-PAC section must be maintained for speeding up liquidating pendency of audit objections.

- Number of pending draft para cases CIT wise shall be listed and reminder letters be sent in arrear cases.

- Position of sending reply in other pending cases CIT wise should in the office of CIT (Audit)/CCIT(CCA) may be cross checked from the offices of the CsIT (Admn).

- CIT(Admn) can also do the similar exercise with Addl/Jt CsIT ranges and the AOs

- Verification of facts from the AOs and Addl/Jt'CsIT be done in pending cases where replies received are not clear.

- Where part replies already filed to DI(Audit), PAC -Section and the time period available is short to reply, records from the AOs may be directly called by the CIT/CIT (Audit)/CCIT (CCA)

- Reports be sent in Proforma A & B in the revised formats.

- In cases where the copies of draft para cases are not available, local Accountant General Office may be requested to supply the same by sending IT[ or special messenger.

*Addresses of Accountant Generals office are given in the folder in the Reference material in CD - AG addresses' enclosed with this Handbook*
3 **Suggested tips to liquidate pendency of Receipt Audit Objections**

**Officers have to deal with**

- Pending arrear Major Audit Objections
- Pending arrear Minor Audit Objections
- Pending current Major Audit Objections
- Pending Current Minor Audit Objections
- Current Cases

Some suggested tips for staff/officials working in audit:-

- In CIT(Audit)/CIT(Admn) office verification of pendency and sorting of cases which are likely to be settled earliest be done.
- Pending cases which are likely to be struck off earliest shall be separated Major Audit Objection and Minor Audit Objections - category wise.
- In such Major Audit Objection Cases separated correspondence shall be taken up on priority as some of such cases may be converted from Proposed Draft Para cases to Draft Para cases and limitation may be involved.
- Only thereafter, Minor Audit Objection cases shall be taken up. But where the time barring limitation is involved, these cases must be taken on priority basis. Thereafter, other pending cases shall be taken up to liquidate the pendency. Practical experience is that much involvement in Minor Audit objection cases sometimes creates the situation where other important matters are left out to be touched upon, though substantial revenue is involved. If, there is no pendency of major audit objection in a charge, then whole concentration can be on the minor audit objections to meet the Action Plan Targets.
- Officers dealing with RAP objection must know the method of the numbering done by the Accountant General's office in the list of pending cases received. Say - Si. No. 25/2002-03 Name of assessee Audit Objection though received in 2004 but 12002-03' indicates that the audit objection in the case was raised in the F.Y. 2002-03 The AOs and their staff members shall also apply the same logic while sorting out the cases and preparing the lists of pending old cases where jurisdictions have changed thereby facilitating them in tracing the connected records for giving replies.
- Lists of pending cases received from AG office is tallied with the office records, then final list be prepared.
- Registers maintained may be updated so that where replies have already been sent may be struck off and if possible coordination with local Accountant General's office be made to reduce the number of pending objections.
- Position of sending reply in other cases, case wise should be ascertained within the office and may also be done from the office of the Addl]/t CIT Range and AOs as sometimes, though replies are received but they are not forwarded further.
- Replies sent to the Accountant General must clearly state whether the objection is accepted/acceptable or not in case of vague replies received, where the time period is short.
records from the AOs may be directly called for.

- Detailed reply must be given with reasons where objection is not acceptable. For support, evidence/documents filed by the assessee may also be enclosed.

4 **Suggested tips to deal with the S stem Review Cases**

CCIT (CCA) / CIT (Audit) /CIT (Admn) Office deals with the C&AG System Reviews. Normally, reports are called from the CIT (Admn) and after vetting by the CIT (Audit)/CCIT (CCA), the Para wise comments are sent to the CBDT, PAC section. In practice Audit Reports year wise are issued by the C&AG e.g C&AG Audit Report for 2002.

Some suggested tips are as under for staff/officials working in audit:-

- Records of different System Reviews must be maintained separately topic wise. Normally, two to four Reviews are conducted by C&AG in one year.
- Year wise folders of CAG Reports for correspondence be maintained for convenience. All records of different System Reviews of a particular year must be clubbed to facilitate in sending a consolidated reply.
- Main reply may need verification of facts from AOs and Range authorities below if there lies Illustrated or key case pertaining to a particular CIT Charge.
- If Audit Report of C&AG in the Review incorporates some Illustrated or key cases related to particular CIT Charge, authorities below may be requested to give their comments in such cases to the concerned CIT.
- In the cases to be commented upon, if they relate to the main reply, no separate Proforma Report may be sent by the CIT /CIT (Audit) through CCIT (CCA) to CBDT, where there is no illustrated case in C&AG Audit Report.
- But where, specific comments are required/called for by the CBDT, on Illustrated or key cases related to particular PIT Charge, Report be sent in the prescribed Proformas A and B as applicable also.
- Sometimes Action Taken Reports are called by the CBDT then a copy of the same shall also be endorsed to DIT(Audit).
- Sometimes Draft of Reviews proposed are sent by the AG of the State for inclusion in the C&AG Reports to CsIT for comments, prompt replies must be given.
- C&AG Audit Reports, also have Appendix/Appendice to clarify and comment upon, these should also be taken into account while drafting replies.

[Soft Copies of C&AG Reports from 2002 to 2008 in PDF files are given in the C&AG Reports portion of Reference Material in CD enclosed with this Handbook]
OTHER IMPORTANT AREAS FOR DEALING WITH RECEIPT AUDIT OBJECTIONS

1. In spite of all care and caution, the acts of omission and commission having impact on revenue, may occur in the course of making assessments and revising them. Consequently, audit objections are bound to occur. Corporate and Non-corporate Auditable cases are audited by the Internal Audit Organizations i.e. IAPs & SAPs and Addl/Jt CsIT(Audit). The statutory audit is also carried out by the Comptroller and Auditor General of India, through Receipt Audit Parties functioning under the respective Accountant Generals of States.

2. The first stage at the time of the receiving objection from Receipt audit is to be dealt with is at the half margin stage. This stage is very important but is most neglected in practice. At this stage the AOs usually give an ad hoc reply like saying that the matter will be looked into, or that, the reply will follow; This is not at all desirable. While it is possible that the issues raised by the audit may require technical examination from legal angle, and there may be genuine differences of opinion with the audit in regard to point of law it is necessary at this stage itself to put the record straight so far as facts are concerned. Thus - it is necessary to examine the correctness and completeness of the facts relied on by the audit and to point out inaccuracies in the facts narrated by audit be also to supply the missing facts if the audit has relied on incomplete facts.

3. It is also necessary to point out to the audit, if the matter was already in the knowledge of the department either through an inspection note or through an audit objection by an Internal- Audit Party or other-wise. Failure to put the records straight at this stage results in avoidable controversies with audit at subsequent stages. This aspect has also been emphasized in the Board's Instruction No. 159 dated 16.04.70, which also lays-down that the half margin notes should be returned along with the reply within three days. A copy of the half margin note is also to be kept on the assessment cover of the relevant case records.

3. It may be stated here that half margin notes are not being issued by the RAPs but they are supposed to consult the AO in regard to their proposed audit objections.

4. After audit objections have been received from office- of the Accountant General or from the ITOs IAPs / SAPs/ or Addl/Jt CIT, action has to be taken for settlement thereof either by taking necessary remedial action or by pointing out the facts and reasons for which audit objections may not be acceptable.

5. The first perquisite for effective control of follow up action is that there, should be a complete and correct record of audit objection so that at any point of time, the ITO is in position to know at a glance, as to what cases require his attention on priority basis. It is quite possible that action may become time barred in some cases. It is therefore essential that one Senior member of the staff (maybe an- Inspector, or O.S., or even a senior T.A.) is specifically made responsible for maintaining the relevant records and attending to this item of work. At the level of the AO, three registers, as below, are required to be maintained-
1. AO's Register No.1 for Internal Audit Objections; divided into, separate sections for major and minor objections

2. AO's Register No.1 for Receipt Audit Major Objections.

3. AO's Register No.2 for Receipt Audit Minor Objections.

6. It should be ensured that, all objections whether receipt audit or Internal Audit received from the Accountant General, DC/AC (Special-Audit), ITO (IAP), or transferred from other circles/wards, are recorded in these registers immediately on their receipt.

7. The next step is to determine priorities in examination of objections and initiation of remedial action. The ideal course to follow would be to examine the objections immediately on their receipt. However, this may not always be possible. The limitations for action u/s 263, 147 and 154 should all be noted against for each objection in the relevant registers and the cases should be taken up for examination in the order in which the earliest of limitations under the aforesaid sections expire. Normally, this would be under sec 263.

8. The official entrusted with this work should first examine the facts stated in the objection with reference to relevant records. It is possible that in some cases, full facts are not on record. The required enquiries should be immediately made from the assessee. If the facts stated or presumed by audit are found to be correct, the matter should be put up for orders of AO who should examine whether the inferences drawn by audit on point of law are correct or not. Wherever: the facts stated or presumed by audit are found to be incorrect or the legal inferences drawn by audit are not correct, a detailed report should be sent to the ITO (HQ)/CIT (Audit) in case of receipt audit objections and to DC/ACIT (SAP)/ITO (SAP) 0/0 CIT (Administration) where the tax effect is Rs. 1,00,000/- or above in Income Tax/CT Cases and Rs. 30,000/- and above in other taxes cases.

If the revenue involved is below Rs. 1,00,000% in Income Tax/CT Cases and Rs. 30,000/- in other taxes cases the reports should be sent through the Range Addl./Joint CIT(Audit), who is prescribed authority for issue of instructions for appropriate remedial action. Wherever revenue involved is in excess of these limits, the reports should be sent to the CIT (Audit) who would obtain the orders of Commissioner. None of these objections should be treated as settled till the settlement of objection is intimated by A.G. or CIT (Audit)/CIT (Admn.).

9. When the objection is found to be acceptable in its entirety, the next step should be to decide the most appropriate remedial action to be taken. The temptation to follow the simplest recourse to action u/s 154 should be avoided, except, in cases where the mistake is clearly apparent on record and no controversial points of fact or law are involved. Similarly, action u/s 147 would be attracted in all cases as the audit objections are normally based on facts on record. In this connection, the ratio laid down by the Supreme Court in the case of Indian & Eastern News paper Society should be kept in view while recording reasons. Briefly Stated, an audit objection would, continue to be information on, the points of fact but the opinion of

Audit would not be so. The Assessing Officers should, therefore, strictly avoid a reference to audit objection on points of law. In all other cases action u/s 263 should be recommended, particularly so where point of fact or law is involved or some, further enquiry is called for.

10. While in cases of objection involving revenue effect below Rs. 1,00,000/- in Income tax ICT Cases and Rs. 30,000/- in other taxes cases, the Assessing Officer should proceed with action decided upon, in cases involving revenue effect exceeding these limits detailed self-contained reports should be sent to the CIT through Addt./Joint CIT as in the preceding paragraphs for approval of remedial action. However, even in these cases limitations should be watched. Particularly, where action is to be taken u/s 263, the proposal may be sent through Range Addl./Joint CIT straightaway instead of sending separate reports on audit objection if limitation under that section is to expire shortly.

11. There may be cases in which the objections are found to be partially acceptable. In such cases the procedure similar to objections not accepted should be followed, except that in reports to the CIT through Addl./Joint CIT as the case may be, remedial action proposed in respect of accepted portion of objections is also to be indicated.

12. After a decision has been taken by CIT(Audit)/Addl./Jt CIT(Audit) / CIT or directions of Range Addl./Joint CIT in regard to the most appropriate remedial action are received-no time should be lost in initiating the same.

13. The objections be treated as settled only when the additional demands are raised and not merely an initiation of remedial action u/s 147 or cancellation of impugned orders u/s 263. The D.I. (Audit) has fixed a limit of four months for completion of remedial action.

Wherever action is taken u/s 154, it should, be completed within one month. Care should be taken to see that re-assessments u/s 147 and fresh assessments after orders u/s 263 are completed expeditiously and are not held up unnecessarily. Wherever action is proposed to be taken u/s 263 it should be found out if any appeal is pending before CIT (Appeals) and if so requests may be made not to decide the appeals in view of proposed action.

14. After completion of remedial action, a report is to be sent to CCIT/CIT (Audit)/Addl. CIT (Audit) indicating action taken, date of orders amount of additional demand raised and DCR numbers. If any of these details are wanting objections would not be settled. In cases where the additional demand raised is different from the amount mentioned in the audit objection, reasons for should be given furnishing details.

15. It may be mentioned that remedial action within the limitation period is required to be taken, even in cases where audit objections of receipt audit are not acceptable, if the departments relies are not accepted by the Accountant General.
Chapter V-A

SYSTEM REVIEWS OF COMPTROLLER AND AUDITOR GENERAL OF INDIA

(with reference to Audit Reports)

The Audit of the C & AG of ‘Union’ is bifurcated into two streams namely

Audit Report – (i) Performance Audit (ii) Regularity (Compliance) Audit

1. Performance Audit –

Performance Audit is done by C & AG to see, whether the Government programmes have achieved the desired objective at lowest cost and given intended benefits. Performance Appraisals are since 1983. Now System Appraisals and Review have been started since 2000 to monitor the performance of the Income Tax Department under “Direct Taxes”

2. Regularity (Compliance) Audit

- Audit against provision of funds to ascertain whether the money shown as expenditure in the Accounts were authorized for the purpose for which they were spent.

- Audit against rules and regulation to see that the expenditure incurred was in conformity with the laws, rules and regulations framed to regulate the procedure for expending public money.

- Audit of sanctions to expenditure to see that every item of expenditure was done with the approval of the competent authority in the Government for expending the public money.

- Propriety Audit which extends beyond scrutinizing the mere formality of expenditure to it wisdom and economy and to bring to light cases of improper expenditure or waste of public money.

- While conducting the audit of receipts of the Central and State Governments, the Comptroller & Auditor General satisfies himself that the rules and procedures ensure that assessment, collection and allocation of revenue are done in accordance with the law and there is no leakage of revenue which should otherwise legally come to Government.

The Parliamentary Committee is constituted namely Public Accounts Committee (PAC) to discuss the issues of national importance and audit Reports of Comptroller and Auditor General are also referred. The PAC exercises check over the functioning of the Government Departments. The Financial Committee not only focuses on individual irregularity but on the defects in the Systems which lead to such irregularity and deals with the need for correction of such Systems and procedures. The C & AG plays a key role in the functioning
of the Financial Committee the Parliament. The Financial Committee presents their Reports to the Parliament. Our Department informs the Committees of the Action Taken on the recommendations of the Committees and the Committees present and Action Taken Report to Parliament. On Audit Reports submitted by the C & AG, which could not be discussed in detail by the Committees, written answers are submitted by the department and which are sometimes incorporated in the Report presented to the Parliament. In order to summarily apprise the readers about the initial understanding of Union Audit Reports on Performance Audit, a year, a year wise summary in brief is given in the following chart for the ready reference.

Performance Audit on Direct Taxes – 2002- System Reviews

<table>
<thead>
<tr>
<th>Year</th>
<th>Period Ending</th>
<th>Name of Review</th>
<th>Audit Report No.</th>
<th>Chapter No.</th>
</tr>
</thead>
<tbody>
<tr>
<td>2002</td>
<td>31.03.2001</td>
<td>Review on Co-operatives Societies</td>
<td>12A of 2002</td>
<td>1</td>
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<tr>
<td>2002</td>
<td>31.03.2001</td>
<td>Review on Private Banking Companies &amp; NBFCs</td>
<td>112A of 2002</td>
<td>2</td>
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<tr>
<td>2002</td>
<td>31.03.2001</td>
<td>Review on Companies in Cement, automobile and textile sectors</td>
<td>12A of 2002</td>
<td>4</td>
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<tr>
<td>2002</td>
<td>31.03.2001</td>
<td>Audit of special Arrangements on section 35 AC of the I.T. Act 1961 on expenditure on eligible projects of schemes</td>
<td>12A of 2002</td>
<td>6</td>
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Performance Audit of Direct Taxes-2003 System Review

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<th>Year</th>
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<th>Name of Review</th>
<th>Audit Report No.</th>
<th>Chapter No.</th>
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<tbody>
<tr>
<td>2003</td>
<td>30.03.2002</td>
<td>Review on Effectiveness of liquidation of outstanding arrear demand of Rs. 50 lakhs and above as on 01.04.2001</td>
<td>13 of 2003</td>
<td>1</td>
</tr>
<tr>
<td>2003</td>
<td>31.03.2002</td>
<td>Review on Implementation of Selected Judgments of Supreme Court.</td>
<td>13 of 2003</td>
<td>2</td>
</tr>
<tr>
<td>2003</td>
<td>31.03.2002</td>
<td>Review on Assessment of Companies in Select Sectors-Pharmaceuticals, Food Processing, Paints &amp; Varnish and Cigarettes.</td>
<td>13 of 203</td>
<td>3</td>
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</table>

Performance Audit of Direct Taxes-2004 System Appraisal

<table>
<thead>
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<th>Year</th>
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<th>Name of Review</th>
<th>Audit Report No.</th>
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</tr>
</thead>
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<tr>
<td>2004</td>
<td>31.03.2003</td>
<td>Review on Assessment of business of</td>
<td>13 of 2004</td>
<td>II</td>
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### Performance Audit of Direct Taxes-2005 System Appraisal

<table>
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<th>Year</th>
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<th>Chapter No.</th>
</tr>
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<tbody>
<tr>
<td>2005</td>
<td>31.03.2004</td>
<td>Review on Status of Improvement of efficiency through the ‘Restructuring’ of the I.T. Department</td>
<td>Report No. 13 of 2005</td>
<td>1</td>
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### Performance Audit of Direct Taxes-2006 System Appraisal

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<th>Audit Report No.</th>
<th>Chapter No.</th>
</tr>
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<tbody>
<tr>
<td>2006</td>
<td>31.03.2005</td>
<td>Review on efficiency of summary assessment scheme and process of selection of cases for scrutiny</td>
<td>7 of 2006</td>
<td>1</td>
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<tr>
<td>2006</td>
<td>31.03.2005</td>
<td>Review on Effectiveness of Search &amp; Seizure Operations</td>
<td>7 of 2006</td>
<td>2</td>
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### Performance Audit of Direct Taxes-2007 System Appraisal

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<th>Year</th>
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<th>Name of Review</th>
<th>Audit Report No.</th>
<th>Chapter No.</th>
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<tbody>
<tr>
<td>2007</td>
<td>31.03.2006</td>
<td>Review on assessment of selected companies in selected sectors of Computer Software, Automobiles Ancillaries, steel &amp; Trading</td>
<td>8 of 2007</td>
<td>1</td>
</tr>
<tr>
<td>2007</td>
<td>31.03.2006</td>
<td>Review on Implementation of TDS/TCS schemas</td>
<td>8 of 2007</td>
<td>2</td>
</tr>
<tr>
<td>2007</td>
<td>31.03.2006</td>
<td>Review on assessment of sports associations/Institutions and Sports personalities.</td>
<td>8 of 2007</td>
<td>3</td>
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</table>

### Performance Audit of Direct Taxes-2008 System Appraisal

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<tr>
<th>Year</th>
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<th>Name of Review</th>
<th>Audit Report No.</th>
<th>Chapter No.</th>
</tr>
</thead>
<tbody>
<tr>
<td>2008</td>
<td>31.03.2007</td>
<td>Review on assessment of Banks</td>
<td>7 of 2008</td>
<td>1</td>
</tr>
<tr>
<td>2008</td>
<td>31.03.2007</td>
<td>Review on appreciation of third party reporting/certification of assessment proceedings</td>
<td>7 of 2008</td>
<td>2</td>
</tr>
</tbody>
</table>
Details of the above Audit Reports are given in the Reference Material CD attached and these Reports of C & AG can also be downloaded from the website of the C & AG – [www.cag.gov.in](http://www.cag.gov.in).

The readers can also refer these reports not only for sending Reports to PAC section of CBDT but can also derive benefit from the nature of mistakes pointed out in the Reviews and Audit Reports in their day to day work relating to Audit and Assessment. Following Chapters have been included in this Handbook for facilitating departmental officers on following topics:

1. Impact of Revenue due to Implementation of Selected Judgments of Supreme Court of India [C & AG Report 13 of 2002] (Chapter IX)
2. General Audit and Tax Audit, Relevance to Income Tax Investigations (Chapter X)
3. Important points for AOs while examining books of account to avoid audit objections /Draft Paras in Tax Audit Cases (Chapter XI)
4. Auditing and Accounting Standards (Chapter XIV)

With the liberalization of economy, C & AG is also dealing with International Audits. The International body is INTOSAI (International Organization of Supreme Audit Institution). Some material download from Internet has also been placed in the Reference Material on CD enclosed with this Handbook beside above four chapters for readers' convenience.
Audit Checksheet,

Common Mistakes of Recurring Nature & FAQs on Audit

Source:


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<tr>
<td></td>
<td></td>
<td>Chapter VII:- Mistakes based on Implementation of Supreme Court Judgments</td>
<td>63-68</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Chapter VIII:- Audit Checksheet</td>
<td>19,72-87</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Chapter IX FAQ’s on Audit</td>
<td>88-92</td>
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</tbody>
</table>
CHAPTER-VI

1. NATURE OF COMMON MISTAKES OF RECURRING NATURE POINTED BY REVENUE / INTERNAL AUDIT

[Source :Compendium of Recurring Mistakes Detected in Audit by DI(RSP & PR) and CD issued by CIT(Audit), Mumbai in 2002/2003-Audit Reference Manual]

I. Over assessment :-

1) Arithmetical Mistakes -
   i) In adopting wrong figure of Income / Loss
   ii) In adopting wrong figure of WDV for allowing depreciation.
   iii) In giving deduction on a wrong figure.
   iv) In giving allowances on a wrong figure.

2) Mistakes While Making Computation of Income:-
   i)Disallowance made on some items on leased assets and some items left out to be disallowed
   ii) Disallowance of different items though discussed in the body of assessment order but actually adoption of a different figure in the assessed income.
   iii) Additions of several items discussed in body of assessment order but left out some, while working out the taxable income.
   iv) Mistake in adopting a wrong figure while determining income on giving Appeal effect.
   v) Adopting incorrect figure of income shown in original return in scrutiny cases instead of figure of income shown in the revised return.
   vi) Leaving digits while adopting figures of proposed additions.
   vii) In loss cases, mistake occurred instead reducing the inadmissible amount, the same amount was added to the loss.
   viii) In computing the total income, while disallowing of the amount under a different head, instead of adding the same amount was deducted.
   ix) No refund due on regular assessment but refund granted in summary assessment not treated as tax payable by the assessee.
   x) Proposed addition more but while computing the total income incorrect figure was adopted being below the proposed addition.
   xi) On non-fulfilment of condition certain amounts disallowed relating to TDS and refund not included while working out tax demand

5. Non-application of provisions of Section 40A(3).

6. Giving wrong appeal effect on issue other than covered by appeal (though appeal pending on the issue).

7. Allowing wrong Double Taxation Relief.

8. Adopting incorrect Income -

[Pages 1, 2,3 and 4 of Chapter 1 of compendium of Recurring mistakes detected in Audit – Published by DI(RSP & PR) on 27.11.2002]

INTERNAL AUDIT OBJECTIONS

i) Adoption of wrong figure of loss.
ii) Failure to account consequential relief allowed by the CIT(Appeals)/ ITAT.
iii) Discussion of disallowance etc. in the assessment order but forgetting to add while computing the total income.
iv) Wrong deductions
v) Applying higher rate of tax.
vi) Mistake in giving refunds.
vii) Computation of income under wrong head & wrong adjustment of brought forward losses.
viii) Wrong carry forward of loss on belated return.
ix) Sales Tax Collected but not brought to Tax.
x) Totaling mistake in the assessment order.
xii) Non-levy of Surcharge.
xii) Non-Business Expenditure wrongly allowed.

[Pages 5,6,7,8 and 9 of Chapter 1 of Compendium of Recurring mistakes detected in Audit-Published by DI(RSP & PR) on 27.11.2002]

II Nature of Mistakes on Allowance of Wrong Deduction u/s 80 HHC : Relating to Export PROHTS (Section 80 HHC omitted w.e.f. 01.04.2005)
i) While allowing deduction towards export profit, business profit being ninety present of interest income not reduced.
ii) Deduction wrongly calculated on gross total income - which included income from house property and other sources.
iii) Deduction wrongly allowed without considering the loss sustained by the assessee from export of trading goods.
iv) No permission of CIT on record for extension of time for realization of sale proceeds which was to be recovered in convertible foreign exchange.
v) AO did not reduced the profits being 90% of Interest income, lease rent and management fee received.
vi) Assessee not a direct exporter but only a supporting manufacturer. AO wrongly allowed the deduction including proportionate increase on account of export incentives as in the case of direct exporters.
vii) Assessee was not eligible for deduction u/s 80 IIHC, since the profit from export of trading goods was a minus figure. From working in form No. 10-CCAC indirect expenses were not taken into account. No export of manufactured goods or local sales was made.
viii) Excess deduction u/s 80 HHC allowed

[Pages and of Chapter of Compendium of Recurring mistakes detected in Audit - Published by DI(RSP & PR) on 27.11.2002]

III NATURE OF NIISTAKES IN ASSESSMENT WHILE GIVING EFFECT TO APPELLATE ORDERS.
i) Figure of revised return of income not adopted.
ii) Credit for advance tax for following year given in the year under consideration.
iii) While computing net demand, refund amount already allowed earlier not considered.
iv) Deduction allowed in respect of new industrial undertaking which was not in order as there was no positive income after set off brought forward losses of earlier years.
v) In giving appeal effect for deduction u/chapter TVA, AO had not added back deduction u/chapter VI-A already allowed u/s 154 at an earlier date.
v) Profits for the purpose of section 80 HHC worked out in original order at 6.09 crores. But after giving appeal effect total income worked out to Rs. 1.16 crores, thereby excess allowance of deduction allowed to assessee at about 48 lacs.

[Pages 23 and 24 of Chapter of Compendium of Recurring mistakes detected in Audit - Published by DI(RSP & PR) on 27.11.2002]
IV NATURE OF MISTAKES - INCOME ESCAPING ASSESSMENT

i) Incentive amounts received on investments in government securities and small savings schemes with postal department were wrongly granted exemption though it is a revenue receipt and assessable to tax.

ii) Credit allowed for TDS on income, which was neither credited to P&L A/c of the relevant Assessment year nor considered in assessment.

iii) “Unclaimed credit balances written back”
- Credited to P&L A/c.
- Also allowed as deduction.
Deduction irregularly allowed to company in view of Supreme Court Judgement in re 222 JTR 344 (SC).

iv) Long term capital gains on transfer of landed property shown in the schedule of fixed assets sold during the previous year not taken into account:
   (1) On the ground that consideration not received.
   (2) Approval for exemption under Urban Land (Ceiling and Regulations) Act, 1976 was not received.

As the assessee maintained accounts in mercantile system, income from capital gains was to be included in the total income of the assessee.

v) Sun representing employee’s contribution to Provident Fund and employee’s contribution to state insurance but not deposited within statutory period to the respective funds,

vi) Business including capital assets sold before the dissolution of the firm and distributed amongst the partners. Capital gain arose should have been treated as the business income of firm as per audit.

vii) After retirement of two partners, consequently assets of the firm, were revalued. The amount paid after revaluation to retired partners along with amount standing to the credit of their Capital account.

As per audit partial distribution of the value of assets to the partners on distribution are liable to tax.

viii) Income of assessee
- Loss
Sale of Consideration of Plant & Machinery
- 12 Lacs
Written Down Value
- 4.02 Lacs

Block of Plant & Machinery wiped out.

As per audit remaining sale consideration of 9.45 Lacs had to be treated as Short Term Capital Gains u/s 50 of the I.T. Act, 1961.

ix) Interest on securities 18-15 lacs omitted to be assessed as income.

x) Agreement between - Assessee firm and Developer land of assessee - development of Commercial Transfer of 55% of land equivalent to 4950 sqft.

In return - transferee had to construct 45% of super built up area and car parking. Audit objection was value of land of 55% transferred at Rs. 41,42,450/- is liable to Long Term Capital Gains and Short Charge was worked out at 24,38,482 + including interest u/s 234 B.

xi) Agreement with builder - assessee shown value for purpose of registration of undivided share holding of the land by various flat owners. As per audit market value of built up area recovered as a part of consideration resulted in under declaration of Income.

xii) Withdrawal from National Savings Scheme not accounted for as income.

xiii) TDS allowed on interest income from FDRs firm but Income from interest on FDRs not taken into computation of income.

[Pages and of Chapter of Compendium of Recurring mistakes detected in Audit - Published by DF(RSP & PR) on 27.11.20021]
OTHER MISTAKES

1. Underassessment of Income and Tax
   a. Incorrect adoption of figures while totaling the disallowances.
   b. Incorrect deduction allowed on account of depreciation allowance
   c. Incorrect adoption of figures resulting in excess computation of loss
   d. While computing the total assessed loss deduction disallowed was increased.
   e. Double deduction of income was claimed and allowed, once by the assessee and again by the
      assessing officer.
   f. Adoption of wrong percentage of 65% instead of 35% while grossing up the net professional receipts.
   g. Depreciation actually debited to P & L a/c. was not added while computing total income.
   h. Non assessment of income offered by the assessee
   i. Business profit erroneously taken as loss figure while revising the assessment.
   j. Refund already adjusted with the demand in summary assessment was not taken into account at
      the time of revising assessment under scrutiny.
   k. Opening stock was taken at excess figure resulting in under assessment of income.
   l. Deduction on account of depreciation and interest was not disallowed during computation even
      though it was proposed while completing the assessment.
   m. Income on account of house property was not added at the time of making assessment.
   n. A claim of expenditure on acquisition of copyright was disallowed in the assessment order but not
      deducted from the book loss.
   o. While determining the tax demand after scrutiny assessment the tax already assessed was incorrectly
      deducted.
   p. While computing total income, the returned income was taken as a negative figure instead of
      positive figure.
   q. Disallowable deduction was added to book loss instead of being reduced and admissible deductions
      were reduced instead of being added.
   r. Adjustment of refund allowed twice towards tax payable.
   s. Assessing officer computed the income as loss even though the assessee had shown it as positive
      income.
   t. Exempted income was incorrectly deducted twice in computation of income.
   U. Incorrect set off of loss though no carry forward loss was available.

2 Incorrect application of rate of tax
   a. Surcharge was not levied
   b. Tax was levied at low rate.

3 Incorrect allowance of capital expenditure
   a. Expenditure incurred on replacement of machinery was allowed as deduction.
   b. The payment of principal amount on account of lease of assets was a capital expenditure and
      hence deduction allowed was not admissible.

4 Incorrect allowance of provisions
   a. Provision of doubtful debts was not an allowable deduction and therefore A.O. had wrongly allowed
      the same.
   b. Provisions made towards purchase tax liability was allowed as deduction even though section
      43B was attracted requiring payment of the statutory liability.
   c. Provision made on account of pension contribution to the staff on adhoc basis was erroneously
allowed.

**d.** Provision made on account of revision of salary in the absence of any approval was an unascertained liability and does not qualify for deduction.

### 5 Incorrect allowance of liability

**a.** The sales tax collected from the traders and not paid to the Government was not added back to the income.

**b.** Royalty and fee were neither paid in the relevant previous year nor before the due date and not added back to the income.

**c.** Contribution to provident fund and ESI fund were not deposited within the stipulated due date, yet these were allowed as deduction.

**d.** Excise duty collected from the traders and not paid to the Govt. was not added to the income.

### 6 Incorrect valuation of closing stock

**a.** The difference between the stocks declared to the bank and in books of account was not added back.

### 7 Co-relation not done with other assessment records.

**a.** Deduction under section 80HH and 801 were admissible up to assessment year 1992-93 and 1990-91 whereas these were allowed even in the assessments completed for assessment years 1995-96 and 1996-97.

**b.** Excess interest tax liability was not withdrawn in the revised assessment.

**c.** As per the appellate order, the interest tax liability was reduced but it was not withdrawn in the subsequent assessment.

### 8 Other mistakes in computation of business income

**a.** Payment of royalty outside India was allowed as deduction though no tax was deducted at source.

**b.** Expenditure relating to acquisition of technical know-how was allowed in excess against the limit of 1/6°.

**c.** As dividend income was exempt, expenditure by way of interest and other expenses incurred on the same should have been disallowed in Assessment Year 98-99.

### 9 Irregular allowance of depreciation

**a.** Depreciation already allowed in earlier year was again considered though the written down value was nil.

**b.** Depreciation was allowed on book value of assets instead of the WDV.

**c.** Depreciation was allowed on plant & machinery even though the commercial production had not commenced.

**d.** Depreciation was allowed on assets which were not in use

**e.** Excess allowance of depreciation was allowed in respect of assets sold under hire purchase scheme.

**f.** Excess depreciation was allowed without reducing from the capital assets the MODVAT credit.

### 10 Incorrect application of rate of depreciation

**a.** Depreciation was allowed in full even though the plant and machinery was put to use for less than 180 days.

**b.** Depreciation allowed on block of assets acquired during the year at 100% instead of the admissible rate of 25%.

**c.** Depreciation allowed on vehicles at the rate of 33% even though admissible rate was 20% in A.Y. 91-92

**d.** Excess depreciation was granted due to incorrect adoption of WDV.

**e.** Incorrect adoption of figures of addition to-fixed assets resulted in excess allowance of depreciation.
11 Incorrect carry forward/set off of unabsorbed depreciation/investment allowance
   a. Carry forward of investment allowance was allowed beyond 8 years.
   b. Even though income was available but was not set off against the unabsorbed business loss and unabsorbed depreciation.
   c. Unabsorbed depreciation was set off in excess
   d. Unabsorbed depreciation was carried forward in excess
12 Incorrect computation of capital gains
   a. Erroneous application of cost indexation method in A.Y. 93-94 & 94-95 resulted in incorrect computation of capital loss and irregular set off in subsequent years.
   b. Short term capital gain was computed by taking cost of assets transferred to new unit at their book value instead of written down value.
13 Income escaping assessment
   a. Interest income was not added to income on the ground that it would go to reduce the cost of borrowing.
   b. Contract receipts in respect of contracts were not credited to the profit & loss account in full.
   c. Payment of interest on fixed deposits were not added to the income though TDS was deducted at source.
14 Incorrect carry forward/set off of losses
   a. Business losses for A.Y. 88-89 were incorrectly allowed to be carried forward to A.Y. 96-97.
   b. Out of the total income a part of income was related to business income and hence set off was to be restricted to that extent only.
   c. Carry forward business income was allowed though the return of income was filed after the due date.
   d. Set off of business loss was allowed beyond the prescribed period of 8 years.
   e. Speculation loss was irregularly set off against income from other sources.
   f. The returned loss included loss under the head capital gain, which was allowed to be set off against the business income,
   g. Unabsorbed depreciation was set off though there was no carry forward balance available.
15 Incorrect allowance of relief in respect of profit from export business
   a. While computing the deductions, income from other sources and 90 percent of interest and rental included in profit were not reduced and the income from diagnostic and hospital services was not considered as part of total turnover even though the income has arisen in the course of normal business activity. After considering these items the resultant amount will be negative and the assessee would not be eligible for any deduction towards export profits.
   b. In the revised assessment the figure of total turnover was incorrectly adopted.
   c. While allowing deduction, loss sustained by the assessee from export of trading goods during the relevant previous year was not considered.
   d. While qualifying the amount of deduction towards export profits, 90 percent of other income i.e. technical know-how was not reduced from the profits of the business to arrive at the adjusted profits.
   e. 90 percent of other incomes such as dividend, rent, royalty etc. were not reduced and net interest was deducted as against gross interest. Also while calculating the indirect cost in respect of trading goods exported, interest paid by the assessee had not been allocated.
   f. While computing the business profit income on account of receipt of dividend was not deducted from the profit of the business. Further, the Assessing Officer omitted to consider the loss sustained by assessee from export of trading goods,
   g. 90 percent of labour charges receipt and receipts from fees for technical know-how received in foreign exchange had not been reduced from business profits and hence the assessee would not be entitled to any deduction.
h. The allowance of deduction was irregular as no extension of time was granted for bringing in convertible foreign exchange within prescribed period.

i. There was no export profit of the business and irregular deduction was allowed against other income.

16 Incorrect deduction in respect of profit from new Industrial Undertaking established after 31.3.1991.

a. Even though the business of poultry farming is not an industrial undertaking the deduction was allowed.

b. The profits were worked out incorrectly by including the profits from export of trading goods and profits not eligible for deduction.

c. Past losses of respective units were not set off before allowing the deduction.

d. Deduction allowed on other income was not admissible.

e. While computing the profit, book depreciation was not added nor depreciation as per Income tax Act allowed as deduction. Further research and development expenditure allowed was also not reduced from profits.

f. The deduction was computed without considering depreciation allowable under the Income tax Act, which resulted in excess allowance of deduction.

g. Profits of the two units for the purpose of deduction were not reduced by the amount of sales tax deducted. Besides sales tax payment allowed otherwise as a revenue item was also required to be considered in arriving at the profits of the units which was not done.

17 Incorrect allowance of deduction in respect of commission etc. from foreign enterprises.

a. Even though the assessee was not entitled to deduction as it brought the amount after more than six months from the end of the previous year and no extension was obtained from the competent authority yet the deduction was allowed.

b. The deduction was allowed on the gross income of the service charges instead of the net income.

c. Even though the assessee was not providing any services eligible for deduction towards commission received from foreign enterprises yet the deductions were allowed.

d. While determining expenses against receipts only direct expenses were considered whereas total expenses were required to be allocated on pro-rata basis between foreign and local receipts.

18 Non levy/short levy of interest for delay in filing the return, short payment of advance tax and delay in payment of tax demand.

a. Even though the return was filed late, interest u/s.234A was not charged in the assessment order passed u/s.144 which was required to be charged.

b. In a case where there was short payment of advance tax, while computing interest leviable the amount paid by the assessee by way of self-assessment tax was fully reduced from the tax payable without being adjusted first towards interest payable on the date of payment.

c. Advance tax paid fell short of 90% of assessed tax and hence interest was short levied.

d. While doing reassessment the interest for short payment of advance tax was wrongly calculated.

e. Even though the assessee did not pay the tax demanded on the dates specified in the demand notices the assessing officer did not raise interest demand-

19 Irregular grant of interest by Government to assessee

a. Interest was paid even though the refunded amount was less than 10% of the tax.

b. Excess payment of interest made due to wrong calculations.

c. Delay in granting the refund resulted in avoidable payment of interest by Govt.

d. Interest on refund due to the assessee was omitted to be allowed.

20 Irregular grant of credit to TDS

a. Even though the income was not offered for tax the credit of TDS was given.

b. In a case, tax- was deducted at source on payment of interest to the creditors, but it was not remitted to
the Central Govt. Neither any interest was charged nor any penalty was levied for the default.

21 Unexplained investment

a. In a non-company case, as the genuineness of the loan liability was not explained satisfactorily, the amount was required to be treated as income.

b. In a non-company case, loan obtained by the assessee from third party was accepted without explaining the source of money.

[Also see Power Point Presentation on Common Mistakes in CD attached]
CHAPTER VII

IMPACT OF REVENUE DUE TO IMPLEMENTATION OF SELECTED JUDGMENTS OF SUPREME COURT OF INDIA RELATED TO DIRECT TAXES

The C & AG had earlier in the Audit Report No 13 of 2003 included a Review on Implementation of selected judgments of Supreme Court of India in the Audit Report for the period 2001-2002. In this Review, 34 selected judgments of Supreme Court of India were taken into account to evaluate the revenue on account of non-implementation of such judgments on assessments made by the Assessing Officers and enlisted the Scope of the Review in the following type of cases:

1. The assessments of returns of Income of parties to the cases in Supreme Court.
2. Assessments of similar cases (Past, present and future) relevant in Supreme Court judgments.
3. Action by the department to bring about necessary changes in the Act as a result of any landmark judgments wherever applicable.

The C & AG commented on 34 judgments only, the nature of mistakes and gists of judgments are given as under:

Nature of Mistakes:

The following nature mistakes are pointed out by the C & AG on the basis of their Review on implementation of Supreme Court Judgments on the following points:

1. Omission to assess interest income received before the commencement of business under the head “Income from other sources” including interest on deposits. [Para 9.1 of the Review] (See Sl. No. 7 and 8 of the brief gist of Supreme Court Judgments on page 2.
2. Omission to disallow interest paid on income tax claimed as expenditure [Para 9.2 of the Review] See Sl. No. 11 of the brief gist of Supreme Court Judgments on page W.
3. Incorrect allowance of expenditure incurred in violation statutory provisions [Para 9.3 of the Review] (Also see Sl. No. 12 of the brief gist of Supreme Court Judgments on page 2).
4. Incorrect allowance of depreciation allowed on building trading as plant. [Para 9.4 of the Review] Also see Sl. No. 13 & 14 of the brief gist of Supreme Court Judgments on page 19.
5. Incorrect allowance of expenditure on contingent liability. [Para 9.5 of the Review] (Also see Sl. No. 17 & 20 of the brief gist of Supreme Court Judgments on page 910.
6. Incorrect allowance of expenditure [Para 9.6 of the Review] (Also see Sl. No. 10 of the brief gist of Supreme Court Judgments on page 1).
7. Incorrect allowance of business loses [Para 9.7 of the Review] (Also see Sl. No. 21 of the brief gist of Court Judgments on page 1).
8. Incorrect allowance of deduction u/s 80 HHC. [(Para 9.8 of the Review) Also see Sl. No. 26 of the brief gist of Supreme Court Judgments on page 3).
9. Incorrect allowance of relief of export profit: [Para 9.9 of the Review] - (Also see Sl. No. 31 & 32 of the brief gist of Supreme Court Judgments on page 4).
10. Deduction on export sale to trading house without disclaimer certificates [Para 9.10 of the Review] (Also see Sl. No. 27 of the brief gist of Supreme Court Judgments on page 3)

11. Incorrect allowance of capital expenditure on account of increase in share capital [Para 9.10 of the Review] (Also see S1. No. 31 & 32 of the brief gist of Supreme Court Judgments on page 4)

12. Omission to assess revenue subsidy [Para 9.12 of the Review] (Also see Si. No. 33 of the brief gist of Supreme Court Judgments on page 4)

13. Incorrect allowance of liability. [Para 9.13 of the Review] (Also see Sl. No. 25 of the brief gist of Supreme Court Judgments on page 3)

14. Incorrect allowance of statutory liability. [Para 9.14 of the Review] (Also see Sl. No. 30 of the brief gist of Supreme Court Judgments on page 4)

15. Incorrect allowance of brief for exclusive and enduring advantage on portion of Royalty. [Para 9.15 of the Review] (Also see Sl. No. 23 of the brief gist of Supreme Court Judgments on page 3)

16. Incorrect allowance depreciation on capital asset in addition to expenditure on scientific research. [Para 9.1 of the Review] (Also see Sl. No. 15 & 16 of the brief gist of Supreme Court Judgments on page 2)

17. Incorrect allowance of deduction u/s 80 HH 1801/801A1841B. [Para 9.17 of the Review] (Also see Sl. No. 1, 2 of the brief gist of Supreme Court Judgments on page 1)

18. Incorrect allowance deductions. [Para 9.18 of the Review] (Also see Sl. No. 3 of the brief gist of Supreme Court Judgments on page 1)

19. Incorrect allowance of deduction u/s 801. [Para 9.19 of the Review] (Also see Sl. No. 4 of the brief gist of Supreme Court Judgments on page 1)

20. Incorrect allowance of capital expenditure held in re 82 ITR 902- CIT vs Coal Shipments (p) Ltd. [Para P.20 of the Review] (Also see Sl. No. 29 of the brief gist of Supreme Court Judgment on page 3.)

21. Incorrect valuation of closing stock (Not in 34 items) (Para 9.21 of the Review) (Also see Sl. No. 34 of the brief gist of Supreme Court Judgments on page 4) (188 ITR 44- CIT vs British Paints Ltd)
## LIST OF SUPREME COURT DECISIONS - WITH BRIEF GIST-

<table>
<thead>
<tr>
<th>S.No.</th>
<th>Reference to ITR</th>
<th>Cases</th>
<th>Gist of objection</th>
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</thead>
<tbody>
<tr>
<td>1.</td>
<td>2451TR830(2000)</td>
<td>MlsLuckey Mimnat Pvt. Ltd. Vs. CIT</td>
<td>The Supreme Court had held that mining of limestone and marble blocks and cutting and sizing them are not manufacturing activity. and assessee is not entitled to special deduction under Section 80HH.</td>
</tr>
<tr>
<td>2.</td>
<td>246 ITR 230 (1998)</td>
<td>DDC of Sales Tax &amp; another Vs Bherhaghat mineral Industries</td>
<td>The Supreme Court had also held that crushing of dolomite lumps into chips and powder does not bring about new commercial commodity.</td>
</tr>
<tr>
<td>3.</td>
<td>237 ITR 174 (1999)</td>
<td>CIT Vs. Venkateswarra Hatcheries Pvt. Ltd. &amp; others</td>
<td>The Supreme Court had held that poultry arming, hatcheries and aqua-culture-are not industrial manufacturing activities and hence deductions under section 801, 801A and 8OHN are not allowable</td>
</tr>
<tr>
<td>4.</td>
<td>249 ITR 307 (2000)</td>
<td>CIT Vs. Gem India Manufacturing Co.</td>
<td>The Supreme Court had held that cutting and polishing uncut raw diamonds do not amount to manufacture or production of article or thing and assessee was not entitled to special deduction under income-tax Act, 1961</td>
</tr>
<tr>
<td>5.</td>
<td>245 ITR 538 (2000)</td>
<td>Indian Hotels Co. Ltd. &amp; others Vs. ITO &amp; Other</td>
<td>The Supreme Court had held that an assessee who is carrying on a trading activity of business of a hotel cannot claim the benefit. Granted to an industrial undertaking by contending that it also produces foodstuff or food packets. The flight kitchen operated produces foodstuff or food packets. The flight kitchen operated by the assessee is not entitled to get the benefit of section 80</td>
</tr>
<tr>
<td>6.</td>
<td>204 ITR 412 (1995)</td>
<td>CIT Vs. Mc. Budharaja &amp; Co. &amp; another</td>
<td>The Supreme Court had held that Firm of contractors formed for construction of a dam Construction of dam not manufacture or production of article Firm not entitled to relief Interpretation of taxing statutes words used I Beneficent object Liberal interpretation Words used take colour from context words used take colour also from history of provisions. Liberal interpretation not to do violence to plain language. Objection to be gathered on reasonable interpretation of language. Assessee carrying on business of laying “pressure piling” foundation for buildings and other structures. Does not manufacture or produce on article or articles. Not entitled to relief “article” Foundation for superstructures of which it is an integral part. Not an “article” Construction of dams and canals Not “construction” of a “thing” or “things”. Assessee not entitled to allowance on machinery and plant. Assessee doing execution of civil engineering and structural work. Assessee digging bore wells. Not entitled to investment allowance.</td>
</tr>
<tr>
<td>7.</td>
<td>234 ITR 412 (1997)</td>
<td>CIT Vs. coromandal Cements Ltd.</td>
<td>The Supreme court had also held that interest received (earned from deposits for pre production period/prior to commencement of business is assessable as income from other sources.</td>
</tr>
<tr>
<td>8.</td>
<td>227 ITR 173 (1997)</td>
<td>Tuticorin Alkali cement &amp; Fertilizers Ltd. Vs. CIT</td>
<td>The Supreme court had held that income from other sources, before commencement of business, was liable to be assessed as such and it should into be reduced from the cost of installation of Plant and machinery or any other asset.</td>
</tr>
<tr>
<td>9.</td>
<td>248 ITR 10 (200)</td>
<td>CIT Vs. Autokast Ltd.</td>
<td>The Supreme court had held that Rule 1 D is mandatory for valuation of even unquoted shares.</td>
</tr>
<tr>
<td>10.</td>
<td>224 ITR 414 (1997)</td>
<td>Balhimal naval Kishore &amp; another Vs. CIT</td>
<td>The Supreme Court had held that expenditure incurred for preserving or maintaining an existing asset is current repairs and where the expenditure incurred bring into existence a new asset or where the cost of replaced part constitutes substantial value of the old machinery, the expenditure incurred would constitute capital expenditure</td>
</tr>
<tr>
<td>11.</td>
<td>230 ITR 733(1998)</td>
<td>Bharat Commerce &amp; industries Ltd. Vs. CIT</td>
<td>The Supreme Court held that income tax itself is not permissible deduction, any interest payable for delay in filling the return and failure to pay advance tax cannot be allowed as deduction.</td>
</tr>
<tr>
<td>12.</td>
<td>229 ITR 534(1997)</td>
<td>Maddi Venkat armr &amp; Co. (P) Ltd. Vs. Cit</td>
<td>The Supreme Court had held that any expenses, incurred in transactions carried out in violation of provisions of statute in force was not allowable.</td>
</tr>
<tr>
<td>13.</td>
<td>243 ITR 81 (1999)</td>
<td>CIT Vs. Dr. B. Venkata Rao</td>
<td>The Supreme Court had held that the asessee's nursing home is equipped to enable the sterilization of surgical circumstances, particularly having regards to the Tribunal's order which states that the sterilization room covers about 250 sq. Ft. that the nursing home is also equipped with an operation theatre. In the circumstance, the finding of the High court should be accepted.</td>
</tr>
<tr>
<td>14.</td>
<td>244 ITR 192 (2000)</td>
<td>CIT Vs. Anand Theates</td>
<td>The Supreme Court had held that hotel building and theatre building remain buildings even if these are specially equipped with moisture and weather control equipment for the purpose of business and as such depreciation is allowable on these buildings at the rates applicable to building and not to the plant</td>
</tr>
<tr>
<td>15.</td>
<td>247 ITR 797 (1999)</td>
<td>CIT Vs. Hico Products P. Ltd.</td>
<td>The Supreme Court had held that where a deductions for scientific expenditure has been allowed in respect of capital asset for the same or any other previous year, no depreciation shall be allowed on that capital asset for the same or any other previous year.</td>
</tr>
<tr>
<td>16.</td>
<td>199 ITR 43 (1992)</td>
<td>Escorts Ltd. &amp; another Vs. Union of India &amp; others</td>
<td>-do-</td>
</tr>
<tr>
<td>17.</td>
<td>248 ITR 4 (20)</td>
<td>Indian Smelti &amp; Refining Co. Ltd. Vs. CIT</td>
<td>The Supreme Court had held that A continent likably could not constitute expenditure for the purpose of Income Tax</td>
</tr>
<tr>
<td>18.</td>
<td>233 ITR 809 (1997)</td>
<td>Marshall Sons &amp; Co. (India) Vs. ITO</td>
<td>The Supreme Court had held that where the scheme of amalgamation specifies a date from which the amalgamation/transfer shall take place and provides that with effect from that date, the transferor company shall be deemed to have carried on the business for and on behalf of the transferee company with all attendant consequences and the courts sanction the schemes without prescribing any specific date, the amalgamation takes effect on the date specified in the scheme.</td>
</tr>
</tbody>
</table>
| 19. | 248 ITR 323 (00) | CIT Vs. Mrs. Grace Collis & others | The Supreme Court had held that the rights of the assesses in the capital asset, being their shares in the amalgamating company, stood extinguished upon the amalgamated company with the amalgamated company. There was, therefore, a transfer of the shares in the amalgamating company within the meaning of section 2(47). It was, therefore, a transaction to which section 47 (vii) applied and, consequently, the cost to the assesses of the
<table>
<thead>
<tr>
<th>Case Number</th>
<th>Reference</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>20.</td>
<td>243 ITR 640 (200)</td>
<td>New India Mining Corporation Pvt. Ltd. Vs. CIT</td>
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<td></td>
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<td>The Supreme Court had held that as expenditure is allowed when it is incurred by way of an obligation to meet it.</td>
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<tr>
<td></td>
<td></td>
<td>The Supreme Court had held that if bad debts debited in the Profit and loss accounts relates to any advances on capital account they are not admissible as deduction as the loss is capital loss. If loan taken on capital account becomes irrecoverable. Te loss incurred is capital loss.</td>
</tr>
<tr>
<td>22.</td>
<td>235 ITR 131 (1997)</td>
<td>State of bihar &amp; others Vs. Steel City Beverages Ltd. &amp; others</td>
</tr>
<tr>
<td></td>
<td></td>
<td>The Supreme Court had held that the company was not entitled to the benefit of deferment in respect of its investment in bottles and crates it could not be said that it had acted contrary to law.</td>
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<td></td>
<td></td>
<td>The Supreme Court had held that grant of technical aid fee for setting up factory and right to sell the products as per collaboration agreement is not allowable as revenue expenditure and was to be treated as capital expenditure.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>The Supreme Court had held that the Indian Income Tax Act., interalia, taxes income which accrues or arises in India. It is immaterial whether the petitioner company has its head office in Sikkim or may be carrying on business activities there. The impugned notice under section 148 of the Income Tax Act has been issued in relation to the income which is stated to have arisen in India and this can be done even if the petitioner has a company in Sikkim.</td>
</tr>
<tr>
<td>25.</td>
<td>245 ITR 428 (2000)</td>
<td>Bharat Earth Movers Vs CIT</td>
</tr>
<tr>
<td></td>
<td></td>
<td>The Supreme Court had held that amount set aside for contingent liabilities is not an allowable expenditure. Expenditure which is allowable for income tax purpose is one which is towards a liability actually existing at that point of time but putting aside of money which may become expenditure on the happening of an event is not Expenditure.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>The Supreme Court had held that while granite alone can be considered as a mineral, any process applied to granite would deprive the quality of rough mineral and therefore the profit derived from the export of granite dimensional blocks alone would be eligible for deduction under Section 80HHC.</td>
</tr>
<tr>
<td>27.</td>
<td>247 ITR 578 (2001)</td>
<td>Sea Pearl Industries &amp; others Vs. CIT</td>
</tr>
<tr>
<td></td>
<td></td>
<td>The Supreme Court had held that deduction to supporting manufacturer is allowable provided it furnishes a certificate from export/trading house declaring that the export/trading house did not claim the deduction on the said sale, duly certified by the statutory auditors who audited the accounts of that house.</td>
</tr>
<tr>
<td>28.</td>
<td>239 ITR 297 (1997)</td>
<td>Hindustan Lever Ltd. Vs. CIT</td>
</tr>
<tr>
<td></td>
<td></td>
<td>The Supreme Court had held that import entitilements utilized to purchase goods for use in the manufacture of other products which were sold in India and profit from such sale was not income derived from export and assessee was not entitled to deduction under section 80 HHCD.</td>
</tr>
<tr>
<td>29.</td>
<td>82 ITR 902 (1971)</td>
<td>CIT West Bengal II Vs. Coal Shipmets (P) Ltd.</td>
</tr>
</tbody>
</table>
| | | The Supreme Court had held that monopoly value payments were imposed for the term of the license on grant or renewal though the fact that permission was...
<table>
<thead>
<tr>
<th></th>
<th>Case Reference</th>
<th>Parties</th>
<th>Decision</th>
</tr>
</thead>
<tbody>
<tr>
<td>30.</td>
<td>248 ITR 3 (2000)</td>
<td>Gore Lal Dubey vs. CIT</td>
<td>The Supreme Court had held that Royalty is taxable for all purposes including application of Section 43-B of IT Act.</td>
</tr>
<tr>
<td>31.</td>
<td>225 ITR 792 (1997)</td>
<td>Punjab State Industrial Development Corporation Ltd. vs. CIT</td>
<td>Brooke Bond India Ltd. Vs. CIT</td>
</tr>
<tr>
<td>32.</td>
<td>225 ITR 798 (1997)</td>
<td>Brooke Bond India Ltd. vs. CIT</td>
<td>Brooke Bond India Ltd. Vs. CIT</td>
</tr>
<tr>
<td>33.</td>
<td>228 ITR 253 (1997)</td>
<td>Sahney Steel and Press works Ltd. &amp; other Vs. CIT</td>
<td>The Supreme Court had held that if some subsidy is given to the assessee for assisting him in carrying out the business operations such. Subsidy must be treated as assistance for the purpose of the trade and hence classified as revenue receipts</td>
</tr>
<tr>
<td>34.</td>
<td>188 ITR 44 (1990)</td>
<td>CIT Vs. British Paints India Ltd.</td>
<td>The Supreme Court had held that any system of accounting which excludes for the valuation of closing stock in trade, all cost other than the cost of raw materials is likely to result in destroyed picture of the state of affairs of business for the purpose of computing the chargeable income. The Board clarified in 1981, that Central Excise/Customs Duties, if any payable, by the manufacturer/trader should go into calculation of production cost and the closing inventories should include an element of this duty or represent such cost. Further, the valuation of stock is a vital factor in determining the taxable income from the business as correct profits of the assessee cannot be ascertained unless the opening and closing stock are valued correctly.</td>
</tr>
</tbody>
</table>

CHAPTER-VIII

CONTENTS OF AUDIT CHECK SHEET AT A GLANCE FOR INTERNAL AUDIT

Audit Check sheet is issued by DI (Audit), which is given at the end of these notes. In the Check Sheet, various issues of checking by the Internal Audit have been dealt from Para -A to Para -Z le. on 26 Paras on various topics and different sections of the Income Tax Act 1961, which are detailed as under:

A. PRELIMINARY CHECK:
B. INCOMES WHICH DO NOT FORM PART OF TOTAL INCOME
C. CHARITABLE TRUSTS AND INSTITUTIONS
D. SECTION 14A
E. SALARY
F. INCOME FROM HOUSE PROPERTY
G. PROFITS AND GAINS FROM BUSINESS OR PROFESSION
H. INCOME FROM CAPITAL GAINS
I. INCOME FROM OTHER SOURCES
J. CLUBBING OF INCOME
K. SET OFF OF LOSSES SECTION 70,71 & 72
L. SECTION 80AB
M. 80G
N. 80 HHC (Omitted w.e.f.14-2005)
O. DEDUCTION U/S 80-IA & 80 IB
P. 801AB
Q. BOLA
R. DEDUCTION UIS 80 - P
S. ASSESSMENT PROCEDURE
T. FRINGE BENEFIT TAX:
U. INTERNATIONAL TAXATION:
V. TRANSFER PRICING
W. CHECK SHEET FOR TDS CASES
X. OTHER POINTS RELATED TO TDS
Y. TAX COLLECTED AT SOURCE
Z. CHECK SHEET FOR REFUND CASES
A. **PRELIMINARY CHECK:** Important checks relating to assessment have been enumerated. These are primary checks to be done by auditors to cover the entire assmt: order.

B. **INCOMES WHICH DO NOT FORM PART OF TOTAL INCOME:** This part deals with sections 10, 1 OA, IOAA, IOBA and IOC and lay down the conditions which are required to be fulfilled by the assessees for availing the benefit of these sections, sometimes non-fulfillment of conditions leads to withdrawal of exemptions.

C. **CHARITABLE TRUSTS AND INSTITUTIONS:** This part deals with checks, whether the Trust is a valid trust, whether trust's objects are charitable, whether the trust is registered U/s 12A/12AA or not, whether condition for application of receipts have been applied or not, whether books of accounts have been maintained as per conditions or not. On section 13—whether the conditions laid down U/s 13 have been violated or not; funds of the trust have been appropriately invested in securities and to examine whether the anonymous donation received U/s 13(7) of the I.T. Act., 1961.

D. **SECTION 14A:** Whether expenditure expended on income exempt from tax has been disallowed or not?

E. **SALARY:** Checks for deduction U/s 80C—Conditions for correct deduction under rule 2A for HRA, U/s 10(14), deduction U/s 89(1) have been correctly allowed, taxation of perquisites and compensation received on VRS etc. have been dealt.

F. **INCOME FROM HOUSE PROPERTY:** There are eleven checks relating to section 23, 24, 25B mid 26 etc. dealt in this part.

G. **PROFITS AND GAINS FROM BUSINESS OR PROFESSION:** There are 54 items of checks are dealt in this part exhaustively covering allowable expenses, methods of accounting, double deductions Penalties Tax Audit Reports besides other checks u/s 2(22) (e), 14A, 32A(5), 35D, 36, 40 (a) (i), 40A (3), 43B, 44AD, 44AF, 50, 50B and 145 etc.

H. **INCOME FROM CAPITAL GAINS:** This part of check list included the correct taxability of capital gains, charging of capital gain on dissolution of firm/ AOP/BOI and covering following section of I.T. Act. 1961 i.e. sections 47, 50A, 54 to 54GA, 55(2) (a), 55(2) (aa), 88 and 112.

I. **INCOME FROM OTHER SOURCES:** This part of check list included type of incomes which are to be brought to tax such as winning from lotteries, crossword puzzles, horse races, card games, taxation of gifts, amounts specified by sections 40A, 70, 71 & 72 and allowability of deduction U/s 80CCC to 80U.

J. **CLUBBING OF INCOME:** This part suggests auditing officers/officials to cover section 60 relating to transfer of income without transfer of assets, U/s 64 relating to remuneration of spouse, income from assets transferred to son's wife, generation of income in the hands of minor child, conversion of self occupied property with Joint family property.

K. **SET OFF OF LOSSES SECTION 70, 71 & 72:** This part of checks sheet to examine the correctness of carry forward and set off of losses including set off of speculative loss and capital loss.

L. **SECTION 80AB:** Relates to disallowance of excess deduction, where the deduction-U/s 80 exceeds the profit and gains of business.
M. **80G** : This part of checks sheet advices deduction is not available to a trust which is wholly/substantially for religious purposes etc.

N. **80 HHC (Omitted w.e.f.1.4-2005)** : 21 items of checks were covered in this checks sheet on various aspects of export profits' allowability, etc in detail running in two pages

O. **DEDUCTION U/S 80-IA & 80 IB** : This part included auditors certificate in Form No. IOCCB and various other conditions of allowability of deductions numbering 16 checks.

P. **801AB** : This part relates to check-whether deduction has been claimed for any ten consecutive asstt. years out of 15 years from the year in which SEZ has been notified or not.

Q. **SOLA** : This part relates to allowability of certain incomes of Offshore Banking Units and International Financial Services Centre to check if the conditions laid down are fulfilled.

R. **DEDUCTION U/S 80 - P** : This part relates to allowability of deduction U/s 80P(2)(a) (ii) only to the primary cooperative societies etc.

S. **ASSESSMENT PROCEDURE** : There are 17 checks laid down, whether correct figure of P&L a/c is adopted to charging of interest u/s 220(2) for delayed payment of demand. Other checks deal with section 1153A, 1153AA, I43(l)(a), chapter VIA, 153A, I53C. This is a very important part of the check sheet.

T. **FRINGE BENEFIT TAX**: This relates to timely filing of return, payment of Advance Tax, interest chargeable, application of correct rate of tax and coverage of all perquisites etc.

U. **INTERNATIONAL TAXATION**: Eleven checks have been enumerated for Sections 90 to 93 dealing with taxation of non-residents income in India.

V. **TRANSFER PRICING**: 4 checks have been given including reference to TPO on audit report in Form 3CEB etc.

W. **CHECK SHEET FOR TDS CASES**: It relates to comprehensive checks numbering 26 points, covering various forms of challans, conditions of TAN whether fulfilled, TDS certificates, and other sections relating to TDS etc.

X. **OTHER POINTS RELATED TO TDS**: It relates to non-deduction or deduction at lower rate of TDS, to check the procedure of refund of excess TDS, whether followed or not.

Y. **TAX COLLECTED AT SOURCE**: To check whether the seller has collected tax at the prescribed rates from the buyer and deposited the tax collected at source in the Govt. Treasury within the stipulated period in respect of the payments received on sale of business of various items.

Z. **CHECK SHEET FOR REFUND CASES**: The C&AG has prepared a detailed review on refunds under the Income-tax Act, 1961 and their findings appear in Chapter V of Report No. 12A of 2002 (Direct Taxes). In their review the C&AG has pointed out very serious lapses, mistakes/errors and irregularities in grant of refund which fall within the preview of internal audit. There are 27 types of irregularities enumerated. This part holds importance and is beneficial for auditing officers and Assessing Officers as well.

Section: IV
Chapter VIII

AUDIT CHECK SHEET

A. PRELIMINARY CHECK

1. Whether all disallowances discussed in the body of the assessment order have been taken into account in the computation of total income?

2. Arithmetical inaccuracies and transcription errors.

3. In loss cases, whether disallowances are reduced from the loss or not?

4. Whether total amounts proposed to be considered separately in the body of the assessment order are first added back to the returned income in the computation of total income?

5. Has mandatory interest under sections 234-A, 234-B, 234-C and 234-D been charged correctly with reference to period of default and amount?

6. Whether interest u/s. 234-B has been calculated up to the date of reassessment.

7. Whether the amounts shown in the TDS certificates are offered for assessment or not?

8. Whether TDS are and are applicable for which such income is assessable i.e. in the prescribed format all the columns duly filled?

9. Whether the total of the TDS included in the pre-paid taxes claim tallies with the total of the amount as TDS Certificates?

10. Whether the return of loss is filed within the time limit permitted under section 139(3)?

11. Whether the disallowances/additions been reduced from the loss in loss cases?

12. Whether Residential Status of the assessee has been correctly determined?

13. Whether accrual of income has been taken into account in the computation of income depending on the residential status?

14. Whether details of b/f losses have been verified from records?

15. With reference to nature of income, whether the status of company (Domestic/non-Domestic) is determined correctly?

16. Whether the rate of tax has been applied correctly? Whether surcharge and/or education cess, if leviable, has been added to the tax on the total income in the case including case of Block Assessment?

17. Whether interest on refund, if any received in the previous year is shown in the taxable income?

18. Whether interest on refunds is granted although:-

   (i) The refund is less than 10% of the tax payable and

   (ii) The delay in grant of refund is attributable to the assessee?

19. Whether MAT has been computed and paid wherever required to be so.

20. Whether appeal effect has been given on time or not?

21. Interest on refunds whether calculated

22. Whether the ‘a’ is liable and pay FBT, SIT & CBTT 7 If yes, Whether he has paid it.

23. The residential status of an assessee must be taken into account before proceeding in the case of any assessee. [Sec. 6]

24. Whether Dividend Income has been included in the income as per the following:

   - 2 (22) (a), (b), (c), (d) Or (e)

   - Any interim dividend to the member.
B. INCOMES WHICH DO NOT FORM PART OF TOTAL INCOME

B.1 SECTION 10

Check whether claim made under any sub-section of Section 10 satisfies the conditions laid down in that sub section

B.2. SECTION 10A:

1. Whether options under sections 10-A has been filed in the initial assessment year?
2. Whether certificate from the Board for the approval of the export oriented unit has been filed or not?
3. Whether declaration in writing specifying the to consecutive assessment years has been filed or not?
4. Whether evidence to prove that plant and machinery of the industrial undertaking are new and not used earlier in India is on record or not?
5. Whether the unit is actually carrying on an activity of manufacture or production and is maintaining separate accounts for the same or not?
6. Whether any sales are made to/from any sister or allied concern so as to disallow claim on excess income?
7. Whether income not derived from export is excluded in claiming exemption?
8. Whether unabsorbed depreciation and other specified unabsorbed allowances/losses brought forwards from earlier years and deductions under section 80 HH, 80HHA, 80IA, 820IB or 80H have been excluded in the claim u/s 10A of the Income Tax Act.
9. Whether person claiming deduction under section 10A(I) after 01-04-2006 has filed his return of income on or before (late specified in section 139(1) of the Act or not?
10. Whether the exemption has been claimed in the percentage and time frame as specified in section 10A(IA).
11. Whether the undertaking has, before the expiry of the exempt ion period, been transferred, amalgamated or de-merged with another company?
12. Whether the sale proceeds been brought in to India by the assessee in convertible foreign exchange within 6 months of the end of the relevant previous year or not?
13. Whether the Special Economic Zone Re-investment Allowance reserve Account has been utilized for the purpose specified in section 10A(1 B) of the Act?

B.3 SECTION 10AA

1. Whether the claim of exemption is commensurate with the time-frame given in section 10AA(I) of the Act.
2. Whether the amount credited to the Special Economic Zone Re-investment Reserve Account has been utilized for the purpose for which it is created and in the time frame specified.
3. If the SEZ was earlier an FIZ(Free Trade Zone) then is the assessee claiming exemption for only
the unexpired period?

4. Whether the undertaking is manufacturing or producing an article or thing in the relevant year and in an SEZ.

5. Whether the company has undergone an amalgamation or demerger in the relevant previous year and the effect thereof on the exemption.

6. Whether only that loss has been allowed to be carried forward which relates to site business of the undertaking.

7. Whether other incomes’ i.e. interest, job work etc. have been excluded or not.

8. Whether the provisions of sub-section (8) or (10) of section 80 IA apply to the claim of exemption or not?

9. Whether the unit has been formed by the splitting up or reconstruction of an earlier unit or through purchase of new machinery or not.

B.4. SECTION I OBA & I OC

Whether the conditions laid down in sections 10BA & 10C have been complied with while claiming exemption under these section.

C. CHARITABLE TRUSTS AND INSTITUTIONS

1. Whether the Trust is valid?

2. Whether the objects of the Trust are mainly for charitable purposes?

3. Whether the Trust is registered u/s. 12AA of the Income Tax Act?

4. Whether 85% of the receipt is applied for the purpose of the Trust and the remaining accumulated as per norm? If 85% is not applied for accumulation of the income whether Form 10 is filed and within the prescribed time limit?

5. In case of business activity whether separate books of accounts are maintained?

6. When income exceeds Rs. 50,000 whether audit report in Form-10B is filed or not?

7. Whether the funds of the Trust are invested in the approved securities as specified under section 13(1)(d) of the IT. Act?

8. Whether any conditions mentioned in Sec. 13 have been violated or not?

9. Whether the Trust has received any anonymous donation taxable u/s 13(7)

D SECTION 14A

Whether expenditure expended on income exempt from tax has been disallowed or not?

E SALARY

1. Whether deduction u/s 80C has been rightly claimed or not?

2. Whether exemption of HRA has been correctly calculated as per Rule 2A?

3. Whether items claimed as exception under section 10(14) read with Rule 2BB have been notified/prescribed?

4. As proof of employment whether TDS certificate or Salary certificate from the employer is filed?

5. In case of arrears of salary for claiming relief under Section 89 whether Form 10-B is filed

6. Whether perquisites have been rightly quantified and offered for taxation.
7. Whether compensation received on VRS has properly been taxed after allowing deductions.

F. INCOME FROM HOUSE PROPERTY

1. Whether annual value is correctly determined?
2. Whether deductions under sections 23 & 24 have been correctly allowed for the following:
   A) Municipal Tax
   B) Insurance Premium
   C) Land Revenue
   D) Interest on borrowings etc.
3. Whether any deduction towards interest on borrowed money in respect of self occupied property is restricted to admissible limit for the relevant assessment year.
4. Whether the deduction towards interest on borrowed money in respect of self occupied property is restricted to admissible limit for the relevant assessment year.
5. Whether the claim for deduction under section 23 of municipal tax is supported by evidence of actual remittance?
6. Whether the ALV of only one house has been taken as `oil' while assessing the ALV of the other in cases of more than one house of self-occupation?
7. Whether the deduction on account of interest payment under section 24 for self occupied property has been given on enhanced rate only after ascertaining the date of borrowing of capital and completion/acquisition of the property.
8. Whether the house property referred in Section 23(2), if consists of more than one house, the annual value of the house or houses other than the self occupied house as per section 23(2) has been determined under section 23 as if such house or houses had been let?
9. Whether special provisions as mentioned in section 25B have been taken into consideration regarding taxing arrears of rent received by the assessee in the year of receipt?
10. In case of house property under co-ownership have the conditions laid down in Section 26 been correctly applied.
11. Whether income on services' provided has been assessed under 'Other sources' or not.

G. PROFITS AND GAINS FROM BUSINESS OR PROFESSION

1. Whether double deduction/allowance has been claimed or made?
2. Whether system of accounting followed by the assessee is kept in view while allowing the expenses? Hybrid System is not permitted w.e.f Assn. Year 1997-98. Verify expenses claimed which are in violation of this prohibition?
3. Whether any provision or contingent liability i.e. Provision of Tax, Provision for liquidated damages, Provision for stock/depreciation etc. have been added back?
4. Whether disallowance for the item like Penalty, Penal Interest, Personal Expenses, Capital Expenses, Donation or Charity etc, have been added back?
5. If interest charged on loans is not apparently reasonable, whether disallowance out of interest claimed, if any, has been considered?
6. Whether disallowances under section 43-B have been correctly made.
7. Whether unpaid portion of employees' contribution to PF, ESI, Gratuity Fund have been treated as income?
8. Whether remarks made in the Tax Audit Report have been considered for disallowance?
9. Whether tax Audit Report is filed as per the provisions of Section 44AB? If not filed in eligible cases whether penalty u/s 27 IB has been initiated?
10. Whether the provisions of section 44AD, 44AE, 44AF have been correctly applied in the eligible cases? If in the above cases profit offered is not within the limit prescribed whether tax audit report is filed?
11. Whether Profit & Loss Appropriation Account has been considered for computing the correct income?
12. Whether refund of excise, sales-tax or liability written back are offered for tax?
13. Whether ST collected Interest not paid has been taxed as revenue receipt or not.
14. Whether Provisions of Sec. 14A has been applied or exempted income or not.
15. Whether receipt of cash assistance, compensatory payment and DEPB duty drawback have been brought to tax? Whether DEPB taxed on gross income or not?
16. In case of firm whether payment of interest to the partner on the capital is reacted to 12%.
17. In case of firm whether remuneration to the working partner is as per the, partnership deed and within the restrictions provided in the Act?
18. In case of fluctuation in the foreign exchange rate whether the actual cost of the asset is changed?
19. Foreign Exchange fluctuation claims whether on revenue or capital account.
20. Whether the closing stock is correctly valued and further adjusted to include the amount of any tax, duty, cess or fee (Modvat) actually paid or incurred by the assesses to bring the goods to the place of its location (reference provisions of section 145A applicable w.e.f. 1.4.1999)? Has the effect of duty drawback and set off of sales tax been considered for the purpose?
21. Whether the closing stock is valued correctly, in particular, whether the component of Excise duty is included? If there is change in method of valuing closing stock whether A.O. has correctly computed the income or not:
22. In case of closure of the business, whether the closing stock is valued at market price?
23. In case of assessee dealing in real estate business, whether the annual value on the properties pending for sale, used by the assesseee, has been brought to tax?
24. Work-in-progress has been made part of closing stock and valued properly.
25. In case of non-corporate assessees, whether Form 3B is filed for claiming amortization of preliminary expenses a/s. 35D on Industrial undertakings.
26. Whether any capital expenditure has been erroneously allowed as a revenue expense?
27. In case of claim a/s. 35D whether the total expenses is restricted to the cost of the project / 2.5% of the capital of the company?
28. Has bad debt been written off in the books of account or not.
29. Has bad debt in respect of banks and financial institutions referred to in section 36(i)(viia) been related in the excess over the reserve for bad debts u/s 36(l)(viia)?
30. In case of allowance of bad debt whether the amount was included in the income of the assess in the earlier year?
31. Whether disallowance Ws. 40A(3) has been made correctly? Whether payments otherwise than through crossed cheque have been verified for disallowance under section 40 A(3)?
32. Whether revenue subsidy/Modvat is offered for tax; for example whether subsidy for running the business such as electricity and/or reimbursement of some expenditure has been subjected to tax?
33. Whether capital subsidy/Modvat is reduced from the cost of the relevant asset?
34. In case of advance/loan to the directors from the private company having reserve whether deemed dividend provision a/s. 2(22)(e) has been applied?
35. In case of investment companies, whether sale of shares is offered as business income or claimed as capital gains or speculation profits/loss?

36. In case of acceptance/repayment of loan/advance exceeding Rs. 20,000 in cash, whether section 271-D and 271-E have been initiated?

37. Whether modernization expenses or replacement of machinery expenses being capital have been allowed wrongly as revenue?

38. In case of claim under section 35 whether certificate of approval from the prescribed authority is filed or

39. Whether bonus in excess of the provision made has been allowed?

40. In case of payment of royalty and technical fee without TDS, whether the allowance u/s. 40 (a) (i) has been made?

41. Whether profits chargeable to tax in terms of section 41(1) have been correctly worked out?

42. Whether profit chargeable to tax u/s. 41(2) in the case where the building, machinery plant or furniture is sold, discarded, demolished or destroyed in respect of power plant is correctly worked out?

43. In case of change in share holding whether the loss is wrongly allowed to be carried forward?

44. Whether block of assets are correctly categorized?

45. a) Whether the depreciation is correctly applied (As per the nature of business).
   b) Whether cost of the building includes cost of land for which no depreciation is allowable?

46. To the assessment year 1995-96, plant and machinery costing Rs. 5,000 or less were allowed 100% write off. Has this been allowed after asst. Year 1995-96 also, instead of allowing depreciation as applicable to the relevant block?

47. Whether disallowance of depreciation u/s 38(2) for personal use of asset has been added?

48. Whether closing/written down of the previous year is correctly carried forward as opening WDV?

49. In case of assets used for less than 180 days whether the rate of depreciation is restricted to ½ of the normal?

50. Whether tea bushes/live stock have been treated wrongly as plant?

51. Whether short-term capital gain assessable u/s. 50 is correctly charged?

52. In case of sale of asset on which investment allowance have been given whether withdrawal of investment allowance u/s. 32A(5) is necessitated?

53. In case of payments of foreign technical company & tax is to be paid by Indian company the total amount of payment includes tax to be paid by Indian company

54. Proceeds of Slump sale of undertaking has been taxed a/s 50B or not.

H. INCOME FROM CAPITAL GAINS

1. Whether the year of taxability is correctly fixed?

2. Whether the definition of transfer is correctly applied:

3. In case of conversion of capital asset into stock in trade whether capital gain is charged?

4. In case of capital contribution to firm/AOP/BOI in the form of an asset, whether capital gain is charged?

5. In case of distribution of capital asset on dissolution of Firm/AOP/BOI whether capital gain is charged?

6. On sale of goodwill whether capital gain is charged?

7. Whether deduction under section 54 to 54GA has been correctly allowed?

8. Whether cost of self-generated assets like goodwill, tenancy rights, stage carriage permits to
loom hours are determined as per Section 55(2)(a)?

9. Whether cost of acquisition of financial assets is determined as per Section 55(2)(aa)?

10. Whether tax on the long term capital is charged as per Sec. 112?

11. Whether rebate u/s. 88 is wrongly allowed on long term capital gains?

12. Whether additional compensation is brought to capital gain lax?

13. Whether deemed profits & gains on transfer of capital asset or intangible asset have been correctly brought to tax by virtue of proviso to cause (xiii) or the proviso to clause (xiv) of section 47?

14. Whether of acquisition of depreciable asset has been correctly worked of out as per provisions of section 50A?

I. INCOME, FROM OTHER SOURCES

Section 54

1. Whether the following incomes have been brought to tax under this head:
   - Dividends, especially with reference for deemed dividend as per Section 2(22)
   - Winnings from Lotteries
   - Crossword Puzzles
   - Horse Races
   - Card Games
   - Income from Machinery, Plant or Furniture let on hire
   - Interest on Securities

2. Whether any gift has been received in cGSs off 25,000/- which can be taxed u/s 56(2)(v)

3. Whether any of following amounts have been claimed as deductible
   - Personal Expenses
   - Interest Payable outside India where there was no TDS on the said amount,
   - Any salary paid outside India without TDS.
   - Any Wealth Tax paid.
   - Amounts specified by virtue of section 40A.
   - Expenditure in respect of Royalty and Technical Fees received by a Foreign Company.
   - Expenditure on winning from lotteries.
   - Losses cannot be set off under section 70, 71 & 72 against the income under this head.
   - No deduction is permissible under section 80 CCC to 80 U.

J. CLUBBING OF INCOME

The auditing officer must examine whether there has been a:-

1. Transfer of Income without transfer of asset, (Section 60)

2. Revocable transfer of asset

3. Remuneration to spouse without any technical or professional knowledge and experience (Section 64)

4. Income from assets transferred to spouse without adequate consideration

5. Income from assets transferred to Son's Wife without adequate consideration (Section 64(l)(vi)
6. Generation of any income in the hands of a minor child which needs to be clubbed with that of his parent (Section 64 (IA)).

7. Conversion of self acquired property with joint family property which may be treated as transfer (Section 64(2))

K. **SET OFF OF LOSSES SECTION 70, 71 & 72**

1) Whether there are any cash credits, unexplained investments, unexplained money, undisclosed, investments, expenditure which needs an explanation Ws 68 to 69D.

(2)(a) The auditing officer may examine whether carry forward and set-off of losses is as per the provisions of Section 70, 71 & 72. Rebate in respect of securities Transaction Tax under section 88 E (applicable from A.Y. 2005-06).

(b) Whether any speculation loss has been setoff against regular business income.

(c) Whether capital loss has been setoff against capital gains only or not.

L. **SECTION 80 AB**

   Where the deduction a/s 80 exceeds the profit and gains of business, whether the excess’s deduction has been disallowed.

M. **80G**

   Deduction u/s 80G not to be given to a Trust which is wholly substantially for religious purposes.

N. **80HHC (Omitted w.e.f. 1-4-2005)**

   a. Whether 90% of other income is excluded 7
   b. Whether certificate in Form 10CCAC or in Form 10CCAB is filed?
   c. Whether deduction is allowed for export of ineligible goods like cinema, video, rights, Mineral and ores etc.
   d. Whether unrealized foreign exchange is excluded from the turnover?
   e. Whether freight and insurance is excluded from the turnover?
   f. Whether excise duty and sales-tax is included in the turnover?
   g. Whether trading profit is reduced from the export profit?
   h. Whether direct cost and indirect cost is correctly computed on trade goods?
   i. Whether negative figures arrived at either for the export profit or for the trading profit is taken into account in the calculation of the deduction?

Whether 90% of the

   i) Export incentive
   ii) Interest receipt
   iii) Labour charges
   iv) Process charges
   v) Sale of import license
   vi) Cash assistance
   vii) Brokerage
   viii) Commission
   ix) Rent etc are reduced from the export profit.

j. Whether curlier year losses were set off before allowing deduction u/s 80HHC?
k. Whether turnover of all branches are taken into account for total turnover?

l. Whether the export for which certificate is issued to other persons is excluded?

m. In Case of claim of bad debt from foreign parties whether wrong allowance u/s 80 HHC allowed is withdrawn in the relevant earlier year?

n. Whether income not derived from exports business is excluded from export business?

o. Whether the remittances received in respect of exports made in earlier years are excluded from the total convertible Foreign Exchange received?

p. Whether deductions u/s 80HHC are claimed in respect of profits arising from Exchange Rate fluctuations?

q. Whether necessary extension for delayed realization of export proceeds is on record from the competent authority?

r. Whether evidence for realisation of export proceeds in forex is on record?

s. Whether turnover of by-products or residuals has been taken in the total turnover?

t. Whether computation of Profits of business’ has been checked as per explanation (baa).

u. Whether disclaimer certificate in the case of supporting manufacturer has been filed

O. DEDUCTION U/S 80-IA & 80IB

1) Whether the assessee is manufacturing/producing any article mentioned in Eleventh Schedule.

2) Whether the assessee is deriving any profits and gains from his business?

3) Whether auditor's certificate in Form 10-CCB is filed?

4) Whether carried forward loss was adjusted before allowing deduction?

5) Whether any loss earned by the eligible unit in the earlier years is adjusted against the income of the present year before allowing any deduction?

6) Whether the deduction exceeds the number of years for which it is to be allowed under section 80IA (2)?

7) Whether the income not derived from industrial undertaking is excluded in arriving at the deduction?

8) Whether the undertaking is formed by spitting up or the reconstruction of a business already is assistance?

9) Whether the undertaking is formed by transfer to a new business of machinery or plan previously used for the purpose?

10) Whether the undertaking has developed and operated or maintained and operated an Industrial part or special Economic Zone notified by the Central Government.

11) In Case of a company engaged in generation or generation and distribution of power or reconstruction or revival of power generating plant, the provisions of Section 80IA(4)(iv) are met.

12) Whether in a transfer of goods or sources from other business to the undertaking or from the undertaking to another business then whether the transfer goods or sources is at market value or not.

13) The deduction should not exceed the amount of profit and gains from such eligible business and should not be again claimed under any other section of Chapter VIA.

14) Whether the profit derived from business between closely connected concerns on which deduction is claimed is reasonable or overstated.

15) Whether there is any amalgamation or demerger in the relevant year.

16) Whether prescribed time limits adhered to, necessary approvals, as per provisions, obtained or not.

P. 80IAB

1. Whether the deduction has been claimed for any ten consecutive assessment years out of 15
years from the year in which SEZ has been notified or not.

Q. 80LA
1. Whether the off shore banking unit is situated in an SEZ?
2. Check the time-limit for which deduction is available.
3. Whether the business of the unit is referred to in sub-section (1) of section 6 of the Banking Regulation Act, 1949.
4. Whether a report of an accountant in Form NO. 10CCF has been filed alongwith the return of income.
5. Whether a copy of the permission obtained under clause(a) of sub-section(1) of Section 23 of the Banking Regulation Act, 1949 has been filed with the return of income.

R. DEDUCTION U/S 80-P
1. It may be verified that the deduction u/s. 80 P(2)(a)(ii) is allowed only to the primary cooperative societies
2. The section relates to the assessment of co-operative Societies and all the conditions relating to the formation of Primary Co-operative Societies must be examined

S. ASSESSMENT PROCEDURE
1) Whether penalties imposable have been initiated properly or not. For each initiation of penalty whether AO has recorded his satisfaction in the body of order or not(Delhi high Court cases)
2) Whether correct figure of profit or loss from the P&L A/c is adopted.
3) In case of rectification and revision whether corresponding reduction in interest u/s 244-A and allowances under Chapter VIA have been done?
4) Whether any proceedings bur, got time barred?
5) In case of any particular decision by appellate authorities having relevance in the earlier years, whether the earlier years have been reopened or not?
6) Whether relevant proceedings under Wealth Tax Act and Dividend Tax has been initiated in eligible cases?
7) Whether interest u/s 220(2) is charged for delayed payment of demand?
8) Whether for delayed payment of TDS, interest u/s. 201(A) and penalty u/s 271-E are charge/initiated?
9) In case of refund of less than 10% of the tax payable whether interest u/s 244A has wrongly been allowed?
10) In case of refund being in excess of 10% of the tax payable u/s 143(1)(a) whether the interest allowed u/s 244A is withdrawn u/s 143(3) when the refund becomes less than 10% of the tax.
11) Whether adjustment of tax paid u/s.115JAA (4) is done after calculation interest under sections 234-A, 234-B and 234-C,
12) Whether surcharge is levied, if leviable?
13) In block assessments, whether basic exemption allowed incorrectly even though no returns have been filed or tiled beyond the due date for the relevant years?
14) Whether notices recommended to be issued u/s 158 BD have been issued or not?
15) In cases of assessments completed u/s 153A the following issues may be considered:

   i) Whether all issues raised in the Appraisal report have been dealt with either in main assessment order or in the office note.
   ii) All assets found during search, and those seized have been considered in either the main assessment order or in the office note.
   iii) All important seized documents have been considered or not, either in the main assessment order or in the office note.
   iv) Whether notices u/s 153C needed to be issued have been so issued or not?

16) U/s. 115JA, loss or depreciation brought forward in the accounts whichever is less is liable to be reduced from the book profit. Check the component of the brought forward loss and reduce the lesser of the allowed business loss or depreciation, if either of the two is ‘nil’ no reduction from the book profit has to be allowed.

17) Tax credit as per Sec. 115 JAA can be carried forward for only 5 years. Set off of tax credit has to be allowed in the year in which the regular income becomes taxable.

T. FRINGE BENEFIT TAX:

   1. Whether return of PUT has been filed as per Section 115 WD or not.
   2. Whether Advance-tax on taxable Fringe Benefit has been paid in time or not.
   3. Whether interest, wherever due, has been charged or not.
   4. Whether the correct rate of tax has been applied or not.
   5. Whether all the perquisites specified in Section 115 WB have been taken into account or not.

U. INTERNATIONAL TAXATION:

   The taxation of non-resident assesses doing business in India is governed by Sections 90 to 93. It may be checked by the Internal Audit Party whether the following issues have been considered by the assessing officer or not.

   1. Whether there is a double taxation avoidance agreement between India and the country where the business entity is situated, and the implication of existence/non-existence of a DTAA.
   2. In case of business- whether the same is a branch or a liaison office(LO). If an LO, whether RBI approval taken. Whether all the conditions of RBI approval met.
   3. For an entity having business of India, whether a fixed place of business (Ph) maintained?
   4. In many cases assessee have shown both project office & Branch office. (PO/BO) whether same set off accounts maintained in PO/BO. Some cases have been seen where income of PO was computed under the deeming provisions of Article 44BBB (10%) and then the same was set off against the loss of Branch Office.
   5. For Individual technicians: Return signed by whom? If by some other person, whether proper authority to sign have been enclosed.
   6. For royalty/fees for technical services- whether the income has been taxed as business income earlier? If so the reason for taxing the same as FTS/Royalty now? Whether proper tax rate has been made applicable
   7. For undertaking project activities- whether the entire duration of project since start of 1st activity, till completion will be taken into account for computation of period of making/ assessment as Permanent Establishment.
   8. Whether tax has been properly computed at the rates applicable to foreign company or not.
   9. Whether deduction for Senior Citizen given to Non-Resident Individual.
   10. Foreign tax credits should be checked
   11 Whether proper records/documentation with regard to international transactions have been maintained and produced or not.

V TRANSFER PRICING

   1. Whether reference has been made to TPO where transaction between assessee and Associated Enterprise exceeds Rs. 5 crores.
2. If referred to TPO, whether reference has been made in proper proforma giving all details or not
3. Whether Report in Form 3 CEB has been submitted by the assessee along with return of income or not.
4. Whether any income has been transferred to non-residents.

W. CHECK SHEET FOR TDS CASES

Under section 206 of Income Tax Act all corporate and government deductors are compulsorily required to file their TDS return as e-TDS returns. However, for other Deductors, filing of e-TDS return is optional. The e-TDS return is a TDS return prepared in form No.24, 26 or 27 in electronic media as per subscribed data structure in either a floppy or a floppy or a CD ROM. The floppy or CD ROM prepared is required to be accompanied by a signed verification in Form No.27A. Forms 24, 26 and 27 have different periodicity.

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<th>Form No.</th>
<th>Particulars</th>
<th>Periodicity</th>
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<tr>
<td>Form 24</td>
<td>Annual return of “Salaries” under section 206 of Income Tax Act, 1961</td>
<td>Annual</td>
</tr>
<tr>
<td>Form 26</td>
<td>Annual return of deduction of tax under section 206 of Income Tax Act 1961 in respect of all payments other than “Salaries”</td>
<td>Annual</td>
</tr>
<tr>
<td>Form 27</td>
<td>Statement of deduction of tax from interest, dividend or any other sum payable to certain persons</td>
<td>Quarterly</td>
</tr>
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</table>

After return is filed online, the processing is done online and tax payment is also checked by the system using OLTAS (On Line Tax Accounting System). The OLTAS envisages the system of single copy challan which are of following types:

1. A common single copy challan No. ITNS 280 for payment of Income tax and Corporation tax;
2. A common single copy challan No. ITNS 281 for depositing Tax Deducted at Source / Tax Collected at Source (TDS/TCS) from corporate or non-corporate;
4. A common single copy challan No. ITNS 283 for payment of Banking Cash Transaction Tax and Fringe Benefits Tax.

For processing of e-TDS returns, the assessing officer has no role to play for physical verification of challans except where the challans are not verifiable online either because of non filing or wrong filing of vital particulars like TAN etc. However in other cases where e-TDS return is not mandatory, following check list will help Internal Audit Wing to audit the TDS return correctly.

1. Whether TAN has been allotted or not/Applied by the assessee or not?
2. Whether TDS has been deducted correctly?
3. Whether the tax deducted at source has been remitted in time to the credit of Govt. Account; if not whether interest u/s. 201(IA) has been charged?
4. Whether original TDS amount has been paid by the deductors to Government Account before issuing the TDS Certificate?
5. Whether annual return of TDS has been filed in time: if not, whether penalty proceedings have been
initiated?

6. Whether the penalty proceedings initiated have been completed within the prescribed time limit? And whether the penalty register has been maintained or not for this purpose.

7. Whether the tax has been deducted at the correct rate. In case of TDS being deducted at a lower rate whether the relevant certificate for deducting TDS at a lower rate has been obtained and is on record?

8. Whether the certificate for non-deduction/lower deduction of tax at source obtained from the assessing officer is relevant for a particular year or is it a blanket Certificate?

9. Whether the entire income on which tax has been deducted at source has been included in the returned income offered for tax?

10. Whether TDS has been made on gross receipts or net receipts?

11. Whether tax has been deducted under section 194E of the income-tax @10% in respect of guarantee money paid to non-resident Sportsmen/Sports Associations in relation to sports played in India?

12. Where the payment was made to a non resident being an individual or a sports association or institution including guarantee money, whether TDS has been deducted @ 10% on the gross payment under section 194E r.w.s. 115BBA?

13. Whether DTAA benefit has been claimed rightly.

14. Whether TDS certificates filed relate to the same Assessment Year. Particular dates to be seen. Totaling should also be checked.

15. Whether valuation of perquisites has correctly been made as per the Rule 3 while deducting tax under section 192 of the Income-tax Act?

16. Whether tax at source has been deducted correctly at the rates in force in respect of interest payments and no incorrect claim for non-deduction of tax at source has been claimed under section 193 of the Act.

17. Whether TDS has been made at correct rates on winnings from lotteries or cross word puzzles where winnings are wholly in kind or partly in cash and partly in kind?

18. Whether TDS has been made uniformly or has been made at the fag end of financial year?

19. Whether the TDS Certificate issued contains the PAN/GIR No. of the TDS payee?

20. Whether any specific system is being followed for allotment of TAN at the field level?

21. Whether the person deducting T.D.S has issued Form No. 26A to the person from whom the sum has been deducted within I month from the end of the month during which the credit has been given (sum has been deducted); if not whether due penalty has been levied or not?

22. Whether Income Tax and Surcharge deducted has separately been shown in the challans through which the payments are made to the credit of Central Govt.?

23. Whether T.D.S. certificate filed pertains to the same Asst. year? Dates to be seen

24. Whether TDS has been property deducted on

(i) Interest on Securities (Section 193)
(ii) Dividend paid to resident shareholder other than dividend covered u/s 115 O
(iii) Interest other than Interest on securities (Section 194A)
(iv) Winnings from lotteries and Crossword Puzzle (section 194 B)
(v) Winnings from horse racing (Section 194BB)
(vi) Payment to a contractor (Section 194C)
(vii) Earning from Insurance Commission (Section 194D)
(viii) Payment to non-resident sportsman etc. (Section 194E)
(ix) Payment towards National Savings Scheme as per Section 8OCCA (Sec. 194EE)
(x) Payment of Commission and/or Brokerage (Section 194H)
(xi) Payment for repurchase of Mutual Fund & UT1 Units (Section 194F)
(xii) Payment of Commission on sale of lottery tickets (Sec. 194G)
(xiii) Payment of Rent (Section 194I)
(xiv) Payment for Professional & Technical Services (194J)
(xv) Income in respect of units (194K)
(xvi) Payment of compensation on acquisition of capital asset.

X. OTHER POINTS RELATED TO TDS
a) Non-deduction or deduction at lower rate of tax deducted at source is allowed on an application made in the prescribed form.
b) Whether procedure of refund of excess tax deducted at source has been followed.
c) Whether TAN (Tax Deduction Account Number) has been mentioned on Challans, Returns and TDS Certificates Issued to persons.

Y. TAX COLLECTED AT SOURCE
A. To check whether the seller has collected tax at the prescribed rates from the buyer and deposited the tax collected at source in the Govt. Treasury within the stipulated period in respect of the payments received on a/c of business of the following:
   a) Alcoholic liquor for human consumption,
   b) Indian made foreign liquor
   c) Tendu Leaves
   d) Timber obtained from forest.
   e) Any other forest produce.
   f) Scrap.
   g) Parking lot, toll plaza and mining and quarrying.
B. To see whether an annual TCS retain has to be filed.

Z. CHECK SHEET FOR REFUND CASES
The C&AG has prepared a detailed review on refunds under the Income-tax Act, 1961 and their findings appear in Chapter V of Report No. 12A of 2002 (Direct Taxes). In their review the C&AG has pointed out very serious lapses, mistakes/errors and irregularities in grant of refund which fall within the preview of internal audit. Some of the important issues are as under:

2. Excess or irregular refunds: Excess refunds were issued due to various mistakes in computation such as incorrect calculation of tax and interest on refunds, incorrect adoption of tax rate, incorrect deductions and reliefs etc.
3. Double payment of refunds: There were instances where the refunds were issued twice.
4. Inadmissible refund due to incorrect allowance of TDS credit: The C&AG pointed out many cases where incorrect allowance of TDS credit resulted in inadmissible refunds.
5. Irregular refund on belated claims: C&AG observed that in some cases belated refund claims were admitted by Department and refunds including interest were allowed although the conditions prescribed in the Board's Instruction of October, 1993 were not satisfied.
6. Non withdrawal of interest: The C&AG has pointed out that interest granted on a refund was not withdrawn when subsequently demand was raised and refund was adjusted.
7. Interest on refunds less than 10% of assessed tax: Under Section 244A of Income Tax Act, 1961 no
interest shall be payable if the amount of refund is less than 10% of the tax determined under summary or regular assessments. C & AG pointed out numerous cases where the assessing officers have allowed interest on the refunds which were less than 100% of the assessed tax.

8. Interest paid on delayed proceedings attributable to assessee: The C&AG has pointed out instances where interest was allowed on refunds even though the delay was attributable to the assessee.

9. Non levy of interest for refunds net off against arrear demand: C&AG has pointed out that though outstanding demand was collected by way of adjustment against refund, no interest under section 220(2) was levied by the department on the outstanding demand so collected.

10. Irregular payment of interest on advance tax/TDS credited to Govt. Account beyond the financial year: C&AG has pointed out that interest is allowed to the assessee on the refunds on account of advance tax/TDS which was credited to the Govt. Account beyond the financial year.

11. Irregular payment of interest on self assessment tax: No interest is payable on account of refund out of self assessment tax but C&AG has pointed out many instances where the interest was allowed on such refunds.

12. Incorrect consideration of MAT credit/Incorrect allowance of interest on refund of MAT Credit: Section 115 JA of Income Tax Act 1961, provides for levy of minimum tax on book profit of a company whose total income as computed in respect of any previous year relevant to assessment year 1997-98 and onward in less than 30 percent of such book profit. Further, where tax is paid by a company for any assessment year in relation to the deemed income under section 115JA(I), credit under Minimum Alternate Tax cannot be refunded but will be allowed in subsequent assessment years in which it becomes allowable. The credit under Minimum Alternate Tax would be set off against the tax and even after this, if there is a refund, no interest is allowable under section 244A in view of the specific provisions of section 2 of section 115AA(2).

13. In addition to the above the C&AG has pointed out many irregularities in issue of refunds which are summarized as under :-

- Procedural irregularities
  i) Delay in issue of refund vouchers.
  ii) Issue of refund vouchers without following prescribed procedure.
  iii) Signature of Cheque writing person and supervisor not available.
  iv) Date of encashment not noted in the office copy of refund voucher.
  v) Quarterly verification is not noted in the office copy of
  vi) Delay in verification of challans.
  vii) Office copy of refund vouchers are not properly maintained.
  viii) Refund vouchers are canceled without the signature of the officers,
  ix) Non verification of refund vouchers with daily refund registers.
  x) Non issue of refund vouchers in serial order.
  xi) Irregularities in the dispatch of refund voucher/advice notes.
  xii) Non maintenance of registers/documents like daily refund register, demand and collection register, register of refund application, cheque register etc.
  xiii) Non obtaining of indemnity bond for duplicate TDS Certificate.
  xiv) Excess refund though TDS certificates not furnished.
  xv) Acceptance of improper TDS certificates.
  xvi) Acceptance of unsigned TDS certificates.
  xvii) Acceptance of TDS certificates not in the name of the assessee.
  xviii) TDS certificates not cancelled after credit.
  xix) Refunds granted after completion of scrutiny assessment which leads to payment of avoidable interest and not immediately after processing u/s 143(1).
xx) Non adjustment of refunds granted in earlier assessments.
xxi) Set off of refund against demands without intimation to the assessee
xxii) Set off of refunds against demands of other direct taxes or vise versa,
xxiii) Set off of refunds against the demands of other assessee.
Xiv) Issue of refunds without proper administrative approval.
xxv) Delay in obtaining administrative approval for issue of refunds.
xxvi) Irregular withholding of refunds.
xxvii) Delay in allowing refund in appeal cases.
CHAPTER IX

FREQUENTLY ASKED QUESTIONS ON AUDIT

Q.1 What is Internal Audit?
Ans. Internal Audit is an organ of the I.T. Department which is set up to deal with audit matters. Its functions also include auditing of cases before the arrival of external audit parties of C & AG. (Also called Revenue Audit parties)

Q.2 What is Regularity audit?
Ans. Regularity Audit monitors the expenses of various departments and is also called Expenditure Audit. (Also called Compliance Audit)

Q.3 What is Performance Audit?
Ans. Performance Audit is also called systems audit, which monitors performance of various departments/Ministries. It contains C&AG Reports on illustrative cases as well as keys, which were earlier numbered as 12/12A/1 3 of the year and now from 2006, numbered as 7/8 of the year. [Details given in Chapter-VIII of this handbook and CD enclosed]

Q.4 What is Receipt Audit?
Ans. Receipt Audit is the external audit setup under the Comptroller and Auditor General of India, a constitutional authority which conducts Performance audit of various departments of the Union (including under the Direct Taxes) and the States. The Receipt Audit is also called Revenue audit.

Q.5 What is the role of Internal Audit?
Ans. The role of Internal Audit is to keep an internal check to prevent the loss of revenue by auditing cases of assessment etc before the arrival of the external/receipt audit:

(i) By regulating the internal set up of audit.

(ii) By keeping a watch over the loss of revenue in the assessments to avoid adverse comments of external audit and to settle the audit objections expeditiously.

Q.6 What are the Instructions of CBDT to be followed by the various functionaries in the Income tax department in respect of Internal Audit?
Ans. Earlier instruction No. 08 of 2001 has now been superseded by instruction No. 03 of 2007 which deals with the new internal audit setup. The functions of different authorities' are now different in metro and non-metro charges for CCIT (CCA), CIT (Audit), and CIT administration. As per Para 7.2 of CBDT Instruction No. 03 of 2007, various types of mistakes and accountability are fixed at various stages, which include that of the staff. AO's have now been made more responsible in internal audit matters. The new Instruction came into force wef 01-06-2007.
Q.7 What is the latest Instruction of CBDT is in respect of Receipt/Revenue audit?
Ans. Latest Instruction is Instruction No. 09 of 2006 relates to Receipt audit superseding various earlier Instructions.

Q.8 What is the nature of matters to be dealt by Instruction No. 09 of 2006?
Ans. It lays down the procedure to be followed by various departmental authorities to deal with Half-Margin Notes, LAR's, Statement of Facts, Draft Para cases and other matters relating to Receipt Audit. It also prescribes the time limits to be followed by various authorities for sending reports and for settlement of the objections.

Q.9 What is a Half-Margin Note?
Ans. This is the audit Note of the Revenue Audit Party at the preliminary/first stage before the Assessing Officers. A reply is also to be given on the note within 3 days. Normally the paper used for audit note is in half-margin and after comments of A.O. on other half-margin a copy is returned to the Receipt Audit Party and one copy is retained by the Assessing Officer.

Q.10 What are the precautions to be followed while giving a reply on the half margin note?
Ans. 10. Suggested precautions to be followed are:-

(i) Replies should be given promptly and carefully on Half-Margin Notes.
(ii) Replies should be given from time to time by the AO's and AO's should not wait to give replies on last day of RAP at a time to avoid hasty replies.

(iii) AO's should try to give replies on audit notes two days before the audit party leaves. If, audit note is given by RAP on the last day, reply must be given.

Q.11 What is LAR?
Ans. (iv) Replies should be given specifically whether the audit note/memo is acceptable or not by the department. If not acceptable, the reasons for not acceptance with reasons, case Laws and CBDT circulars may also be quoted. In case audit note is factually incorrect, photocopies of evidence on record may be given to RAPs and a receipt may also be taken from Audit Party

What is LAR?
LAR stands for Local Audit Report which is sent by the office of the Accountant General of the India to the department. LAR is nothing but the edited view of the Accountant General office on audit note given in the Half-Margin note by the RAP. In those cases of audit objections, where at the level of Half-Margin Note, AG is satisfied to drop the objection, no Local Audit Report is sent to the department by AG office. If the AG is of the view that the audit objection raised cannot be dropped or does not agree with the view of the department it sends the LAR in such cases.
Q.12 What are the issues to be taken into account while giving reply to the AG on LARs?

Ans. Normally the replies sent on audit objections raised at the time of Half-Margin Note are not in detail due to shortage of time at the first stage of raising audit objection (with the AO as well as with the audit party). Therefore, before sending detailed replies AO’s should first of all carefully examine, the nature of issues:-

(i) Legal Issues

(ii) Arithmetical error

(iii) Factual Mistake

(iv) Disagreement if discretionary powers of AO have also been interfered with by the audit

(v) May be some administrative reasons

Q.13 How the department should reply on LAR?

Ans. (1) If the department accepts the LAR or audit observation of AG, further steps for remedial action and directions shall be issued to officer/officials and other staff below. Therefore, department must send reply to AG accepting or not accepting the LAR. Steps taken at various levels of functionaries in the department are given in Para 2.4 & 2.5 of Instruction No 09 of 2006 and in Flow Chart in Chapter 1V of this handbook. The department can take action under action 263,148,154. The reply should be sent to AG office after taking such action if the time is available.

(2) In cases, where the department does not accept the audit observation, reply should be given after following Instruction No. 09 of 2006 and Instruction No. 03 of 2007.

Q.14 How to deal with audit objections where AG office sends the statements of Facts "SOF" and does not drop the audit objection?

Ans. There may be some disagreement on facts or other issues at this stage of "Statement of Facts" sent by AG Office to the department. Reply be sent after segregating the facts on points on which department agrees and on points where department does not agree with the view of audit. Where disagreement is on some issues, photocopies of all related evidence available may be enclosed in the reply with reasons. Case laws, copies of CBDT Circulars and copies of evidence if on record may also be enclosed to the reply to avoid further correspondence with AG. In such cases, reply should be given after following Instruction No. 09 of 2006 and Instruction No. 03 of 2007.

Q.15 How to deal with the proposed Draft Para cases?

Ans. Sometimes when the AG does not agree to drop the objection or does not agree with the view of the department in SOFAG sends the copy of proposed draft pars and seeks clarification or comments. This is the last opportunity department gets to reply to AG to avoid the draft para if the proper reply reaches AG before it finalizes to send Draft Para to C&AG.

Q.16 What procedure is to be followed in giving reply to AG in Draft Para cases?

Ans. In Draft Para cases, reply should be given in the revised Proformas `A' & `B' as mentioned in instruction.
Q. 17 What are the time limits to be observed at various stages and what other precautions should be taken, while giving replies to AG?

Ans (1) In Half Margin Cases reply should be given by the AO within 3 days accepting or not accepting the audit objection/observation.

(2) On Local Audit Report (LAR) -Part I and Part II - Reply should reach from AO through Addl JCIT within 30 days. Addl/JCIT must send reply within a fortnight to CIT. Therefore, time available with AO is only for 15 days. In cases where the tax effect involved is Rs 1, 00,000 or above in IT1CT cases and Rs 30,000 and above in other taxes cases appropriate remedial action must be taken within one month.

(3) On Local Audit Report (LAR) -Part IIIT - A.O. may not reply but appropriate remedial action should be taken within three months.

(4) On Statement of Fact (SOF), the reply from CIT should reach the AG within 15 days.

(5) If AG Office intimate about proposed Draft Para, the reply must be immediately sent

6) In DP cases, Proforma Report in Part A and Part B has to reach C&AG within 4 weeks from the receipt in the CIT office .Therefore, AOs should not wait and must send the report as abundant precaution at the earliest possible so that sufficient time is made available to Addl/Jt CIT,CIT(Admn),CIT(Audit) and CCIT(CCA) so that reply to C&AG reaches within the stipulated time of four weeks.

Q. 18 In many cases, the time limits are not followed and report are delayed due to laxity at the AO's level in DP cases? To prevent such delays, what precautions AO must take?

Ans18. While, the DP comes for reply, the AO should not leave the entire matter to the Inspector or other staff. AO must retain a photocopy of the Para in personal custody while it comes directly or routed through the Dak. Immediate steps should be taken by the AO for procuring Case records of DP matter from the ITV Staff. The reply should be given in the revised proforma Part A and Part B and must send the report in the shortest time without waiting for last days to come, In the new procedure responsibility has also been carted upon AOs to send reply within time.

Q. 19 What is the nature of Audit Reports prepared by the C&AG?

Ans. Earlier the Audit Report on audit observations was No 12112A113 of C&AG and now this has been renumbered as No 7/8 from 2006 on Performance Audit. The C&AG reports contain comments on specific cases; illustrative cases on different types of mistakes and sometimes it also include the Key cases, which are to be replied.

Q.20 What distinguishes the normal Receipt Audit from the Systems Review?

Ans. The Receipt Audit normally concerns auditing of cases completed under Scrutiny and some other cases by the Assessing Officers as per the criteria fixed by the C&AG. However, in the System Review, instead
of concentrating on individual cases, the emphasis is also to point out similar nature of mistakes in certain specific areas of business or profession or industry on 3-5 topics selected by the C&AG in a year (including matters relating to administrative efficiency) on performance of the department [whether the case/ cases selected in scrutiny or not]. Normally, AG parties of each State take up the cases of selected topics of all administrative CIT Charges on similar nature of mistakes noticed and desire the reply / comments thereupon, which are likely to be incorporated in the Audit Report. Replies in both the cases are sent by the CsIT in Proforma Reports in Part A and Part B. The parawise comments are called by the C&AG in cases of System Reviews specifically on illustrative cases /Key cases pertaining to specific CIT charge.

Q.21 What are the illustrated cases and key cases in the cases of System Review?

Ans. Illustrated or illustrative cases are those bigger cases of concerned State, where audit has pinpointed mistakes in the System Review, not only indicating the nature of mistake, error or shortcoming but also the quantum of revenue involved on account of the mistake is substantial [where there is no positive income or nil income potential tax effect is pointed by the audit] The illustrated cases are discussed in the main body of the Audit Report of the particular year issued by the C&AG. Key Cases are the similar cases having lesser revenue effect and they are normally mentioned in a chart not in the main body of the Audit Report, which may be called ‘Key’ and forms placed at the end of the Audit Report of the C&AG in the form of a Consolidated Chart States wise.

Q.22 What is the potential tax effect in Audit?

Ans. The potential tax effect is the notional tax effect calculated in those cases, where the resultant income after the additions/disallowances proposed by the audit is either Nil income or Loss or the income calculated is not taxed in the year. Actually, where there is positive income after the proposed addition, simply the tax is calculated on the basis of rate of tax to be applied by the Finance Act of that particular year. But in those cases, where the resultant income after the additions proposed by the audit is either Nil or a Lass or the income calculated is not taxed in the year, though the tax liability is not to be paid in the year but is calculated notionally at the applicable rates of that year’s Finance Act on the proposed addition for taking further action. There may arise positive income in cases of the assessee resulting in tax liability in future years but not in the year for which the objection is raised.

[Based upon CBDT Instructions No 09 of 2006 and No 03 of 2007 mentioned in Annexure -2 and 3 of this Handbook and Manual of Office Procedure issued by the department and Audit Reports of C&AG]
TAX AUDIT REPORT:

How information is useful for Internal Audit

(With special reference to C & AG Review No PA-7 of 2008)

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CHAPTER X

GENERAL AUDIT AND TAX AUDIT -RELEVANCE TO

INCOME TAX INVESTIGATIONS

(With special reference to C & AG Review No PA=7 of 2008)

In the Performance Audit Report of C&AG on Direct Taxes, a Review was made in Report No. PA7 of 2008 in chapter 2 on "Review on appreciation of third party/ reporting certification of assessment proceedings" with the following objectives:-

i. To ensure that the tax audit reports were complete in themselves to provide sufficient and requisite information to the assessing officer, thereby aiding him in completing the assessment under the Income Tax Act, 1961.

ii. To determine the extent to which the assessing officers have evaluated and utilized information provided in the prescribed reports while completing assessments.

iii. To determine the adequacy and relevance of the formats of the tax audit reports as provided in the Income Tax Act, 1961.

iv. To determine the effectiveness of the Department's internal control mechanism in ensuring that the objective of obtaining a report from a third party (the accountant) is fulfilled.

The Tax audit report issued by an accountant is one of the tools in the hands of the Department for deciding the correctness of the income and deductions claimed by the assessee. As per Delhi High Court, while deciding on whether the ITO should insist upon production of records or details in spite of a tax Audit report u/s 44AB in the judgment in Goodyear India Ltd. vs CIT (2000) 112 Taxman 419 held "No doubt, sanctity is to be attached to the audit report given by a qualified charted accountant. Merely, because an audit report is available there in no fetter on the power of the ITO to require the assessee to justify its claim with reference to record, material and evidence. Such a power is inherent in an assessing officer in the scheme of the Act."

Details of the Review PA 7 of 2008 are given in the PDF file in CD portion.

2. The CBDT, in order to ensure that the assessee, accountant and assessing officer comply with the various provisions of the Income Tax Act, 1961 had issued Instruction No. 1959 and 1976 in January, 1999 and Nov. 1999. These Instructions contain detailed procedures for effective utilization of information available in the tax audit reports while finalizing the assessments. The instructions issued included that the assessing officer may again examine the tax audit report thoroughly at the time of completion of assessment of the detailed scrutiny u/s 143(3), to ascertain whether any addition to the income is possible on the basis of the same or whether any further investigation is required pursuant to the information submitted therein.

3. The Comptroller and Auditor General desired some mechanism with the department with a view

   (i) To discourage tax avoidance and tax evasion
   (ii) To ensure that an internal control is placed on- tile- Tax Audits completed by CAs on the-defaults-committed: by them.
   (iii) To remove various shortcomings of accountants on various defaults committed by them in future as mentioned in the Review.
   (iv) To remove various shortcomings in the assessments- completed by the-Assessing Officers while: examining. Tax Audit Reports.
4. With a view to having some internal control in the department on Tax Audit and to apprise the AO's and Internal 'Auditors to have-a detailed knowledge-of procedure, the types of records and nature of details called by the Accountants [Charted Accountants, Cost Accountants etc] from the assessees, this Chapter has been included; in this handbook and please also see Reference Material in CD enclosed for details of Auditing and Accounting Standards in this Handbook.

4.1 Almost every return of income that is being picked up these days for scrutiny is accompanied by one or more audit reports. Auditing is a compulsory requirement for companies under the Companies Act, 1956. Various sections in the Income-tax Act, 1961 such as sections 44AB, 80 HHB, 80HHC and 801A, 115JA, International taxation and some other transactions require not only a general audit of the assessee's accounts, but also specific audit of certain prescribed particulars. Hence in almost every scrutiny assessment, the audit reports have become important sources of information which must be analyzed in order to carry out effective and well planned investigations.

4.2 It is, therefore, important for investigators to know the manner, in which audits are conducted, the guidelines and professional requirements, which auditors have to follow, the extent of verification done by them, and the precise meaning and value of the opinions-expressed by them in-the Audit reports.

4.3 Auditing procedures and practices are laid-down by the Institute: of Chartered-Accountants Of India, based at New Delhi. The Institute issues from time-to-time various statements to secure compliance on matters critical for proper discharge-of Auditor's functions. Compliance with such statements is mandatory for every auditor. And for any deviation, adequate-disclosures are-to be made, in the Audit reports, and-attention-is to be drawn to material departures. Apart from statements the Institute also issues 'Guidance Notes', on particular types of 'auditing', work, such as 'Guidance Note on Tax Audit'. These notes are for general benefit of the auditors and need not be followed strictly.

4.4 A number of Statements on Auditing Practices, have been issued, specifying the basic-principles governing an audit; objective and scope of Audit, the documentation and maintenance of records in respect of each audit etc, the salient features brought-out in these Statements are discussed in the separate Chapter XIV of this handbook.

5. **Definition of Audit:** An audit is defined as an independent, examination of financial information with a view to express opinions or the same. An audit report, therefore, consists of two parts-

a) Statement of facts where the Auditor is required to specifically state whether he was able to obtain all necessary information and explanations, from the management and whether the Balance Sheet and Profit and Loss account are in conformity with the books of accounts.

b) Opinion-where the Auditor is required to give his frank judgment as to whether proper books of accounts are maintained, whether the accounts clearly disclose all material information required; and whether the Balance sheet and Profit and Loss Account give a true and fair view of the financial state of affairs of the concern.

5.1 The report must disclose not only every feature material to the results of the working of the concern, but also every transaction of an exceptional and non-recurring nature.

5.2 In some audit reports such as the tax audit report u/s 44AB and the report u/s 80HHC, the auditor is also required to give specific comments on certain particulars prescribed in Form 3 CD, Form 1 OCGAB etc. These comments have to be much more precise than those-required in general audit reports, and the auditor must certify that the given particulars, to the best of his information and knowledge, are true and correct (and not merely true and fair, as required in-the-case of general audit.)
6. **General Principles of Audit.** Basic Principles governing an Audit describe that every member of Institute of Charted Accountants of India to ensure that the "Statements" relating to auditing matters are followed in the audit of financial information covered by their audit reports. If for any reason, if he is not able to perform his report should draw attention to the material departures there from.

(a) **Objectivity** - The auditor has to be unbiased and un-prejudicial in doing his work. His impartial attitude must be evident from the face of the report. Through the same time the auditor's job is ‘that of a “watchdog”, and not that of a “bloodhound”’. He is not supposed to detect fraud or concealment of facts but he should definitely bear in mind the possibility of such fraud or concealment.

(b) **Materiality** - The auditor obviously is not supposed to comment on each and every minute aspect of the concerns (assessee's) functioning. However, he is required to bring out and comment upon every material feature. What is "material", cannot be defined, and depends upon the facts each of the case. In general it can be said that in respect of the profit and loss Account, the materiality of a feature is to be judged in view of the profit/loss shown and the income and expenditure disclosed under particular heads etc. While in respect of the Balance Sheet, the materiality is to be judged in relation to the particular, type and group to which the asset or liability belongs. The basic north, which can be laid down is that anything which may influence the use of the financial statements, is material: (The user may be - the assessee management itself, the banks and financial Institutions, "the shareholders of a company, the Income-tax Department etc.).

(c) **Test-check in** The concept of test checking flows from the above mentioned principle of materiality. Its is expected, however, that the auditor should be able to thoroughly understand the accounting system being followed by the management, and keeping in view the, internal checks and controls present in the system. He should – be able to identify areas which require intensive audit, and areas where the extent of checking can be comparatively less. For example, in the case of a large professionally managed concern having a detailed system of accounting for purchases, the auditor may decide that the purchases do not require thorough checking, and may carry out only a test check of some of the purchase vouchers.

(d) **Auditor is not a technical expert/valuer** - The auditor is a professional accountant and cannot be expected to have a detailed technical knowledge of manufacturing processes, working-capacity of machines etc. Hence he cannot specifically say whether production yield, or valuation of stock, is low or high. However, he is expected to have some basic technical knowledge necessary for understanding the accounting system followed and for checking whether proper procedures and records are maintained in respect of production-processes, or stock inventories etc.. The opinions given by the auditor in such matters must be based on a study made by him with due care and skill.

(e) **Opinion** - Giving an opinion on the financial information available is the crux of the auditor's job. The opinion has to be as clear and unambiguous as possible. If the auditor, due to some reasons, is not able to give an absolutely clear (unqualified) opinion on some matter, he must also indicate the 'reasons there for and specify the extent to which he is sure of his opinion "subject to ...".'(such an opinion is called' qualified'). Normally, such qualifications are made in the audit reports by prefacing opinions with "subject to.....". The notes to the Balance sheet contain not only the details of the qualifications, but also the explanations given by the assessee, and details of remedial action, if any, taken by him. Further, the effect of each such qualification has to be, as far as possible, quantified in financial terms. (Obviously, such qualified opinions are of great relevance and interest to the tax investigator.)

(f) **Confidentiality** - The auditor is required to respect the confidentiality of information acquired in the course of his work. Such information can be disclosed only with specific authority, or where there is a legal or professional duty to disclose. This implies that if tax authorities can call for such information from the...
7. **Auditing Procedures** - An audit has to be organized so as to cover adequately all aspects of the functioning of the concern as far as they are relevant to the financial statements under audit. An auditor has to properly plan his work in order to conduct an effective audit in a timely manner. For this planning he has to:

a) gain understanding and knowledge of the client's business, accounting systems and policies and internal control procedures;
b) evaluate the reliability of the internal control procedures;
c) determine and programme the nature, timing and extent of audit procedures to be performed;
d) coordinate the work to be performed.

7.1 For assessing the reliability of internal controls, the auditor performs certain "compliance procedures" which are the tests designed to obtain reasonable assurances those internal controls on which reliance an audit in effect can be placed upon. One of the methods is to get the response of the assessee to an Internal Control Questionnaire. (For Tax Audit Auditors)

7.2 Once the areas and extent of audit are decided, the auditor performs various "substantive procedures" designed to obtain evidence as to the completeness, accuracy and validity of the data produced by the accounting system. These include tests of details of transactions and balances, comparison of financial statements with underlying accounting records and any other source & date and sometimes also an analysis of significant ratios and trends noticed in the accounts.

7.3 From time to time, the Auditor seeks the management's explanation regarding any discrepancies or unusual features noticed.

7.4 Finally, after completing all procedures, the auditors has to review and assess all the evidence and information gathered, together with explanations given by the assessee in order to form an overall conclusion as to whether:

a) the financial information has been prepared using acceptable accounting principles & policies, which have been consistently applied;
b) the financial information complies with relevant regulations and statutory requirements;
c) there is adequate disclosure of all material matters relevant to the proper presentation of the financial information;

7.5 A clear written expression of opinion on the financial information is then given. If Form or content of the report is specified (e.g. Form 3CD), specific comments are given on the prescribed particulars. In case of qualified opinions, adverse opinions or reservation of opinion on any matter, detailed reasons are given therefore.

8. **Documentation**

The auditor is required to document all matters which are important in providing evidence that the...
audit was carried out in accordance with the basic principles and procedures. Documentation refers to the working papers prepared or obtained by the auditor and retained by him in connection with the performance of his audit. These papers are the property of the auditor and he should take steps for their proper custody and retention for a period of time sufficient to meet the needs of his practice, and to satisfy professional requirements. In case of any allegation of misconduct on the part of the Auditor, ICAI (Institute of chartered Accountants of India) bases its enquiry on such working papers.

8.1 The extent of documentation is a matter of professional judgment. But the papers should be sufficiently complete and be in detail for an auditor to obtain an overall understanding of the case and to perform an effective audit. The papers must record the audit plan, the nature, timing and extent of auditing procedures performed and the conclusions drawn from the evidence obtained.

8.2 In particular, all significant matters, which require the exercise of judgment together with the audit is conclusion there upon, should be included in the working papers. Thus the papers should clearly reveal the facts like-

- a) evaluation of the internal controls existing in the accounting system;
- b) decisions on the nature and extent of auditing procedures performed in various areas, together, with reasons for these decisions;
- c) details of all the discrepancies and deficiencies noticed during audit and the management's explanations on the same;
- d) reasons for accepting or rejecting the explanations and certificates given by the management.
- e) detailed information collected by the auditor from banks, debtors and creditors;
- f) reasons for arriving at various conclusions and for giving qualified opinions etc.

8.3 In the case of recurring audits, working papers are sometimes classified as permanent audit files and current audit files.

8.4 The permanent audit file normally contains information of a permanent nature, such as-

- a) organizational structure of the concern and system of management;
- b) copies of Memorandum of Articles, Partnership deeds and other important legal documents;
- c) record of the study and evaluation of the internal controls related to the accounting system;
- d) notes regarding significant accounting policies;
- e) significant audit observations of earlier years;
- f) analysis of significant ratios and trends;

8.5 The current audit file normally contains, among other things,

- a) evidence of planning process of audit;
- b) analysis of transactions and balances;
- c) record of auditing procedures performed;
- d) evidence that the work performed by assistants was supervised and reviewed;
- e) copies of communications with experts, debtors/creditors, banks and other third parties;
- f) copies of notes concerning audit matters communicated to or discussed with the assessee's, management.
- g) extracts of minutes of Board meetings and General meetings, concerning matters important to audit;
- h) conclusions reached by the auditors including manner in which discrepancies and deficiencies noted, were treated or resolved.

8.6 Thus it can be seen that the documentation has to be fairly comprehensive, and contains a lot of information which can be of great relevance to the tax investigator.

**Types of Audit** -
The areas and accuracy of an audit depend not only on the nature and size of the concern and the accounting system followed, but also on the proforma for the report required, and different statutory requirements. The two main types of audit encountered by a tax investigator are the Company Audit and the Tax Audit.

(A) **Company Audit**

9. The accounts of every company are required to be compulsorily audited, under section 227 of the Companies Act, 1956. The audit is carried out in accordance with the above mentioned principles and procedures. There are 29 Company Audit Standards as per Company Audit Standard Rules, 2006. The detailed rules and other connected statutes can be downloaded from the website www.mca.gov.in of Ministry of Corporate Affairs. (Govt. of India) This important area of auditor report which are essential for the assessing officers and internal audit wing to have knowledge and idea of the correct picture of Financial Affairs a company. Copies of Auditing Standards for Companies numbering 29 in PDF files have also been placed in the Reference Material portion on the CD.

However, u/s 227(7A) of the Companies Act, the Auditor is required to make certain specific enquiries ' during the course of audit, the auditor is not required to report on these enquiries, unless he has any special comment to make on them. Some of these enquiries are:

(i) Whether loans and advances made by the Company against securities have been properly secured, and whether the terms, of such loans and advances are not prejudicial to the interests of the company and its members. This enquiry is to be made in respect of all loans/ advances made during the year, even if they are not outstanding on the date of audit. The enquiries include detailed valuation of the securities.

(ii) Whether, transactions represented merely by book entries are not prejudicial to the interests of the company. The auditor has to first ascertain whether such transactions have actually taken place, and if so, whether they are not prejudicial to the interest of the company made during the year.

(iii) In the case of companies other than investment or banking companies, whether shares and other securities have been sold at prices less than the purchase price and if so, whether the sale was bona fide and at a reasonable price.

(iv) Whether personal expenses have been charged to revenue account, and if so, whether contractual obligations are based upon accepted business recover the expense practices.

(v) Whether loans and advances have been shown by way of deposits.

(vi) Where it is stated in the books and papers of the company that any shares have been allotted for ash; whether the cash has actually been received and if no cash has been received, whether the position stated in account books and balance sheet is correct, regular and not misleading.

9.1 It is to be noted that the auditor is required to make enquiries into the above matters and not a full-scale investigation. Only if the auditor finds some adverse feature, he will comment upon it in the audit report. However, details of enquiries made and conclusions drawn can always be obtained from the working papers of the Auditor.

9.2 In addition to the above u/s 227(4A) of the Companies Act, the Central Government may by order, specify certain companies in whose case the audit report must contain comments on specified matters. Under this provision, the Government has issued an "Manufacturing and Other Companies (Auditor's Report) Order (referred to as MAOCARO) in 1975 and subsequently also revised in 1988. New order for auditors very much known as CARO i.e. Companies (Auditor Report) order, 2003 vide notification No. GSR 480 dated June 12 2003 has been issued. The provisions of sub-section (1A),(2), (3) and (4) of section 227 are applicable to all companies but this order applies to service company, manufacturing company, mining company, trading company etc. It also applies to
(a) Companies incorporated outside India, which after the commencement of Companies Act, 1956 established a place of business in India

(b) Companies incorporated outside India, which have, before the commencement of the Companies Act, 1956 established a place of business within India and counties to have an established place of business in India. The order is also applicable to audit of branches.

Companies not covered by the Order

(i) Banking companies - Banking companies as defined under clause (c) of section 5 of the Banking Regulation Act, 1949 (10 of 1949)

(ii) Insurance companies - Insurance company as defined under clause (29) of section 2 of the companies Act, 1956 (1 of 1956)

(iii) a company licensed to operate u/s 25 of the Companies Act, 1956 (1 of 1956)

(iv) The order also exempts from its application private limited company which must fulfill all the following conditions -
   a) Its paid up capital and reserves are rupees fifty lakhs or less
   b) It has not accepted any public deposit
   c) It has no outstanding loan of rupees ten lakhs or more from any bank or financial institution and
   d) Its turnover does not exceed Rupees five crores.

This order came into effect on first day of July, 2003. The tax investigators must go through the auditors report and the information can be of great help for them. The detailed order and other connected statutes can be downloaded from the website www.mca.gov.in of Ministry of Corporate Affaires. (Govt. of India) This important area of auditor report which are essential for the assessing officers’ knowledge to understand the correct picture of financial affairs a company. A copy of the MACARO, CARO and comparison thereof in PDF files have also been placed in the Reference Material portion on the CD. The order is applicable to almost all companies. A large number of matters are specified therein, the relevant ones being those mentioned below:

a) Stock inventory - whether physical inventory of stock, has been carried out at regular internals; whether the procedures followed for physical verification are adequate; whether any material discrepancies are noticed in such inventories; whether the valuation of the stock is fair and proper and in accordance with accepted accounting policies.

b) Inter corporate loans- Whether loans have been taken from sister/group concerns; whether the rate of interest and other terms of the loans are prejudicial to the interests of the company.

c) Purchases/sales with sister/group concerns- Whether the purchase/sale prices are reasonable in view of prevailing market prices.

d) Damaged goods - Whether there is any generation of unserviceable or damaged goods; whether the resulting loss is determined and accounted for.

e) Scrap- Whether adequate records are maintained for generation, disposal and sale of scrap.

9.3 The CARO report is a very detailed statement where comments have to be given on all the specified matters by the Charted Accountant. The report is normally annexed to the main audit report and should be filed along with the return of income.

Important matters to be included in the Auditors Report

1) Whether the company is maintaining proper records showing full particulars, including qualitative details and situation of fixed assets.

2) Whether the management of the assessee at reasonable intervals has physically verified the fixed assets; whether any material discrepancies were noticed on such verification and if so, whether the same have been properly dealt with in the books of account.

3) If a substantial part of fixed assets have been disposed off during the year, whether it has affected the on going concern.

4) Whether physically verification of inventory has been conducted at reasonable intervals.
by the management.

5) Whether the procedures of physical verification of inventory followed by the management are reasonable and adequate in relation to the size of the company and the nature of its business? If not, if not the inadequacies such procedures are reported.

6) Has the company either granted or taken loans, secured or unsecured to / from companies, fixed or other parties covered in the register maintained under section 301 of the companies Act, 1956. It so the number of parties and amount involved in the transition has been disclosed.

7) Whether the rate of interest and other times and condition of loans given or taken by the company, secured or unsecured are prima facie prejudicial to the interest of the company?

8) Whether the payment of principal amount and interest are also regular?

9) Whether adequate internal control procedure commensurate with the size of the company and notes of business, for the purchase of inventory & fixed assets and for the sale of goods have been followed? If there is a continuing failure to correct major weakness in internal control, it shall be pointed out (See Auditing and Assurance standards - AAS-6 and AAS-32) 10). Whether in case of transaction exceeding the value of five lakh rupees in respect of any party in are year is at prices, which are reasonable, having regard to the prevailing market prices at relevant time?

10) Whether in case of transaction exceeding the value of five lakh rupees in respect of any party in are year is at prices, which are reasonable, having regard to the prevailing market prices at relevant time?

11) Whether in case of the company which has accepted deposits from the public within whether the directives issued by Reserve Bank of India and the provisions of section 58A and 58AA of the companies Act, 1956 have been followed and compliance of the order passed of any by the company law Board have been followed?

12) Whether in case of listed companies and or other companies having a paid up capital and reserves exceeding Rs. 50 lakh (as at the commencement of the financial year) or having annual turnover exceeding five crores (for a period of three consecutive years), internal audit system commensurate with its size and nature of its business has been followed?

13) Whether u/s 209(1) (d) of the companies Act, 1956 in the case of companies (a class of companies) engaged in the production, processing, manufacturing as mining activities, has maintained proper records showing particulars relating to utilization of material-or labour or to other items of cost?

14) Whether, the auditors have indicated almost non deposit of the extent of outstanding statutory dues on the last day of the financial year by the company in respect of undisputed dues etc e.g. provident fund, investor education, provident fund, employees state insurance, income-tax, sales tax, wealth tax, custom duty, excise duty, cess or any other statutory dues to appropriate authorities. These arrears include municipal taxes, electricity, bills, taxes deducted at source, fees payable to the authority (including to Cinema Hall, malls, commercial building case of dispute.

15) Whether in case of company that is in existence for more than five years from the date of registration till the last day of the financial year, the auditor has reported.
   (i) Whether the account tax losses at the end of the financial year are more than 50% of its not work?
   (ii) Whether the company has increased cash losses during the period covered by the report and in the financial year immediately preceding to period covered by the report?

16) Whether adequate document and records are maintained in cases where the company has granted loan and advances on the basis of security by way of pledge of shares, debentures and other securities? If not, the deficiencies must be pointed out.

17) In respect of nidhi, mutual benefit funds and societies, whether statutory requirements have been complied with

18) If the company is dealing in trading in shares securities and other investments, whether proper record have been maintained of the transaction and controls and whether timely entries have been made therein; also whether the shares, securities debentures and other securities have been held
by the company, in its own name expect to the extent of the exemption; if any, granted u/s 49 of the companies Act, 1956.

[Also see www.mca.gov.in website of Ministry of Corporate Affairs for statement on the Companies (Auditor’s Report) Order, 2003(CARO) , ICAI-website www.icai.org and Reference Material CD portion for further details]

The Comments therein must be carefully scrutinized and any qualified or vague opinion not to be following up by the AOs and further reference to the auditor’s working papers must be made.

9.4 **Cost Audit** - Under section 209(i)(a) of the Companies Act, the Government may direct any class of industries to maintain cost records prescribed under the cost Accounting Record Rules for that industry. Till date, more than 30 industries, etc. cement, paper, aluminum, sugar, cotton textiles, motor vehicles etc. have been covered under these rules. Under section 233B of the Companies Act, the Govt. (Company Law Board), any by order direct are such company to have an audit of the cost accounts conducted, for a particular year(s). The Board of Directors then have to appoint a Cost Auditor, who has to furnish a very detailed cost audit report to the Govt. within a specified time from the close of the accounting period. A copy of the report is also given to the Company, and should normally be submitted along with the Income tax return. [Also see folder on Cost Audit in CD enclosed with this Handbook].

9.5 Though Cost Audit is not an annual compulsory affair, the Govt. these days is directing such audit for a large number of companies. The CARO report normally indicates whether such cost audit has in fact been done in that particular year. Hence, if the, cost audit report is not enclosed with the return; it can always be called for and scrutinized.

9.6 The details given in cost audit reports are immensely useful to the tax investigator. Apart from detailed costing of different parts of the production process, and reasons for variation in such costs, the report also analyses significant financial ratios and trends, expenditure on salaries and wages, other overheads including expenditure on marketing and sales, abnormal and non-recurring costs etc. Figures are also obtained by auditors not only for the year under audit, but also or the two preceding years. Hence scrutiny of this report can lead to gathering of extensive date and consequently can lead to provide significant investigation. The Central Government has now framed the Cost and Works Accountants (Procedure of Investigations of Professional and Other Misconduct and Conduct Cases) Rules, 2007 under clause (c) and (d) of Sub-section (2) of Section 38A read with sub-sections (2) of section 21 and sub-sections (2) and (4) of section 21 B of the Cost and Works Accountants Act, 1959(23 of I959).The Notification GSR 113(E) dt 27-02-2007 has now been incorporated in the Reference Material in the CD

(B) **Tax Audit** -

10. The tax audit report required u/s 44AB of the IT.Act 1961, consists of two parts. The first part, given in Form 3CA/3CB/3CD (depending on whether company/non-company/professional), is the general audit report, where the auditor is required to certify that the balance sheet and profit and loss account give, a true and fair-view of the financial state of affairs and profits of the assessee.

10.1 The second part, given in Form 3CD or Form 3CA/3CB (for business and profession respectively) [Rule 6G of Income-tax Rules ,1962] is a report on certain specific prescribed particulars, which pertains to specific sections of the I.T. Act 1961. In this report the Auditor has to be absolutely sure of the information to be furnished therein, and has to certify that the same is true and correct. The Central Board of Direct Taxes has issued Notification No 208/2006 dated 10August,2006 containing the Income-tax (91h Amendment),Rules ,2006 and made significant amendments/changes in Form13CD It has also inserted Annexure ii for the computation of the value of fringe benefits in terms of section 11 5 WC read with section 11 5 WB. On account of consequential impact of the Finance Act ,2006 and the Taxation Laws (Amendment )Act ,2006 the Institute of Charted Accountants of India has also issued a Guidance Note on Tax Audit This change has also been brought about for meeting out the following requirements :-

Compiled for DTRTI, Chandigarh’s Workshop on Audit ; 22nd and 23rd November 2010 at Delhi and Chandigarh
(i) revision of accounts of a company after its adoption in annual general meeting.
(ii) change of law i.e. such as to meet the retrospective amendment.
(iii) change in interpretation i.e. to meet the requirements of CBDT Circulars judgments.

10.2 It is to be noted that u/s 44AB, the Auditor is supposed to submit the report to the assessee only, and not to the banks or any other agency. Hence the Auditor must give his own opinions and comments and should not write things like "according to the management..." or "as certified by the management...". If at all, such a certificate or contention of the client is accepted by him, the Auditor must be almost absolutely sure of its correctness. Auditors are making such remarks in a large number of tax audit reports.

Stock inventories are stated to be "as certified by the Management". If at all, such a certificate or contention of the assessee is accepted by him, the Auditor must be almost absolutely sure of its correctness. Such remarks are being made by auditors in a large number of tax audit reports. Stock inventories are stated to be "as certified by the management". Quantitative details of production and yield are not given since "according to the management such quantification is not possible", capital expenditure is not reported since "in the opinion of the management no such expenditure has been incurred". In all such cases, the auditor must be required to show, by referring to his working papers, as to how he has accepted the certificates and contentions of the assessee as correct. Such remarks may also call for independent investigation into the relevant areas.

10.3 Now, the Chartered Accountants are adopting Computer Aided Audit Techniques (CAATs). These Techniques may result in the design of systems that provide less visible evidence than those using manual procedure. System characteristics which may result from the nature of EDP processing that demand the use of CHAT are:

- Data may be entered directly into computer systems without supporting documents.
  a) In manual system, it is normally possible to follow a transaction by examining the source documents, books of accounts, records, files and reports. But in this system certain data may be maintained on computer files only and it may exist for a limited period of time.
  b) In manual system, it is normally possible to examine visually the results of processing in EDP system; the results of processing may not be printed.
  c) Data and computer programmes may alter at the computer centre or through the use of computer at remote locations.

Thus, there may be absence of input documents, lack of visible transaction trail, lack of visible output and ease of access to data and computer programmes for the CAs, who may have other advantages by following these techniques but the departmental officers ‘task of investigation, becomes difficult. Those officers who are computer savvy and have background of accounts can break the advantages of techniques adopted (by C 4s) in the interest of revenue easily.

11. Specific areas of audit:-- Institute of Chartered Accountants of India has issued guidelines for CAs in respect of the following

a) Audit of Banks
b) Audit of General Insurance Business
c) Audit of Life Insurance Business
d) Audit of Small entities
e) Audit of Stock exchanges

Details of some of specific areas are given here as under:-
11.1 **Audit of Banks** :- Audit of Banks is an important area, where important points mostly in following areas are covered :-

i.) Information about the banking industry, its legal framework, accounting and audit framework.

ii.) Significant financial statement items their presentation in the financial statements, relevant RBI guidelines.

iii.) Basic audit considerations in Branch Office vis a vis head office etc.

iv.) RBI circular

v.) Other important circular such as outsourcing of banks, testing etc.

11.2 **Audit of General Insurance Business** :- In Audit of General Insurance Business, important aspects of the audit of such companies in following areas are dealt with :-

i.) Contract of Insurance, classes of general insurance business etc.

ii.) Requirements as to minimum paid up capital, deposits, and important statues as applicable to audit of general insurance.

iii.) Applicability of according standards respects and returns to be furnished.

iv.) Features of According Systems and framework.

v.) Auditing framework

vi.) Audit at Head Office.

vii.) Segment wise audit of reinsurance

viii.) Investments- include IRDA guidelines, balance sheet disclosures, valuation of Investments, audit producers etc.

ix.) Norms for valuation of assets and liabilities.

x.) Format of financial statements, specimen Auditors report, statement of assets and liabilities.

11.3 **Audit of Life Insurance Business** :- In Audit of General Insurance Business, important aspects of the audit of such companies in following areas are covered:

xi.) Life Insurance Contracts.

xii.) Statutory books and Returns.

xiii.) Valuation of Assets and Liabilities

xiv.) Accounting Records.

xv.) Accounting policies and information.

xvi.) Audit of accounts.

xvii.) IRDA guidelines, balance sheet disclosures, valuation of Investments, etc.

xviii.) Audit at Head Office, Divisional and Branch Offices.

xi) In this respect Guidance Note has also been issued specifically for CAs for Audit of Insurance Business.

11.4 **Audit of Small entities**

Small entities which are subject to audit are

i) Sole Proprietorship Concerns

ii) Large Partnership Accounting Firms

iii) All types of Practitioners

11.5 **Audit of Accounts of Members of Stock Exchanges** -

Auditing of accounts of Members of stock exchanges deals with following areas :-

i) Functioning of Stock Exchanges

ii) Securities Leasing Schemes

iii) Derivatives

iv) Rolling Settlements

v) Accounting for stock exchange transactions
vi) Registers, books of accounts.

vii) Audit and Accounting of Derivatives

Certain other areas of specific Audit are Educational Institutions, Hotel Industry, Non-Government Organizations (NGOs), Government Companies etc for which different set of rules and procedures are followed by the auditors. In case of Audit of Members of Stock Exchanges, as per SEBI (Disclosure and Investor Protection) Guidelines 2000, an auditor is required to report on financial information to be included in the offer documents.

11.5.1 **Stock**: Inventory and valuation of stock is one of the most difficult areas to tackle both for the tax investigator and for the auditor. The auditor obviously cannot carry out a physical inventory of the closing stock for every concern he is auditing. The statements on Auditing practices make it clear that physical verification of stock is the responsibility of the assessee. The Auditor is, however, concerned with the methods and procedure of verification followed by the assessee.

11.5.2 As mentioned earlier, the Auditor can rely upon a stock certificate given by the assessee but before accepting the same, he must exercise all reasonable care and skill to satisfy himself that-

a) Proper records are maintained and/or systems are existing, which could enable the assessee to ascertain the stock,

b) Proper procedures of verification are followed.

One of the ways in which this is done is by getting the assessee to issue, before commencement of physical verification, detailed instructions to the staff on how to compile the inventory. The auditor can also review original physical verification sheets and traced selected items into the final inventories. Normally, a summary of each such verification sheet is kept on the auditor's file along with details of the verification carried out by him.

11.5.3 Regarding valuation of stock, the auditor has to be satisfied that the method of valuation is adequate and reasonable having regard to the circumstances of the case, and that the method is consistently followed. Although the auditor is not expected to be an expert valuer, he can always make test checks of the records within limits of his knowledge.

11.5.4 The auditor is also required to obtain a very detailed stock certificate from the assessee giving quantity and value of different types of stock, declaration as to ownership of the same, basis of valuation etc. (A sample of such a certificate is attached as Annexure --I of this chapter)

11.5.5 The information available with the auditor, including copies of original physical inventories and detailed stock certificate, can be extremely, useful to the tax investigator in scrutinizing the figures of stock.

12.1 **Bank balances and securities**

The auditor is required to verify all bank balances by obtaining direct confirmation from the Banks. A detailed proforma for getting such information has been laid down by the ICAI. The proforma gives details of all types of accounts, sanctioned limits for overdraft and loan accounts, description and value of securities held by bank, investments and other documents of title held in safe custody, margins against letters of credit, guarantees given on behalf of clients etc. The information is duly certified by the Bank (copy of sample proforma is enclosed as Annexure II of this chapter).

12.2 Thus here again the information available with the auditor, which is more detailed than that which the assessee is likely to give to the Deptt. can be of great help, to the investigation.

13. Fraudulent financial reporting: - Fraudulent financial reporting involves intentional misstatements or omissions of amounts or disclosures in financial statements to deceive financial statement users. Fraudulent financial reporting may involve:

- Deception such as manipulation, falsification, or alternation of accounting records or supporting documents from which the financial statements are prepared.
- Misrepresentation in, or intentional omission from, the financial statements of events, transactions of other significant information.
• Intentional misapplication of accounting principles relating to measurement, recognition, classification, presentation, or disclosure.

Professional Ethics must be followed by a Chartered Accountant. In case of a practicing Chartered Accountant, he can be found guilty as per Clauses 2 and 3 of Part I of the First Schedule to the Chartered Accountants Act, 1949 of Professional Misconduct if he shares fees or profits with a person who is not a member of ICAI such as lawyers, engineers, etc. Disciplinary action under section 21 of the Chartered Accountants Act, 1949 can be taken if found to be guilty of any professional or "Other Misconduct"

14. Case Laws on Professional Misconduct

(1) Council of Institute of Chartered Accountants of India vs P.C. Parikh, CA. AIR 2003 Gujarat 334 BCAJ]. In this case Chartered Accountant authored a book titled "Tax Planning for Secret Income". It was held

(a) Book is a clear venture to reach out with such assistance to generators of black money
(b) To educate tax evaders, how they can reduce their tax liability.

The Chartered Accountant was found to be of professional misconduct.

2. B.V. Kamath vs Institute of Chartered Accountants of India 130 Taxman 435 Kerala - A Chartered Accountant is entitled to "Specified number of Tax audit assignments." It has been specified by clause (ii) of Part II of the second schedule to the Chartered Accountants Act, 1949 (38 of 1949) that a member of the Institute in practice shall be guilty of professional misconduct if accepts in a financial year, accepts more than "Specified number of Tax audit assignments." under section 44AB of the Income Tax Act, I 961. Now, the maximum limit has been from 30 (specified in 1989) to 45 for practicing charted accountant as an individual or as a partner of a firm [Decided at 268°i meeting of the council of ICAI Hon'ble M.P High Court has also affirmed this view in Arun Grover V's Institute of Chartered Accountants of India [1998] 93 Comp Cas 618, 624 (MP). However, the Madras High Court dissented in re K.Bhagvatheesharam Vs Institute of Chartered Accountants of India [ (1998) 93 comp Cas 625, 631, 633, 634 (Mad)] the view of MP High Court but in case of KV Kamath case restriction has been held to be valid.


3. Reasons to be Stated for Unfavorable or Qualified Answers

Where, in the auditor's report, the answer to any of the questions referred to in paragraph 8.3 is unfavorable or qualified, the auditor's report (C.A's) shall also state the reasons for such unfavorable or qualified answer, as the case may be. Where the auditor is unable to express any opinion in answer to a particular question, his report shall indicate such fact together with the reasons why it is not possible for him to give as answer to such question.

15. Conclusion.

The above study of auditing procedures and practices makes it clear that the Auditor is expected to do his job impartially, carefully and in conformity with the standards and requirements of his profession. The fact that the audit report is meant for the use of a number of persons and organizations makes it imperative for the Auditor, particularly in audits of large industrial-and business concerns, to do his job with the utmost sincerity and meticulousness. Hence a large quantity of information is collected and analyzed by the Auditor, The audit report itself may be a small document, but it has been based on a huge amount on analyzed data. This data and information can not only be of help to the Assessing Officer in making zero-error assessments, but more importantly can provide a large number of clues and if-ads for proper, effective and well planned investigation. It is, therefore, strongly recommended
that such information and data must be scrutinized at least in a few cases, which have been selected for deep investigation.

The auditing procedures and practices also clearly indicate that discrepancies can be noticed from the details furnished to the auditor and can also break the notion that no concealment of income can be detected from audited accounts. Sometimes, it can be said that tax evasion can be detected more easily in cases having audited accounts.

[Various other important points AO’s/ Auditors of department in the Internal Audit shall take into account other points, which are given in the chapter XI of this Handbook]
CERTIFICATE TO BE ISSUE) TO AUDITORS
WHERE PHYSICAL STOCK CHECKING WAS CARRIED
OUT BY ASSESSEE ON CLOSING DATE

Dear Sirs,
Following is a summary of stocks held by ........................................(Name of company)....
as at ...................................................(Accounting year and date...............):-

<table>
<thead>
<tr>
<th>Description</th>
<th>Quantity</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stores and Spare parts</td>
<td></td>
<td>Rs.</td>
</tr>
<tr>
<td>Loose Tools</td>
<td></td>
<td>Rs.</td>
</tr>
<tr>
<td>Raw Materials</td>
<td></td>
<td>Rs.</td>
</tr>
<tr>
<td>Work-in-progress</td>
<td></td>
<td>Rs.</td>
</tr>
<tr>
<td>Finished goods</td>
<td></td>
<td>Rs.</td>
</tr>
<tr>
<td>Any other heads</td>
<td></td>
<td>Rs.</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td>Rs.</td>
</tr>
</tbody>
</table>

With respect to the above stocks, I hereby certify that to the best of my knowledge and belief-

(i) All quantities were determined by actual physical count or weight or Measurement as on (date of physical inventory ... ......... ..)except as follows: -

(ii) All goods included, in. the inventory are the property of this company and are not subject to any charge, none of the goods held on consignment from others or as bailee and none being subject to lien of any kind except as follows :

(iii) The inventory includes all goods of try value which are the property of this Company wherever located, including goods sent on consignment account to customers.

(iv) The inventory does not includes:-

(a) goods purchased for which invoices have not been entered as liabilities;
(b) goods returned by customers without credit to their accounts or
(c) goods billed to customers, in advance of delivery.

(v) In valuing the inventory, due consideration has been given to the saleability of the stock and no obsolete or useless items were included therein except at their not are resalable value.

(vi) The goods have been valued on the following basis :-

(Work-in-progress .............
Stores and Spare parts .............
Raw Materials .............
Finished goods .............
Loose Tools .............
Any other head .............

(In describing the method of valuation, state exactly what is meant by cost - whether first in first out or average cost, etc., and whether cost includes overheads and if so to what extent. In describing market value, state whether this means replacement value or no realizable value).

(vii) No item of stock has a value on realization, in the ordinary course of business, which is less then the amount stated in the inventory.
(viii) The basis of valuation adopted is the same as was used in the previous year, except as follows

………………………………… …………………………………
………………………………… …………………………………

Yours faithfully •

To be signed by Managing Director/Manager and Chief Executives Officer or Chief Accountant or other person who has over all responsibility for the valuation.

Annexure -II

PROFORMA USED BY BANKS FOR SUPPLYING INFORMATION TO AUDITORS

Auditor's Name
Address

Dear Sirs,

Re : (Name of Assessee)

At the request of our clients, we submit below particulars or their accounts, investment, bills, etc., as at the close of business on ... ...as shown by our records.

1. Current Accounts in Credit;
   Designation of Account
   Amount

2. Overdrawn Current Accounts:
   Overdraft Accounts or cash credit Accounts
   designation of Accounts
   Amount
   Security Held (Give brief description. In the case of securities please list fully.)

3. Loan Accounts
   Due date
   Particulars of any charges of lines
   Amount

4. Fixed Call and Short deposit Accounts
   Amount. Interest accrued to the closing date
   Face Value or number of shares held

5. Investments and other documents of title held in Safe Custody :
   Designation
   Face Value or number of shares held.

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

7. Bills for Collection,
   Designation of Account.
   Amount
   Due date.

8. Bills Discounted or purchased
   Name of Drawee
   Amount
   Due date.

9. Letters of Credit open and outstanding.
   In favour of
   Amount
   Not utilized
   Valid upto
   Date.

Dated ......................
10. Guarantees given on behalf of clients:

We certify that the above particulars are full and correct and do not exclude any other obligations of the Company to us.

(On the basis of old Article given at DTRTI, Lko, C & AG Report 2008 and ICAI’s Statement on the Companies Auditors Report Order, 2003. Also see for details Chapter XIV on Accounting Standards for various types of Accounting Standards. Please see CD on Reference Material - One folder for Companies and Cost Audit and two folders for text of Accounting Standards and International Accounting Standards in PDF files attached with this Handbook)
CHAPTER-XI

IMPORTANT POINTS FOR AO’s WHILE EXAMINING BOOKS OF ACCOUNT TO AVOID AUDIT OBJECTIONS/DRAFT PARAs IN TAX AUDIT CASES

The whole scenario of Tax Audit has taken a new look in view of the changes brought about by the Finance Act, 2006 and Taxation Laws (Amendment) Act, 2006 and issue of Notification No 2081 2006 dated 10-08-2006.

After the changes made in the Form 3CD applicable for returns filed for Assessment Year 2007-08 onwards, Form 3CD has to be more carefully checked by the AOs. This also covers the important changes introduced by the Finance(No 2)Act 2004 relating to interest, commission brokerage fee for professional services or payable to a resident contractor or sub-contractor after deduction has not been paid or not within the time prescribed u/s 200(1) of the Income tax Act 1961 are significant The drastic changes brought about in Form 3CD relate to sections 40(a)(i),section 43A, on conversion of capital asset into stock in trade refunds of certain indirect taxes not credited to the P&L A/c, treatment of payments made u/s 43B, certificates for taking or accepting or repaying loan, nature of business and compliance of TDS provisions by the assessee. These changes have come into effect by the Income-tax(Ninth Amendment )Rules, 2006 vide Notification No 208/2006 dt 10-08-06. The Internal Audit wing of the department is also required to be apprised of the changes beside assessing officers.

Now, Annexure I and II (Brief given at the end of the chapter and details can be seen in Income-tax Rules, 1962) are also to be attached duly filled with the Form 3CD. The Tax Audit Report can be treated as incomplete without these Annexures and AO can resort to ex parte assessment u/s 144 after application of provisions of section 145(2) of the Income-tax Act, 1961. In cases where, information furnished in the Audit Report is incomplete or non-committal replies are furnished, Assessing Officers can also refer the cases to the CIT for taking further action u/s 288 of the Income tax Act, 1961.

The knowledge of finer points of the details required to be checked by the Assessing Officers is very essential as the Tax Auditors normally take various other ways and adopt other escape routes. If you glance at the Audit Reports of the Union in Performance Audit etc from 2002 to 2008 of C&AG, a large number of mistakes on part of the Assessing Officers occurred due to lack of knowledge on various issues and number audit objections are still pouring in. A Review was made in Report No. PA7 of 2008 in chapter 2 on “Review on appreciation of third party/reporting certification of assessment proceedings” by the C&AG. It has been said that the prevention is better than cure. Therefore, the finer points in Tax Audit Reports submitted after 10-08-2006 needs further checking point wise by Assessing Officers. These points are now placed at one point to facilitate the Assessing Officers. They can also call for a revised Tax Audit Report from the CAs for a period prior to 10-08-2006 in the following circumstances:

(i) where, retrospective amendments have taken place in the law.
(ii) where, there lies change in interpretation due to judgments CBDT circulars
(iii) where, a decision has been taken by the company to revise the accounts in a annual general meeting of the company
In view of the changes brought about by the Finance Act, 2006 and Taxation Laws (Amendment) Act, 2006 and issue of Notification No 208/2006 dated 10-08-2006 and the Income Tax Rules by the Income Tax (Ninth Amendment) Rules the following points in the Tax Audit Report may be taken into account as far as possible to avoid future mistakes:

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<tr>
<td>1</td>
<td>(a) If firm or Association of Persons, indicate names of partners/members and their profit sharing ratios.</td>
<td>: Procure details from assessee disclosing the names of partners/members and their profit sharing ratios.</td>
</tr>
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</table>
|   | (b) If there is any change in the partners/members or their profit sharing ratios, the particulars of such change. | (1) Take a view of partnership deeds and other relevant documents.  
(2) Enquire whether there has been any change in the partners/members and or their profit sharing ratios. |
| 2 | (a) Nature of business or profession.  
(b) If there is any change in the nature of business or profession, the particulars of such change. | (1) Have a look at financial statements and other relevant information to ascertain whether there is any apparent change in the business carried out by the assessee, especially under this clause.  
(2) Examine whether any business or activity has been commenced or whether there has been any expansion of the existing business. |
| 3 | (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 systems mention the books of account generated by such computer system)  
(c) List of books of account examined by CA | (1) Ascertain whether books of account are prescribed under section 44AA.  
(2) Take notice whether presently books of account have been prescribed only for professional and Rule 6F details the books/records to be maintained by such assesses.  
Procure details indicating the list of books of account maintained.  
Make note of the list of books of accounts examined by the Tax Audit. |
| 4 | Whether the profit and loss account includes any profits and gains assessable on presumptive basis, if yes, examine that the amount vis a vis the relevant sections. (44AD, 44AE, 44AF, 44B, 44BB, 44BA, 44BBB or any other relevant section) | : Procure an analysis of revenues and ascertain whether the profits and gains arising from such revenues are assessable on a presumptive basis for the following:  
- 44AD Business of civil construction.  
- 44AE Business of plying, hiring or leasing goods carriages.  
- 44AF Retail business.  
- 44B Shipping business of non |
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<tr>
<td>5</td>
<td>(a)</td>
<td>Method of accounting employed in the previous year.</td>
</tr>
<tr>
<td></td>
<td>(b)</td>
<td>Whether there has been any change in the method of accounting employed in the immediately preceding year.</td>
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<td></td>
<td>(c)</td>
<td>If answer to (b) above is in the affirmative, obtain details of such change, and the effect thereof on the profit or loss.</td>
</tr>
<tr>
<td></td>
<td>(d)</td>
<td>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 be examined.</td>
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</table>

- 44BB Business of exploration of mineral oils.
- 44BBA Operation of Aircraft by non-resident.
- 44BBB Foreign companies engaged in civil construction, etc. in turnkey power projects.
- Other relevant sections e.g. section 172 shipping business of non-residents.

Past assessments completed/prior year tax returns to ensure that the basis adopted in earlier years for assessing such profits/gains have been continued.

The assessee may have carried out other businesses, profits included in the profit and loss account arising from the business covered by these sections has been disclosed.

Give opportunity of being heard to the assessee.

Procure details of the accounting polices followed by the assessee given in the financial statements and other relevant information.

Make sure that the your investigation should look at the accounting polices whether they are followed in respect of:
- Refund for income-tax, sales tax, etc.
- Export incentives
- Claims
- Grants/Subsides
- Others

Examine details where there has been any change in the method of accounting employed in the immediately preceding year.

Make sure that any change in the method of accounting employed is appropriately disclose preceding year.

Provide opportunity to assessee if any change is there.

The accounting standards prescribed under section 145 may be examined if they have been followed in conformity with such standards. It should be noted that vide notification number SO 69(E)
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|   |   | dated January 1, 1996 of ICAI, the following accounting standard have been notified under section 145- (please see Chapter XIV for details);  
- AS I relating to Disclosure of Accounting Policies.  
- AS II relating to Prior Period any Extraordinary items and Changes in Accounting Policies.  
Make sure that deviation from such standards is appropriately taken into account and the effect thereof on the profit/loss is also made in the body of asstt order. |
| 6 | (a) | To verify the application of correct Method of valuation of closing stock employed in the previous year. |
|   |   | 1. Procure a chart indicating the method of valuation of closing stock employed during the year item wise. Earlier the ICAI had recommended that stock-in-trade would include raw materials, finished goods and work in progress only and stores and spare parts and loose tools would not be included. Since the new clause refers to “closing stock” instead of “stock-in-trade”, store and spare parts and loose tools should therefore also be included as part of closing stock. |
|   |   | 2. Change in the method of valuation of opening and closing stock, including effect of change, is now covered under Para 5 above. |
|   |   | 3. The method of accounting prescribed under section 145A may be examined and ascertains whether valuation of closing stock includes the amount of any tax, duty cases or fee actually paid or incurred by the assessee to bring the goods to the place of its location and condition as on the date of its valuation Also examine whether;  
- Duties payable in respect of goods held in bound have been included;  
- Excise duty paid in respect goods cleared any lying at branches/deports etc. have been included;  
- The accounting for modvat credit has bee done in properly in respect of MODVAT.  
Ensure that any deviation form the method of valuation prescribed under section 145A is appropriately disclosed by the assessee and the effect thereof on the profit/loss is also indicated |
|   | (b) | Details of deviation, if any, from the method of valuation prescribed under section 145A, and the effect thereof on the profit or loss. |
| 7 | To examine the amounts not credited to the profit and loss account, being-
   (a) The items falling within the scope of section 28;
   (b) The proforma 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 | Enquire whether any item of income chargeable under Profit and Gains Business of Profession has not been credited to the profit and loss account has not been added to total income, Section 28 covers;
- Profits and gains of business of profession
- Compensation received on termination of employment, agency, etc.
- Income of trade or professional or similar association from specific services to members
- Export incentives
- Perquisites received during the course of business
- Interest, salary, bonus, remuneration, etc. received by a partner from firm, which is allowable under section 40B.
- Amount received under key man’s insurance policy
Examine the details and financial statements to determine whether such income has been credited directly to reserves or retained as a credit under the head current liabilities and provisions or any other head. Give opportunity to assessee in case of doubt.
Procure details indicating the following claims admitted as due by the concerned authorities but not credited to the profit and loss account. The details should also indicate the year in which it was admitted as due.
- Proforma credits
- Duty drawbacks
- Excise/Custom duty refunds
- Sales tax refunds
Procure an understanding of the relevant accounting policies [refer clause 11 (a)]. Further ensure that claims have been
(c) Escalation claims accepted during the previous year; admitted as due by the concerned authorities.

Take note of the relevant assessment orders of excise authorities to determine whether any such claims are due. In case of variation give an opportunity to assessee to clarify..

Procure the details of escalation claims accepted during the year but not credited to the profit and loss account. The details obtained should also indicate the year in which it was accepted as due. Certain instances of escalation claims may be in relation of contract with government customers and other sales to customers having escalation clause in contracts. Obtain as understanding of the relevant accounting polices.

Take note of the relevant assessment orders passed by excise authorities and sales tax authorities to determine whether any such claims are due. In case of variation give an opportunity to assessee to clarify..

(d) any other item of income;

Enquire whether any item of income chargeable to tax under heads of income other than ‘Profit and Gains of Business or Profession’ has not been left to be credited to profit and loss account.

Examine the audited details and financial statements to determine whether such income has been credited directly to reserves or retained as a credit under the head current liabilities and provisions or any other head. Take note of the details obtained to determine whether any such claims are due. In case of variation give an opportunity to assessee to clarify..

(e) Capital receipt, if any.

Enquire whether any capital receipt has not been credited to profit and loss account e.g. capital receipts may be in the nature of grants/subsides, non complete fees etc.

Examine the audited details and financial statements to determine whether such capital receipt has been credited directly to reserves or retained
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<tr>
<td>8</td>
<td>To verify the correct application of provisions of Depreciation in the IT Act, 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</td>
<td>as a credit under the head ‘current liabilities and provisions’ or any other hand. Take note of the details obtained to determine whether any such claims are due in case of variation give an opportunity to assessee to clarify.</td>
</tr>
<tr>
<td></td>
<td>(a) Following form:- Description of asset/block of assets</td>
<td>Procure a schedule providing the relevant details indicated in the aforesaid clause in respect of each asset or block of assets. Ensure that the following have been included;</td>
</tr>
<tr>
<td></td>
<td>(b) Rate of depreciation</td>
<td>- Written down value at the beginning of the year</td>
</tr>
<tr>
<td></td>
<td>(c) Actual cost or written down value, as the case may be deductions during the year Case may be.</td>
<td>- Assets acquired during the year have been segregated between the assets put to use for less than 180 days</td>
</tr>
<tr>
<td></td>
<td>(d) Additions/deductions during the year with dates; in the case of any addition of an asset, the date put to use; including adjustments on account of –</td>
<td>- Adjustment on account of modvat, change in exchange rates and subsidy/grant have been separately disclosed</td>
</tr>
<tr>
<td></td>
<td>(i) Modified Value Added Tax credit claimed and allowed under the Central Excise Rules, 1994, in respect of assets acquired on or after 1st March 1994.</td>
<td>- Deductions during the year represent the sale proceeds of assets sold</td>
</tr>
<tr>
<td></td>
<td>(ii) Change in rate of exchange of currency, and</td>
<td>- Rates of depreciation</td>
</tr>
<tr>
<td></td>
<td>(iii) Subsidy or grant or reimbursement, by whatever name called</td>
<td>Examine assessments completed/prior year tax returns to examine the basis adopted in earlier years for determination of depreciation allowable. Also ascertain whether any aggressive positions have been adopted by the assessee are consistent with the requirements of the Income Tax Act, 1961.</td>
</tr>
<tr>
<td></td>
<td>Depreciation allowable Written down value at the end of the year.</td>
<td>For assets acquired during the year, examine whether the accounting policy for the following has been followed;—;</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- Modvat credit</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- Exchange fluctuation including in respect of realized gains/losses, unrealized gain/losses and treatment of forward exchange contracts.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- Subsidy or grant or reimbursement. See whether the amounts included as adjustments on account of modvat, change in exchange rates and subsidy/grant with the details obtained and to other relevant supporting documents are included. Examine the deductions during the year with audited schedules filed by the assessee and ensure that such amount</td>
</tr>
</tbody>
</table>
| 9 | To examine the amounts admissible under section 33AB, 33ABA, 33AC, 35, 35ABB, 35AC, 35CCA, 35CCB, 35D, 35DDA, 35E:-
|   | (a) Debited to the profit and loss account (showing the amount debited and deduction allowance under each section separately);
|   | (b) Not debited to the profit and loss account. |

reconciles with the amount considered for determining the profit/loss on assets sold, discarded etc. The depreciation computation be examined and ensure the arithmetical accuracy of the depreciationalowable and the written down value at the end of the year.

Procure a Chart from assessee reflecting details of deduction admissible section, wise, indicating separately, the amounts debited to profit and loss account.

The aforesaid sections are as follow:
- 33AB Tea development account
- 33ABA Site restoration fund
- 33AC Reserve for shipping business
- 35 Expenditure by way of payment to associations and institutions for carrying out rural development programmes
- 35CCB Expenditure by way of payment to associations and institutions for carrying out programmes of conversation of nature resources.
- 35D Amortization of certain preliminary expenses
- 35DD Amortization of expenses in amalgamation/demerger
- 35DDA- Amortization of expenses in VRS
- 35E Deduction of expenditure of prospecting, etc. for certain minerals

Examine the computation of the amounts admissible under the aforesaid sections and tally the same with financial statements and other relevant supporting documents.

In case of variation give opportunity to assessee.

| 10 | (a) To examine 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)
|   | Procure details of sum paid to an employee as bonus or commission for services rendered, where such sum was otherwise payable to him as profits or dividend. Examine the amounts paid as bonus and commission to employees and ensure that there are no such sums other than those disclosed in the details obtained, which would have otherwise
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<tr>
<td>(b)</td>
<td>To examine 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).</td>
</tr>
<tr>
<td></td>
<td>been payment as profit or dividend. Procure details of contributions received towards the specified funds, due date of payment to the authorities. Tally the details with audited schedules and other relevant supporting documents.</td>
</tr>
</tbody>
</table>
| 11 | To examine amounts debited to the profit and loss account, being:-  
  (a) Expenditure of capital nature;  
  (b) Expenditure of personal nature;  
  (c) Expenditure on advertisement in any souvenir, brochure, tract, pamphlet or the like, published by a political party; |
|   | Whether understanding of the capitalized policy followed by the assesses.  
Procure details indicating expenditure of capital nature debited to the profit and loss account.  
e.g. capital expenditure debited to the profit and loss account could be:  
- Capital expenditure on scientific research  
- Capital items below a certain rupee limit (write of items of value below Rs. 5,000  
- Preliminary expenses of a capital nature  
- Obsolete assets written off  
Tally the details with audited schedules and other relevant accounts to ensure that no other capital expenditure has been charged to profit and loss account.  
Give opportunity to assesssee in case of difference. |
|   | Under section 227(1A)© of the Companies Act, 1956, the personal expenses are to be charge to the revenue account.  
I there is nay such comments in the auditor’s statutory report then;  
Examine the relevant accounts to ensure that no other expenditure of personal nature has been debited to the profit and loss account.  
Give opportunity to assesssee in case of difference.  
Procure details indicating expenses incurred on advertisement if any publication of a political party  
Tally the details with the relevant |
(d) Expenditure incurred at clubs-

(i) As entrance fees and subscriptions;
(ii) As cost for club services and facilities.

(e) Expenditure be way of penalty or fine for violation of any law for the tome being in force; and other penalty or fine;

(i) expenditure incurred for any purpose which is an offence or which is prohibited by law;

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

<table>
<thead>
<tr>
<th>supporting documents.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Please note: Political parties would include both national and regional parties, which are approved by the Election Commission.</td>
</tr>
<tr>
<td>Examine the advertisement, sales promotion and other relevant accounts to ensure that all such expenditure has been appropriately disclose. Give opportunity to assessee in case of difference</td>
</tr>
<tr>
<td>Procure details indicating payments made to clubs classified under the following heads;</td>
</tr>
<tr>
<td>- Entrance fees</td>
</tr>
<tr>
<td>- Subscriptions</td>
</tr>
<tr>
<td>- Expenditure towards use of club services and facilities i.e. entertainment, staying expenses etc.</td>
</tr>
<tr>
<td>Please note that</td>
</tr>
<tr>
<td>I. Reimbursement of club payments to directors/employees should be included in the details obtained.</td>
</tr>
<tr>
<td>II. Subscriptions and other payments to credit organization like Diners Club should be excluded.</td>
</tr>
<tr>
<td>Examine the relevant accounts and ensure that all expenditure incurred at clubs has been appropriately disclosed by the assessee. Give opportunity to assessee in case of difference.</td>
</tr>
<tr>
<td>Procure details indicating the payments made under the following:</td>
</tr>
<tr>
<td>- Penalty or fine for violation of any law</td>
</tr>
<tr>
<td>- Expenditure which is an offence of which is prohibited by law</td>
</tr>
<tr>
<td>- Any other penalty or fine</td>
</tr>
<tr>
<td>Examine the legal and professional fees and other relevant accounts. Give opportunity to assessee in case of difference.</td>
</tr>
<tr>
<td>Procure details indicating the following in respect of amounts inadmissible under section 40(a):</td>
</tr>
<tr>
<td>- Interest, royalty, fees for technical services, which is</td>
</tr>
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</tbody>
</table>

(g) Interest, salary, bonus, commission or remuneration inadmissible section 40(b)/40(ba) and computation thereof;

(h) Amount inadmissible under section 40A (3) read with Rule 6DD and computation thereof;

(i) Provision for payment of gratuity not allowable under section 40A(7)

Procure details indicating the amount inadmissible under section 40(b)/40(ba) and computation thereof, classified under the following heads:
- Interest
- Salary
- Bonus
- Commission or any other remuneration Give opportunity to assessee in case of difference

Procure details of all payments made in excess of Rs. 20,000 made in cash. If such payments are exempt under any of the clauses(a) to (1) of Rule 6DD, indicate in the schedule. Ensure that the conditions for specific exemption under any of the clauses (a) to (1) of Rule 6DD are satisfied. Ensure that the schedule indicates the computation of disallowance as per section 40A (3).

I. Payments exceeding Rs. 20,000 otherwise than by crossed Cheque or draft will attract 20 percent disallowance.

II. This should include payments to staff by way of salary, travel allowance etc.

III. Only revenue payments would be covered.

IV. Payment to purchase of raw materials and stocks would be covered.

V. As per the ICAI, is case no proper evidence for verification of the payments by crossed
| (j) | Any sum paid by the assessee as an employer not allowable under section 40A(9); |
| (k) | Particulars of any liability of a contingent nature |

If a crossed cheque or draft is available the report should comment that it is not possible for us to verify whether the payments in excess of Rs. 20,000 have been made otherwise than by crossed cheque of bank draft as the necessary evidence is not in the possession of the assessee.

Give opportunity to assessee in case of difference

Procure details indicating the provision for payment of gratuity not allowable under section 40A(7);

Tally amounts provided with the details obtained financial statements and other relevant supporting documents and ensure that all such expenditure has been appropriately taxed.

Whether contributions have been made to approved gratuity fund, review the copy of the trust deed and rules and the order of the Commissioner of Income Tax granting recognition to the gratuity fund may be examined.

Give opportunity to assessee in case of difference.

Procure details indicating the sum paid by the assessee as an employer, not allowable under section 40A(9) i.e. towards setting up or formation or contribution to any fund, trust company, etc. other than;

- Recognized provident fund
- Recognized gratuity fund
- Recognized superannuation fund
- As required by or under any other law.

Tally the details and examine the staff welfare expenses and other relevant accounts to ensure that all such not allowable under section 40A(9) have been appropriately brought to tax.

Procure details of contingent liabilities debited to the profit and loss account indicating the nature of the demand and the reason for making provisions in the accounts. Tally the audited accounts, in particular the notes to the accounts to ensure that all liabilities of a disputed nature have been identified for further discussion.
<p>| | | |</p>
<table>
<thead>
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</tr>
</thead>
<tbody>
<tr>
<td>12</td>
<td>Particular of payments made to persons specified under section 40A(2)(b).</td>
<td>Give opportunity to assessee in case of difference. Procure details from the assessee indicating the following: - List of persons specified under section 40A(2)(b) - Details of payments made to persons specified in above list. Tally with - Relevant contracts/agreements with specified persons - Relevant supports for payments made to such specified persons. Examine the relevant accounts to identify any payments made to persons specified under section 40(2)(b). Give opportunity to assessee in case of difference.</td>
</tr>
<tr>
<td>13</td>
<td>Amounts deemed to be profits and gains under section 33AB or 33ABA or 33AC may be examined.</td>
<td>(d) Directors and their relatives of companies having a substantial interest in the company; and (e) And person, in whose business or profession, the directors or their relatives have a substantial interest as defined in the explanation to section 40A(2)(b). Give opportunity to assessee in case irregularity is found before assessment.</td>
</tr>
<tr>
<td>14</td>
<td>Any amount of profit chargeable to tax under</td>
<td>Procure details indicating amounts</td>
</tr>
<tr>
<td>Section</td>
<td>Description</td>
<td></td>
</tr>
<tr>
<td>---------</td>
<td>-------------</td>
<td></td>
</tr>
<tr>
<td>15* (i)</td>
<td>In respect of any sum referred to in clause (a), (c), (d) or section 43B the liability</td>
<td></td>
</tr>
</tbody>
</table>

(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 or 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 (c) 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 provision to section 43B; |
(c) Actual date of payment |
(d) If paid otherwise than in cash whether |

deemed to be profits and gains under the relevant sections. Examine whether in assessments completed/prior year tax returns the basis adopted in earlier years was followed. Give opportunity to assessee in case of difference. Procure details indicating amount of profit chargeable to tax under the aforesaid clause and the computation thereof. Give opportunity to assessee in case of difference. Obtain a schedule indicating the following information in respect of the items referred to in clause (a), (c), (d) or (e) of section 43B: |

- Liability a the beginning of the year |
- Amount paid during the year including the date of payment |
- Amount not paid during the year |

Tally the amounts and dates with audited schedules and relevant supporting documents. Obtain details in respect of any payable by assessee as an employer by way of contribution to an provident fund, superannuation fund, gratuity fund or any other fund for the warfare of employee, specifically indicating the following: |

- Nature and amount of liability in the beginning of the year |
- Due dated of payments under second proviso to section 43B |
- Amount paid and date of payment |
- Mode of payment i.e. cash,
the sum has been realized within fifteen days of the aforesaid due date

<p>| | | | |</p>
<table>
<thead>
<tr>
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</tr>
</thead>
<tbody>
<tr>
<td>(B)</td>
<td>Was incurred in the previous year;</td>
<td>cheque, etc., also indicating date of realization where payments have been made otherwise that in cash.</td>
<td></td>
</tr>
<tr>
<td>(a)</td>
<td>Nature of liability;</td>
<td>- Amount not paid on or before the aforesaid due date</td>
<td></td>
</tr>
<tr>
<td>(b)</td>
<td>Due date of payment under second proviso to section 43B;</td>
<td>Tally the amounts and dates with audited schedules and relevant supporting documents. Date of realization should be verified with certificate from banks or the relevant evidence.</td>
<td></td>
</tr>
<tr>
<td>(c)</td>
<td>Actual date of payment</td>
<td>Obtain details in respect of any sum payable by assessee as an employer by way of contribution to any provident fund, superannuation fund, gratuity fund or any other fund for the welfare of employees, specifically indicating the following;</td>
<td></td>
</tr>
<tr>
<td>(d)</td>
<td>If paid otherwise than in cash, whether the sum has been realized within fifteen days of the aforesaid due date.</td>
<td>- Nature and amount of liability incurred during the year.</td>
<td></td>
</tr>
</tbody>
</table>

*BState whether sales tax, customs duty, excise or any other indirect tax, levy, case, impost etc. is passed through the profit and loss account.

<table>
<thead>
<tr>
<th>16</th>
<th>(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.</th>
<th>Obtain details indicating separately the following in respect of capital goods and law material and components;</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>- Modvat credit availed during the year.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- Modvat credit utilized during the year.</td>
</tr>
</tbody>
</table>

- Make sure that the method followed is disclosed appropriately.

Verify whether the cheque issued for the payments have been realized within 15 days from the due date or not.
<p>| | | |</p>
<table>
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<tr>
<th></th>
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<tbody>
<tr>
<td>(b)</td>
<td>17</td>
<td>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).</td>
</tr>
<tr>
<td>(a)</td>
<td></td>
<td>Particulars of each loan or deposit in an amount exceeding the limit specified in section 269SS taken or accepted during the previous year;</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>(i) Name, address and permanent account number (if available with the assessee) of the lender or depositor;</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(ii) Amount of loan or deposit taken or accepted;</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(iii) Whether the loan or deposit was squared up during the previous year;</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(iv) Maximum amount outstanding in the account at any time during the previous year.</td>
<td></td>
</tr>
</tbody>
</table>

- Treatment of the same in the Profit and Loss account.
- Treatment of outstanding modvat credit.

Tally the details with relevant supporting documents produced by the assessee.

Obtain appropriate disclosure on the accounting policy followed by the company on ‘treatment of modvat’.

Give opportunity to the assessee in case of some deviation noticed.

Obtain details indicating income/expenditure relating to prior period credited/debited to the profit and loss account during the year.

Tally the details with audited schedules and relevant supporting documents.

Examine the items under the head prior period adjustment and the notes to the accounts to ensure all such expenditure/income has been disclosed in the above schedule.

Give opportunity to the assessee in case of some deviation noticed.

Obtain details of borrowing and repayments (including interest) of hundi loans otherwise than by account payee cheques.

Tally the details with the audited books and relevant supporting documents.

Give opportunity to the assessee in case of some deviation noticed.

Obtain details of loans and deposits of Rs. 20,000 or more taken or accepted during the year giving the relevant details as per the aforesaid clause.

Tally the details with the audited books and other relevant supporting documents.

Examine the loan, deposit and other relevant accounts ensure all such particulars have been appropriately disclosed by the assessee.
(v) Whether the loan or deposits was taken or accepted otherwise than by an account payee cheque or an account payee bank draft.

* (These particulars need not be obtained as per ICAI in the case of a Government Company, a banking company or a corporation established by a Central, State or Provincial (Act).

(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.

Give opportunity to the assessee if not disclosed.

Obtain details of loans and deposits of Rs.20,000 or more repaid during the year giving the relevant details as aforementioned.

Tally the details with the audited schedules and other relevant supporting documents.

Examine the loan, deposit and other relevant accounts to ensure all such particulars have been appropriately disclosed and taken accounts while framing assessment order.

Give opportunity to assessee if any discrepancy is found.

Note: Refer note (i) to (v)

<table>
<thead>
<tr>
<th>19</th>
<th>Details of brought forward loss or depreciation allowance in the following manner, to the extent available;</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Serial Number</td>
</tr>
<tr>
<td></td>
<td>Assessment Year</td>
</tr>
<tr>
<td></td>
<td>Nature of loss/allowance (in rupees)</td>
</tr>
<tr>
<td></td>
<td>Amount as returned (in rupees)</td>
</tr>
<tr>
<td></td>
<td>Amount as assessed</td>
</tr>
</tbody>
</table>

Obtain details indicating the details as per the aforesaid clause will cover the following:

- Business loss
- Unabsorbed depreciation
- Speculation loss
- Loss under the head capital gains.

Tally the basis and details with the return of income, assessment orders etc. and other relevant supporting documents.

<table>
<thead>
<tr>
<th>20</th>
<th>Section –wise of deductions if any, admissible under Chapter VIA</th>
</tr>
</thead>
</table>

Obtain a detailed chart from assessee disclosing the section-wise details of deductions claimed under Chapter VIA.

Ensure that deductions claimed by the client are admissible under Chapter VIA.

Tally the details with the details obtained and other relevant supporting
<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
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</tr>
</thead>
<tbody>
<tr>
<td>21</td>
<td>(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.</td>
<td>documents. Examine assessment completed/prior year tax returns to examine the basis adopted in earlier year. Verify the basis and computation of deductions. Give opportunity to assessee before making addition on this account.</td>
</tr>
<tr>
<td></td>
<td>(b) If the answer to (a) above is negative, then give the following details;</td>
<td>Procure details aforementioned. Tally the details with the relevant supporting documents and returns submitted for the purpose. Examine the relevant accounts to ensure that tax has been deducted as per XVII-B. e.g. salaries, interest on securities, other interest, dividends, royalties, payments to non-residents, payment to contractors etc.</td>
</tr>
<tr>
<td></td>
<td>- Serial Number</td>
<td></td>
</tr>
<tr>
<td></td>
<td>- Particulars of head under which tax is deducted as source</td>
<td></td>
</tr>
<tr>
<td></td>
<td>- Amount of tax deducted at source (in rupees)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>- Due date for remittance to the Government</td>
<td></td>
</tr>
<tr>
<td></td>
<td>- Details of payment date/amount (in rupees)</td>
<td></td>
</tr>
<tr>
<td>22</td>
<td>(a) In the case of a trading concern, give quantitative details of principal items of goods traded;</td>
<td>Obtain details as aforementioned in paras 20 &amp; 21. Tally the details with audited schedules and the stock records maintained by the company. Examine accounts to ensure all such particulars has been appropriately taken into account Give opportunity to assesse before making addition on this point.</td>
</tr>
<tr>
<td></td>
<td>(i) Opening stock;</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(ii) Purchase during the previous year;</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(iii) Sales during the previous year;</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(iv) Closing stock;</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(v) Shortage/excess, if any</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(b) In the case of a manufacturing concern, give quantitative details of the principal items of raw materials, finished products and by-products;</td>
<td></td>
</tr>
<tr>
<td></td>
<td>A. Raw Material</td>
<td>Obtain details as given in paras 20,21</td>
</tr>
<tr>
<td></td>
<td>(i) Opening Stock</td>
<td>Tally the details with schedules given with Tax Audit Reports and the stock records maintained by the company/firm. For items (vi) and (vii) verify the calculations made by the assessee.</td>
</tr>
<tr>
<td></td>
<td>(ii) Purchase during the previous year;</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(iii) Consumption during the previous year;</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(iv) Sales during the previous year;</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(v) Closing stock;</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(vi) *Yield of furnished products;</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(vii) *Percentage of yield</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(viii) *Shortage/excess, if any.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>B. Finished products/By-products:</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(i) Opening Stock;</td>
<td>Obtain details as per para 20 &amp; 21 and 22 above</td>
</tr>
<tr>
<td></td>
<td>(ii) Purchase during the previous year;</td>
<td></td>
</tr>
</tbody>
</table>
### Annexure Ito Form 3 CD consists of two parts -

**Part A** - Consists of General Information relating to the assessee

**Part B** - Consists of Nature of business or profession carried on during the previous year and a code of the business carried out shall be filled in. 73 codes for various business activities under 9 heads viz Manufacturing Industry, Trading, Commission Agents, Builders Contractors, Professionals, Service Sector, Financial Service Sector, and Entertainment Industry have been mentioned in the Income-tax Rules, 1962.

**Annexure II** to Form 3CD consists of detailed chart to be submitted for Value of Fringe benefits in Terms of Section 115 WC read with section 115 WB of the Income-tax Act, 1961 for the Assessment Year. In this chart CAs have to furnish the details of 19 types of expenditure/payments renting to Fringe Benefits.
[Based upon Income-Tax Rules, 1962; Tax Audit Check Sheets normally issued to CAs for Tax Audit issued by

Audit Issues u/s 44 AB

Audit Seminar of RTI Chandigarh

 Audit Issues u/s 44 AB

Scheme of Presentation
➢ Why Tax Audit (TA) ?
➢ Are all cases eligible for TA ?
➢ Concept of Business or Profession and Turnover
➢ How to make information of TA useful for Internal Audit ?

For Whom Tax Audit u/s 44 AB

Every person—
➢ 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 (60 lakhs from AY2011-12) in any previous year;

or

➢ carrying on profession shall, if his gross receipts in profession exceed ten lakh rupees (15 lakhs from AY2011-12) in any previous year;

or


Compiled for DTRTI, Chandigarh’s Workshop on Audit ; 22nd and 23rd November 2010 at Delhi and Chandigarh
For Whom Tax Audit u/s 44 AB

- 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 or section 44BB or section 44BBB, 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, .......

( Amendment in Finance Act, 2010)

- Get his accounts of PY audited by an accountant before the specified date and furnish by that date report in the form prescribed under this section.

Issues in Tax Audit u/s 44 AB

Business S 2(13): 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 earn income. The expression business does not necessarily mean trade or manufacture only-

Profession

- Section 2 (36): 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).

- 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).
Profession

The following have been listed out as profession in section 44AA (rule 6F) and notified there under (Notifications No. SO-17 (E) dated 12.1.77, No. SO 2675 dated 25.9.1992 and No. So 385(E),dated 4.5.2001):

- Accountancy, Architectural, Authorised Representative, Company Secretary, Engineering, Film Artists/Actors, Camera man, Director, Singer, Story Writer, Etc., Interior Decoration, Legal, Medical, Technical Consultancy, Information Technology

- Whether Business or Profession
- Advertising Agent,
- Clearing, Forwarding and Shipping agents
- Couriers.
- Insurance agent.
- Nursing Home.
- Stock and share broking and dealing in shares and securities
- Travel agent.

Relevant Judgements

- Clearing, Forwarding and Shipping agents
  CIT V. Jeevanlal Lallubhai & Co, [1994] 206 ITR 548 (Bom)

- Nursing Home (135 ITR146) and 90 ITD 235

- Stock and share broking and dealing in shares and securities (CIT v. Lallubhai Nagardas & Sons 204 ITR 93,Bom).

Speculation and Derivatives

- Speculation Transaction 43(5)
- Derivatives Exempted from Speculative Transaction
  i) Definition of Trading carried electronically on screen based system
  ii) Through stock broker registered with SEBI o by banks or MF on a recongised stock exchange
  iii) Supported by time stamped contract note indicating Unique Client Identity No and PAN
- Determination of Turnover: Speculative vs Derivatives
Capital Gains Vs. Business

Depends on facts and circumstances of each case taking into consideration nature, frequency and volume of transaction.

Landmark Judgments:


Board Circular No. 4/2007, dated 15-6-2007 It is possible for tax payer to have two portfolios, i.e., an investment portfolio comprising of securities which are to be treated as capital assets and a trading portfolio comprising of stock in trade which are to be treated as trading assets. Where an assessee has two portfolios, the assessee may have income under both heads i.e.,

Instances of Receipts forming part of Gross Receipts

- Duty Draw Back
- Commission - Brokerage
- Job Work
- Sale of License
- Foreign Exchange surplus/ difference on Export Sales
- Surplus on reimbursement e.g. packing forwarding, freight etc.
- Advance receipt from customer forfeited
- Interest Income if assessable as business income
- Income of a partner from a partnership firm such as remuneration and interest on capital account.

Instances of receipts not forming part of Gross Receipts

- Rental Income
- Reimbursement of expenses and other charges to a clearing / consignment agent
- Amount received by a traveling agent for reimbursement of expenses. Except a travel agent engaged in Package Tour
- Write Back of Provisions
- Recoveries from Bad Debts. nature,
Situational Analysis

- Mr. Taxmania is a proprietor of a business, where the sales are Rs. 30/- lakhs and purchases are Rs. 50/- lakhs. Is he liable for tax audit u/s. 44AB?
- In case of a person doing only Derivative trading, what will be the method of arriving at the turnover for determining the applicability of S. 44AB?
- In the business of speculation of shares, whether the entire value of sales should be taken into account for determining the limits for the purpose of S. 44AB or whether only the aggregate of the differences should be considered?
- In case of investors Mr. Taxcomplaya having long term capital gain or STCG
- In case of Mr. Taxhonara having rental income assessable under house property
- In case of 44AD etc., if T.O. is more than 40 lakhs 44AB is applicable or not (if minimum income is offered for taxation)
- Sale of a car is not included in sales for the purpose of tax audit but according to some Supreme Court judgments under Sales tax Act, the sale of a car is to be treated as sales and sales tax has to be charged. Then, why should the same be excluded for tax audit purposes?

Rule 6G

Report of audit of accounts to be furnished under section 44AB.
(1) The report of audit of the 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), be in Form No.3CB.
(2) The particulars which are required to be furnished under section 44AB shall be in Form No.3CD.

Applicability of Accounting Standards

- Issued by the ICAI
- It is clarified that the mandatory accounting standards also apply in respect of financial statements audited u/s 44AB of the Income Tax Act, 1961.
- Accordingly, the members of ICAI should examine compliance with the mandatory accounting standards when conducting such audit. (Published in The Chartered Accountant Journal, August 1994.)
- Issued u/s 145 of the I.T.Act
- Companies Act, 1956 Refer section 211
Applicability of Sec 194C

- Person responsible for paying any sum for carrying any work to any contractor should deduct tax at source.
- Tax should be deducted at source only if the contract is between the contractor and the following specified persons

- Any individual or Hindu Undivided Family whose books are required to be audited under section 44AB during the immediately preceding financial year.
- [The turnover from business/profession exceeds the limits specified u/s 44AB during the immediately preceding financial year]

Applicability of Sec 194C

- Budget 2008 introduced the burden of deduction of tax under this section to Association of Persons and Body of Individuals also, whether they are incorporated or not.
- Individual or HUF need not deduct tax if the contract is exclusively for personal purposes.
- Income Tax should be deducted at the time of payment or credit to the account of the contractor whichever is earlier.
- Provisions of Section 194C are applicable only where the contract is either a “contract for carrying out any work” or a “contract for supply of labour for works contract”. Hence, these provisions are not applicable for payments made under the contract of sale of goods.

Applicability of Sec 194C

- For the purpose of this section, the following contracts are also included in the scope of “Work”:

1. Advertising-
2. Broadcasting and telecasting including production of programs for broadcasting and telecasting
3. Carriage of goods and passengers by any mode of transport other than Railways.
4. Catering
Applicability of Sec 194C

No deduction of tax at source shall be made under this section in the following circumstances:

1. If the amount paid/payable or credited/likely to be credited to the contractor/sub-contractor does not exceed Rs.20,000/- in a single instance (30,000 from 1-7-2010).
2. However, the total of amounts paid or credited during the financial year should not exceed Rs.50,000/- (75000 w.e.f.1-7-2010)
3. If the said amount exceeds Rs.50,000/-, then, the liability for payment arises on the whole of amount paid or credited and not on the amount in excess of Rs.50,000/-
4. Based on vehicles in Transporters Case (Amendment in Finance Act, 2010 FOR PAN)

Practical Issues in Form 3CD

Clause 12A- Conversion of Capital Asset Into Stock in Trade at fair market value: Section 45(2)

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

The particulars to be stated are required to be furnished with reference to the previous year in which the conversion has taken place.

The taxability of capital gains or business income arising from such deemed transfer is not required to be reported.

The legislation has not visualized the situation where stock in trade is to be converted into capital asset.

Section 145A v/s AS-2 (ICAI)

Valuation of Inventory on the basis of AS-2 ICAI

Cost of Purchase --- The 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.

Cost of Inventories ---- The cost of inventories should comprise all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition.
**Section 145A/ Service Tax/ 43B**

- Service Tax Charged in bills.
- Payment not received till the date of filing of ITR as such no liability to pay service tax.
- Mercantile System of accounting followed
- There is a fundamental difference between Sales tax and Service tax. In case of Sales tax, the seller is responsible to deposit the sales tax even if he has not collected that from the customer but in case of service tax the liability of service provider arises only when he has received the value of taxable service from the customer. [Section 68 read with Rule 6 of Service Tax Rules]

- Whether Disallowance u/s 43B?
  - No. ACIT V Real Image Media Tech P Ltd (Chennai) 306 ITR 106 and CIT vs Noble and Hewitt India (P) Ltd. 305 ITR 324
  - 145A does not apply to service tax.
  - If no expenditure is claimed - No disallowance u/s 43B

**Clause 17 (e) i), ii) iii) : Penalty**

- Explanation to s 37: -For the removal of doubts, it is hereby declared that any expenditure incurred by an assessee for any purpose which is an 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.
  - 201 ITR 684 Prakash Cotton SC and 205 ITR 163 Ahemadabad Cotton.
  - Penalty is required to be examined as per the provisions of the relevant statue notwithstanding the nomenclature.
  - If the impost is compensatory in nature, it is to be allowed, however, if it is penal in nature it is to be disallowed.

**Clause 17 (e): Penalty**

- Explanation to s 37: - ALLOWBILITY OF KICKBACKS/SECRET COMMISSION AS BUSINESS EXPENDITURE UNDER SECTION 37(1) OF IT ACT
  - The Explanation will come into picture only when the amounts were proved that they were spent for business purpose, but a purpose which is an offence/prohibited by law.
  - Invoking the provisions of Explanation will come into picture only when the amount is proved to be justified otherwise.
  - The assessee had failed to adduce satisfactory evidence to establish the genuineness of the payment. In regard to the applicability of section 37(1) proviso, it was held that such payments would evidently constitute a breach of trust on the part of recipients towards their own employers which constitutes an offence u/s. 408 of IPC.
Clause 17 (f) Sec. 40(a)

- Deduction of TDS at lower rates or non deduction or non deposit
- STT up to AY 2008-09
- FBT
- Wealth Tax

Clause 17 (f): Section 40(a)(ia)

- Interest u/s 193 or 194A, Payment to Contractors/sub-contractors u/s 194C, Commission or brokerage u/s 194H, Rent u/s 194-I, Fees for technical/professional services u/s 194J, Royalty (Expl 2 s 9(1)(vi).

- **Inadmissible if :-**
  i) Tax is not deducted at all.
  ii) Tax was deductible and was so deducted during the month March but not paid on or before the due date of filing of return
  iii) In any other case i.e (Tax deducted from April to Feb) TDS is not paid up to 31st March.
Clause 17 (i): Section 14A

- S14A(1) Deduction inadmissible u/s 14A of the expenditure incurred in relation to income not includable in total income

- S14A(2) - The AO, if he is not satisfied with the correctness of claim of the assessee, shall determine the amount of expenditure incurred, in relation to income which does not form part of the total income in accordance with method prescribed under rule 8D (w.e.f. 24-3-2008)

- S14A(3) - S14A(2) is applicable in cases where Assessee claims that no expenditure has been incurred by him in relation to such income

Clause 17 (i): Rule 8D:

Determination

(2) The expenditure in relation to income which does not form part of the total income shall be the aggregate of following amounts, namely:

(i) the amount of expenditure directly relating to income which does not form part of total income;

(ii) in a case where the assessee has incurred expenditure by way of interest during the previous year which is not directly attributable to any particular income or receipt, an amount computed in accordance with the following formula, namely:

\[ A \times \frac{B}{C} \]

Where:

- A = amount of expenditure by way of interest other than the amount of interest included in clause (i) incurred during the previous year;

- B = the average of value of investment, income from which does not or shall not form part of the total income, as appearing in the balance sheet of the assessee, on the first day and the last day of the previous year;

- C = the average of total assets as appearing in the balance sheet of the assessee, on the first day and the last day of the previous year.
Clause 17 (i): Rule 8D: Determination

(iii) an amount equal to one-half per cent of the average of the value of investment, income from which does not or shall not form part of the total income, as appearing in the balance sheet of the assessee, on the first day and the last day of the previous year.

3. For the purposes of this rule, the 'total assets' shall mean, total assets as appearing in the balance sheet excluding the increase on account of revaluation of assets but including the decrease on account of revaluation of assets.

Clause 17(m) 36(1)(iii).

➢ The auditor to compute the amount inadmissible under the proviso to section 36(1)(iii)

➢ Interest paid, in respect of capital borrowed for acquisition of an asset or extension of existing business or profession (whether capitalized in the books of 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.

Clause 21(B): Section 43B

➢ The present provisions of section 43B
➢ the payment made by the employer towards contribution of PF, ESI, and other welfare funds are allowable if the same are paid before filing the return of income. Now no disallowance of such payment would be made even if the same are made beyond the due dates prescribed in section 36(1)(va).
➢ View of the decision of the SC in the case of CIT v Vinay Cement 213 ITR 268 has been followed CIT v Dharmender Sharma 297 ITR 320 (Delhi high court) and CIT v P M Electronics Ltd (313 ITR 121 Delhi High court)
Clause 25(b) Section 79

- u/s 79 of the Income –Tax Act Change in shareholding of the company and carry forward of the losses.
- Business loss cannot be carried forward and set off in the previous year in which a change in shareholding takes place in case of a company in which public are not substantially interested,
- If on the last day of the previous year in which the change in shareholding took place 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 not beneficially held by the same persons.

Brain storming issue

- During the present scenario of e-filing, No tax audit is required to be filed before the AO
- Can a tax auditor revise his tax audit report and Form No. 3CD?
## Annexures

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<th><strong>Annexures</strong></th>
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<td>Annexure III:- Instruction No. 3 of 2007</td>
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<td>Annexure IVB:- Instruction No. 1976</td>
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ANNEXURE-1
REGISTERS IN AUDIT

RECEIPT AUDIT REGISTERS, REPORTS AND RECORDS

The accuracy and timely submission of reports and returns has assumed great importance in view of the fact that correct statistics are required to be furnished to the PAC from time to time. This, in turn, depends on the proper maintenance of the prescribed records and registers, which essentially forms the basis of the various reports and returns sent by the field formations. Due care must, therefore, be exercised to ensure that the prescribed records and registers are properly maintained and accurate reports and returns are submitted in time.

REGISTERS TO BE MAINTAINED IN THE INTERNAL AUDIT WING

(a) **Receipt Audit Register-I** - This is the Register recording Receipt Audit Major Objections. Apart from particulars regarding the objections and remedial action thereon, Column 16 of this Register also maintains information whether the case was seen by Internal Audit, and if not, the reasons therefor.

<table>
<thead>
<tr>
<th>Sr. No.</th>
<th>PAN</th>
<th>Name of the assessee/circle</th>
<th>LAR no &amp; date, Para No.</th>
<th>Assessment year/dated of order under objection/Section under which the order passed</th>
<th>Tax effect as per LAR</th>
<th>Gist of objections</th>
<th>Accepted or not</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
<td>6</td>
<td>7</td>
<td>8</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Date of instruction by CIT/Addl. Cit/JCIT reg appropriate remedial action</th>
<th>Last date for action u/s 263/24 7/154 etc.</th>
<th>Date of remedial order</th>
<th>Tax effect as per remedial order</th>
<th>DCR No.</th>
<th>Date of collection/refund</th>
<th>Where not accepted date of communication from AG or Board on the basis of which treated as settled</th>
<th>Whether the case was seen by the Internal Audit. If not reasons therefore</th>
</tr>
</thead>
<tbody>
<tr>
<td>9</td>
<td>10</td>
<td>11</td>
<td>12</td>
<td>13</td>
<td>14</td>
<td>15</td>
<td>16</td>
</tr>
</tbody>
</table>

(b) **Receipt Audit Register-2** - This the Register of Receipt Audit Minor Objections.

<table>
<thead>
<tr>
<th>S.No.</th>
<th>PAN</th>
<th>Name of the assessee/circle</th>
<th>LAR no &amp; date</th>
<th>Assessment year/dated of order under objection/Section under which the order passed</th>
<th>Tax effect as per LAR</th>
<th>Gist of objection</th>
<th>Accepted or not</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
<td>6</td>
<td>7</td>
<td>8</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Last date for section u/s 63/247/154 etc</th>
<th>Date of remedial order</th>
<th>Tax effect as per remedial order</th>
<th>DCR No.</th>
<th>Date of collection/refund</th>
<th>Where not accepted Reference No. &amp; date of communication from AG or Board on the basis of which treated as settled</th>
<th>Whether the case was seen by the Internal Audit. If not reasons therefore</th>
</tr>
</thead>
<tbody>
<tr>
<td>9</td>
<td>10</td>
<td>11</td>
<td>12</td>
<td>13</td>
<td>14</td>
<td>15</td>
</tr>
</tbody>
</table>

(c) **Receipt Audit Register-3** - This Register records details of Receipt audit Objections (both Major & minor)
settled during the month.

<table>
<thead>
<tr>
<th>Sr.No.</th>
<th>S. No in Receipt Audit Register</th>
<th>Name of theassessee/circle/ward</th>
<th>Revenue as Audit objections</th>
<th>Revenue as per the remedial order, if any</th>
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<tbody>
<tr>
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<td>Arrear</td>
<td>Current</td>
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<tr>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4(a)</td>
<td>4 (b)</td>
</tr>
</tbody>
</table>

(d) Receipt Audit Register-4- This is the Register regarding Draft Paras.

<table>
<thead>
<tr>
<th>S.No.</th>
<th>DP no of Board</th>
<th>Date of receipt</th>
<th>Date of sending proforma report to Board Pt I Pt II</th>
<th>Name of the assessee</th>
<th>AO to whom it relates</th>
<th>Assessment year tax effect</th>
<th>Whether accepted or not accepted by the CIT</th>
<th>Board’s final decision regarding</th>
<th>Las date of remedial action</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
<td>6</td>
<td>7</td>
<td>8</td>
<td>9</td>
<td>10</td>
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Date of
initiation
of remedial
action/ section under which initiated

<table>
<thead>
<tr>
<th>Date of completion of remedial action</th>
<th>Amount of additional demand raised/ date of collection</th>
<th>If objection accepted, date when explanation of persons responsible for mistake called for</th>
<th>Date of receipt of explanation</th>
<th>Date of disposal of explanation</th>
<th>Whether Auditing Officer’s explanation called for</th>
<th>Date of receipt of Auditing officer’s explanation</th>
<th>Date of disposal of Auditing Officer’s explanation</th>
<th>Date of final report to Director</th>
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<td>16</td>
<td>17</td>
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</table>

REGISTERS TO BE MAINTAINED BY A.O.s

(a) Register of Requisitions - A register should be maintained by the A.O.s to keep particulars of all case records requisitioned by Receipt Audit, the date of supplying such records, reasons for not supplying, if any, gist of objections raised in Audit Memos in all cases and also the date when the Audit Memo was received and replied to.

(a) AO's Register No. I dealing with Receipt Audit Major Objections

<table>
<thead>
<tr>
<th>Sr.No</th>
<th>PAN</th>
<th>Name of the assessee</th>
<th>LAR no and date</th>
<th>Assessment year/ date of assessment / Section under which the order passed</th>
<th>Tax effect as per LAR</th>
<th>Date of issue of instruction by the CIT/Addl/JCIT reg appropriate remedial action</th>
</tr>
</thead>
<tbody>
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</table>
During the course of Audit, the ZAPS and SAPs should verify the maintenance of these registers with the A.O. and see to it that these are properly maintained. In case of any lapse on the part of the A.O.s in this regard, the matter should be reported to the CIT(Audit) through the Addl. CIT(Audit) who will take up the matter with the concerned CIT for taking action against the erring officer. The Range Addl./JCIT are requested to give information about these Registers in the Inspection Proforma, when the Inspection of audit work is taken up by the DIT (A).

**Records of Important Irregularities - Pendency and Settlement thereof**

(i) Monthly Progress Report of Major & Minor Receipt Audit Objections (TAMS- A-13). The Proforma is included in Section III of this Manual. It is due in the office of the CCIT/DGIT by the 15th of the following month. A copy of the same has also been given in this Handbook.

(ii) Quarterly Report (QAR-A-14) on Inter-departmental machinery - set-up vide Board's Instruction No. 1552 dated 08.03.1984 to expedite the settlement of Major Receipt Objections at various levels. This report should reach the CBDT by 151 of the month following. the quarter, with a copy to the DIT(A).

**REGISTER OF DRAFT AUDIT PARAS OF THE C&AG RECEIVED BY CsIT FROM THE CBDT**

This is to be maintained separately for each Audit Report in the office of the CIT.

**Records & Returns after Settlement of Receipt Audit Objections.**

(i) Report on recovery in settled Receipt Audit Objections - Vide DIT (A)'s Circular dated 22.03.1 996,
Receipt Audit Objections were to be treated as settled on raising of demand. Hence, it was decided that a quarterly statement be sent to the AG by the CIT, with a copy to the DIT(A), in respect of recovery in such cases.

(ii) Statistical Report to the AG of objections settled by the CIT- For objections settled at the level of the CIT and AG (viz. having a tax effect above Rs. 1,00,000 under Income Tax & Corporation Tax and above Rs. 30,000 under other direct taxes), statistical data will be sent by the CIT to the AG in the prescribed form, with a copy to the CBDT for information.

[Source : Circulated by DIT(Audit)]

INTERNAL AUDIT REGISTER

AO’S REGISTER-1

Major/Minor objections

AO’S REGISTER OF INTERNAL AUDIT OBJECTION

<table>
<thead>
<tr>
<th>S.N o.</th>
<th>PA N</th>
<th>Name of the assess ee</th>
<th>Date of Audit Report</th>
<th>S.N o in the audit report if any</th>
<th>Assessm ent year</th>
<th>Date of Assessm ent</th>
<th>Tax effect as per Audit objection</th>
<th>Whether accepted or not accepted</th>
<th>Last date for action u/s 23/147/154</th>
<th>Date of rectification/revis ion</th>
<th>Tax effect</th>
<th>DCR No.</th>
<th>Date of collection/refund</th>
<th>Where not accepted date of communication from AO</th>
</tr>
</thead>
<tbody>
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<td>5</td>
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<td>7(a) 7(b)</td>
<td>8</td>
<td>9</td>
<td>10</td>
<td>11(a) 11(b)</td>
<td>12</td>
<td>13</td>
<td>14</td>
<td>(Internal Audit) Dropping the objection</td>
</tr>
</tbody>
</table>

[Take reference to Para 2.2 of instruction referring page 156-157 of Internal Audit Manual – 2003]
ANNEXURE-2

F.No. 246/9/2005- A & PAC-II
GOVERNMENT OF INDIA
MINISTRY OF REVENUE
DEPARTMENT OF REVENUE
CENTRAL BOARD OF DIRECT TAXES,

INSTRUCTION No. 09 OF 2006

INSTRUCTION ON RECEIPT! REVENUE AUDIT OBJECTIONS

1. Board has issued a number of instructions from time to time on various aspects of the work relating to Revenue Audit. These Instructions, inter, alia, addressed to the procedure to be followed at different stages of Audit Objections, appropriate remedial action thereon, schedule of replies, monitoring and accountability measures, and quite a few of these continue to be applicable simultaneously. A need is therefore, felt to consolidate all such instructions into one all encompassing instructions so that management and processes relating to audit objections are streamlined with a greater sense of accountability. The present instruction is accordingly issued in super cession of instruction No 159, 484, 499, 612, 828, 854, 1046, 1057, 1071, 1176, 1205, 1473, 1598, 1609, 1928, and 1971 for strict compliance by all concerned.

2. Broad Outline of Procedure:

2.1 The programme of local Audit is communicated by the Revenue Audit at least one month before the Local Audit. All co-operation & assistance should be extended to the Revenue Audit Party (RAP) during the audit process. The records requisitioned by the RAP should be entered in the `Register’ maintained for this purpose and complete records should be made available. If it is not possible to make available any particular record required by the RAP, the reasons for the same should be communicated to the RAP, in writing. The record should on no account be withheld on flimsy grounds.

2.2 The CsIT should ensure that complete and accurate record of revenue audit objections are maintained in the `Register’ prescribed in chapter --12 of the Internal Audit Manual, 2003 [ ref pages 156 - 157 ], and in the Revenue Audit Modules of AST. The CsIT should also ensure that the pendency of objections are reconciled within a month of receipt of the annual statements furnished by the AGs to CSIT.

2.3 The Revenue Audit Party issues an Audit Memo (Half Margin Note) on any irregularity or mistake observed in regard to individual cases. The AO should furnish a reply to the Audit Memo, in all cases, including cases where the validity of the objection needs further consideration, stating clearly whether he agrees with the Audit Memo, within three days of the date of its receipt.

2.4 The Dy. Account General (DAG) forwards the local Audit Report (LAR) to the AO with a copy to the CIT. The AO should send his report on the objection in respect of the individual cases including in the respective audit `paras’ of part - I (Part -1( Introductory and Outstanding objections of the previous Report) and part -II ( Major Irregularities and Important Points) of the LAR to the CIT through the Addl.CJT Range within 30 days of the receipts of LAR. No reply is required to be sent regarding part -III, but appropriate remedial action must be taken by the AO within three months.
2.5 On receipts of the AO's report, the JT./Addl.CIT Range will examine the audit objections in the light of the AO's comments and send a reply to the CIT within a fortnight. The CIT should take a decision and send an appropriate reply to the AG/ DAG within a fortnight thereafter.

2.6 Where the AG does not accept the views of Commissioner and / or is not prepared to drop the audit objection, he conveys this to the CIT through a 'Statement of Fact' (SOF). The CIT should send appropriate reply to the AG within a fortnight of the receipt of 'SOF'.

2.7 In the case where the AG does not accept the views of the Commissioner and / or is not prepared to drop the audit objection is converted into a 'Draft Para' proposed to be included in the Audit Report of the C&AG of India. On receipt of the Draft Para, the CIT, through the CCIT, should send a report immediately to the Board so as to enable the Board to submit reply to the C&AG of India within the scheduled six weeks. Indeed, if the earlier stages of processing of the objection had been carefully gone into, the required information should already be on the CIT's file.

2.8 In respect of the 'Draft Para' a copy of the Proforma report is to be sent to the DIT(Audit) so as to enable him to prepare comprehensive Action Taken Note (ATNs) ON Audit Para [Performance Audit] included in the Audit report No. 12 [now renumbered as 8 from 2006] of the C&AG to the C&AG of India through the Board.

2.9 On receipt of the above mentioned report from CCIT/CIT, the Board will inform the C&AG inter alia about the acceptance or non-acceptance of the Audit objection, endorsing a copy to the CCIT/CIT/DIT (Audit). On receipt of the above endorsement, the DIT (Audit) will move ahead with the preparation of the comprehensive ATNs after securing such further information from the field formation as may be required.

2.10 After the receipt of the Audit report presented to the parliament, the DIT (Audit) will give concluding shape to the ATNs on 'Audit Paras', and send these to the board, through the DGIT (Admin), for submission to the C&AG of India after necessary vetting and consideration in the Board.

3. Accountability:

3.1 Furnishing of records to Revenue Audit: It has been noticed that, in spite of the existing instruction Number 1071 dated 28/06/1977, records and the relevant register are not being made available to RAP without adequate reasons, which

(a) invites adverse comments from the Hon'ble Public Accounts Committee and the C&AG of India, and,
(b) results in loss of substantial revenue which could be collected on account of audit objection had the records been produced to the Audit in time. Henceforth, the C.Cs./DsG.I.T, through the Cs.i.T concerned, shall ensure that,

(a) the relevant records are given to officials of the C&AG on requisition, and that,
(b) Wherever records are not given, without adequate reasons, explanation of the officers / staff concerned is called and suitable action taken against defaulting officers / staff.

3.2 Role of Supervisory Officers: In order to exercise an effective control with regard to timely and appropriate remedial action on Audit objection, it has been decided that,

(a) in respect of Audit objection involving revenue of Rs. 1,00,000/- or more in Income Tax / Corporate Tax cases and Rs. 30,000/- or more in order Direct Taxes cases, the Commissioners concerned shall be personally responsible for careful examination of such objections and issue of instructions to the A.Os on the appropriate remedial action to be taken within a month of the receipt of the Local Audit Report.

(b) In respect of Audit objections involving revenue below the limits prescribed in (a) above, the Commissioners should ensure that the Addl./J.t.Cs.I.T Range issue similar instructions to the AOs within the said period of one months; and,
(c) The choice of such remedial action, whether under section 154 or 147 or 263, should be carefully considered in the light of existing legal provisions and its sustainability in appeal.

4. **Remedial action:**
   
   (i) An Audit objection should be accepted and remedial action should be taken in a case where the Audit objections relating to an error of facts or an issue of Law is found to be correct.
   
   (ii) Even if objections is not accepted by the CIT, remedial action should be initiated, as a precautionary measure, in respect of such audit objections, save as provided in para (v) below.
   
   (iii) Appropriate remedial action should invariably be initiated within two months of the receipt of the Local Audit Report, and necessary orders should be passed within six months thereafter.
   
   (iv) Remedial action should invariably be initiated in respect of the following circumstances:-
   
      (a) where an assessment u/s 143(1) was made and the objection pointed out by Audit could not have been considered under the provisions of section 143(1);
      
      (b) where the interpretation of facts or law by the audit is in conflict with any decision of a High Court (not being the jurisdictional High Court) which is squarely applicable to the facts of the case, or
      
      (c) where there are conflicting decisions of High Courts (not being the jurisdictional High Court) : or
      
      (d) where the matter involves interpretation of statute and there is no decision of any High Court on the matter.

However, in case falling under (b), (c) & (d) above, the remedial action initiated can be dropped only with the prior approval of the Board. For this purpose, the CIT should immediately send a reference to the Board for decision, not later than three months from receipt of LAR by the CIT concerned, stating cogently therein the detailed reasons for consideration of the proposal for dropping the remedial action initiated.

(v) **Remedial action need not be initiated a case where,**

   (a) the CIT is of the view that the interpretation of fact or law by the audit is in conflict with a decision of the Supreme Court and the decision squarely applies to the facts of the case,
   
   (b) the CIT is of the view that that the interpretation of fact or law by the audit is in conflict with a decision of the Jurisdictional High Court, which is squarely applicable to the facts of the case and the operation of which has not been stayed by the Supreme Court, or
   
   (c) The CIT is of the view that the Assessing Officer has acted in conformity with Board's Instruction/Circular, or ' 
   
   (d) The audit objection raised is on facts, and the CIT, after necessary verification, is of the opinion that the audit objection is factually incorrect.

However, considering that C.Cs / Ds.G IT are the competent authority for accepting or contesting adverse judgments of High Court, in respect (a) and (b) above prior approval of the C Cs/Ds.G I.T concerned should be obtained for taking a decision for not initiating remedial action, and in respect of (c) above the matter should be referred to the relevant Divisions to the relevant Divisions of the Board for examination and decision.

The CsIT should ensure that necessary reply / reference is sent to the AG (Audit) concerned I the Board within a month of the receipt of the Local Audit Report.

5. **Second Appeal-in case involving Revenue Audit Objection:**

   (i) where a Revenue Audit objection has been accepted by the CIT or by the Ministry and an assessment has been framed in pursuance thereof, and the first appellate authority
passes an order taking a view contrary to that of audit, the adverse appellate order should be carefully scrutinized and appeal should be preferred if the order is not justified either in law or on facts;

(ii) where a Revenue Audit objection has not been accepted by the CIT or by the Minister but an assessment has been framed in pursuance of the audit objection, an adverse appellate order by the first Appellate authority should be dealt with in the same manner as in the case of an objection accepted by the CIT and / or the Minister till the AG/ C&AG agree with the views of the Department / Ministry;

(iii) However, if it is proposed not to file second appeal, the CIT should record reasons as to why an appeal is not considered necessary despite the audit objection.

6. **Draft Para on Audit Objections - Proforma Report and Follow up Action:** In order to make the Proforma report more meaningful and effective with regard to control and accountability, the same has been modified and is enclosed as [Annexure-I](#). Henceforth, all replies should be sent to the Board in this modified format, with all columns duly filled up & complete in all respects.

(i) the Proforma report in Part A should be sent to the Board strictly **within four weeks** of the receipt of the Draft Para Key by the CCs (CCA), with a copy to the DIT (Audit): and,

(ii) the Proforma report in Part B should be sent to the DIT (Audit) within **two months** of the receipt of the Draft Para Key by the CCs (CCA). With a copy-to the Board, to facilitate preparation of the Action Taken Note (ATN).

7. **Explanation of officers / staff concerned and disciplinary action:** With a view to enforcing accountability, the CCsIT / DsGIT Concerned should ensure that the following procedure is strictly followed:

7.1 **Ledger Card:** The present system of the maintaining Ledger Card, as detailed in chapter 5 of the Internal Audit Manual, 2003 should be followed meticulously.

(a) the Ledger Card should be maintained by the CsIT concerned, and,

(b) a quarterly report thereof should be sent to the CCs (CCA) [the CIT(Audit) in metropolitan charges3, and,

(c) the CCs(CCa) [the CIT(Audit) in metropolitan charges] should maintained a centralized data of the Ledger Cards of his region:

7.2 **Calling Explanation & Action thereon:** Explanation of the officer and staff concerned should invariably be obtained where the Revenue Audit objection, involving revenue of Rs 1,00,000/- or more in Income Tax 1 Corporate Tax and Rs. 30,000/- or more in other Direct Taxes, have been accepted, or the mistakes, inter alia, arises from any one or more of the following reasons:-

(a) Failure to follow department instructions / circulars;

(b) Failure to follow binding judicial decisions; and

(c) Palpable mistake on fact or law, or mistake arising from gross negligence or malafide action.

7.3 Besides, explanation of the officer and staff concerned should be obtained,

(a) in a case of default in adhering to the time limit prescribed for various action mentioned in paras 2.3,2,4,2.5,2.6,3.2,4(iii),4(iv),4(v) 6(i) & 6(ii) herein above, and,

(b) where failure to take timely and appropriate remedial action in respect of objections raised by Revenue Audit leads to irretrievable loss of revenue.

7.4 Further, in case of objections involving arithmetical inaccuracy in calculation or computation, the accountability of the dealing staff, besides that of the assessing officer, cannot be over emphasized. Hence, if mistake is, inter alia, on account of any or more of the following reasons, the explanation of the staff responsible for the mistake should be obtained,

(a) where an issue is considered / discussed in the body of assessment order, and necessary addition on the issue is-directed to be made, or where a deduction is directed to be allowed by the assessing officer, but such directions are not taken into account at the time of
calculation of tax, interest and surcharge;
(b) where there totaling mistake in the computation of income;
(c) Where an income disclosed in the return is not included in the computation in the assessment order, except where the assessing officer has discussed in the body of assessment order and directed not-to include it;
(d) Where there is wrong calculation of tax including application of wrong rate of tax:
(e) Where there is wrong calculation of interest including application of wrong rate of interest or wrong calculation of period for which interest is leviable:
(f) Where any income is added in the computation of income more then once:
(g) Where wrong set off brought forward losses, unabsorbed depreciation, loss on long / short term capital gain etc. in the scrutiny / search assessment, not commented by the assessing officer in the assessment order, has been allowed:
(h) Where wrong verification of, or failure to verify, the arrear demand before the issue of refund results in wrongful issue of refund.
(i) Where credit of pre-paid taxes is wrong allowed.

7.5 However, where objection is against summary assessment u/s 143(l) and the objection pointed out by audit could not have been considered at the time of summary assessment u/s 143(1). The explanation of the AO & Staff should not be called for:

7.6 Procedure for A propriate Action against the erring officer / staff:
(a) The CIT in whose charge the mistake has occurred [ the CCIT concerned where the default in terms of 7.3 above is on part the CIT] should call for the explanation of the officer / staff responsible for the mistake, and indicate whether the explanation is acceptable or not and as to whether the mistake was bonafide or otherwise;
(b) After considering the explanation of the officer / staff concerned, where it is proposed that a simple warning should be issued, the final decision to give simple warning should be taken by the CIT in whose charge the mistake occurred but he should communicate his decision along with the facts of the case to the Commissioner under whom the officer / staff is working and the latter should administer the warning;
(c) Where the mistake pointed out in the Revenue Audit. objection is of a serious nature, which may call for penal action against the officer / staff concerned, the CIT in whose charge the mistake occurred

(hereinafter referred as first CIT) shall, after considering the explanation of the officer / staff concerned, from a view in this regard in consultation with- the CIT under whom the officer is presently working. The first CIT shall accordingly recommend appropriate action in the case to the member (A&J), through CCIT (CCA), for necessary examination. in the Board. In a case where the Member (A&3) decides that disciplinary proceeding needs to be initiated, the CCIT (CCA), concerned would then refer the case to the appropriate Disciplinary Authority alongwith all material evidence relevant to the case.

7.7 The DIT (Audit) would act as the field arm of the Board and monitor strict compliance with the above instructions, except that at para 7.6 above, and ensure that the action is taken to logical conclusion.

8. The above Instructions would apply mutatis mutandis to the Revenue Audit’s observations in cases covered in Systems Review so far as taking of remedial action, accountability measures and necessary action against the officer / staff responsible for the mistake is concerned.

9. These Instructions may be brought to the knowledge .of all concerned for strict compliance.

This issue with the approval of the Board.

[Vijay Kumar]
Director (A&PAC)
PROPROMA REPORT ON THE DRAFT AUDIT PARA No._____________ PROPOSED TO BE INCLUDED IN.
THE AUDIT REPORT BY THE C&AG FOR THE YEAR

Board's reference calling for the report____________________________
Dated: __________________________

PART'A'

1.  (a) Name of the assessee
   (b) CIT’s charge

2.  (a) Assessment year(s) to which the audit objection relates
   (b) Accounting year(s) of the assessee
   (c) Date if filing of return(s) (where relevant)
   (d) Date of assessment & other order(s), if any, and section
       Under which the assessment / other order(s) were made
   (e) TOTAL INCOME / NET WEALTH RETURNED
       (where applicable)
   (f) TOTAL INCOME / NET WEALTH ASSESSED
       (where applicable)
   (g) Demand raised on original assessment or Demand as per
       any order
       which is subjected to audit (Both gross dt rand and act
       demand after adjustment of pre-paid taxes may be
       indicated)
   (h) Amount of revenue mentioned in the droll audit para

3.  (a) Gist of the audit objection
   (b) C.I.T.’s comments
       (i) If the facts stated by Audit are not correct, full & correct
           facts must be stated
       (ii) Reasons for acceptance or non-acceptance must invariably
           be given
       (iii) If the objection is accepted, the circumstances in which
           the mistake occurred must be stated

4.  (a) Date of issue of notice(s) initiating remedial action and
    the section under which issued?
   (b) Whether appropriate remedial action was taken with CIT’s
       /ADDL.CIT’s prior as per Board's Instruction. If so, when?
       If not, reasons thereof.
   (c) Date of order revising the assessment(s) / other order(s)
   (d) Amount of additional demand raised ascribable to Audit
       objection or amount of refund allowed & adjusted

Compiled for DTRTI, Chandigarh’s Workshop on Audit ; 22\textsuperscript{nd} and 23\textsuperscript{nd} November 2010 at Delhi and Chandigarh
5 (a) If no remedial action is taken, give reasons.

(b) If remedial action is barred by limitation reasons and circumstances there of.

[Name]
COMMISSIONER OF INCOME TAX
Annexure-2    Instruction on Receipt/ Revenue Audit Objections 09/2006

PROFORMA REPORT ON THE DRAFT AUDIT PARA No______  PROPOSED TO BE INCLUDED IN.
THE AUDIT REPORT BY THE C&AG FOR THE YEAR

Board's reference calling for the report_____________________
Dated:_____________________

PART'B'

1. (a) Name of the assessee
   (b) Assessment year(s) to which the audit objection relates

2. General remedial measure taken to avoid recurrence of such mistake in future

3. Whether the case was reviewed for similar mistake in earlier and later years?

4. Is there any implication under the Direct Tax Laws? If so, whether appropriate action has been taken?

5. (a) Whether the additional demand has been recovered? If so, date of collection.
   (b) If not recovered, the reasons for not recovery.
   (c) Has any appeal been filed against the order revising the assessment or other order giving effect to audit objection? If so, state the out come thereof.

6. (a) If the objection id accepted, Name of the AO and staff who is responsible for the mistake.
   (b) Name of the Rang Addl. /JCIT if he had approved the order. Was the case to be otherwise checked by Range Addl/J CIT.
   (c) Date on which explanation of order I staff was called for as per Board's Instruction
   (d) Date of receipt of the explanation of officer /staff
   (e) if the objection has been accepted, the gist of explanation of the assessing officer (a copy of AO's explanation should be enclosed)
   (f) CIT's opinion indicating whether the mistake was bonafide or otherwise
   (g) Previous history of the officer's I staff other mistake and consequential action against the ofCee I staff (enclosed copy of ledger card)
   (h) Does the case require further looking into from the vigilance angle? If so, state what action is being taken?

If remedial action got barred by limitation, whether responsibility has been fixed and what action has been taken against the officer and / or staff responsible for the mistake.

If there has been delay in sending reply, or if reply has not been sent, after receipt of LAR reasons thereof and action taken against the officer I staff concerned.
PART B' Contd.

9. (a) Whether the case was earlier checked by the Audit Officer?
(b) If not, the reason thereof.

(e) (i) If the mistake not detected by the Auditing officer, which necessary explanation was called for?
(ii) CIT's comments thereon.

DATE:

[NAME]
Commissioner of income - tax
ANNEXURE-3
F.No.246/109/2004/-A&PAC - 1 GOVERNMENT OF INDIA
MINISTRY OF FINANCE
DEPARTMENT OF REVENUE
CENTRAL BOARD OF DIRECT TAXES

INSTRUCTION No. 010F 2007 ON NEW INTERNAL AUDIT SYSTEM

As a result of the mounting backlog of the auditable case, the Chain Audit System for Internal Audit introduced in F.Y 2001-02 has come in for considerable criticism from the Public Accounts Committee and the C&AG of India, and the Central Vigilance Commission. With a view to have an effective and objective set up of Internal Audit wherein the assessment functions and audit functions are assigned to separate specialized wings, the Board have decided to abolish chain Audit System, as well as the Quality Audit System introduced in 2005, and substitute it with a new Internal Audit System. Accordingly, the following instruction is issued in supersession of all instructions on the subject.

II. Structure of the Internal Audit Wing: The organization structure of the Internal Audit Wing shall be as under :-

i. there shall be two CsIT (Audit) each in Mumbai, Delhi, and Chennai & Kolkata under the direct administrative control & supervision of CCIT (CCA). They will be designated as CIT (Audit)-I and CIT (Audit)-II. The CCIT (CCA) shall make equal distribution of the audit work in respect of cases assessed under the Corporate and non-Corporate Charges, Central Charges, DGIT (Int. Taxation) and DGIT (Exemption) to the two CsIT (Audit)-

ii. there shall be one CIT(Audit) in the non-metro charges under the direct administrative control & supervision of CCIT (CCA), who shall be responsible for audit work pertaining to all the cases in that jurisdiction;

iii. the CCIT (CCA) would not delegate the administrative control & supervision over the CsIT (Audit) to any other CCIT;

iv. the CsIT (Audit) would have their headquarters at the same station as that of the CCIT (CCA);

v. under each CIT (Audit) there shall be one Addl.CIT, who would be responsible for Internal Audit of bigger cases as per the norms laid down below, and for the supervisor of the audit work of the Special Audit Parties (SAPs) headed by Dy./Asst.CsIT and the Internal Audit Parties (IAPs) headed by TTOs;

vi. there shall be one SAP headed by Dy./Asst.CsIT under each Addl.CIT (Audit), except at Guwahati, Lucknow, Nagpur and Kochi CCA charge where the IAPs will look after the functions of SAP;

vii. there shall be one additional SAP headed by Dy./Asst.CsIT under each Addl.CIT(Audit) at Delhi and Mumbai;
viii. for each administrative CIT, there shall be one TAP headed by an ITO stationed at the headquarter of that CIT as per station wise list below. All IAPs thus constitute in CCIT (CCA) charge shall function under the administrative control of CIT (Audit);

ix. there shall be one ITO (Hqrs) assisted by one ITI and Sr. TAs/TAs under each CIT (Audit) to take care of the Administrative matters and to co-ordinate and monitor the functioning of the SAPs and the IAPs. The CsIT (Audit) shall not delegate the administrative functions, including the HOO/DDO functions to the Addl.CIT (Audit);

X. there shall be one ITO (Receipt Audit), with one ITI and two Sr. TA./TAs, directly under each CIT(Audit) to look after the work of the Receipt/Revenue Audit;

xi. there shall be one ITO (IAP) each for International Taxation,(including Transfer Pricing) and Exemptions at stations where the Directorates of International Taxation, Transfer Pricing & Exemption are situated;

xii. there shall be one ITO, with two ITIs and two Sr.TAs/TAs, under each Addl CIT(Audit);

xiii. there shall be two ITIs and one Sr. TA(FA in each SAP;

xiv. there shall be two ITIs and one Sr. TA/TA in each LAP;

xv. The deployment of officers and staff for each such IAP as in (viii) and (xiv) above shall be made from the existing strength of concerned CIT. if more than one TRO is posted in a CIT charge presently, one TRO along with supporting staflmay be surrendered to be deployed for the LAP.

xvi. The CCIT(CCA), in consultation with the CCIT (Central) and /or other CCsIT / DGsJT concerned and the CIT (Audit), may deploy additional LAPs at the headquarter of CCIT(CCA) for the audit of cases assessed under the central or International Taxation or Exemptions charges depending upon the work riorins 1 targets of audit.

The distribution of newly sanctioned ITOs, ITIs and Sr.TAs/TAs at the headquarters of CIT (Audit) shall be as under:

<table>
<thead>
<tr>
<th>Sl.No.</th>
<th>Designation</th>
<th>ITOs</th>
<th>ITIs</th>
<th>PA/Steno</th>
<th>Sr.TAs/TAs</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>CIT (Audit)</td>
<td>2</td>
<td>2</td>
<td>1</td>
<td>4</td>
</tr>
<tr>
<td>2</td>
<td>Addl.CIT(Audit)</td>
<td>1</td>
<td>2</td>
<td>1</td>
<td>2</td>
</tr>
<tr>
<td>3</td>
<td>Dy.Asst. CIT(SAP)</td>
<td>Nil</td>
<td>2</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>4</td>
<td>ITOs (IAP)</td>
<td>1</td>
<td>2</td>
<td>-</td>
<td>1</td>
</tr>
</tbody>
</table>

This will deploy evenly the newly sanctioned post of 22 CITs (Audit), 22 Additional CsIT (Audit) 22 Dy./ACIT (SAP), 88 ITOs, 176 ITIs, 66 PAs/ Stenographer, 176 Sr. TAs/TAs for the Internal Audit Wing.

The hierarchy chart of Internal Audit set-up for metros and non-metros are given at Annexure -I and II.
The Station wise Special Audit Parties/Internal Audit Parties are shown below:

<table>
<thead>
<tr>
<th>Sr.No.</th>
<th>Station</th>
<th>At CCIT (CCA)</th>
<th>Hqrs</th>
<th>At field</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>SAP</td>
<td>IAP</td>
<td>IAP</td>
<td>SAP</td>
</tr>
<tr>
<td>1.</td>
<td>Delhi</td>
<td>2+2</td>
<td>2</td>
<td>20</td>
<td>2+2</td>
</tr>
<tr>
<td>2.</td>
<td>Mumbai</td>
<td>2+2</td>
<td>2</td>
<td>34</td>
<td>2+2</td>
</tr>
<tr>
<td>3.</td>
<td>Kolkata</td>
<td>2</td>
<td>2</td>
<td>24</td>
<td>2</td>
</tr>
<tr>
<td>4.</td>
<td>Siliguri</td>
<td>1</td>
<td></td>
<td></td>
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<tr>
<td>5.</td>
<td>Durgapur</td>
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<td>6.</td>
<td>Burdwan</td>
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<td>7.</td>
<td>Asansol</td>
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<tr>
<td>8.</td>
<td>Jalpaiguri</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>9.</td>
<td>Chennai</td>
<td>2</td>
<td>2</td>
<td>12</td>
<td>2</td>
</tr>
<tr>
<td>10.</td>
<td>Coimbatore</td>
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<tr>
<td>11.</td>
<td>Salem</td>
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<td></td>
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<td>12.</td>
<td>Madurai</td>
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<tr>
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<td></td>
<td>2</td>
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<tr>
<td>17.</td>
<td>Vijaywada</td>
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<tr>
<td>18.</td>
<td>Guntur</td>
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<td>19.</td>
<td>Rajamundry</td>
<td>1</td>
<td></td>
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<tr>
<td>20.</td>
<td>Tirupati</td>
<td>1</td>
<td></td>
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<tr>
<td>21.</td>
<td>Patna</td>
<td>1</td>
<td>1</td>
<td>3</td>
<td>1</td>
</tr>
<tr>
<td>22.</td>
<td>Ranchi</td>
<td>1</td>
<td></td>
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<td>23.</td>
<td>Dhanbad</td>
<td>1</td>
<td></td>
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<tr>
<td>24.</td>
<td>Muzaffarpur</td>
<td>1</td>
<td></td>
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<tr>
<td>25.</td>
<td>Bhagalpur</td>
<td>1</td>
<td></td>
<td></td>
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</tr>
<tr>
<td>26.</td>
<td>Jamshdpur</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>27.</td>
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III. Internal Audit – Auditable Case: Norms and Targets

I. The minimum number of cases to be each Additional CIT, SAP OR IAP in a year shall be as under:

Additional CIT: 50
SAP: 300
IAP: 600 (Corporate Case); & 700 (Non-Corporate Cases)

II. The work load of auditable cases for internal audit shall be the number of cases selected by CCIT (CCA) during the year keeping in view above norms and depending upon the manpower. The CCIT (CCA) and CsIT (Audit) shall draw an Action Plan for the year accordingly,

III. The norms of Auditable cases for Internal Audit Shall be as laid down herewith:-

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### For Additional CIT / Joint CIT (Audit)

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<th>Non-Corporate</th>
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<td>Delhi &amp; Mumbai</td>
<td>Other Metro</td>
<td>Non-Metro</td>
<td>Delhi &amp; Mumbai</td>
<td>Other Metro</td>
<td>Non-Metro</td>
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<td>Above 5</td>
<td>Above 10</td>
<td>Above 5</td>
<td>Above 1</td>
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<td>3.</td>
<td>Asst. of non-S &amp; S Cases</td>
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<td>Above 10</td>
<td>Above 5</td>
<td>Above 10</td>
<td>Above 5</td>
<td>Above 1</td>
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<td>4.</td>
<td>Scrutiny Asst. with claim of deduction u/s. 10a, 10b, 10c, 10(23c), 11,32,54 &amp; Chapter VIA</td>
<td>Above25</td>
<td>Above10</td>
<td>Above 5</td>
<td>Above 10</td>
<td>Above 5</td>
<td>Above 1</td>
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<td>5.</td>
<td>Asst. of Cases of Other Taxes</td>
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<td>Above 10</td>
<td>Above 5</td>
<td>Above 10</td>
<td>Above 5</td>
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### B For Dy. Asst. CIT (Audit)- SAP

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<th>Non-Corporate Returned/Assesses Income/Loss (in Rs. Crore)</th>
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<td>Delhi &amp; Mumbai Other Metro Non-Metro</td>
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<td>Above 10 Above 1 Above 0.5</td>
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<td>Above 1 Above 1 Above 0.5</td>
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<td>Above 1 Above 1 Above 0.5</td>
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<td>4.</td>
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<td>Above 1 Above 1 Above 0.5</td>
<td>Above 1 Above 1 Above 0.25</td>
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<td>Asst. of Cases of Other Taxes</td>
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<td>Above 10 Above 5 Above 0.5</td>
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<td>Refunds (IT/CT)</td>
<td>Above 10 Above 5 Above 1</td>
<td>Above 1 Above 1 Above 1</td>
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(C) For IAP (CENTRAL) :-

IAP Central will audit the cases in Central charges not taken up by Additional CIT (Audit) and SAP.
### (D) For ITO (IAP):-

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<td>Asst. of non-S &amp; S Cases</td>
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<td>Below 5</td>
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<td>Below 0.25</td>
<td>Below 1</td>
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<td>6.</td>
<td>Refunds (IT/CT)</td>
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<td>7.</td>
<td>TDS Cases</td>
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**Note:- The other Metros include**

**Note:** - The other Metros include Chennai, Kolkata, Bangalore, Ahmedabad, Pune and Hyderabad.

iv. In respect of the audit of non-core search & seizure cases, the criteria for non-search assessment shall
apply.

v. For the propose of audit of search & seizure assessment, the Appraisal reports shall be shown to SAP or IAP if so requisitioned.

vi. While preparing the basket of auditable cases for SAP & IAP, it shall be ensured that at least top 100 cases of the charge are included in the basket. The remaining cases may be a representative mix of cases selected for scrutiny.

(a) under CASS,
(b) based on AIR inputs
(c) by approval of CCIT, and
(d) cases of delayed refund including defaults in granting interest.

ix. CCIT (CCA) may relax the norms for audit by Additional CIT, SAP and / or IAP so as to ensure that number of auditable cases is not less than the number of cases to be audited by each as per target laid down in sub-para (i) above.

X. While regard to e-TDS Returns, after the returns are processed, the Internal Audit Party will check all action taken by the assessing officers. This would include checking of Interest charged as well as penalty notices issued and penalty levied under various provisions of the IT Income Tax Act 1961.

IV. Role of Various Authorities

1. **Role of CCIT (CCA)** The CCIT (CCA) shall
   (i) review the performance of Internal Audit Wing, at least quarterly;
   (ii) be responsible and accountable for effective functioning and performance of the Internal Audit Wings under the CsIT (Audit);
   (iii) providing requisite infrastructure ( adequate office space & furniture I fittings, PCs. telephone & fax etc) for Internal Audit Wing;
   (iv) ensure position of competent officers & staff under CsIT (Audit). The normal stay in Audit Wings shall be two years;
   (v) ensure in co-ordination with the NADT/RTIs and MSTUs, that appropriate training is imparted to the officers and staff posted in the Internal Audit Wing, every year after the AGT;
   (vi) ensure that CDs and Journals on Case Laws, Circulars, Notification and Instructions, and the Commentaries on Tax Laws,' are provided to the AddUJJt. CsIT Ranges and the Assessing Officers as also the CsIT (Audit), and are regularly updated;
   (vii) ensure that the norms for Internal Audit followed I implemented, and targets thereof, as well as the targets for Receipt Audit are achieved;
   (viii) ensure that the necessary reports and statistics are set to the Board / Directorates and the AGs;

2. **Role of Jurisdictional CCIT / DGIT:**
   In case there is a difference of opinion between concerned CIT (Adorn.) and CIT(Audit), the CCITIDGIT having administrative control over the C1T/ DIT in whose charge an audit objection has been raised shall be the authority to decide whether an audit objection raised by an IAP is to be accepted or not.

3. **Role of CsIT (Audit):** The CsIT (Audit) shall
   (i) have jurisdiction for Internal Audit in respect of cases assessed under CsIT assigned to him;
   (ii) have administrative control over additional CsIT (Audit), SAPs and IAPs;
   (iii) be responsible and accountable for effective functioning and performance of the Internal Audit Wing and, for this purpose, shall regularly review the work of IAPs and SAPs;
   (iv) co-ordinate with the administrative CCsITIDGsIT and CsIT IDslIT for preparation of the list of auditable cases, timely production of records I registers to the Internal I Receipt Audit teams
within the scheduled time frame, smooth conduct of audit and settlement of Internal, as well as Receipt, Audit, objections and action to be taken against officers / staff in respect of Internal Audit;

(v) maintain the Ledger Cards and the Register in respect of Internal/Receipt Audit as per guidelines given in the Internal Audit Manual, 2003, as amended from time to time, and ensure that these are maintained by the administrative CsIT;

(vi) draw action plan for internal Audit for year in consultation with CCIT/DGIT concerned with the approval of CCIT(CCA);

(vii) ensure that the norms for Internal Audit are followed / implemented, and targets thereof, as well as the target for Receipt Audit, are achieved;

(viii) ensure that the Internal Audit of the auditable cases of a particular month are completed within 30 days, and the records / registers received with the list of auditable cases are handed over to the Addl./Jt.CIT Range / the Assessing Officers within one week thereafter;

(ix) ensure that the audit objection memos are sent to the administrative CsIT, with copies to the Addl./Jt.CIT Range and the AOs, within a week of audit;

(x) settle, with the administrative CIT concerned, the major internal audit objections having tax effect above Rs. 1,00,000/- in IT/CT and Rs. 3 0,000/- in Other Taxes, and ensure that the Addl.CIT (Audit) settle the internal audit objections involving tax effect below these limits with the Addl./Jt.CIT Range concerned, within 4 months of sending audit memos to the CsIT;

(xi) take measure to the effect that a uniform stand is taken by the officers in the Region on a issue/fact of law; and

(xii) prepare and send the necessary reports and statistics to the Board / Directorates and the AGs.

4. **Role of administrative CCIT/DsIT** - The administrative CsIT /DsIT shall:

(i) extend all cooperation to the CIT(Audit) for preparation of the list of auditable cases, production of records / registers to the Internal Audit within the scheduled time frame, conduct of audit by the Internal Audit and settlement of Internal, as well as Receipt Audit objections and action taken against the officers/staff in respect of internal audit;

(ii) ensure maintenance of ledger Cards and the Registers, manual as well as in electronic media, as per guidelines given in the Internal Audit Manual, 2003, as amended from time to time;

(iii) prepare and send the necessary reports and statistics to the CIT(Audit);

(iv) ensure that the list of auditable cases (category wise) of a particulars month are sent to the CIT(Audit) concerned by the 1P of the following month;

(v) ensure that the relevant records / registers are produced before the Internal Audit along with the list of auditable cases, and wherever records etc are not given to Internal Audit without adequate reasons, take suitable action against the officers / staff concerned under intimation to the CIT(Audit);

(vi) ensure that the internal audit objections are examined in accordance with parameters laid down in paras V and VI below, and that remedial action in accepted cases are initiated accordingly within a month of the receipt of the internal audit memos;

(vii) ensure that acceptance / non-acceptance of the internal audit objection is done with appropriate reasons and the details of remedial action initiated in accepted cases, is communicated to the CIT(Audit) within 3 months of receipt of the internal audit memos;

(viii) settle, with the CIT(Audit) concerned, the major internal audit objections having tax effect above Rs 1,00,000/- and Rs.30,000/- in Other Taxes, and ensure that the Addl.Jt. CIT Range settles the internal audit objections involving tax effect below these limits with the Addl.CIT (Audit), within 4 months of the receipt of the Internal Audit memos;

(ix) in a case where there is dispute between the administrative CIT and the CIT (Audit) with
regards to the settlement of the internal audit objection, and / or the remedial action taken, the administrative CIT shall report the matter, with full facts and reasons, to his / her jurisdictional CCITs, who shall take up the matter with the CIT (Audit), and the decision of the CCIT shall be final.

5. **Role of Additional CsIT (Audit):** The Addl: CsIT (Audit) shall,

   (i) have audit jurisdiction over cases pertaining to jurisdiction of CsIT assigned to him;
   (ii) have administrative control and supervision over the working of IAPs and SAPs functioning under him;
   (iii) ensure the effective functioning of the IAPs and SAPs;
   (iv) submit monthly reports to CIT (Audit) with regard to the work done by the IAPs and SAPs;
   (v) assist the CIT (Audit) in maintenance of Ledger Cards and Registers with regard to Internal / Receipt Audit objections;
   (vi) coordinate with the concerned Addl.CIT / JCIT Range with regards to expeditious settlement of Internal Audit Objections involving tax effect below Rs. 1,00,000 in IT/CT and Rs.30,000 in Other taxes, within prescribed time limit;
   (vii) ensure that the norms of Internal Audit are followed / implemented and that the target of Internal Audit are achieved; and
   (viii) assist the CIT (Audit) in ensuring proper maintenance of prescribed registers and timely submission of reports and statistics.

6. **Role of Addl.CsIT / JCsIT (Assessment Range):** The Addl./Jt.CsIT (Assessment Range) shall,

   I. ensure that remedial action is taken within the prescribed time limits, and shall facilitate prompt recovery of tax;
   II. ensure that records requisitioned by the IAP/SAP are made available expeditiously;
   III. ensure that the AOs maintain the relevant records and registers with regards to Internal/Receipt audit objections;
   IV. ensure timely submission of reports relevant to the Audit set up;
   V. ensure that cases selected for internal audit are audited by Internal audit before relevant case records are given to Receipt Audit;

7. **Role of DIT (Audit):**
The Director of Income Tax (Audit), through the DGIT (Admin), shall continue to act as the field arm of the Board in respect of the Internal Audit functions of the Department. The functions of DIT (Audit) shall, inter alia, include,

   (i) preparation of the National Action Plan Targets for Internal Audit wing, both for Internal and Receipt Audit for consideration of the Board for its inclusion in the Annual Central Action Plan;
   (ii) prescription of the norms for Internal Audit, keeping in view the increase in the tax base, focus areas of the Department and other relevant factors as may be prescribed by the Board;
   (iii) monitor the functioning of the Internal Audit Wings;
   (iv) monitoring the settlement of major internal audit objections in accordance with the criteria and the time schedule;
   (v) carry out Inspection of the functioning of the Internal Audit Wing under the respective CCs(CCA), with the approval of the DGIT (Admin.), and submit report to the DGIT(Admin) within a fortnight thereafter;
   (vi) collection and collation of information regarding critical areas where mistake have been detected by Revenue Audit and Internal Audit;
   (vii) coordination with CIT (Audit) and Administrative CIT regarding maintenance of Ledger Cards, and Register, in respect of both the Internal Audit and Receipt Audit;
   (viii) preparation of updates ‘Check Sheet’ for Internal Audit, to be incorporated in the
software subsequently and to be revised / updated every 3 years, and its circulation to the CCs(CCA) / CsIT (Audit);

(ix) conduct Seminars / Workshops every year for the officers / staff posted in the Internal Audit Wing in co-ordination with the CCs(CCA) / CsIT(Audit), and ensure that similar training programmes are organized by the CCs(CCA) / CsIT (Audit) every year;

(x) devise necessary reporting mechanism, and to prescribe the forms and register in consultation with DIT(System) and DOMS;

(xi) prepare Annual Report of Internal Audit Functions of the Departments, incorporating the highlights gathered through Inspections and Performance Audit, and submit the Annual Report to the Board by 30th June every year.

V. **Timely and appropriate action:** With regards to remedial action on the internal audit objection,

(i) in respect of audit objections involving revenue of Rs. 1,00,001/- or more in Income Tax / Corporate Tax cases and Rs.30,000/- or other Direct Taxes cases, the Commissioners concerned shall be personally responsible for careful examination of such objections and issues of instructions to the AOs on the appropriate remedial action to be taken **within a month of the receipt of Internal Audit objection memo;**

(ii) in respect of audit objections involving revenue below the limits 'Prescribed in (a) above, the Commissioners should ensure that the Addl. / Jt. CsIT Ranges issue similar instructions to the AOs within said period of one month; and, (iii) the choice of such remedial action, whether under 154 or 147 or 263, should be carefully considered in the light of existing legal provisions and its sustainability in appeal.

VI. **Remedial action:**

(i) An Audit objection should be accepted and remedial action should be taken in a case where the audit objection relating to an error of facts or an issue of law is found to be correct;

(ii) Even if objection is not accepted by the CIT, remedial action should be initiated, as a precautionary measure, in respect of such audit objections pending final settlement with the CIT(Audit) / the decision of the CCIT concerned, except where,

(a) the CIT of the view that the interpretation of fact or law by the Internal Audit is in conflict with a decision of the Supreme Court and the decision squarely applies to the facts of the case, or,

(b) the CIT of the view that the interpretation of fact or law by the Internal Audit is in conflict with a decision of jurisdictional High Court, which is squarely applicable to the facts of the case and the operation of which has not been stayed by the Supreme Court, or

(c) the CIT is of the view that the Assessing Officer has acted in conformity with Board's Instructions / Circular, or

(c) the audit objection raised is on facts, and CIT, after necessary verification, is of the opinion that the audit objection is factually incorrect.

(iii) Appropriate remedial action should invariably be initiated **within one month of the receipt** of the internal audit memo except for in circumstances mentioned in sub-paras (ii) a, b, c, & d above.

VII. **Calling of Explanation & Action thereon:**

(i) Explanation of the office and staff concerned should be invariably be obtained where the Internal Audit objection, involving revenue of Rs. 1,00,000/- or more in Income - Tax / Corporate Tax and Rs. 30,000/- or more in other Direct Taxes, have been accepted, or the mistakes, inter alia, arise from any one more or more of the following reasons:-

(a) failure to follow departmental instructions / circulars;

(b) failure to follow binding judicial decision; and;

(c) palpable mistake on fact or law, or mistake arising from gross negligence or malafide action.

(ii) Beside, explanation of the officer and staff concerned should be obtained,
(a) in a case of default in adhering to the time limit prescribed or other defaults in complying with requirements mentioned in pars IV,

(b) Where failure to take timely and appropriate remedial action in respect of objections raised by Internal Audit leads to irretrievable loss of revenue.

(iii). Further, in cases of objections involving arithmetical inaccuracy in calculation or computation, the accountability of the dealing staff, besides that of the assessing officer, cannot be over-emphasized. Hence, if the mistake is, inter alia, on account of any one or more of the following reasons, the explanation of the staff responsible for the mistake should invariably be obtained,

(a) Where an issue is considered / discussed in the body of assessment order, and necessary addition on the issue is directed to be made, or where a deduction is directed to be allowed by the assessing officer, but such directions are not taken into account at the time of calculation of tax, interest and surcharge;

(b) Where there is totaling mistake in the computation of income;

(c) Where an income disclosed in the return is not included in the computation in the assessment order, except where the assessing officer has discussed in the body of assessment order and directed not to include it;

(d) Where there is wrong calculation of tax including application of wrong rate of tax;

(e) Where there is wrong calculation of including application of wrong rate of interest or wrong calculation of period for which interest is leviable;

(f) Where any income is added in the computation of income more than once;

(g) Where wrong set off brought forward losses, unabsorbed depreciation, loss on long/ short term capital gain etc. in the scrutiny / search assessment, not commented by the assessing officer in the assessment order, has been allowed;

(h) Where wrong verification of, or failure to verify the arrear demand before the issue of refund results in wrongful issue of refund;

(i) Where credit of pre-paid taxes is wrongly allowed;

iv. The procedure outlined at para 7.6 of the Instruction No..09 of 2006 shall apply mutatis mutandis to the major objections raised by the Internal Audit.

VIII Scope of Internal Audit: Besides the parameters mentioned above, the scope of Internal Audit would continue to be guided by para 2.2 of Chapter-2 of the Internal Audit Manual, 2003 as amended from time to time.

This Instruction would be applicable effect from 01-06-2007.

Encl: Annexure -I&II

Sd-

Dated: 16/04/2007

[Deepak Kumar]

Under secretary

Govt. of India.
INTERNAL AUDIT SETUP - NON METRO

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NOTES:

1. COMPOSITION OF EACH IAP: 1 ITO, 2 ITIs, 1 Sr. TA/TA,
2. COMPOSITION OF EACH SAP: 1 DC / AC, 2 ITIs, 1 Sr. TA/TA, 1 PA/STENOGRAPHER.
3. X-NO. OF ADMINISTRATIVE COMMISSIONERS IN CCA REGION.
4. OFFICERS / OFFICIALS FOR IAPs I TO X ARE TO BE TAKEN FROM EXISTING STRENGTH.

(EXCEPT GUWAHATI, NAGPUR, LUCKNOW AND KOCHI)
INTERNAL AUDIT SETUP – METRO

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NOTES:

1. COMPOSITION OF EACH IAP: 1 ITO, 2 ITTs, 1 Sr. TA/TA.
2. COMPOSITION OF EACH SAP: 1 DC / AC, 2 ITIs, 1 Sr. TA/TA, 1 PA/STENOGRAPHER.
3. EACH CIT (AUDIT) WILL HAVE THE SAME SET UP. IAPs FOR THE CIT (AUDIT)- II SET UP WILL START FROM IAP- (M+1) AND GO ON TO IAP-X, WHERE X IS THE NO. OF ADMINISTRATIVE COMMISSIONERS IN CCA REGION. THUS THE NUMBER OF IAPs TAKEN TOGETHER FOR BOTH THE CIT (AUDIT) SETUP WILL EQUAL THE NO. OF ADMINISTRATIVE COMMISSIONERS IN CCA REGION.
4. OFFICERS / OFFICIALS FOR IAPs I TO X ARE TO BE TAKEN FROM EXISTING STRENGTH.
ANNEXURE-4 A

OTHER IMPORTANT INSTRUCTIONS,
CIRCULARS AND AMENDMENTS

INSTRUCTION NO.1974

Subject: Need for prompt and careful attention to reference from Directorate of Audit - regarding-

It has been noticed that reference and requisitions addressed by the Directorate of Audit to the offices are not receiving due and prompt attention. The Board has taken a serious view of the matter.

In this connection, it is stated that Directorate of Income - Tax (Audit) handles all matters pertaining to Public Account Committee and Comptroller & Auditor General and requires comments/data/information from the field formations for furnishing replies to these authorities on time bound basis. In the event, these comments/data/information are delayed or not received in the appropriate form, then the Department faces embarrassment and adverse criticism.

It is therefore, reiterated that all Chief Commissioners and Director General must ensure that prompt and due attention is given in their respective regions to the references and requisitions received from the Directorate of Audit and that the replies are sent in appropriate form expeditiously.

(VIMALENDU VERMA)
Under Secretary (A&PAC-II)
Tel.No. 3362928

(FNo. 246/20/99-A&PAC-II/dated 8.10.99/Issued by CBDT, Deptt. Of Revenue, New Delhi)
INSTRUCTION NO.1976


Attention is invited to Board's Instruction No.- 1959 dated 28.01.99 which was issued earlier for proper administration of provisions of section 44AB of Income Tax Act, 1961. In the mean time, The Finance Act, 1999, has amended the provisions of section 143 (1) (a), doing away with the requirement of processing under that section. Therefore, certain activities namely, listed at para 2(i), (ii) and (iii) of Instruction No.1959 dated 28.01.99, previously required to be undertaken at the time of processing of the return u/s 143(1) (a) are to be omitted.

2. In this context, it is suggested that Assessing Officers may take the following steps:

(i) Return liable to be held defective from the point of view of section 44AB should be identified and steps shall be taken to remove the defects in accordance with section 139(9): An identification mark in the form of sticker or rubber stamps should be put on the returns where the Tax Audit Report are not files or filed late specifying the period of the delayed so that the levy of penalty for such failure/lapse can be promptly initiated.

(ii) The audit report wherever filed separately, should be linked with the return. Audit reports are also required to be examined to see if it contained any credible information on the basis of which case can be picked up for assessment under section 143(3).

(iii) While scrutinising audit report attention should also be paid to para 2(vi) & (vii) of Instruction No 1959 dated 28.01.99. In view of revised format of audit reports, the Institutes of Chartered Accountant of India has since revised its guidance notes.

(iv) A "Control Register of Income Tax audit cases under section 44AB" should be maintained by Assessing officer as per format prescribed in Annexure "A" to this instruction. The maintenance of this register either manually or on computer would enable Assessing Officers to keep effective check on (i) all cases where tax audit report is mandatory, (ii) cases of non-filing or late filing of Tax audit report, and (iii) penalty proceeding under section 271B. Point No. (viii) of para 2 of Instruction No. 1959 dated 28.01.99 is modified to this extent.

(v) The quarterly progress for Assessing Officer will also include one more annexure in the prescribed format as per Annexure “B” to this instruction to report progress on tax audit cases under section 44AB. Till the time form of Quarterly progress is revised the Assessing Officers will fill up the information in prescribed format and attach with quarterly progress report.

3. The above instruction may be brought to the notice of all Assessing Officers in your region and necessary compliance ensured. The Supervisory Officers should also be asked to monitor the compliance of these instructions on a regular basis.

(KAMLESH C. VARSHNEY)
Under Secretary to the Govt. of India
ANNEXURE `B' QUARTERLY REPORT OF TAX AUDIT CASES U/S 44AB
S.N. PARTICULARS DURING THE QUARTER UPTO THE END OF QUARTER

1. No. of returns received.
2. No. of cases out of (1) where audit u/s 44AB was required.
3. No. of cases out of (2) in which audit reports have been filed.
4. No. of cases out of (2) above where audit reports were not filed.
5. No. of cases out of (3) above where audit reports were filed beyond the due date.
6. No. of cases in which penalty proceedings were initiated during the quarter.
7. No. of cases where penalty levied.
8. Amount of penalty levied.
9. No. of cases in which irregularities in audit report noticed.
10. No. of cases out of (9) where action u/s 288 was taken.
11. No. of cases out of (3) selected for assessment u/s 143(3).
AUDIT OF ACCOUNTS OF CERTAIN BUSINESSMEN OR PROFESSIONALS

1. Compulsory Audit: Whether the provision is applicable to commission agents, aarhtias, etc.

Section 44AB, as inserted by the Finance Act, 1984, casts an obligation on every person carrying on business to get his accounts audited, if his total sales, turnover or gross receipts, as the case may be, exceed Rs. 40 lakhs in any previous year relevant to the assessment year commencing on 1-4-1985 or any subsequent assessment year.

2. The Board have received representations from various persons, trade associations, etc. to clarify whether in cases where an agent effects sales/turnover on behalf of his principal, such sales/turnover have to be treated as the sales/turnover of the agent for the purpose of section 44AB.

3. The matter was examined in consultation with the Ministry of Law. There are various trade practices prevalent in the country in regard to agency business- and no uniform pattern is followed by the commission agents, consignment agents, brokers, Kachha aarhtias and paccaraarhtias dealing in different commodities in different parts of the country. The primary necessity in each instance is to ascertain with precision what are the express terms of the particular contracts under consideration. Each transaction, therefore, requires to be examined with reference to its terms and conditions and no hard and fast rule can be laid down as to whether the agent is acting only as an agent or also as a principal.

4. The Board are advised that so far as Kachha aarhtias are concerned, the turnover does not include the sales effected on behalf of the principals and only the gross commission has to be considered for the purpose of section 44AB. But the position is different with regard to paccaraarhtias. A paccaraarhtia is not, in the proper sense of the world, an agent or event del credere agent. The relation between him and his constituent is substantially that between the two principals. On the basis of various Court pronouncements, following principals of distinction can be laid down between a Kachha aarhtia and a paccaraarhtia.

1. A kachha aarhtia acts only as an agent of his constituent and never acts as a principal. A paccaraarhtia, on the other hand is entitled to substitute his own goods towards the contract made for the constituent and buy the constituent’s goods on his personal account and thus he acts as regards his constituent.

2. A kachha aarhtia brings a privity contract between his constituent and the third party so that each becomes liable to the other. The paccaraarhtia, on the other hand, makes himself liable upon the contract not only to the third party but also to his constituent.

3. Though the kachha aarhtia does not communicate the name of his constituent to the third party, he does communicate the name of the third party to the constituent. In other words, he is an agent for an unnamed principal. The paccaraarhtia, on the other hand, does not inform his constituent as to the third party with whom he has entered into a contract on his behalf.

4. The remuneration of a Kachha consists solely of commission and he is not interested in the profits and losses made by his constituent as is not the case with the paccaraarhtia.

5. The Kachha aarhtia, unlike the paccaraarhtia, does not have any dominion over the goods.

6. The kachha aarhtia has no personal interest of his own when he enters into a transaction and his interest is limited to the commission agent’s charges and certain out of pocket expenses whereas a paccaraarhtia has a personal interest of his own when he enters into a transaction.

7. In the event of any loss, the kachha aarhtia is entitled to be indemnified by his principal as is not the case with paccaraarhtia.
5. The above distinction between a kachha arahtia and pacca arahtia may also be relevant for determining the applicability of section 44AB in cases of other types of agents. In the case of agents whose position is similar to that of kachha arahtia, the turnover is only the commission and does not include the sales on behalf of the principals. In the case of agents of the type of pacca arahtia, on the other hand, the total sales/turnover of the business should be taken into consideration for determining the applicability of the provisions of section 44AB.


2. Compulsory audit- Tax audit in case of companies have accounting year other than financial year.

1. The Board have received representations regarding difficulties faced in complying with the provisions of section 44AB of the Income-tax Act in case of companies which follow an accounting period other than financial year.

2. Section 3 of the Income-tax Act, inter alia, provides that with effect from 1st April, 1989, "previous year" for the purpose of that Act means financial year immediately preceding the assessment year. In spite of the introduction of a uniform previous year for purposes of Income-Tax, some companies may adopt an accounting period other than the financial year, say the calendar year, under the Companies Act for other purposes.

3. In such cases, a question has arisen as to whether, under section 44AB of the Income-tax Act, the tax auditor can audit and certify the accounts for the period for which accounts have been maintained under the Companies Act (i.e. in the case the calendar year) or whether the tax auditor will have to certify the accounts for the relevant financial year which is the uniform accounting year for tax purposes.

4. The Board have considered the matter and are of opinion that as the income of the previous year is chargeable to tax and, for the purpose of Income-tax Act, the previous year is the financial year, the tax auditor would have to carry out the audit under section 44AB in respect of the period covered by the previous year, i.e. the relevant financial year. The proviso to the aforesaid section 44 AB, therefore covers only the cases where the accounts year is different from the financial year, the proviso to section 44 AB will not apply. Consequently the tax auditors would have to carry out the tax audit in respect of the period covered by the relevant financial year and submit his report in Form 3CB as required in rule 6G(l ) (b) of the Income Tax Rules. Circular: No. 561, dated 22-5-1990.
1. **Important Amendments**

1. **Rationalization of provision relating to special audit under section 142 (2A)**

   1. The existing provisions of sub-section (2A) of section 142, provides that at any stage of the proceedings before him, if the Assessing Officer having regard to the nature and complexity of the accounts of the assessee and the interests of the revenue, is of the opinion that it is necessary so to do, he may, with the previous approval of the Chief Commissioner or Commissioner, direct the assessee to get the accounts audited by an accountant, as defined in the Explanation below sub-section (2) of section 288.

   The accountant is to be nominated by the Chief Commissioner or Commissioner in this behalf and he is to furnish a report of such audit in the prescribed form duly signed and verified by him and setting forth such particulars as may be prescribed and such other particulars as the Assessing Officer may require.

   Subsection (2D) of section 142 provides that the expenses of, incidental to, any audit under subsection (2A) (including the remuneration of the accountant shall be determined by the Chief Commissioner (which determination shall be final) and paid by the assessee and in default of such payment, shall be recoverable from the assessee in the manner provided in Chapter XVII-D for the recovery of arrears of tax.

   2. The provisions of sub-section (2A) of section 142 of Income tax Act were reviewed by the Hon'ble Supreme Court in the case of Rajesh Kumar and Others Vs. Deputy Commissioner of Income-tax Other [287 ITR 91 (2006). The Hon'ble Supreme Court observed that the direction under sub-section (2A) of section 142 of Income tax Act for special audit of the accounts 142 of Income tax Act administrative in nature and is a quasi-judicial order. Therefore, while arriving upon a decision to order special audit under the said provisions, the principles of natural justice are required to be applied, inter-alia, to minimize arbitrariness. The Hon'ble Apex Court further observed that the expression "having regard to the nature and complexity of accounts" is significant, and if the assessee is put to a notice, he could show that the nature of the accounts is not such as would require appointment of a special auditor, and assessee could further show that what the Assessing Officer considers complex is, in fact not so. For these reasons, the Hon'ble Apex Court held that it is necessary to give an opportunity to the assessee before arriving upon a decision for ordering a special audit under sub-section (2A) of section 142. This issue again came up for consideration by the Hon'ble Supreme Court in the case of M/S Sahara India. The Hon'ble Supreme Court observed that the decision in the case of Rajesh Kumar and others does not appear to be the correct position of law and accordingly referred the matter to a larger bench. The Court also directed that the order directing the Special Audit shall be operative and assessment proceedings, if and, shall continue subject to the outcome of the petition in this case. The decision of the Larger Bench is awaited.

   3. There is no legislative intent to allow the assessee an opportunity of being heard before ordering a special audit under sub-section (2A) of section 142 of the Income tax Act. Accordingly the Income Tax Department has over the years ordered a large number of special audits without giving any opportunity to the tax payer of being heard. While it is not feasible to give effect to the ratio of the decision of the Hon'ble Supreme Court in the case of Rajesh Kumar and others in view of the large number of cases where such audit has been ordered in the past, respectfully following the decision of the Hon'ble Supreme Court in the said case, a proviso has been inserted in sub-section (2A) of section 142 proviso that the Assessing Officer shall not direct the assessee to get the accounts so audited unless the assessee has been given a reasonable opportunity of being heard. This will apply prospectively.

   4. A proviso has also been inserted to the sub-section (2D) so as to provide that where any direction is issued under sub-section (2A) by the Assessing Officer to an assessee to get the accounts audited, the expenses of, and incidental to, such audit (including the remuneration of the Accountant) shall be determined by the Chief Commissioner or Commissioner in accordance with such guidelines as may be prescribed and the expenses so determined shall be paid by the Central Government. ApplicabilityThese amendments will take effect from the I" day of June, 2007.
Important Amendments

2. Extension of Time limitation for making assessment
where a reference is made to the Transfer Pricing Officer

1. The existing provisions of the Act does not provide and additional time to the Assessing Officer of completing assessment or reassessment in cases where a reference is made by him under sub-section 92CA to the Transfer Pricing Officer for determination of the Arm's length price of an international transaction. Since, the time in limit for selection of cases for scrutiny is one year from the end of the month in which the return was filed; references to Transfer Pricing Officer are made mostly after one year of filing of one the return. Thus, Transfer Pricing Officers are not getting adequate time to make a meaningful audit of transfer price in cases referred to them.

2. With a view that the Transfer Pricing Officers get sufficient time make the audit transfer price and also to provide Assessing Officers sufficient time to make assessment in case involving international transactions, the time limits specified in sections 153 and 153B for making the assessment or reassessment, in cases where a reference has been made to the Transfer Pricing Officer, has been revised. The revised time limits in such cases shall be the time limits specified under the aforesaid sections, as increased by twelve months. Further, it has also been provided that the Transfer Pricing Officer shall determine the Arm's length price at least two months before the expiry of statutory time limit for making the assessment of reassessment. Thus, a time-limit has been provided in the statute, making it obligatory for the TPO to complete audit of transfer price within the stipulated time.

3. The provisions of sub-section (4) of section 92CA, provides that on receipt of the order under sub-section under sub-section(3) of the said section, the Assessing Officer shall proceed to compute the total income of the assessee under sub-section (4) of section 92C having regard to the Arm's length price determined under sub-section (3) by the Transfer Pricing Officer.

4. Sub-section (4) of section 92CA has been amended so as provide that, on receipt of the order under sub-section (3) of section 92CA, the Assessing Officer shall proceed to compute the total income of the assessee under sub-section (4) of section 92C in conformity with the Arm's length price determined under sub-section (3) of section 92CA by the Transfer Pricing Officer. Thus, with the amendment in the provisions, the arm's length price determined by the Transfer Pricing Officer (TPO) would be binding on the Assessing Officer.

5. Applicability- These amendments shall apply in cases where reference to Transfer Pricing Officer was made on or after 15 June, 2007 and shall also be applicable in cases where a reference to the Transfer Pricing Officer was made prior to 01.06.2007 but the Transfer Pricing Officer did not pass order under sub-section (3) of section 92CA before the said date.
Auditing & Accounting Standards

<table>
<thead>
<tr>
<th></th>
<th>Auditing &amp; Accounting Standards</th>
<th>Auditing &amp; Accounting Standards</th>
<th>180-203</th>
</tr>
</thead>
<tbody>
<tr>
<td>6</td>
<td><strong>Extracts from PA 25 of 2009</strong></td>
<td>i) Review of shipping and related sectors</td>
<td>204-245</td>
</tr>
<tr>
<td></td>
<td></td>
<td>ii) Deductions u/s 80IB</td>
<td>246-277</td>
</tr>
</tbody>
</table>
AUDITING AND ACCOUNTING STANDARDS

1. INTRODUCTION

Audit is incomplete now a days without the knowledge of Auditing and Accounting Standards. The reports on Tax Audit submitted by auditors on the regular basis maintained in course of business are normally taken as correct unless there are strong and sufficient reasons to indicate that they are unreliable. For maintenance of Account books, the presumption is always in favour of correctness and completeness and therefore the income deduced from Auditors Reports should be based upon standards fixed for Auditing and Accounting, so that correct income of the assessee can be assessed by the Income Tax Department.

The C & AG in the "Review on Appreciation of Third Party Reporting / Certification in Assessment Proceedings" Audit Report No 7 of 2008 has emphasized that tax audit reports must be complete in themselves to provide sufficient and requisite information to the Assessing Officer, thereby aiding him in completion of the assessment as required under the Income-tax Act, 1961.

Section 145 of _the Income Tax Act.1961 not only requires that either cash or mercantile system of Accounting is regularly employed but also directs that the Central Government may notify from time to time Accounting Standards to be followed by any class of assesseees or in respect of any class of Income. The Central Government vide Notification No. SO 69(E) dated 25.01.1996 has issued notification in this regard is placed at the end of this Annexure.

If the assessee or his auditors do not provide the correct or complete accounts of the assessee not conforming to accounting standards notified, the Assessing Officer can make assessment in the manner provided u/s 144 of the Income Tax Act, 1961.

Under section,145A of the Income Tax Act, 1961, the valuation of purchase and sale of goods and inventory for the purposes of determining income chargeable under the head "Profits and gains of business or profession "shall also be in accordance with the Method of Accounting regularly employed by the assessee. The Institute of Chartered Accountant of India issues Guidance Notes for this purpose to auditors. The List of Auditing Standards and Accounting Standards prescribed is laid down in subsequent paragraphs.

2. AUDITING STANDARDS

In Tax Audit in India, the Institute of Charted Accountants of India issues the auditing procedures / practices, which are called Standards on Auditing (SA). Earlier, these were known as Auditing and Assurance Standards (AAS) and Standard Auditing Practices (SAP). SAs are the benchmarks by which the quality of audit performance is measured and they prescribe the way auditing should be conducted by the auditors.
Effective Dates of Revised/ New Standards on Auditing (SAs) issued by AASB

NOTE: Effective date means that the SA is effective for audits of the financial statements for periods beginning on or after the specified date

<table>
<thead>
<tr>
<th>SA</th>
<th>Title of Standard on Auditing</th>
<th>April 1, 2008</th>
<th>April 1, 2009</th>
<th>April 1, 2010</th>
<th>April, 2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>SQC 1</td>
<td>Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements</td>
<td></td>
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<tr>
<td></td>
<td><strong>200-299</strong> General Principles and Responsibilities</td>
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</tr>
<tr>
<td>200</td>
<td>Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing</td>
<td></td>
<td></td>
<td></td>
<td>√</td>
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<tr>
<td>(Revised)</td>
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<tr>
<td>210</td>
<td>Agreeing the Terms of Audit Engagements</td>
<td></td>
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<tr>
<td>(Revised)</td>
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<tr>
<td>220</td>
<td>Quality Control for an Audit of Financial Statements</td>
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<tr>
<td>(Revised)</td>
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<tr>
<td>230</td>
<td>Audit Documentation</td>
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<tr>
<td>(Revised)</td>
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<td>240</td>
<td>The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements</td>
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<td>(Revised)</td>
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<tr>
<td>250</td>
<td>The Auditor’s Responsibilities Relating to Laws and Regulation in an Audit of Financial Statements</td>
<td>(Revised)</td>
<td>✓</td>
<td></td>
<td></td>
</tr>
<tr>
<td>260</td>
<td>Communication with Those Charged with Governance</td>
<td>(Revised)</td>
<td>✓</td>
<td></td>
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</tr>
<tr>
<td>265</td>
<td>Communicating Deficiencies in Internal Control to Those Charged with Governance and Management</td>
<td></td>
<td>✓</td>
<td></td>
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</tr>
<tr>
<td>300-499</td>
<td>Risk Assessment and Response to Assessed Risks</td>
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<td></td>
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<tr>
<td>300</td>
<td>Planning an Audit of Financial Statements</td>
<td>(Revised)</td>
<td>✓</td>
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<tr>
<td>315</td>
<td>Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment</td>
<td></td>
<td>✓</td>
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<tr>
<td>320</td>
<td>Materiality in Planning and Performing an Audit</td>
<td>(Revised)</td>
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<tr>
<td>330</td>
<td>The Auditor’s Responses to Assessed Risks</td>
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<td>✓</td>
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<tr>
<td>402</td>
<td>Audit Considerations Relating to an Entity Using a Service Organisation</td>
<td>(Revised)</td>
<td>✓</td>
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<td>450</td>
<td>Evaluation of Misstatements Identified during the Audit</td>
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<td><strong>500-599</strong></td>
<td><strong>Audit Evidence</strong></td>
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<tr>
<td>500 (Revised)</td>
<td>Audit Evidence</td>
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<tr>
<td>501 (Revised)</td>
<td>Audit Evidence - Specific Considerations for Selected Items</td>
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<td>505 (Revised)</td>
<td>External Confirmations</td>
<td>✓</td>
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<td>510 (Revised)</td>
<td>Initial Audit Engagements—Opening Balances</td>
<td>✓</td>
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<tr>
<td>520 (Revised)</td>
<td>Analytical Procedures</td>
<td>✓</td>
<td></td>
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<tr>
<td>530 (Revised)</td>
<td>Audit Sampling</td>
<td>✓</td>
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<tr>
<td>540 (Revised) Related Disclosures</td>
<td>Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures</td>
<td>✓</td>
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<tr>
<td>550 (Revised)</td>
<td>Related Parties</td>
<td>✓</td>
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<tr>
<td>Section</td>
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<td>560</td>
<td>Subsequent Events</td>
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<td>Going Concern</td>
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<td>580</td>
<td>Written Representations</td>
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<td>600-699</td>
<td>Using Work of Others</td>
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<td>600</td>
<td>Special Considerations — Audits of Group Financial Statements (Including the Work of Component Auditors)</td>
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<td>610</td>
<td>Using the Work of Internal Auditors</td>
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<td>620</td>
<td>Using the Work of an Auditor’s Expert</td>
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<td>700-799</td>
<td>Audit Conclusions and Reporting</td>
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<td>Forming an Opinion and Reporting on Financial Statements</td>
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<td>Modifications to the Opinion in the Independent Auditor’s Report</td>
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<td>706</td>
<td>Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor’s Report</td>
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<td>Specialized Areas</td>
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<tr>
<td>710 (Revised)</td>
<td>Comparative Information - Corresponding Figures and Comparative Financial Statements</td>
<td></td>
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<tr>
<td>720</td>
<td>The Auditor’s Responsibility in Relation to Other Information in Documents Containing Audited Financial Statements</td>
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<td>800-899</td>
<td>Special Considerations-Audits of Financial Statements Prepared in Accordance with Special Purpose Framework</td>
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<td>800</td>
<td>Special Considerations-Audits of Single Purpose Financial Statements and Specific Elements, Accounts or Items of a Financial Statement</td>
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<td>805</td>
<td>Engagements to Report on Summary Financial Statements</td>
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</table>
3. ACCOUNTING STANDARDS

CATEGORISATION OF ENTERPRISES FOR THE APPLICABILITY OF VARIOUS ACCOUNTING STANDARDS

AS PER ICAI:

Enterprises are classified as Level-I, Level-II and Level-III Enterprises. Small & Medium Scale Enterprises (SMEs) are split up in two categories, i.e., Level-II and Level-III enterprises. Level-I is termed as “Other than SMEs”. Till date ICAI has notified AS 1 to AS 32, out of which AS 30, AS 31, AS 32 are applicable w.e.f. 01.04.2011.

AS PER COMPANIES (ACCOUNTING STANDARDS) RULES, 2006 notified by Ministry of Corporate Affairs, w.e.f. 07.12.2006 Vide GSR 739(E) dtd 07-12-2006 within the powers conferred by clause (a) of sub-section (1) of Section 642 of the Companies Act, 1956 (I of 1956) read with sub-section (3c) of Section 211 and sub section (1) of Section 210A of the Companies Act, 1956 has notified the Accounting Standards for Companies. Till date AS 1 to AS 29, have been notified for compliance by Companies.

The Companies (Accounting Standard) Rules, 2006 provides certain exemptions / relaxations from the provisions of the certain Accounting Standards to SMCs. Additional exemption / relaxation from the provisions of the Accounting Standard which has been given by ICAI pertains to Non-Corporate Entities only.
THE LIST DEPICTING COVERAGE OF VARIOUS ENTERPRISES IN LEVEL-I, LEVEL-II, LEVEL-III ENTERPRISES IS AS UNDER:

<table>
<thead>
<tr>
<th>Level-I Enterprises</th>
<th>Level-II Enterprises (SMEs)</th>
<th>Level-III Enterprises (SMEs)</th>
</tr>
</thead>
<tbody>
<tr>
<td>* Enterprises whose equity or debt securities are listed whether in India or outside India</td>
<td>--</td>
<td>Enterprises which are not covered under Level-I and Level-II are considered as Level-III Enterprises</td>
</tr>
<tr>
<td>* Enterprises which are in the process of listing their equity or debt securities whether in India or outside India</td>
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<tr>
<td>* Banks including co-operative banks</td>
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<td></td>
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<tr>
<td>* Financial Institutions</td>
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<td></td>
</tr>
<tr>
<td>* Enterprises carrying on insurance business</td>
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</tr>
<tr>
<td>* All commercial, industrial and business reporting enterprises, whose turnover (excluding other income) <strong>exceeds</strong> Rs. 50 crores in the <strong>immediately preceding</strong> accounting year</td>
<td>* All commercial, industrial and business reporting enterprises, whose turnover (excluding other income) <strong>exceeds</strong> Rs. 40 lacs but does not exceed Rs. 50 crore in the <strong>immediately preceding</strong> accounting year</td>
<td></td>
</tr>
<tr>
<td>* All commercial, industrial and business reporting enterprises having borrowings (including public deposits) in <strong>excess</strong> of Rs.10 crore at any time during the immediately preceding accounting year</td>
<td>* All commercial, industrial and business reporting enterprises having borrowings (including public deposits) in <strong>excess</strong> of Rs.1 crore but does not exceed Rs. 10 crore at any time during the immediately preceding accounting year.</td>
<td></td>
</tr>
<tr>
<td>* Holding and Subsidiary enterprises of above</td>
<td>* Holding and Subsidiary enterprises of above</td>
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</tbody>
</table>
THE SUMMARY / A GLANCE VIEW OF THE APPLICABILITY OF ALL ACCOUNTING STANDARDS, RELAXATIONS ETC TO VARIOUS ENTERPRISES, WHETHER CORPORATE OR NON-CORPORATE ENTITY IS AS UNDER:

<table>
<thead>
<tr>
<th>ACCOUNTING STANDARD</th>
<th>APPLICABILITY TO LEVEL-I ENTERPRISES (Other than SMEs)</th>
<th>APPLICABILITY TO LEVEL-II ENTERPRISES (SMEs)</th>
<th>APPLICABILITY TO LEVEL-III ENTERPRISES (SMEs)</th>
</tr>
</thead>
<tbody>
<tr>
<td>AS 1</td>
<td>Disclosure of Accounting Policies</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>AS 2</td>
<td>Valuation of Inventories</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>AS 3</td>
<td>Cash Flow Statements</td>
<td>Yes</td>
<td>N.A.</td>
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<td>AS 4</td>
<td>Contingencies &amp; Events Occurring After the Balance Sheet Date</td>
<td>Yes</td>
<td>Yes</td>
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<td>AS 5</td>
<td>Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies</td>
<td>Yes</td>
<td>Yes</td>
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<tr>
<td>AS 6</td>
<td>Depreciation Accounting</td>
<td>Yes</td>
<td>Yes</td>
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<tr>
<td>AS 7</td>
<td>Construction Contracts</td>
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<tr>
<td>AS 8</td>
<td>Accounting for Research &amp; Development</td>
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<td>AS 9</td>
<td>Revenue Recognition</td>
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<td>AS 10</td>
<td>Accounting for Fixed Assets</td>
<td>Yes</td>
<td>Yes</td>
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<tr>
<td>AS 11</td>
<td>The Effects of Changes in Foreign Exchange Rates</td>
<td>Yes</td>
<td>Yes</td>
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<tr>
<td>AS 12</td>
<td>Accounting for Government Grants</td>
<td>Yes</td>
<td>Yes</td>
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<tr>
<td>AS 13</td>
<td>Accounting for Investments</td>
<td>Yes</td>
<td>Yes</td>
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<td>AS 14</td>
<td>Accounting for Amalgamation</td>
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<td>AS 15</td>
<td>Employee Benefits</td>
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<td></td>
<td><em>Level-II and Level-III enterprises entitled to conditional exemptions from</em> Para 11 to 16, 46, 50 to 116, 117 to 123, 129 to 131, 139)</td>
<td></td>
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<tr>
<td>AS 16</td>
<td>Borrowing Costs</td>
<td>Yes</td>
<td>Yes</td>
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<td>AS 17</td>
<td>Segment Reporting</td>
<td>Yes</td>
<td>N.A.</td>
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<td>AS 18</td>
<td>Related Party Disclosures</td>
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<td></td>
<td>For Corporate Entities:</td>
<td>Yes</td>
<td>Yes</td>
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<td></td>
<td>For Non-Corporate Entities:</td>
<td>Yes</td>
<td>Yes</td>
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<td>AS 19</td>
<td>Leases</td>
<td>Yes</td>
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<td><em>Level-II Corporate Entities exempt from:</em> Para 22(c), 22(e), 22(f), 25(a), 25(b), 25(e), 37(a), 37(f), 46(b), 46(d)</td>
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<td></td>
<td><em>Level-II Non-Corporate Entities exempt from:</em> “Same as above”</td>
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<td><em>Level-III Corporate Entities exempt from:</em> Para 22(c), 22(e), 22(f), 25(a), 25(b), 25(e), 37(a), 37(f), 46(b), 46(d)</td>
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<td><em>Level-III Non-Corporate Entities also exempt from:</em> “As above” and Para 37(g) &amp;</td>
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Compiled for DTRTI, Chandigarh's Workshop on Audit; 22nd and 23rd November 2010 at Delhi and Chandigarh
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<td>Earnings Per Share</td>
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<td>(exempt from : Disclosure of Diluted EPS)</td>
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<td>Consolidated Financial Statements</td>
<td>Provisions of the standard are applicable only if Consolidated Financial Statements are prepared by an enterprise whether for - Compliance of Statute - Compliance of Regulator - Voluntarily (Presently the compulsion for preparing Consolidated Financial Statement is only as per SEBI under listing agreement. Therefore, the provisions are mandatory applicable only to certain Level-I enterprises)</td>
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<td>Yes</td>
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<tr>
<td>23</td>
<td>Accounting for Investments in Associates in Consolidated Financial Statements</td>
<td>Provisions of the standard are applicable only if Consolidated Financial Statements are prepared by an enterprise whether for - Compliance of Statute - Compliance of Regulator - Voluntarily (Presently the compulsion for preparing Consolidated Financial Statement is only as per SEBI under listing agreement. Therefore, the provisions are mandatory applicable only to certain Level-I enterprises)</td>
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<td>25</td>
<td>Interim Financial Reporting</td>
<td>Provisions of the standard are applicable only if Interim Financial Statements are prepared by an enterprise</td>
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whether for
- Compliance of Statute
- Compliance of Regulator
- Voluntarily
(Presently the compulsion for preparing Interim Financial Statements is only as per SEBI under listing agreement. Therefore, the provisions are mandatory applicable only to certain Level-I enterprises)

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AS 27  Financial Reporting of Interests in Joint Ventures
Provisions of the standard relating to Consolidated Financial Statements are applicable only if Consolidated Financial Statements are prepared by an enterprise whether for
- Compliance of Statute
- Compliance of Regulator
- Voluntarily
(Presently the compulsion for preparing Consolidated Financial Statement is only as per SEBI under listing agreement. Therefore, the provisions of AS:27 relating to Consolidated Financial Statements are mandatory applicable only to certain Level-I enterprises)

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AS : 30 Financial Instruments : Recognition & Measurement

AS : 31 Financial Instruments : Presentation

AS : 32 Financial Instruments : Disclosures

are applicable to Level-I enterprises only and are mandatory applicable for accounting periods commencing on or after 1-4-2011. These are recommendatory in nature for accounting periods commencing or after 1-4-2009.
The Institute of Chartered Accountants of India for all Accounting Standards and has also separately issued Guidelines for Audit of

- Audit of Banks
- Audit of General Insurance Business
- Audit of Life Insurance business Audit of Small Entities
- Audit of Stock Exchanges

The Assessing Officers, who are dealing with the cases of aforementioned Entities can call for Audit Reports from the auditors, to check whether Prescribed audit notes have been followed by them, while auditing such cases.

The format of each accounting standard contains the following:-

1. Effective Date of applicability.
2. Statement of concepts and fundamental Accounting principle applicable.
3. Definition of Terms.
4. Manner of application of accounting principles in formulating the Accounting Standard
5. Presentation and Disclosure requirements

For the above purpose an entity would qualify as a -Small and Medium-sized Entity, if the conditions mentioned therein art satisfied as at the-end of the relevant accounting period.
4. **COMPANIES (ACCOUNTING STANDARDS) RULES, 2006**

**Form & Content of Balance Sheet as per Companies Act:**

Section 211 of the Companies Act, 1956, deals with the form and contents of balance sheet and profit and loss account. The relevant extracts of section are re-produced below:

*Section 211 (3A): ‘Every profit and loss account and balance sheet of the company shall comply with the accounting standards’*

*Section 211 (3B): ‘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:-
  a) the deviation from the accounting standards;
  b) the reasons for such deviation; and
  c) the financial effect, if any, arising due to such deviation’*

*Section 211 (3C): ‘For the purposes of this section, the expression “accounting standards” means the standards of accounting recommended by the Institute of Chartered Accountants of India, constituted under the Chartered Accountants Act, 1949 (38 of 1949), 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’*

**NACAS:**

The National Advisory Committee on Accounting Standards (NACAS) has been constituted under Section 210A as referred to under Section 211 (3C) to advise the Central Government on formulation and laying down of the accounting standards for adoption by companies or class of companies.

**The Companies (Accounting Standards) Rules, 2006:**

On the recommendation of NACAS, the Ministry of Company Affairs has issued a Notification dated 7th December, 2006, issuing rules namely ‘Companies (Accounting Standards) Rules, 2006’ whereby it has prescribed Accounting Standards 1 to 7 and 9 to 29.
As per the Notification, these shall come into effect in respect of accounting periods commencing on or after i.e., 7th December, 2006. Specific relaxations are given to Small and Medium Sized Companies.

**Accounting Standards issued by ICAI vs. Notified by Government under the Companies (Accounting Standards) Rules, 2006**


Till now, the Companies (Accounting Standards) Rules, 2006 have notified AS:1 to AS:29 (except AS:8)

**Duty of management & auditor:**

The above legal provisions have cast a duty upon the management to prepare the financial statements in accordance with the accounting standards.

The Section 227 of the Companies Act, 1956 cast a duty upon the auditor of the company to report on such compliance. A clause (d) under sub-section 3 of Section 227 of the Companies Act, 1956 is read as under:

'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'

As far as the reporting of compliance with the Accounting Standards by the management is concerned, clause (i) sub-section 2AA of Section 217 of the Companies Act, 1956 prescribes that the Board’s report should include a Directors’ Responsibility Statement indicating therein that in the preparation of the annual accounts, the applicable accounting standards had been followed along with proper explanation relating to material departures.
5. INTERNATIONAL FINANCIAL REPORTING STANDARDS

Introduction:

There is no uniformity in application of accounting standards in different countries as different set of accounting standards are followed in various countries. In US and some other countries US GAAP accounting standard is followed. In India, Indian GAAPs are followed, In more than 170 countries IFRS is followed. In this era of globalization and liberalization, according to some people, the world has now almost become an economic village. But with the development of e-commerce, majority of the countries desire to have a single globally accepted financial reporting system. Emerging economies are now increasingly assessing the global markets for fulfilling their capital needs. Now, more Indian Companies are getting their securities listed on the Stock Exchanges outside India.

It is very important to know the background of history of accounting standards in the world in order to understand their applicability in different countries. Therefore, Assessing Officers and Auditing Officers also now require knowledge and understanding of International Accounting Standards. Accounting Standards issued by the Institute of Charted Accountants of India is called Indian GAAP and they relate to different purposes.


IAS were issued between 1973 and 2001 by the Board of IASC. In April 2001 the International Accounting Standard Board (IASB) adopted all International accounting Standards (IAS) and continued their development, calling the new standards as International Financial Reporting Standards (IFRS).

By resolution of the IASB, IASs and related Interpretations remain applicable, with the same authority as IFRSs developed by the IASB, unless and until they are amended or withdrawn by the IASB.

Till now, 41 IAS has been issued out of which 29 are in force, the remaining standards have been withdrawn. Apart from this, 9 IFRSs have also been issued. IFRS is applicable from the year 2013. Thus, in total 37 IAS / IFRS are in force.

These are:

IFRS 1  First-time Adoption of International Financial Reporting Standards
IFRS 2  Share-based Payment
IFRS 3  Business Combinations
IFRS 4  Insurance Contracts
IFRS 5  Non-current Assets Held for Sale and Discontinued Operations
IFRS 6  Exploration for and Evaluation of Mineral Resources
IFRS 7  Financial Instruments: Disclosures
IFRS 8  Operating Segments
IFRS 9  Financial Instruments (w.e.f. 1.1.2013)
IAS 1:  Presentation of Financial Statements
IAS 2:  Inventories
IAS 7:  Statement of Cash Flows
IAS 8:  Accounting policies, changes in Accounting estimates and errors
IAS 10: Events after the Reporting period
IAS 11: Construction Contracts
IAS 12: Income Taxes
IAS 16: Property, Plant and Equipment
IAS 17: Leases
IAS 18: Revenue
IAS 19: Employee Benefits
IAS 20: Accounting for Government Grants and Disclosure of Government Assistance
IAS 21: The Effects of Changes in Foreign Exchange Rates
IAS 23: Borrowing Costs
IAS 24: Related Party Disclosures
IAS 26: Accounting and Reporting by Retirement Benefit Plans
IAS 27: Consolidated and Separate Financial Statements
IAS 28: Investments in Associates
IAS 29: Financial Reporting in Hyperinflationary Economies
IAS 31: Interests in Joint Ventures
IAS 32: Financial Instruments: Presentation
IAS 33: Earnings per Share
IAS 34: Interim Financial Reporting
IAS 36: Impairment of Assets
IAS 37: Provisions, Contingent Liabilities and Contingent Assets
IAS 38: Intangible Assets
IAS 39: Financial Instruments: Recognition and Measurement
IAS 40: Investment Property
IAS 41: Agriculture
6. IFRS : INDIAN APPROACH TO IMPLEMENTATION

The convergence process of Indian Accounting Standards with International Financial Reporting Standards (IFRS) to be implemented from April, 2011 got a major boost when Ministry of Corporate Affairs’ core group announced that there will be two separate sets of accounting standards under section 211 (3C) of the Companies Act, 1956. According to it:

- First set would comprise the Indian Accounting Standards which are converged with the IFRS, which shall be applicable to the specified class of companies.
- Second set would comprise the existing Indian Accounting Standards and would be applicable to other companies, including small and medium companies (SMCs).

Converged Accounting Standards vs. IFRS

In accordance with the roadmap, the government shall continue to notify accounting standards under the Companies (Accounting Standards) Rules. However, it is possible that in notifying the standards, certain alternative accounting treatments allowed under IFRS may not find place in converged Accounting Standards.

Companies required to follow Indian Accounting Standards converged with IFRS:

(a) From 1st April, 2011

The following categories of companies (excluding insurance & banking companies) are required to convert their opening balance sheets as at April 1, 2011, if financial the financial year commences on April 1, 2011. If the financial year commences later, on another date, the conversion of the opening Balance Sheet will be made from that date:

- Companies which are part of NSE – Nifty 50
- Companies which are part of BSE - Sensex 30
- Companies whose shares or other securities are listed on stock exchanges outside India
- Companies, whether listed or not, which have a net worth in excess of Rs.1,000 crores.
Computation of Net Worth:

The Net Worth, for above criteria, will be calculated as the Share Capital plus Reserves less Revaluation Reserve, Miscellaneous Expenditure and Debit Balance of the Profit and Loss Account.

Date of determination of Net Worth:

The net worth, for companies covered in above criteria, will be calculated as per the audited balance sheet of the company as at 31st March 2009 or the first balance sheet prepared after that date, if financial year ends on another date. For companies which are not in existence on 31st March 2009, the net worth will be calculated on the basis of the first balance sheet ending after that date.

(b) From 1st April, 2012

The following categories of companies are required to convert their opening balance sheets as at April 1, 2012, if the financial year commences on April 1, 2012. If the financial year commences later, on another date, the conversion of the opening Balance Sheet will be made from that date:

- All insurance companies

(c) From 1st April, 2013

The following categories of companies are required to convert their opening balance sheets as at April 1, 2013, if the financial year commences on April 1, 2013. If the financial year commences later, on another date, the conversion of the opening Balance Sheet will be made from that date:

- All scheduled commercial banks
- Urban co-operative banks (UCBs) having a net worth in excess of Rs. 300 crores.
- Non Banking Finance Companies (NBFCs). which are part of NSE-Nifty 50 or BSE-Sensex 30 and those, whether listed or not, which have a net worth in excess of Rs 1000 crores.
- Other Companies, whether listed or not, which have a net worth exceeding Rs. 500 crores but not exceeding Rs. 1,000 crores

**Date of determination of Net Worth:**

The net worth will be calculated as per the audited balance sheet of the company as at 31st March 2011 or the first balance sheet prepared after that date, if financial year ends on another date. For companies which are not in existence on 31st March 2011, the net worth will be calculated on the basis of the first balance sheet ending after that date.

(d) **From 1st April, 2014**

The following categories of companies are required to convert their opening balance sheets as at April 1, 2014, if the financial year commences on April 1, 2014. If the financial year commences later, on another date, the conversion of the opening Balance Sheet will be made from that date:

- Urban co-operative banks (UCBs) which having net worth exceeding Rs. 200 crores but not exceeding Rs. 300 crores
- All listed Non Banking Finance Companies (NBFCs)
- Unlisted Non Banking Finance Companies (NBFCs) having net worth in excess of Rs. 500 crores.
- Other Companies (Listed) which have a net worth of Rs. 500 crores.

(e) **Companies excluded from following Converged Accounting Standards**

- Companies (unlisted) having net worth of Rs. 500 crores or less and whose shares or other securities are not listed on Stock Exchanges outside India
- Small and Medium Companies (SMCs).
- UCBs which have a net worth not exceeding Rs. 200 crores
- Regional Rural banks (RRBs)
- Unlisted NBFCs having net worth of Rs. 500 crores or less

**Early adoption of converged Accounting Standards:**

The companies covered under the above criteria (b), (c) and (d), may voluntarily adopt converged Accounting Standards earlier than the prescribed date but not before 1st April, 2011.

**Optional adoption:**

The companies referred to in (e) above, have been given an option to continue to follow either existing Accounting Standards or to follow converged Accounting Standards.
Method of accounting

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 assessees 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.

Notified accounting standards - The following accounting standards are notified, to be followed by all assessees following mercantile system of accounting, namely:—

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 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 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 the 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 taxable 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 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 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 includes material adjustments necessitated by circumstances which though related to years preceding to 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 item;
(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.

This notification shall come into force with effect from 1st day of April, 1996 and shall, accordingly, apply to the assessment year 1997-98 and subsequent assessment years.


Method of accounting in certain cases.

145A. Notwithstanding anything to the contrary contained in Section 145, the valuation of purchase and sale of goods and inventory for the purposes of determining the income chargeable under the head Profits and gains of business or profession shall be

(a) in accordance with the method of accounting regularly employed by the assessee; and

(b) further adjusted to include the amount of any tax, duty, cess or fee (by whatever name called) actually paid or incurred by the assessee to bring the goods to the place of its location and condition as on the date of valuation.

Explanation. For the purposes of this section, any tax, duty, cess or fee (by whatever name called) under any law for the time being in force, shall include all such payment notwithstanding any right arising as a consequence to such payment.]
Chapter 1

Review on exemptions, deductions and allowances to shipping and related sectors

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Report No. PA 25 of 2009 (Performance Audit)

Highlights

Audit carried out a review of the income tax assessments of assessees in shipping and related sectors with a view to ascertain the adequacy of systems and procedures available and implemented. The review covered assessees engaged in shipping operations and related activities, such as shipping agents, clearing and forwarding agents, port trusts and non-residents deriving profits from maritime business availing relief under DTAAs or otherwise. All scrutiny assessments of major shipping companies and major port trusts were checked in audit. In addition 10 to 50 per cent of the port clearance certificates issued by the jurisdictional income tax officers were test checked. Ten per cent of the cases identified under related activities such as shipping agents, clearing and forwarding agents etc. were also test checked.

(Paragraphs 1.1, 1.3 and 1.5)

Systemic deficiencies relate to creation and utilisation of reserves under section 32A and 33AC, tonnage tax, port trusts and assessment of income arising to non-residents engaged in maritime business. These issues involve a revenue impact of Rs. 187.40 crore. Compliance issues such as adoption of incorrect figures, incorrect deduction for payments made outside India without tax deduction at source, etc. with a revenue impact of Rs. 299.81 crore were noticed.

(Paragraph 1.6.3)

The reserves created under section 32A are still unutilised and no action has been taken on the same. There appears to be no monitoring mechanism for reserves created under section 33AC. Further, the safeguards for mis-utilisation/non-utilisation of reserve created under section 33AC are inadequate.

(Paragraph 1.7.5)

As envisaged in the TTS proposal, the share of Indian bottoms ferrying Indian trade increasing from 27-30 per cent to 50 per cent and that of coastal fleet to one million GRT has not been achieved.

(Paragraph 1.8.2.1)

Whereas in certain port trusts depreciation on port basin, wharves and break water, capital dredging and railway sidings was being allowed @ 25 per cent treating them as plant & machinery, in other port trusts depreciation thereon was being allowed @ 10 per cent as applicable to buildings. Excess allowance of depreciation resulted in underassessment of income involving a short levy of Rs. 84.18 crore.

(Paragraph 1.10.6)

There is no consistency in the taxation of shipping profits arising to residents of countries where there is no tax on shipping income under the domestic law of those countries. Further, there is no analysis available on the impact of these exemptions on revenue in India.

(Paragraph 1.15.3)
Two PSUs viz. BPCL and ONGC are deducting tax at source from payments to non-residents for import of crude; four PSUs viz. MRPL, HPCL, IOCL and SAIL are not deducting tax at source on import of crude/steel products. Taxation records of ships, belonging to countries with which there was no DTAA or where shipping income was taxable in India, revealed that freight payment of Rs. 2,271.76 crore during April 2005 to March 2007 had been made for imports on which tax of Rs. 71.02 crore was not levied.

(Paragraph 1.16)

In Goa, Gujarat, Karnataka and Tamil Nadu, returns filed under section 172 were processed, whereas in Andhra Pradesh, Maharashtra, Orissa and West Bengal these returns were not processed. It is improbable that all the returns filed from 1961 onwards would be assessed by 31.12.2008 as prescribed under section 172(4A). Even if these are processed, possibility of recovery of tax demand, if any, is remote.

(Paragraph 1.17)

DTAA relief of hundred per cent was being allowed to foreign ships involved in coastal shipping in contravention of the DTAAAs. The coordination mechanism for taxation of coastal shipping of non-residents was inadequate.

(Paragraph 1.19)

Audit recommends that:

- The Ministry may like to ensure that the creation and utilisation of reserves is adequately monitored so that the intended purpose is not lost.
- The Ministry may consider instituting a mechanism so that relevant data from the customs authorities and port authorities are periodically obtained and reconciled with the port clearance certificates issued by the Department.
- The Ministry may like to prescribe an appropriate mechanism to ensure that all relevant documents and facts are verified before issue of NOCs.
- The Ministry may consider setting up a suitable mechanism for taxation of freight earnings from imports.
- The Ministry may like to institute a mechanism for ensuring coordination with DG Shipping so that income derived by non-residents from coastal shipping is brought to tax.
1. Introduction

Maritime transport is a critical infrastructure for the economic development of a country. It influences the pace, structure and pattern of development. The shipping policy of the Government is geared towards increasing the share of Indian fleet in sea borne trade. Investments in the shipping sector have been made by the State, mainly because of the large resources required, long gestation, uncertain returns and a number of externalities, associated with the infrastructure sector. Owing to the special requirements and cascading effect of the infrastructure sector on the economy, the Government has provided several fiscal incentives.

The Income Tax Act, 1961 (Act) apart from exemption and deductions available in general, provides for specific incentives to the maritime sector in the form of investment reserves, deduction under 80IB etc. From the assessment year 2005-06, the Government has introduced a new scheme, tonnage tax scheme (TTS) for the shipping industry to make it more competitive and to induce growth by encouraging capital investment. This scheme provides for presumptive taxation of income of qualifying ships based on the net tonnage and the period of its operation.

Audit carried out a review of the income tax assessments of assessees in shipping and related sectors with a view to ascertain the adequacy of systems and procedures available and implemented. Audit directed its efforts towards focused examination of contribution to revenue in the form of direct taxes by the assessees in the shipping and related sector.

1.2 Objective of the review

The review was conducted to:
- derive an assurance that the systems and procedures are sufficient and promote compliance with the provisions of the Act/Rules,
- analyse the allowance of exemptions and deductions to the shipping and related sectors under the Act,
- analyse the impact of the tonnage tax scheme,
- examine the allowance of relief under the Double Taxation Avoidance Agreements (DTAA) to non-residents engaged in maritime business.

1.3 Scope of the review and period of coverage

The review covered assessees engaged in shipping operations and related activities, such as shipping agents, clearing and forwarding agents etc, port trusts and non-residents deriving profits from maritime business availing relief under DTAAAs or otherwise. The review covered assessments relating to the assessment years 2003-04 to 2006-07 and 2007-08, wherever available.
1.4 Law and procedure

In respect of residents, apart from the general provisions of the Act applicable to all business, specific provisions relating to shipping sector are covered under section 32A, 33AC and 80IB of the Act. TTS applicable from the assessment year 2005-06 is covered under section 115V to 115VZC.

Section 44B, section 172 and DTAAs concluded under section 90 and section 91 define the scope and extent of taxation of income/profits which arise/accrue to non-residents.

1.5 Audit methodology and sample size

In the absence of database of assessees engaged in shipping or related activities, audit adopted a multi pronged strategy for identifying assessees and for collection of data on the shipping sector. Analysis of the TTS and taxation of imports was carried out by utilizing data obtained from the Department of Shipping. Taxation of non-residents was examined utilizing the data obtained from the Director General of Shipping, Department of Central Excise, Customs and Service Tax and the jurisdictional Port Trusts.

Copies of the draft review reports containing audit observations were issued to the respective Chief Commissioners of Income Tax/Commissioners of Income Tax/Director of Income Tax (International Taxation) by the Principal Directors of Audit/Principal Accountants General/Accountants General.

1.5.1 Sample size

All scrutiny assessments of major shipping companies and major port trusts were checked in audit. In addition 10 to 50 per cent of the port clearance certificates issued by the jurisdictional income tax officers were test checked. Ten per cent of the cases identified under related activities such as shipping agents, clearing and forwarding agents etc. were also test checked. Audit appraisal was carried out in the income tax jurisdictions covering the states of Andhra Pradesh, Delhi, Goa, Gujarat, Karnataka, Kerala, Maharashtra, Orissa, Tamil Nadu and West Bengal.

1.5.2 Acknowledgement

Indian Audit and Accounts Department acknowledges the cooperation of the Income tax Department in providing the necessary records and information for audit. The draft review report was issued to the Ministry in October 2008. An exit conference was held in December 2008 with the Central Board of Direct Taxes/Ministry of Finance to discuss the results of the reviews. The views expressed by them in the exit conference have been appropriately incorporated in this report.

1.6 Audit findings

Audit noticed that there were systemic deficiencies in the provisions and implementation thereof governing assessment of income arising to assessees relating to
the shipping sector. Audit findings have been broadly compiled under two heads residents and non-residents.

1.6.1 The issues relating to residents, *inter alia*, include:
- Creation and utilisation of shipping reserves, • Tonnage tax scheme (TTS) and
- Port trusts.

1.6.2 The issues relating to non-residents, *inter alia*, include:
- Co-ordination with other Government authorities • Issues relating to NOCs
- Allowance of relief under DTAAs
- Assessment of freight charges paid on imports
- Status of assessments of returns filed under section 172
- Filing of returns in respect of ships engaged in coastal trade

1.6.3 Systemic deficiencies relate to creation and utilisation of reserves under section 32A and 33AC, tonnage tax, port trusts and assessment of income arising to non-residents engaged in maritime business. These issues involve a revenue impact of Rs. 187.40 crore. Compliance issues such as adoption of incorrect figures, incorrect deduction for payments made outside India without tax deduction at source, etc. with a revenue impact of Rs. 299.81 crore were noticed.

**ISSUES RELATING TO RESIDENTS**

1.7 Creation and utilisation of shipping reserves

1.7.1 Shipping industry has an important linkage between economic growth and trade. It is estimated that about 70 per cent of India’s overseas trade by value is carried by sea. The demand for shipping services has been steadily increasing as India’s trade, post liberalization has increased phenomenally. The number of Indian ships carrying goods on coastal and overseas voyages is brought out in the diagram below:

![Indian Shipping Tonnage](chart)

Compiled for DTRTI, Chandigarh’s Workshop on Audit; 22nd and 23rd November 2010 at Delhi and Chandigarh
Report No. PA 25 of 2009 (Performance Audit)

Though there has been a steady increase in the share of Indian ships in coastal carriage, its share in the overseas sector is stagnant. The Government has time and again recognized the importance of shipping industry in overseas trade and has given fiscal incentives viz. higher rate of depreciation (section 32), investment allowance for acquisition of ships (section 32A), investment deposit account (section 32AB), shipping reserves (section 33AC) and the latest being TTS, introduced with effect from assessment year 2005-06.

1.7.2 Section 32A and 33AC

Acquisition and operation of ships being capital intensive, the government sought to provide an impetus to the shipping industry by giving fiscal incentives in the form of tax deductions. With a view to provide tax incentive to government and public companies engaged in the business of operation of ships for generation of resources internally to augment their fleet, section 32A and later section 33 AC were inserted (w.e.f. 01.04.1990) in the Act. Subsequently, the TTS was introduced w.e.f. 01.04.2005.

Section 32A introduced w.e.f. 01.04.1976, inter alia, provides that in respect of a ship which is owned by the assessee and is wholly used for the purpose of the business, an additional deduction of a sum by way of investment allowance equal to 25 per cent of the actual cost of the ship shall be allowed. The deduction shall be allowed only if an amount equal to 50 per cent of the investment allowance is debited in an ‘investment allowance reserve account’. The investment allowance shall be utilised for acquisition of a new ship within a period of eight years immediately succeeding the assessment year in which the ship was acquired failing which the relevant amount would be added back to income. The scheme was withdrawn by Board Notification dated 19.03.1990 and no investment allowance is allowed to any ship acquired after 31.3.1990.

Consequent to withdrawal of section 32A, section 33AC, inter alia, provides that an assessee being a government company or a public company engaged in the business of operation of ships is entitled to a deduction of an amount not exceeding 50 per cent of the profits derived from the business of operation of ships and credited to a reserve account to be utilised for acquiring a new ship. The reserves were to be utilised within 8 years failing which the amount would be taxed as income. Pending acquisition of a ship, the accumulated reserves could be utilised for the purposes of the business of the assessee. To safeguard against mis-utilisation of the reserve, it has been provided that the reserve would be taxed as income in the year in which it is utilised for other purposes like distribution of dividends etc.

The TTS provides that twenty per cent of the book profits derived from eligible shipping business, shall be transferred as ‘tonnage tax reserve account’ and be utilised within a period of 8 years. In case the reserve is not utilised or utilised for other purposes, the same would be brought to tax.
1.7.3 Monitoring of shipping reserves

Common feature of sections 32A and 33AC, as also the newly inserted TTS, is the creation of specific purpose reserve account, utilisation of the reserve within a specified period and monitoring of the same by the Department. Audit sought to examine whether the reserves created under the schemes were being utilised and in case of mis-utilisation/non-utilisation, the same was brought to tax.

- **Section 32A**

In Goa, CIT Panaji charge, test check of the records for the assessment year 2005-06 revealed that in four cases² investment allowance reserve created continued to be carried forward. Since the scheme was withdrawn with effect from 01.04.1990, the same should have been added back to the income of the assessee and brought to tax. Omission resulted in under assessment of income of Rs. 3.31 crore involving a short levy of tax of Rs. 1.18 crore.

- **Section 33AC**

Test check by audit of the assessments of 13 companies (Appendix 1), wherein deduction under section 33AC had been allowed revealed that huge balances amounting to Rs. 887.13 crore, Rs. 693.03 crore and Rs. 306.70 crore were outstanding under shipping reserve account during the years 2004-05, 2005-06 and 2006-07 respectively. A perusal of these assessment orders reveals that there was no specific mention of outstanding reserves under section 33AC, period to which they relate or when they would lapse. This data in the assessment order would have enabled the assessing officers to monitor the utilisation or otherwise of the reserve.

1.7.4 Inadequate safe guard to ensure utilisation of shipping reserve under section 33AC

Shipping reserve has to be utilised for the purchase of a new ship within a period of 8 years following the previous year in which the reserve was created. The effort to bring the unutilised shipping reserve to tax was not achieved as the assessee had brought forward business losses or unabsorbed depreciation which was set off against the additions. Section 155 (4A), which is to safeguard against wrong utilisation of investment reserves created under section 32A, provides that the wrongly utilised reserve would be added back to the income of the assessee for the year in which the reserve was created and assessed to tax with consequential levy of interest to date.

In Maharashtra, CIT City 5 Mumbai charge, audit scrutiny revealed that the following two companies which were allowed deduction under section 33 AC had not utilised the reserve at the end of eight years for acquisition of a new ship.

- The assessment of M/s. Pranik Shipping and Services Ltd., for the assessment year 2004-05 was completed after scrutiny in December 2006. Audit scrutiny

² Unutilised investment allowance related to Chowgule & Co (Rs. 305.10 lakh), Srimanguesh Shipping Co. (Rs. 10.37 lakh), Nigel Ship Yard Pvt Ltd. (Rs. 13.29 lakh) and Aquarius Pvt Ltd (Rs. 1.79 lakh)
revealed that the assessee was allowed to adjust current and earlier years’ unabsorbed depreciation and losses against the deemed profit of Rs. 5.92 crore arisen due to non-utilisation of reserve created during assessment year 1995-96. Had a deterrent provision been available in 33AC as available under section 155(4A) for section 32A, the tax leviable would be Rs. 8.45 crore.

• The assessment of M/s. Garware Shipping Corporation Ltd., for the assessment years 2003-04, 2004-05 and 2005-06 was completed after scrutiny in December 2006, February 2005 and March 2007 respectively. Audit scrutiny revealed that the assessee had offered deemed income on account of non-utilisation of shipping reserve created in assessment years 1994-95, 1995-96 and 1996-97 of Rs. 53.81 lakh, Rs. 80.26 lakh and Rs. 1.98 crore respectively during the assessment years 2003-04, 2004-05 and 2005-06. The reserves were created out of profits relating to the assessment years 1994-95, 1995-96 and 1996-97 when the tax rate was 40 per cent plus surcharge as applicable but offered to tax during assessment years 2003-04, 2004-05 and 2005-06 when the rate of tax was 35 per cent plus applicable surcharge. If section 33AC had a deterrent provision as available under section 155(4A) for section 32A, the tax leviable would be Rs. 4.54 crore.

1.7.5 The reserves created under section 32A are still unutilised and no action has been taken on the same. There appears to be no monitoring mechanism for reserves created under section 33AC. Further, the safeguards for mis-utilisation/non-utilisation of reserve created under section 33AC are inadequate. Since the TTS also has provisions for creation and utilisation of ‘reserves’ it is necessary that a monitoring mechanism be put in place.

1.7.5.1 During the exit conference, the Ministry stated that the new system of ‘internal audit’ and the ‘review and inspection’ by Commissioners of Income Tax (CsIT) would address the monitoring issues raised by audit.

1.7.5.2 The Ministry may like to ensure that the creation and utilisation of reserves is adequately monitored so that the intended purpose is not lost.

Compliance issues

1.7.6 Incorrect allowance of deduction on income not derived from the operation of ships

1.7.6.1 In Maharashtra, CIT City 5 Mumbai charge, the assessment of a company, M/s. Arcadia Shipping Ltd., for the assessment year 2004-05 was completed after scrutiny in December 2006. Audit scrutiny revealed that the assessee was allowed deduction under section 33AC in respect of income not derived from operation of ships such as interest, vehicle hire charges, brokerage, rent, service charges etc. This resulted in underassessment of income of Rs. 1.56 crore with consequent short levy of tax of Rs. 74.47 lakh.

The Department has accepted the audit observation (October 2008).
1.7.6.2 In Maharashtra, CIT City 5 Mumbai charge, the assessment of a company, **M/s. Mercator Lines Ltd.**, for the assessment year 2003-04 was completed after scrutiny in December 2005. Audit scrutiny revealed that the assessee was allowed deduction under section 33AC in respect of insurance claim of Rs. 1.29 crore which was not derived from the business of operation of ships. This resulted in underassessment of income of the said amount with consequent short levy of tax of Rs. 47.44 lakh.

1.7.7 **Non-assessment of reserve utilised for other purposes**

1.7.7.1 In Andhra Pradesh, CIT-1 Visakhapatnam charge, the assessment of a company, **M/s. Dredging Corporation of India**, for the assessment year 2004-05 was completed after scrutiny in January 2006 determining an income of Rs. 188.46 crore. On appeal, the ITAT allowed relief to the assessee and order giving effect to appellate order was passed in March 2008 at an income of Rs. 8.21 crore after allowing relief of Rs. 180 crore under section 33AC.

During the year the assessee utilised Rs. 45 crore withdrawn from ‘Reserve under section 33AC utilisation account’ for distribution of dividends and transfer to general reserve. Audit scrutiny revealed that no new ships had been acquired during the assessment year as evidenced from the asset schedule. As Rs. 45 crore was not utilised for acquiring ships, the same was to be brought to tax. Omission resulted in underassessment of income of Rs. 45 crore with a consequential tax effect of Rs. 24.22 crore including interest.

The Department, while not accepting the objection, replied that the assessee purchased three dredgers worth Rs. 600 crore in assessment years 1999-2000 and 2000-01 and as such, applied the reserve well within time limits provided under section 33AC. However, the assessee made book entry in the accounting year 2003-04 relevant to assessment year 2004-05 for Rs. 45 crore.

The reply is not acceptable because if the reserve had been utilised during the assessment year 1999-2000 and 2000-01, the same ought to have been reflected in the books of accounts in the relevant year as per the provisions of the Companies Act. Further, the reserve would no longer exist in the balance sheet as on 31.3.2004 (assessment year 2004-05).

1.7.8 **Incorrect computation of income under special provisions**

For the purposes of special provisions viz., section 115JB, book profit means the net profit as shown in the profit and loss account as increased by the amounts carried to any reserves by whatever name called, other than the reserve specified under the section 33AC apart from other adjustments prescribed in the section.

1.7.8.1 In Maharashtra, CIT City 5 Mumbai charge, the assessment of a company, **M/s. Mercator Lines Ltd.**, for the assessment year 2003-04 was completed after scrutiny in December 2005. Audit scrutiny revealed that as against a shipping reserve of Rs. 2.20 crore allowable under section 33AC, Rs. 3.50 crore was reduced from book profits. This
resulted in underassessment of income of Rs. 1.31 crore with consequent short levy of tax of Rs. 10.28 lakh.

1.7.8.2 In Maharashtra, CIT City 5 Mumbai charge, the assessment of a company, M/s. South East Asia Marine Engineering and Construction Ltd., for the assessment year 2004-05 was completed after scrutiny in December 2006. The assessment was completed under normal provisions levying a tax of Rs. 56.59 lakh (on an income of Rs. 1.47 crore) as it exceeded the tax payable under special provisions.

Audit scrutiny revealed that book profit had been computed after reducing Rs. 17 crore (being reserve created under section 33AC) instead of Rs. 15.15 crore (being deduction allowed under section 33AC). Consequently, the book profit works out to Rs. 8.27 crore with a tax of Rs. 63.57 lakh which is more than tax under normal provisions. Incorrect allowance of deduction under section 33AC while computing book profits resulted in short levy of tax of Rs. 14.52 lakh including interest.

The Department in not accepting the objection (June 2008), stated that, the words used in section 115JB are ‘reserve specified under section 33AC’ and not ‘amount allowed as deduction under 33AC’. Reply is not tenable as the ‘reserve created’ and ‘deduction allowed’ cannot have different connotations under section 33AC and 115JB as otherwise creation of reserve would provide an opportunity for tax evasion. Incidentally, in the case of another assessee (M/s. Great Eastern Shipping Co Ltd - assessment year 2003-04- CIT Central, Mumbai) the Department while computing tax under section 115JB had restricted the deduction under section 33AC to amount actually allowed as against reserve created.

1.8 Tonnage Tax Scheme

The ownership of the world fleet is controlled by a select few countries viz. Greece, Japan, Germany, China and Norway with a market share of 53 per cent. India has a world market share of 1.52 per cent (2006-07). Recognising the vital role of shipping in the national economy and the need to provide a fiscal regime to enable Indian shipping to be internationally competitive, TTS was introduced by the Finance Act, 2004.

The proposal for TTS (mooted in November 2002) was not only to facilitate ‘growth of Indian shipping tonnage’ but also to spur fleet expansion and auxiliary activities in the shipping sector. TTS was to facilitate growth of Indian shipping tonnage; increase the share of Indian bottoms ferrying Indian trade from 27-30 per cent to at least 50 per cent in the next five years; and to augment the Indian coastal fleet to one million GRT in the next 2-3 years. As about 90 per cent of the Indian overseas tonnage requirements were being met by foreign ships, it was envisaged that the increased share of Indian overseas tonnage would result in substantial foreign exchange savings.

Chapter XII G of the Act, covering sections 115V to 115VZC, deals with the scope, application and implementation of the TTS. Tonnage income of a qualifying company shall be deemed to be the profits chargeable to tax under the head ‘profits and gains of business or profession’. The TTS provides for computing income arising from the
operation of a ship on presumptive basis and is determined on the daily tonnage income of the qualifying ship. The tonnage income of an opting company for a previous year shall be the aggregate of the tonnage income of each qualifying ship and equal to daily tonnage income of each of such ship multiplied by the number of days in the previous year, or by the number of days the ship is operated. The income so arrived shall be taxed at rates prescribed under the Act. The tax payable under TTS was substantially less than that payable under normal provisions of the Act as the income was computed on notional basis.

1.8.1 Efficacy of the scheme

It is necessary that the tax concession allowed are evaluated periodically to ensure that they have the desired impact and are serving the purpose for which they were designed. Audit sought to examine the efficacy of the scheme and its impact by a study of the growth in the shipping sector involving the following parameters:

- Tonnage of Indian vessels
- Average age of Indian fleet
- Foreign exchange outgo

1.8.2 Tonnage of Indian vessels

The development of Indian Gross Registered Tonnage\(^3\) (GRT) for the period from 1.04.2000 to 01.01.2008 (i.e. before and after introduction of TTS) is given in the table below:

('000 tonnes)

Table 1.1: Tonnage of Indian vessels

<table>
<thead>
<tr>
<th>As on</th>
<th>Coastal</th>
<th></th>
<th></th>
<th>Total</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Position prior to introduction of tonnage tax scheme</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1.04.2000</td>
<td>273</td>
<td>681.60</td>
<td>240</td>
<td>6,231.36</td>
<td>513</td>
</tr>
<tr>
<td>1.04.2001</td>
<td>316</td>
<td>697.24</td>
<td>230</td>
<td>6,119.35</td>
<td>546</td>
</tr>
<tr>
<td>1.04.2002</td>
<td>336</td>
<td>733.65</td>
<td>224</td>
<td>6,087.28</td>
<td>560</td>
</tr>
<tr>
<td>1.04.2003</td>
<td>425</td>
<td>805.26</td>
<td>191</td>
<td>5,372.29</td>
<td>616</td>
</tr>
<tr>
<td>1.04.2004</td>
<td>436</td>
<td>807.80</td>
<td>203</td>
<td>6,136.40</td>
<td>639</td>
</tr>
<tr>
<td>Position after introduction of tonnage tax scheme</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1.04.2005</td>
<td>458</td>
<td>810.59</td>
<td>228</td>
<td>7,202.36</td>
<td>686</td>
</tr>
<tr>
<td>1.04.2006</td>
<td>496</td>
<td>817.44</td>
<td>243</td>
<td>7,646.98</td>
<td>739</td>
</tr>
<tr>
<td>1.04.2007</td>
<td>530</td>
<td>842.03</td>
<td>257</td>
<td>7,753.15</td>
<td>787</td>
</tr>
<tr>
<td>1.01.2008</td>
<td>573</td>
<td>893.13</td>
<td>277</td>
<td>8,813.41</td>
<td>850</td>
</tr>
</tbody>
</table>

Source Annual reports of Ministry of Shipping
1.8.2.1 Coastal shipping with 573 ships and GRT of 893.13 thousand tonnes constitutes 10 per cent of the total GRT while overseas shipping constitutes the remaining. India has a world market share of about 1.52 per cent (2006-07). Thus, though there is an increase in the absolute number of ships and gross tonnage, the position of overseas tonnage (as a percentage) remains constant. Thus, the share of Indian bottoms ferrying Indian trade increasing from 27-30 per cent to 50 per cent as envisaged in the proposal for TTS has not been achieved. Further, Indian coastal fleet has not achieved the target of one million GRT as envisaged in the TTS proposal.

1.8.2.2 A study of the ownership data of ships in India reveals that out of total 850 ships (as on 1 January 2008), 47 are owned by government departments or parastatals, 73 by port trusts and 16 of them are dredgers. These 136 vessels involving tonnage of 193.54 thousand tonnes GRT would not be available for commercial exploitation for carriage of goods.

1.8.3 Average age of Indian fleet

The average age of the fleet owned by India (as on 1 January 2007) vis-à-vis the average age of developing countries, developed countries and the world average is given in table below:

Table 1.2: Average age of Indian fleet vis-à-vis developing and developed countries

<table>
<thead>
<tr>
<th>Sl.No.</th>
<th>Name of the country and world ranking</th>
<th>Age 0 to 4 Years</th>
<th>Age 5-9 Years</th>
<th>Age 10-14 Years</th>
<th>Age 15-19 Years</th>
<th>Age 20 years and above</th>
<th>Average</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>India*</td>
<td>9.9</td>
<td>14.4</td>
<td>13.8</td>
<td>11.6</td>
<td>50.3</td>
<td>17.9</td>
</tr>
<tr>
<td>2.</td>
<td>Developing countries#</td>
<td>24.6</td>
<td>18.9</td>
<td>17.1</td>
<td>11.8</td>
<td>27.7</td>
<td>12.4</td>
</tr>
<tr>
<td>3.</td>
<td>Developed countries#</td>
<td>28.4</td>
<td>29.9</td>
<td>17.6</td>
<td>7.8</td>
<td>16.3</td>
<td>9.9</td>
</tr>
<tr>
<td>4.</td>
<td>World#</td>
<td>25.1</td>
<td>21</td>
<td>16.7</td>
<td>10.9</td>
<td>26.2</td>
<td>12</td>
</tr>
</tbody>
</table>

*Indian National Ship Owners Association, Mumbai #UNCTAD

Thus, in spite of deductions to the shipping sector (over a period of 20 years) under sections 32A, 33AC and the favourable tax regime in the form of TTS, the average age of Indian fleet is higher than that of the industry average.

1.8.4 Foreign exchange outgo

The position of volume of maritime tonnage handled by foreign vessels for the financial years 2004-05 to 2006-07 is given in the table below:

('000 tonnes)
Table 1.3: Volume of maritime tonnage handled by foreign vessels

<table>
<thead>
<tr>
<th>Financial Year</th>
<th>Loaded</th>
<th>Percentage to total loaded cargo</th>
<th>Unloaded</th>
<th>Percentage to total unloaded cargo</th>
<th>Total of loaded and unloaded</th>
<th>Percentage to total</th>
</tr>
</thead>
<tbody>
<tr>
<td>2004-05</td>
<td>1,55,730</td>
<td>94.8</td>
<td>1,90,717</td>
<td>81.0</td>
<td>3,46,447</td>
<td>86.7</td>
</tr>
<tr>
<td>2005-06</td>
<td>1,71,770</td>
<td>95.2</td>
<td>2,14,253</td>
<td>80.3</td>
<td>3,86,023</td>
<td>86.3</td>
</tr>
<tr>
<td>2006-07</td>
<td>1,89,552</td>
<td>94.9</td>
<td>2,47,393</td>
<td>83.0</td>
<td>4,36,945</td>
<td>87.8</td>
</tr>
</tbody>
</table>

Given the fact that about 90 per cent of the India’s maritime overseas shipping needs are being met by non-residents, there is considerable foreign exchange outgo to the owners/operators of ships registered abroad.

The expenditure incurred for transportation in foreign exchange\(^4\) during the years 2004-05, 2005-06 and 2006-07 was Rs. 20,363 crore, Rs. 34,746 crore and Rs. 40,029 crore respectively. Approximately, 95 per cent of the country’s trade by volume and 70 per cent\(^5\) by value are moved by sea. Thus, the foreign exchange outgo on account of engaging the services of ships owned by the non-residents has not reduced even after the introduction of TTS.

1.8.5 Evaluation of tonnage tax scheme

The TTS was introduced to reduce the impact of taxes on eligible shipping companies. Audit sought to examine the revenue foregone on account of TTS and the number of assessees opting for the scheme.

In the absence of relevant data with the Department, audit obtained data on companies opting for TTS from the Ministry of Shipping. Data obtained from the Ministry revealed that of the 169 entities (excluding parastatals) owning ships, 25 companies had opted for the TTS during assessment year 2005-06. Audit sought to examine the impact of tax paid under the TTS vis a vis that under the normal provisions of the Act as also the tax paid by these companies during the pre tonnage tax period. Audit analysis of 18 assessees revealed that nine companies during assessment year 2003-04 and six companies during assessment year 2004-05, which were not paying taxes on account of availing the deduction under section 33AC, had to pay taxes under TTS. In respect of eight companies there has been a substantial reduction in taxes paid (Appendix 2).

1.8.6 The growth in Indian shipping tonnage subsequent to the introduction of the TTS has not kept pace with either the requirements of the Indian overseas shipping or the growth in maritime trade of India. The Ministry, during exit conference, stated that TTS is an internationally accepted best practice for taxing income from shipping. Apart from taxation the performance of the shipping industry is dependent on a host of other factors both domestic and international. The performance of shipping industry in this overall scenario cannot be a reason for modification in the taxation law.

1.8.6.1 The Ministry may review the tonnage tax scheme.

Compliance issues

1.9 Mistakes noticed in assessments of assessees other than port trusts are brought out in the following paragraphs:

\(^4\)Reserve Bank of India annual reports
\(^5\)Annual Report 2007-08, Department of Shipping, GOI
1.9.1 Non-qualifying income assessed under TTS

In Andhra Pradesh, CIT 2 Hyderabad charge, the assessment of a company, M/s. Kei-Ross Maritime Ltd., for the assessment year 2005-06 was completed after scrutiny in March 2007 accepting the returned income including income of Rs. 0.91 lakh under TTS. The assessee owned four tugs and was accorded approval under TTS. Audit scrutiny however revealed that the assessee had computed income from seven tugs (four owned and three chartered) under TTS as against four tugs approved. Further, the assessee had not furnished a certificate issued by the DG, Shipping under the Merchant Shipping Act, 1958 as required under section 115VD and a certificate of minimum training requirement as required under section 115VU in respect of these three tugs. Hence, the income of Rs. 2.24 crore relating to these three tugs which should have been computed under normal provisions of the Act, was not done. This resulted in under assessment of income of Rs. 2.24 crore with a consequential tax effect of Rs. 1.13 crore.

The Department stated (October 2008) that all the qualifying ships need not be approved to be eligible for tonnage tax scheme and certificates required under section 115VU were available on record. The reply is not acceptable as the assessee, while applying for TTS, did not furnish the details, in the prescribed form\(^6\), in respect of the three chartered ships, in accordance with the Rule 11P of the Income Tax Rules, 1962. The valid certificates available on record pertained to owned ships and not to the three chartered ships.

1.9.1.1 In Andhra Pradesh, CIT Hyderabad charge, mistakes in computing income under TTS were noticed in three other cases involving a short levy of Rs. 32.34 lakh.

1.9.2 Income not offered to tax

Assessing officers have to determine and assess the income correctly after verifying accounts, claims and records of the assessee.

In Tamil Nadu, CIT III Chennai charge, the assessment of a company, M/s. Poompuhar Shipping Corporation Ltd., for the assessment years 2003-04 and 2004-05 was completed after scrutiny and in summary manner in February 2006 and March 2006 respectively. The assessee was allowed an expenditure of Rs. 13.46 crore and Rs. 6.51 crore for the assessment years 2003-04 and 2004-05 respectively from the freight income towards under performance of voyages on own vessels in pursuance of freight agreement with M/s. Tamil Nadu Electricity Board (TNEB).

Audit scrutiny revealed that there was no such condition for reduction of freight income owing to under performance of voyages of own vessels as per the freight agreement entered into with TNEB (original in 1978 and subsequent revisions till date). Therefore, the reduction made towards under performance of voyages from freight income for the above assessment years aggregating to Rs. 19.97 crore was irregular involving a short levy of Rs. 9.58 crore.

\(^6\) Form No. 65
1.9.3 Implementation of appellate order

An aggrieved assessee can appeal to the Commissioner of Income Tax (Appeals) against the order of an assessing officer who shall comply with the directions given in the appellate order. Any mistake committed while giving effect to an appellate order results in underassessment/overassessment of income.

In Gujarat, CIT Gandhinagar charge, the assessment of M/s. Gujarat Maritime Board was completed after scrutiny in December 2006 determining an income of Rs. 1.16 crore as against ‘nil’ income returned by the assessee. On an appeal by the assessee, all the additions were deleted. Audit scrutiny of the order of April 2007 giving effect to appeal order revealed that instead of depicting the income of the assessee as ‘nil’ it was shown as loss of Rs. 28.46 crore. This resulted in incorrect computation of loss of Rs. 28.46 crore involving a potential tax effect of Rs. 8.54 crore.

1.9.4 Audit also noticed other mistakes in respect of 34 assessee involving tax effect of Rs. 24.16 crore of which 12 assessee involving tax effect of Rs. 20.26 crore are given in Appendix 3.

1.10 Port Trusts

1.10.1 Port trusts are parastatals set up under the Major Port Trusts Act, 1963 discharging the set of functions as prescribed under the Major Port Trust Act. The accounting standards to be followed have been laid down by the Department of Shipping and are based on the Indian Companies Act, 1956. The tariff fixations for various services rendered by the ports are based on orders of the Tariff Authority for Major Ports.

Indian port sector comprises 12 major ports and 200 minor ports. Eleven major ports are governed by the provisions of Major Port Trust Act, 1963 and the twelfth is the Ennore Port Limited, the first corporate major port. The remaining ports are under the administrative control of the respective maritime State Governments. The total volume of the traffic handled by all the Indian ports during 2007-08 was 649.38 million tonnes, of which 463.84 million tonnes (71 per cent) was handled by major ports and remaining 185.54 million tonnes by the non-major ports.

1.10.2 Status of port trusts

Till the assessment year 2002-03, the income of the port trusts were exempt under section 10(20) of the Act as they were deemed to be local authorities. Consequent to the amendment of section 10(20), he port trusts became taxable from the assessment year 2003-04 onwards. A study of the assessments of the port trusts revealed that there was no uniformity in the status accorded to port trusts in the income tax assessments as brought out in the table below:
Report No. PA 25 of 2009 (Performance Audit)

Table 1.4: Status of port trusts

<table>
<thead>
<tr>
<th>Sl.No.</th>
<th>Name of the port trust</th>
<th>Status under which assessed as in assessment year 2005-06</th>
<th>Rate at which tax has been levied</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Kolkata,</td>
<td>Local Authority</td>
<td>35 per cent</td>
</tr>
<tr>
<td>2.</td>
<td>Mumbai, Paradip, Chennai, Kandla</td>
<td>Local Authority</td>
<td>30 per cent</td>
</tr>
<tr>
<td>3.</td>
<td>Kochi (Cochin)</td>
<td>Artificial Juridical Person</td>
<td>35 per cent</td>
</tr>
<tr>
<td>4.</td>
<td>Mormugao</td>
<td>Trust (Charitable Institution)</td>
<td>Exempted</td>
</tr>
<tr>
<td>5.</td>
<td>Tuticorin</td>
<td>Association of Persons</td>
<td>30 per cent</td>
</tr>
<tr>
<td>6.</td>
<td>Vishakhapatnam</td>
<td>Local Authority</td>
<td>30 per cent</td>
</tr>
<tr>
<td>7.</td>
<td>New Mangalore</td>
<td>Local Authority</td>
<td>30 per cent</td>
</tr>
<tr>
<td>8.</td>
<td>Jawaharlal Nehru (JNPT)</td>
<td>Local Authority</td>
<td>30 per cent</td>
</tr>
</tbody>
</table>

Sl. No.3: Based on order of ITAT, Kerala, assessee has been granted registration as ‘charitable trust’ as defined under section 12AA.
Sl. No.4: As held by ITAT, Panaji.
Sl No.5: Assessee sought registration as ‘trust’ with CIT I, Madurai, Tamil Nadu which was rejected. Assessee has preferred an appeal before ITAT after obtaining approval from Committee of Disputes.
Sl. No.6: Based on order of ITAT, Hyderabad, assessee has been subsequently granted registration as ‘charitable trust’ as defined under section 12AA with retrospective effect.
Sl. No.7: Assessee’s application for registration as ‘trust’ is pending in appeal (May 2008) with CIT(A). Sl No 8 Assessee has been subsequently accorded the status of ‘charitable trust’.

1.10.2.1 Given the fact that the port trusts are engaged in the same set of activities and are governed by the same set of rules and regulations, it becomes necessary that the status for assessment purposes under the Act is clarified to ensure consistency.

1.10.3 Assessments in appeal

A study of the assessments of the major port trusts and disputes arising thereon revealed that there are several appeals pending (October 2008) resulting in locking up of government revenue of Rs. 756.28 crore in litigation (Appendix 4).

A majority of the cases pertain to the written down value to be adopted for allowing depreciation on assets purchased and put to use prior to 2003-04 (when port trusts were not taxable). The Department, while allowing depreciation on these assets, had taken the stand that depreciation would deem to have been allowed notionally and written down value adopted accordingly in assessments after assessment year 2003-04. The assessees went in appeal on the above stand of the department and consequent disallowances. Subsequently, Finance Act, 2008 introduced an explanation under section 43(6) with retrospective effect from 01.04.2003.

Audit study revealed that no action had been taken by the Department to speed up the judicial
process by filing necessary applications with the relevant authorities.

\footnote{Passed by Parliament in May 2008. The explanation clarified that where assessee was not required to compute his total income for the purpose of this Act during preceding years (as in the case of port trusts), then while arriving at w.d.v of assets, the depreciation provided in the books of accounts of the assessee shall be deemed to be the depreciation actually allowed under this Act.}
1.10.4 Alternatives to assessment of port trusts

The Supreme Court has held that income of an authority, even constituted by a notification under an Act enacted by the Legislature, is not the income of the Government and the Authority cannot claim exemption from Union taxation. The Prime Minister’s Council on Trade and Industry in its recommendation on Ports under Infrastructure Development has recommended that ‘to ensure that the port trusts start operating along more commercial lines, it is necessary to corporatise them’. Further, section 5 of the Major Port Trust Act, 1963 provides that ‘every Board constituted under this Act shall be a body corporate having perpetual succession and a common seal with power, subject to the provisions of this Act, to acquire, hold or dispose of property and may by the name by which it is constituted, sue or be sued’. Further, the Ministry of Shipping guidance note provides that ‘the format of financial statements prescribed by the Indian Companies Act, 1956 has been used as the basis for developing the accounting format of port trusts together with the requirement of accounting standards’.

1.10.4.1 The port trusts thus follow accrual system of accounting and the identification of revenue and expenditure is based on the principles contained in the Companies Act, 1956. Further, steps have already been taken for corporatisation of JNPT, New Mangalore and Tuticorin port trusts viz. registering with the jurisdictional Registrars of Companies.

1.10.4.2 In case port trusts are treated as ‘companies’, apart from providing clarity and consistency for assessment purposes, it would also be possible for the Department to collect additional revenue by levy of tax under special provisions (Minimum Alternate Tax).

1.10.5 Consequent to amendment to section 10(20), the port trusts became taxable from the assessment year 2003-04. Audit study of the assessments of the port trusts revealed that there was no uniformity in the status accorded to port trusts in the income tax assessments as also the levy of tax. Whereas, four port trusts had been accorded the status of ‘charitable trusts’ after repeated appeals, the application of two others are pending approval. Further, there have been moves to corporatise the port trusts. Not only is the contribution of port trusts to the exchequer in the form of income tax meagre, the tax demands raised are locked up in disputes.

1.10.5.1 While accepting the views of audit that ‘ports trusts’ were being assessed differently, the Ministry during exit conference stated that section 2 of the Act has been amended through Finance Act 2008 effective 01.04.2009, by which the term charitable purpose has been redefined to exclude activities in the nature of trade or business carried out for a fee or cess or any other consideration.

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8 Adityapur Industrial Area Development Authority v. Union of India (2006) 283 ITR 97
9 Ministry of Shipping (Ports Wing) letter No PR-20021/2/98-PG dated 06.11.2002
1.10.6 Allowance of depreciation

Under section 32 of the Act, depreciation shall be allowed on assets owned by the assesssee and used for the purposes of the business of the assesssee at the rates prescribed in Rule 5 of the Income tax Rules. Wharves are fixed platforms which serve as interim storage areas intended to enable unloading and reloading vessels as quickly as possible. Breakwaters are structures constructed on coasts as part of coastal defence or to protect an anchorage from the effects of weather. Therefore, these structures are in the nature of buildings. Similarly, since capital dredging relates to creation of harbour berth or waterway or to deepen existing facilities in order to allow access to larger ships, it forms part of building. It has been judicially held that railway track or rail road are ‘roads’ and hence are to be treated as buildings and depreciation allowed accordingly.

Audit scrutiny revealed that depreciation on port basin, wharves and break water; capital dredging and railway sidings was being allowed @ 25 per cent treating them as plant & machinery as against the allowable rate of 10 per cent as applicable to buildings as detailed in the following paragraphs:

1.10.6.1 Whereas in the assessment port trusts at Mumbai and Kandla depreciation on wharves and related structures had been allowed at the rate of 10 per cent, depreciation at M/s. Ennore Port Ltd. had been allowed at the rate of 25 per cent. This resulted in excess allowance of depreciation of Rs. 110.23 crore involving a short levy of Rs. 40.11 crore (Appendix 5).

1.10.6.2 Whereas in the assessment port trusts at Mumbai, Kochi, Tuticorin and Marmugao depreciation on capital dredging had been allowed at the rate of 10 per cent, depreciation at Visakhapatnam, Kakinada, New Mangalore and Chennai had been allowed at the rate of 25 per cent. This resulted in excess allowance of depreciation of Rs. 78.98 crore involving a short levy of Rs. 26.28 crore (Appendix 5).

1.10.6.3 Whereas in the assessment port trusts at Paradip and Kandla depreciation on railway sidings had been allowed at the rate of 10 per cent, depreciation at Visakhapatnam, Kakinada, Mumbai and JNPT had been allowed at the rate of 25 per cent. This resulted in excess allowance of depreciation of Rs. 42.30 crore involving a short levy of Rs. 17.79 crore (Appendix 5).

In respect of Kakinada, the Department inviting a reference to various judgements, replied that railway sidings and capital dredging are to be treated as plant and allowed depreciation accordingly. Reply of the Department may be viewed in the light of different treatments accorded to ports located elsewhere as also judicial pronouncement pertaining to allowance of depreciation on similar assets.

1.10.6.4 The Ministry should reconcile these differences so as to ensure consistency in treatment of assets and charge depreciation accordingly.

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11 CIT v. Mazagaon Dock Ltd (1994) 206 ITR 260 (Bom.)
Compliance issues

1.10.7 Adoption of incorrect figures

In a scrutiny assessment, the income of the assessee shall be correctly computed after making the required adjustments as laid down in the Act.

In Maharashtra, CIT Thane charge, the assessment of M/s. Jawaharlal Nehru Port Trust for the assessment year 2005-06 was completed after scrutiny in December 2007 and rectified in March 2008. During the scrutiny assessment, capital loss of Rs. 23.21 crore was incorrectly treated as capital gains to arrive at the taxable income. The rectification order of March 2008 was passed to rectify this mistake. Audit scrutiny of the rectification order revealed that instead of reducing Rs. 23.21 crore, Rs. 46.41 crore was reduced. This resulted in underassessment of income of Rs. 23.21 crore involving a short levy of tax of Rs. 9.83 crore.

1.10.8 Other miscellaneous mistakes noticed in the assessments of port trusts in 10 cases involving tax effect of Rs. 13.27 crore are detailed in Appendix 6.

ISSUES RELATING TO NON-RESIDENTS

1.11 Maritime transport is a critical infrastructure for the social and economic development of a country. India’s maritime needs are predominantly being fulfilled by foreign ships, as has been discussed earlier. The share of foreign ships in total overseas trade is about 80-95 per cent. The overseas trade of India is a major source of revenue to foreign vessels.

India’s overseas trade of 497809 thousand tonnes is predominantly carried by foreign lines (95 per cent in exports and 83 per cent in imports). 12 Audit sought to examine the adequacy of rules and procedures for taxation of income accruing to non-residents engaged in maritime business on account of carriage of goods from Indian ports.

1.11.1 Provisions for taxation

1.11.1.1 Sections 90 and 91 deal with powers of the Central Government to enter into agreement with foreign countries for granting relief to doubly taxed income. Generally DTAAs provide that profits derived by an enterprise of a contracting state from the operation of ships in international traffic shall be taxable only in that state.

1.11.1.2 Section 172(1) deals with taxation of non-residents from occasional shipping business and provides for levy and recovery of tax in case of any ship, belonging to or chartered by non-resident, which carries passengers, livestock, mail or goods shipped from a port in India. Section 172(3) provides that the master of the ship shall furnish a return of the tax amount paid/payable on account of such carriage before departure from any port in India. The assessing officer may, however allow the ship to depart by issuing ‘no objection certificate’ (NOC), if the master of the ship makes satisfactory

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12 Annual Report of Ministry of Shipping 2006-07

Compiled for DTRTI, Chandigarh’s Workshop on Audit; 22nd and 23rd November 2010 at Delhi and Chandigarh
arrangement for filing of the return within 30 days of the departure of the ship and payment of tax. Under section 172(4), the assessing officer shall assess the income and determine the tax payable. Section 172(4A) introduced by Finance Act, 2007\(^\text{13}\) provides that no order under section 172(3) shall be passed after nine months. Returns pending assessment shall be processed before 31.12.2008. Section 172(7) provides an option to the assessee to get his income assessed under other provisions of Income Tax Act. In such a case, the annual return filed by the assessee shall be assessed under section 143(3).

1.11.1.3 The Board laid\(^\text{14}\) down that where it is not possible for the master of the ship to furnish the return before the departure of ship, arrangements could be made in the form of suitable bond or bank guarantee to safeguard the interest of revenue. It is further provided\(^\text{15}\) that the assessing officer may issue annual NOC where ships are owned by an enterprise belonging to a country with which India has entered into DTAA and the agreement provides for taxation of shipping profits only in that country of which the enterprise is resident and no tax is payable by them in India. The assessing officer is to ensure before issue of NOCs that all the requisite documents or evidence such as proof of residence, details of loading port and discharge port, freight payable as per charter agreement, have been submitted. The NOCs are being issued by designated jurisdictions of the Department.

1.11.1.4 Section 44B details the special provisions for computing profits and gains of shipping business in the case of non-resident assessees. In section 44B, the incidence of tax is on a non-resident engaged in the business of operation of ships owned or chartered by him for carriage of passengers, livestock, mails or goods shipped from a port in India. This provision covers non-resident assessees engaged in regular shipping business.

1.12 Taxation of maritime business of non-residents

Audit noticed inconsistencies in issue of NOCs, incorrect issue of NOCs and allowance of DTAA relief where there were no agreements and irregular exemption allowed under DTAA to Indian ships. In some cases, tax relief was allowed invoking provisions of inapplicable DTAA. Audit findings are brought out in the following paragraphs:

1.13 Co-ordination with other government authorities

Since port trusts are the nodal authorities for regulating the movement of ships, audit obtained data on foreign ships which have sailed out of ports and attempted to correlate it with the issuance of NOCs by the Department.

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\(^\text{13}\) w.e.f. 01.04.2007
\(^\text{14}\) vide instruction 838 dated 3 June 1975
\(^\text{15}\) vide circular 732 dated 20 December 1995
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1.13.1 Port trusts

In Visakhapatnam Port, relatable to ITO (International Taxation) Visakhapatnam charge, Kandla Port, relatable to CIT I Rajkot charge, Mumbai Port, relatable to DIT International Taxation, Mumbai charge, and Paradip port relatable to CIT Cuttack charge differences were noticed between number of foreign ships sailing out of port and number of NOCs issued as detailed below:

Table 1.5: Number of foreign ships sailing out of port and number of NOCs issued

<table>
<thead>
<tr>
<th>Assessment Year</th>
<th>As per per port trust</th>
<th>As per record of the Department</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Number of ships which have embarked on international voyage</td>
<td>Number of applications received for issue of NOC for international voyage</td>
</tr>
<tr>
<td></td>
<td>Visakhapatnam</td>
<td>Karidla</td>
</tr>
<tr>
<td>2003.04</td>
<td>1,142</td>
<td>1,610</td>
</tr>
<tr>
<td>2004-05</td>
<td>1,327</td>
<td>1,630</td>
</tr>
<tr>
<td>2005-06</td>
<td>1,519</td>
<td>1,843</td>
</tr>
<tr>
<td>2006-07</td>
<td>1,490</td>
<td>1,926</td>
</tr>
<tr>
<td>2007-08</td>
<td>727</td>
<td>NA</td>
</tr>
<tr>
<td></td>
<td>6,205</td>
<td>7,009</td>
</tr>
</tbody>
</table>

* Vessels set sail for international voyage as per information received from Mumbai Port Trust and Jawaharlal Nehru Port Trust.  
5 Data does not include NOCs issued by one charge viz. Range I DIT International Taxation Mumbai during 2004-05 and 2005-06.

The system of issuing NOC under section 172 and processing the return before a foreign ship left the Indian port on international voyage was conceived as a safeguard to ensure that the non-resident discharged his tax liability before leaving the Indian port. It appears that the Department has not made adequate attempts to coordinate with the port authorities to obtain data on foreign ships carrying cargo from Indian ports and reconcile the same with the port clearance certificates issued. Thus an effective tool for safeguarding the interests of revenue has been left untapped.

1.13.2 Customs Authorities

Returns filed under section 172 are to be carefully verified with the details filed by the assessee. Assessing officer has to call for the relevant documents and wherever necessary, ‘voyage accounts’ need to be summoned and examined to ensure that tax payable is correctly determined.

1.13.2.1 In Maharashtra, DIT International Taxation, Mumbai, four NOCs were issued for carriage of cargo totaling to 810 Teus.\(^{16}\) Audit scrutiny revealed that the actual cargo carried was 4,827 Teus, far exceeding the load declared in the NOCs. Similarly, in two other cases, NOCs were issued for carriage of 8200 Metric tonnes but the actual cargo carried was 18,155 Metric tonnes. Thus, goods carried and taxes paid as per NOCs were far less than what was actually carried.

1.13.2.2 In Andhra Pradesh, Visakhapatnam Port Trust relatable to ITO (International Taxation), Visakhapatnam charge, audit obtained details of ships that have set on international traffic during 2003-04 to 2006-07 and the quantity of goods carried by

\(^{16}\)Twenty equivalent units
them from the port of Visakhapatnam and correlated the same with data in the Income-tax Department. Audit scrutiny revealed that the quantity of goods actually carried was more than the quantity declared at the time of seeking NOCs and consequently, full freight charges was not brought to tax. Failure of the Department to implement a mechanism to cross verify and bring to tax full freight charges paid for exports resulted in loss of revenue of Rs. 15.01 lakh.

1.13.2.3 A correlation of records of Karwar Port relating to CIT Mangalore charge with the records of the Income-tax Department revealed that three ships carrying export cargo had neither applied for a NOC nor had filed returns of income under section 172 (3). However, these ships were given clearance from the port and had embarked on international voyage.

Table 1.6: Ships which had neither applied for NOC nor had filed returns

<table>
<thead>
<tr>
<th>Sl.No.</th>
<th>Name of vessel</th>
<th>Nationality</th>
<th>Date of sailing from the port</th>
<th>Nature of goods</th>
<th>Quantity in MTs</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>MT Uni Tank</td>
<td>Panama</td>
<td>05.03.2007</td>
<td>Molasses</td>
<td>10,223</td>
</tr>
<tr>
<td>2.</td>
<td>MV Chiat</td>
<td>Not indicated</td>
<td>19.04.2007</td>
<td>Iron ore</td>
<td>37,700</td>
</tr>
<tr>
<td>3.</td>
<td>MV Moriera</td>
<td>Croatia</td>
<td>01.02.2008</td>
<td>Iron ore</td>
<td>54,261</td>
</tr>
</tbody>
</table>

There is no DTAA either with Panama or with Croatia and hence the income from freight earnings would necessarily be taxable in India.

1.13.3 Lack of adequate follow up of action after issue of NOC and lack of coordination with the port trusts and customs authorities jeopardized the interest of revenue.

1.13.3.1 The Ministry may consider instituting a mechanism so that relevant data from the customs authorities and port authorities are periodically obtained and reconciled with the port clearance certificates issued by the Department.

1.13.3.2 While accepting the audit view during exit conference, the Ministry stated that the responsibility of ensuring payment of applicable taxes and verifying the port clearance certificate was with the Customs authorities [section 172 (6)]. The Ministry added that it will explore the possibility of establishing online mechanism for coordination with the Customs authorities.

1.14 Deficiencies in issue of NOCs

On receipt of an application from master of a ship or his agent, the assessing officer shall issue an NOC to the applicant after examining the necessary details. NOCs shall be issued after careful examination of nationality of freight recipient, DTAA applicable, proof of incorporation of the company, nature of business, port of discharge, residential proof, indemnity bond or bank guarantee to cover the tax on freight income, master bond by the master of the ship nominating an agent, etc. Audit examination revealed mistakes in issue of NOCs as given below:
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Table 1.7: Deficiencies in issue of NOCs

<table>
<thead>
<tr>
<th>Sl.No.</th>
<th>Charge and nature of mistakes</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>CIT Jamnagar Gujarat</td>
</tr>
<tr>
<td></td>
<td>• Of the 145 cases checked in audit, the date of issue was not indicated in 113 Master Bonds filed and were thus open ended and were to be treated as defective. No Master Bonds were available in 14 cases. Further, in respect of 18 cases, NOCs were issued prior to obtaining Master Bond.</td>
</tr>
<tr>
<td></td>
<td>• In seven cases NOCs were issued to M/s. Venkatesh Carriers Ltd., Jamnagar who acted as agent in India for USL Shipping FZE UAE, wherein a tax of Rs. 35.87 lakh was payable for which cheques were issued to the Department between November 2003 and October 2005. These cheques were, however, not remitted to bank for realization and all the cheques had become time barred (May 2007) resulting in loss of revenue of Rs. 35.87 lakh.</td>
</tr>
<tr>
<td></td>
<td>• The Department accepted the audit observation and stated that remedial action taken by raising a demand of Rs. 35.87 lakh.</td>
</tr>
<tr>
<td></td>
<td>• During the period 2003-04 to 2005-06, 87 NOCs had been issued to M/s Atlantic Shipping Pvt Ltd. (shipping agent) on behalf of various ships even though there was no challans or other proof (like indemnity bond) for payment of applicable taxes. The tax payable amounted to Rs. 50.29 lakh.</td>
</tr>
<tr>
<td>2.</td>
<td>CIT-I Rajkot Gujarat</td>
</tr>
<tr>
<td></td>
<td>• In 15 cases, Master’s Certificate/authority (i.e. Master Bond) was not available on record and of these final returns were not filed in 10 cases.</td>
</tr>
<tr>
<td></td>
<td>• In 21 cases, it was noticed that NOCs were issued after departure of the ship which defeated the very purpose of issue of NOCs.</td>
</tr>
<tr>
<td></td>
<td>• In 17 cases, during the financial year 2007-08, NOCs were issued allowing 100 per cent tax relief, based on NOCs issued earlier by the Joint Director (International Transaction), Mumbai during financial year 2006-07 without de novo verifying the applicability of the treaty benefits resulting in irregular exemption of DTAA involving a tax effect of Rs. 6.37 lakh.</td>
</tr>
<tr>
<td>3.</td>
<td>CIT Panaji Goa</td>
</tr>
<tr>
<td></td>
<td>• During the period 2003-04 to 2006-07, 2160 NOCs were issued to non-resident shipping companies through the Indian agents on the basis of indemnity bonds filed by the agent without verifying the requisite details such as residential proof of owner or charterer responsible for paying the tax, freight payable as per charter agreement, the agreement between owner and the agents. Thus, verification of the authenticity of appointment of the agents was not complete. Audit could not ensure as to how the assessing officer had verified the eligibility or otherwise for allowing DTAA relief.</td>
</tr>
</tbody>
</table>

1.14.1 NOCs were thus being issued even where the applicants had not provided the relevant information and without proper examination of the facts to the detriment of revenue.

1.14.1.1 The Ministry may like to prescribe an appropriate mechanism to ensure that all relevant documents and facts are verified before issue of NOCs.
1.14.1.2 During the exit conference, the Ministry stated that the existing mechanism provides for verification of relevant facts. However, in view of the audit observations, the Ministry agreed to ensure that the facts were checked properly before issue of NOCs.

### 1.15 Incorrect allowance of relief under DTAA

Relief under DTAA should be allowed based on the DTAA relevant to the nationality of the freight beneficiary. Freight beneficiary may be owner or charterer of the ship. The commercial arrangements in shipping trade are complex and charter parties operate in a chain. This makes it difficult to identify the nature and purpose of the arrangement and the relationship between the ship owner, charterer, sub-charterer and shipper. This complicates the issue as to which party in the chain is liable to tax especially under section 172.

1.15.1 Audit study revealed that in the following cases DTAA relief had been incorrectly allowed:

(Rs. in lakh)

**Table 1.8: Incorrect allowance of relief under DTAA**

<table>
<thead>
<tr>
<th>Sl.No.</th>
<th>Provision of treaties</th>
<th>Details of audit observations</th>
<th>Tax effect.</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Indo Switzerland DTAA</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>There is no separate clause for taxation of income arising from maritime business. However, under article 7 relating to 'business profits' it has been stated that 'business profits of an enterprise of a Contracting State other than the profits from the operation of ships in international traffic shall be taxable only in that State’. Thus income from operation of ships in international traffic would be subject to tax in the other State but only so much of the profit as is directly or indirectly attributable to that State. Hence, the profit arising from carriage of goods</td>
<td>ITO (International Taxation) 13.63Visakhapatnam, BHP Billiton Marketing Agency, Switzerland Tax relief of Rs. 13.63 lakh on a freight income of Rs. 27.63 lakh (being .5 per cent of freight payment of Rs. 368.40 lakh) was allowed which was irregular</td>
<td>13.63</td>
</tr>
<tr>
<td></td>
<td></td>
<td>CIT Rajkot 30 NOCs had been issued to freight beneficiaries belonging to Switzerland during the period 2005-06 to 2007-08 wherein tax relief of Rs. 219 lakh had been allowed, which was irregular.</td>
<td>219</td>
</tr>
<tr>
<td></td>
<td></td>
<td>CIT Kochi Mediterranean Shipping Company, Switzerland Tax relief of Rs. 2.48 lakh in respect of two NOC’s had been allowed.</td>
<td>2.84</td>
</tr>
</tbody>
</table>
from India would be liable to tax as provided under section 172 of the Act.

The Department stated that a new article no. 22 was inserted w.e.f. 20.12.2000 in the DTAA which provides that the tax on income of a resident of contracting state wherever arising, not dealt with in the foregoing article of this agreement shall be taxable only in that state. Reply is not tenable as Article 22(1) is of a general nature and taxation of shipping profits is already covered under Article 7 of the Indo Swiss DTAA.

2. **Indo south Korea DTAA**

   Article 9(2) of the DTAA read with Protocol of July 1985, profits derived from the operation of ships in international traffic may be taxed in the Contracting State in which such operation is carried on; but the tax so charged shall not exceed 90 percent of the tax otherwise imposed by the internal law of the State.

   Cit Jammangar,
   S.K. Shipping, Seoul

   Tax on freight income of Rs. 24.38 lakh works out to Rs. 10.20 lakh. DTAA relief of Rs. 5.10 lakh (@50 percent) was allowed and the NOC was issued after payment of remaining amount. Relief allowable under Indo-Korea (South) DTAA was only 10 percent as against 50 percent allowed.

   The Department accepted (April 2008) the audit observation.

3. **Indo Greece DTAA**

   Article 6(1) of the Indo Greece DTAA provides that when a resident of Greece operating ships derives profits from India through such profits may be taxed in Greece as well as in India. But the tax so charged in India shall be reduced by 50 percent thereof and the reduced amount of Indian tax payable shall be allowed as a credit against Greek tax charged. Article 6(4) provides that Article 6(1) shall not in the case of India affect the application of section 172(1) to 172(6) for the assessment of profits from occasional shipping i.e. the provisions of Article 6(1) shall apply only when an adjustment is made under section 172(7).

   CIT Kakinada

   15 NOCs has been issued during 2003-04 to 2007-08 wherein DTAA relief of 50 percent had been allowed even though in none of the cases, assessees’ had opted for regular assessment under section 172(7) either by exercising an option or filing a regular return of income. Thus as against a tax leviable of Rs. 115.85 lakh, only a tax of Rs. 46.64 had been levied resulting in excess relief of Rs. 69.21 lakh apart from interest of Rs. 13.46 lakh.

   CIT Mangalore

   In one case, NOC was issued without levying or collecting any tax.

4. **Indo Norway DTAA**

   Article 9 of Indo Norway DTAA provides that profits

   CIT Panaji, Goa

   Returns filed by M/s Salgaokar Mining Industries (P) Ltd. In the capacity of agent on behalf of entities

   16.93
<table>
<thead>
<tr>
<th>4.</th>
<th><strong>Profits of a Contracting State from the Operation of Shops in International Traffic</strong></th>
<th><strong>Audit Scrutiny</strong> revealed that the relief allowed under Indo-Norway DTAA was only 50 percent resulting in short levy of tax of Rs. 16.93 lakh.</th>
</tr>
</thead>
<tbody>
<tr>
<td>5.</td>
<td><strong>Entities from Bermuda</strong></td>
<td><strong>NOCs</strong> had been issued in seven cases on the basis of Indo-UK DTAA to M/s. Interoccean Shipping (I) Pvt. Ltd in respect of voyages by various ships. The freight beneficiary in these cases was M/s. Mansel Oil Limited of Hamilton, an enterprise based in Bermuda. As nationality of the freight beneficiary was Bermuda, Indo UK-DTAA would not be applicable. Hence, the NOCs granted without collection of tax of Rs. 73.32 lakh was irregular.</td>
</tr>
<tr>
<td>6.</td>
<td><strong>Entities from Liberia</strong></td>
<td><strong>Tax relief</strong> of Rs. 2.17 lakh was allowed in case of the ship MV EL Tango for the assessment year 2006-07 on the basis of Indo-Japan DTAA. Audit scrutiny revealed that the ship and the freight beneficiary belonged to Liberia, with which there is no DTAA and hence income would be taxable in India. Failure to invoke the DTAA based on nationality of the freight beneficiary who is located in Liberia resulted in incorrect allowance of relief of Rs. 2.17 lakh.</td>
</tr>
<tr>
<td>7.</td>
<td><strong>Indo France DTAA</strong></td>
<td><strong>Audit Scrutiny</strong> revealed that the relief allowed under Indo-France DTAA was only 50 percent resulting in short levy of tax of Rs. 8.54 lakh.</td>
</tr>
</tbody>
</table>

The Department agreed to examine the issue.

The Department accepted the audit observation.
Article 9 provides that profit derived by an enterprise of a contracting state from the operation of ships in international traffic shall be taxable only in that contracting state. Notwithstanding the above, such profits may be taxed on other state from which they are derived, provided that, tax so charged shall not exceed during the first five fiscal years after the entry into force of this convention, 50 per cent and during the subsequent five years 25 per cent of the tax otherwise imposed by the internal law of that state.

Article 30 of DTAA provides that this convention shall enter into force on the first day of the second month following the date of receipt of the letter of the notification and shall thereupon have effect in India in respect of income arising in any fiscal year beginning on or after the first day of April following the calendar year in which the convention enters into force. The DTAA was notified vide Notification No GSR 681(E) dated 07.09.1994 (calendar year 1994) and would be applicable to income arising on or after 01.04.1995 relevant to the financial year 1995-96.

M/s. South India Corporation (Agencies) Ltd. filed a return of income in the capacity of an agent on behalf of M/s. Setaf Saget Exploitation, belonging to France. The return related to freight income of Rs. 83.29 lakh earned during October 2004 and December 2004, was processed after allowing relief (@100 per cent) of Rs. 34.15 lakh by invoking the Indo France DTAA.

Audit scrutiny however revealed that 25 per cent of the applicable taxes would be payable as against ‘nil’ tax assessed by the Department. This omission resulted in non-levy of tax of Rs 8.54 lakh.
The Department replied that as the DTAA came into force from 01.08.1994, the freight earnings received in December 2004 was ten years after the date of agreement and hence the assessee was eligible for 100 per cent exemption. Therefore, the assessment dated 28 February 2005 was in order. The Department’s reply is not acceptable as Article 9 states that 100 per cent tax relief under DTAA agreement was available after 10 years after the entry into force of the convention. The date of reckoning is available in Article 30 which provides that ‘the notification shall have effect in India in respect of income arising in any fiscal year beginning on or after the first day of April following the calendar year in which the convention enters into force’. Thus, the period of 100 per cent exemption was available from 1 April 2005 onwards.

| 8. | India does not have DTAA with Panama, Bahamas, Liberia and Marshall Islands | **CIT Mangalore Karnataka**

DTAA relief of 100 per cent had been allowed in respect of 17 ships/voyages during the period from 2004-05 to 2007-08. The freight beneficiaries belonged to countries (Panama 7, Bahamas 3, Liberia 6 and Marshall Islands 1) with which India does not have a DTAA. Audit scrutiny revealed that 100 per cent tax relief had been allowed by the Department by invoking the nationality of the purchaser of goods as against the nationality of the freight beneficiary which was irregular.

|  |  | **259** |
1.15.1.1 Thus, port clearance certificates were being issued in a routine manner without actually examining the allowability or otherwise of DTAA relief. Given the complexity of the trade, NOCs are being obtained invoking the nationality of registry of the ship, or flag or shipper or charterer or sub charterer or owner where hundred per cent relief is available to shipping profits under DTAA.

1.15.1.2 The Ministry may like to review the situation so as ensure clarity and reduce complexity in application of DTAA.

1.15.1.3 While agreeing to the audit view, the Ministry during exit conference stated that the assessing officers concerned would be further sensitized on the clauses contained in DTAA relating to taxation of maritime business.

1.15.2 DTAA relief to entities of countries where shipping income is exempt

A study of the provisions relating to taxation of shipping profits in Cyprus, Singapore, Malaysia and United Arab Emirates (UAE) reveals that no tax is leviable on ships belonging to these countries which are engaged in international maritime traffic.

1.15.2.1 Article 8 of the Indo-UAE DTAA provides that profits derived by an enterprise of a contracting state from the operation of ships by that enterprise in international traffic shall be taxable only in that State. UAE does not have any enforced Income Tax Legislation for general business. An Income Tax Decree has been enacted by each Emirate, but in practice the enforcement of these decrees is restricted to foreign banks and oil companies only. Audit also observed from the certificates produced by the UAE freight beneficiaries that they were not liable to tax in the UAE. Thus, there is effectively no tax on shipping income derived from international maritime business of entities/ships of UAE.

Reference is invited to the ruling given by the Authority for Advance Rulings in the case of Cyril Eugene Pereira holding that ‘liability to pay tax both in India and the foreign country entities a taxpayer to claim relief under rules laid down in the DTAA. If the taxpayer pays tax or is liable to pay tax under the laws in force in one country alone, he cannot claim any relief from a non-existent burden of double taxation. DTAA is meant only for the benefit of taxpayers who are liable to pay tax twice on the same income’.

Applying this logic to the Indo-UAE DTAA implies that if shipping income is exempt in UAE, the assessee can not claim any deduction on that shipping income. However, the following was observed:

1.15.2.2 In Delhi, DIT IT charge, M/s. Emirates Shipping Lines, FZE, UAE had been issued an annual NOC by JDIT (OSD) International Taxation for the period 1.4.2006 to 31.03.2007 allowing 100 per cent relief. The assessee was required to submit an annual consolidated freight tax return under section 172. In view of the position detailed above, since no tax was payable in UAE, 100 per cent relief allowed to the assessee was irregular. This resulted in non-assessment of income of Rs. 16.88 crore (being 7.5 per cent of freight charges of Rs. 225.12 crore) involving short levy of tax of Rs. 7.13 crore.

In Andhra Pradesh in 21 cases relating to Kakinada Port, six cases relating to Visakahapatnam Port, in Kerala four cases relating to Kochi Port, in Karnataka five cases relating to Mangalore Port and in Gujarat two cases relating to Kandla port, Jamnagar charge freight beneficiaries of UAE were allowed tax relief of Rs. 1.94 crore, Rs. 20.23 lakh, Rs. 3.58 lakh, Rs. 18.33 lakh and Rs. 12.08 lakh respectively. The relief granted was
irregular as these entities would be taxable in India applying the ratio of the above ruling.

1.15.2.3 While the assessing officer at Kakinada jurisdiction replied that the audit observation would be examined, in Visakhapatnam the audit observation was not accepted on the ground that there is no pre-condition that, to enjoy relief under DTAA, the freight beneficiary should be taxable in the country of residence. In Jamnagar charge, the Department stated that the matter was referred to parties concerned for making the payment.

In Delhi, the Department stated that the Authority for Advance Rulings (AAR) was specific to the assessee and the applicability of the same cannot be extended to other assesseees. While inviting a reference to the Supreme Court judgment in the case of Azadi Bachao Andolan 19, it stated that there was no scope of denying the benefit of the tax treaty to a company which is incorporated in UAE. It added that if the contention of audit was accepted, it would lead to dishonouring international agreements which is against the spirit of Vienna Convention-Law of Treaties.

1.15.2.4 The reply is not acceptable in view of the following:

- The Supreme Court was dealing (in this case) with residency certificate, taxation of capital gains under Article 14 and treaty shopping especially in the context of Indo Mauritius DTAA and Board Circular No 789 wherein the Court has held the circular as valid.
- The issue in the current objection relates to taxation of shipping profits and nowhere has audit contested the residency or primacy of DTAA over the Act.
- The Supreme Court neither set aside the principles enunciated by the AAR in the Cyril Eugene Pereira’s case nor was it set aside when it took the view that though actual payment may not be necessary, it should be shown to be payable in other country.
- There is no corresponding law in UAE and exemption of shipping profits has not led to development of mutual economic relations, trade and investment as required in section 90(2). Discharge of fiscal obligations by non-residents on income earned in India cannot be treated as violation of the spirit of Vienna Convention Law of Treaties.

1.15.3 There is no consistency in the taxation of shipping profits arising to residents of countries where there is no tax on shipping income under the domestic law of those countries. Further, there is no analysis available on the impact of these exemptions on revenue in India.

1.15.3.1 The Ministry may like to conduct a study of the tax exemptions being extended to countries where income from shipping are exempted under domestic laws and the non-residents escape paying taxes both in India and abroad.
1.15.3.2 The Ministry, during the exit conference, stated that DTAAAs are intended not only to avoid double taxation but also for other economic interests of the country.

1.16 Non-assessment of freight charges paid on imports

Though there is specific mention of taxability of freight charges paid for goods shipped from a port in India (i.e. exports) and a mechanism for implementation of the same (viz., section 172), there is no specific mention regarding the taxation of income contained in the freight charges paid for goods brought to a port in India (i.e. imports). The Kolkata High Court in the case of Czechoslovak Ocean Shipping International Joint Stock Company and Another v. Income Tax Officer \(^{20}\) held that income earned on freight charges paid for import is liable to tax.

1.16.1 The quantum of goods imported through various major ports during 2002-03 to 2005-06 was 1,68,565, 1,81,618, 2,00,795 and 2,27,640 thousand metric tonnes. Audit sought to examine the revenue implication with reference to freight income earned by non-residents engaged in the maritime business of carrying goods into India. Since a substantial portion of imports in India comprises crude and petroleum products (more than 75 per cent) and steel/iron ore, audit examined the payment of tax or otherwise of the freight charges paid for import of crude and steel products by public sector companies which revealed the following:

(Rs. in crore)

Table 1.9: Deduction of tax at source from payments to non-residents for import

<table>
<thead>
<tr>
<th>Sl.No.</th>
<th>Particulars year</th>
<th>Financial paid</th>
<th>Freight of TDS</th>
<th>Amount</th>
<th>Remarks</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Bharat Petroleum Corporation Ltd. (BPCL)</td>
<td>2006-07</td>
<td>1.72</td>
<td>0.20</td>
<td>TDS effected @ 11.8 percent</td>
</tr>
<tr>
<td></td>
<td></td>
<td>2007-08</td>
<td>45.58</td>
<td>4.83</td>
<td>TDS effected ranged between 1.66 percent to 11.8 percent</td>
</tr>
<tr>
<td>2.</td>
<td>Managalore Refinery and Petrochemicals Ltd. (MRPL)</td>
<td>2005-06</td>
<td>76.38</td>
<td>Nil</td>
<td>Freight charges in nine cases paid to residents of Liberia with which India does not have DTAA.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>2006-07</td>
<td>62.37</td>
<td>Nil</td>
<td>Freight charges in five cases paid to residents of Liberia with which India does not have DTAA.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>2007-08</td>
<td>69.65</td>
<td>Nil</td>
<td>Freight charges in seven cases and two cases paid to residents of Liberia and Marshall islands with which India does not have DTAA.</td>
</tr>
<tr>
<td>3.</td>
<td>Oil &amp; Natural Gas Commission Ltd. (ONGC)</td>
<td>2005-06</td>
<td>34.98</td>
<td>1.16</td>
<td>TDS affected on charter hirer charges paid to contractors.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>2006-07</td>
<td>33.99</td>
<td>1.08</td>
<td>TDS affected on charter hirer charges paid to contractors.</td>
</tr>
<tr>
<td>4.</td>
<td>Hindustan Petroleum Corporation Ltd. (HPCL)</td>
<td>2006-07</td>
<td>12.78</td>
<td>Nil</td>
<td>Freight charges in one case have been paid to resident of Monaco with which India does not have DTAA.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>2007-08</td>
<td>46.88</td>
<td>Nil</td>
<td>Freight charges have been paid to residents of Liberia (45), Panama (6), Taiwan (5), Marshall Islands (1), Iran (4), Hong Kong (2), Kuwait (1), which</td>
</tr>
<tr>
<td>5.</td>
<td>Indian Oil Corporation Ltd. (IOCL)</td>
<td>2007-08</td>
<td>76.71</td>
<td>Nil</td>
<td>Freight charges have been paid to residents of Liberia (45), Panama (6), Taiwan (5), Marshall Islands (1), Iran (4), Hong Kong (2), Kuwait (1), which</td>
</tr>
</tbody>
</table>
India does not have DTAA. Payments were also made to residents of Greece (11) and Korea (8) where India has DTAA and shipping income would be taxable in India.

<table>
<thead>
<tr>
<th></th>
<th>Steel Authority of India Ltd. (SAIL)</th>
<th>2003-04</th>
<th>453.81</th>
<th>Nil</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>2004-05</td>
<td>743.73</td>
<td>Nil</td>
</tr>
<tr>
<td></td>
<td></td>
<td>2005-06</td>
<td>961.90</td>
<td>Nil</td>
</tr>
<tr>
<td></td>
<td></td>
<td>2006-07</td>
<td>973.40</td>
<td>Nil</td>
</tr>
<tr>
<td></td>
<td></td>
<td>2007-08</td>
<td>1,648.90</td>
<td>Nil</td>
</tr>
</tbody>
</table>

No tax has been deducted at source on freight charges.

1.16.2 Whereas two Public Sector Undertakings (PSUs) importing crude viz. BPCL and ONGC are deducting tax at source from payments to non-residents for import of crude, four PSUs viz. MRPL, HPCL, IOCL and SAIL are not deducting tax at source on import of crude/steel products.

1.16.3 Audit requisitioned data on imports managed/arranged by the Chartering Wing in the Department of Shipping, Ministry of Shipping, Road Transport & Highways for the period from 1.4.2005 to 31.3.2007. The imports managed/arranged for by the Chartering Wing comprises 10 per cent (approx.) of the total imports by India. Audit study of taxation of ships belonging to countries with which there was no DTAA or where shipping income was taxable in India revealed that freight payment of Rs. 2,271.76 crore have been made for imports as given below:

(Rs. in crore)

Table 1.10: Non-assessment of freight charges paid on imports

<table>
<thead>
<tr>
<th>S.No.</th>
<th>States</th>
<th>Imports in MT</th>
<th>Freight Payment</th>
<th>Loss of revenue</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Andhra Pradesh</td>
<td>5436,652</td>
<td>685.68</td>
<td>21.50</td>
</tr>
<tr>
<td>2.</td>
<td>Gujarat</td>
<td>29,98,000</td>
<td>366.95</td>
<td>11.00</td>
</tr>
<tr>
<td>3.</td>
<td>Karnataka</td>
<td>*</td>
<td>523.27</td>
<td>16.70</td>
</tr>
<tr>
<td>4.</td>
<td>Maharashtra</td>
<td>33,42,918</td>
<td>679.45</td>
<td>21.31</td>
</tr>
<tr>
<td>5.</td>
<td>Orissa</td>
<td>1,60,000</td>
<td>16.41</td>
<td>0.51</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>2,271.76</td>
<td>71.02</td>
<td></td>
</tr>
</tbody>
</table>

* Not quantifiable. The freight payments have been arrived at based on Import General Manifests furnished by the Customs Department at Karnataka.

1.16.4 Thus though provisions in the Act exist for taxation of both exports and imports, failure of the Department to implement a mechanism for taxation of income contained in freight charges paid for imports resulted in substantial loss of revenue.

1.16.5 While in Mangalore, Karnataka, the Department agreed to examine the audit point raised, in Kandla, Gujarat it stated that the taxability is determined on the basis of

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residency of actual freight beneficiary and added that unless the ultimate freight beneficiary and its country of residence is ascertained, it cannot be said with certainty that loss of revenue has taken place.
1.16.6 There is no mechanism in place to ensure that the freight earnings on imports received by the non-resident assessees involved in maritime business were assessed to tax by the Department.

1.16.6.1 *The Ministry may consider setting up a suitable mechanism for taxation of freight earnings from imports.*

1.16.6.2 The Ministry, during the exit conference, stated that freight payments accruing or arising out of India are subject to taxation as per the Income Tax Act. It added that the individual cases would be examined.

1.17 Status of assessment of returns filed under section 172

On receipt of a return the assessing officer shall assess the income and determine the tax payable thereon at applicable rates. Section 172(1) gives a right to the ITO to levy and recover tax in case of any ship belonging to a non-resident in a ‘summary manner’ (ad hoc assessment) not withstanding anything contained in other provisions of the Act.\(^{21}\) Since preliminary scrutiny of the taxability or otherwise of the freight income has already been carried out while issuing the NOC, the assessment scheme contemplated under section 172(3) is summary greed.\(^{22}\)

1.17.1 Audit examination revealed that jurisdictional offices at Goa, Gujarat, Karnataka and Tamil Nadu had processed the returns filed under section 172 and others had not processed the same as detailed below:

Table 1.11: Status of assessment of returns filed under section 172

<table>
<thead>
<tr>
<th></th>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Andhra Pradesh</td>
<td>648</td>
<td>Nil</td>
<td>814</td>
<td>Nil</td>
<td>953</td>
<td>Nil</td>
<td>887</td>
<td>Nil</td>
<td>3,302</td>
<td>3,302</td>
<td></td>
</tr>
<tr>
<td>2.</td>
<td>Karnataka</td>
<td>326</td>
<td>306</td>
<td>456</td>
<td>448</td>
<td>499</td>
<td>430</td>
<td>411</td>
<td>328</td>
<td>1,692</td>
<td>1,512</td>
<td>180</td>
</tr>
<tr>
<td>3.</td>
<td>Orissa</td>
<td>302</td>
<td>Nil</td>
<td>413</td>
<td>Nil</td>
<td>476</td>
<td>Nil</td>
<td>529</td>
<td>Nil</td>
<td>1,720</td>
<td>Nil</td>
<td>1,720</td>
</tr>
<tr>
<td>4.</td>
<td>West Bengal</td>
<td>3,526</td>
<td>Nil</td>
<td>5,457</td>
<td>Nil</td>
<td>7,089</td>
<td>Nil</td>
<td>8,640</td>
<td>Nil</td>
<td>24,712</td>
<td>Nil</td>
<td>24,12</td>
</tr>
<tr>
<td>5.</td>
<td>Maharashtra</td>
<td>NA</td>
<td>NA</td>
<td>1,08</td>
<td>Nil</td>
<td>1,566</td>
<td>Nil</td>
<td>2,314</td>
<td>Nil</td>
<td>4,888</td>
<td>Nil</td>
<td>4,888</td>
</tr>
<tr>
<td>6.</td>
<td>Gujarat</td>
<td>2,304</td>
<td>132</td>
<td>2,098</td>
<td>Nil</td>
<td>1,945</td>
<td>Nil</td>
<td>1,680</td>
<td>Nil</td>
<td>8,027</td>
<td>132</td>
<td>7,895</td>
</tr>
<tr>
<td>7.</td>
<td>Goa</td>
<td>458</td>
<td>458</td>
<td>469</td>
<td>44</td>
<td>364</td>
<td>26</td>
<td>873</td>
<td>639</td>
<td>2,164</td>
<td>1,567</td>
<td>597</td>
</tr>
<tr>
<td>8.</td>
<td>Tamilnadu*</td>
<td>7,852</td>
<td>7,852</td>
<td>6,264</td>
<td>6,264</td>
<td>8,384</td>
<td>8,384</td>
<td>11,758</td>
<td>11,758</td>
<td>34,258</td>
<td>34,258</td>
<td>Nil</td>
</tr>
</tbody>
</table>

*Please see paragraph on Default filling of returns

1.17.2 On the issue of non-processing of returns, the Department at Kerala, Maharashtra, Andhra Pradesh and Orissa has given varying replies such as no returns have been assessed; the units dealing with administration and implementation of


\(^{22}\) Union of India v. Gosalia Shipping Pvt Ltd [1978] 113 ITR 307 (SC)
Report No. PA 25 of 2009 (Performance Audit)

Section 172 were created in June 2003 and June 2004; no information is available in the Department regarding the number of non-resident assessee who defaulted to file return of income as required under section 172 and no internal audit was conducted in respect of NOCs issued and returns processed under section 172; there is no practice of processing returns under section 172 and that there was no time limit prescribed for processing of returns filed under section 172 prior to 2007.

1.17.3 The reply of the above offices needs to be viewed in the background of action taken and processing done by offices at Karnataka, Goa, Tamil Nadu and Gujarat where the returns filed under 172 have been processed. Section 172 clearly provides for assessment of returns filed and just because no time limits are specified does not mean that the returns are available for assessment indefinitely. The recourse to take shelter under the new section 172 (4A) and the reasoning that time is available till 31.12.2008 for all returns filed to date does not sustain, as it is improbable that all the returns filed from 1961 onwards would be assessed by 31.12.2008. Even if these are processed, possibility of recovery of tax demand, if any, is remote.

1.17.3.1 The Ministry may like to review the situation since the issue involves non-residents involved in maritime business who do not have a permanent establishment in India.

1.17.3.2 The Ministry, during the exit conference, agreed to ensure that all the returns are processed within the prescribed period.

Compliance issues

1.18 Default in filing of returns

In Tamil Nadu, DIT (IT) Chennai charge, 984 and 1118 port clearance certificates had been issued during the year 2005-06 and 2006-07 respectively. Pertaining to these PCCs, 16,046 and 14,476 returns were to be filed under section 172 (3). However, it was noticed that only 4,558 and 9,900 returns were received and assessed under section 172. In respect of the balance 11,488 and 4,576 returns for the financial years 2005-06 and 2006-07, respectively, neither the assessee filed the return as envisaged under section 172 (Board’s circular of December 1995) nor the Department initiated any action to obtain the same.

On this being pointed out (August 2006 and August 2007), the Department replied that in the absence of any laid down procedure, the Income Tax Office would call for such returns telephonically, if required after going through the port clearance register.

Similarly, the position in respect of Karnataka and Maharashtra is as follows:
Table 1.12: Default in filing of returns

<table>
<thead>
<tr>
<th>Sr.No.</th>
<th>Jurisdiction</th>
<th>Charge</th>
<th>Period</th>
<th>NOCs issued</th>
<th>Returns receivable</th>
<th>Returns not filed</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Karnataka</td>
<td>ITO, Ward 1, Karwar</td>
<td>2003-04 to 2006-07</td>
<td>682</td>
<td>682</td>
<td>157</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Total</td>
<td>682</td>
<td>791</td>
</tr>
</tbody>
</table>

*Note issued to principal charterers who are responsible for filing returns in respect of all the slot charterers

1.19 Non-filing of returns by non-residents in respect of ships engaged in coastal trade

Section 407 of the Merchant Shipping Act, 1958 provides that a foreign ship entering a port in India may carry goods to other ports in India after obtaining approval from DG Shipping, Mumbai. The profits earned from the operation of ships in coastal traffic between ports in India are taxable in India.

Audit sought to examine the procedures for coordination with DG Shipping, Mumbai for obtaining data on foreign ships engaged in coastal shipping so as to ensure that necessary returns were being filed and incomes assessed to tax. Audit study revealed inadequacies as detailed in the following paragraphs:

1.19.1 DTAAs with Japan, UAE and Singapore provide that profits derived from the operation of ships in international traffic carried on by an enterprise of a Contracting State shall be taxable only in that State. However, profits arising to non-residents out of carriage of goods within places situated in a contracting state shall be taxed in the contracting state in which income was derived. Board reiterated the above position.

In Andhra Pradesh ITO (International Taxation), Visakhapatnam charge and Gujarat DIT International Taxation, Gandhidham charge audit scrutiny revealed that DTAA relief was incorrectly granted though voyages were between ports within India resulting in under-assessment of income of Rs. 1.05 crore with a tax effect of Rs. 48.50 lakh.

1.19.2 A test check of records of the New Mangalore Port Trust and the Department revealed that ships with foreign flags had operated in coastal trade. It was noticed that in 44 instances, between 2006 and 2008, ships with foreign flags had not filed returns under section 172 declaring their earnings on such voyages nor had they arranged for the same through their agents. The Department of Customs had also not insisted upon furnishing NOC from the Income-tax Department in terms of section 172(6) at the time of allowing these ships to set sail. In the absence of details of freight paid or payable to the ship owners/charterers, escapement of income and tax chargeable thereon could not be quantified.

The Department agreed to examine the audit observation.


Compiled for DTRTI, Chandigarh’s Workshop on Audit; 22nd and 23rd November 2010 at Delhi and Chandigarh
1.19.3 DTAA relief of hundred per cent was being allowed to foreign ships involved in coastal shipping in contravention of the DTAAAs. The coordination mechanism for taxation of coastal shipping of non-residents was inadequate.

1.19.3.1 The Ministry may like to institute a mechanism for ensuring coordination with Director General, Shipping so that income derived by non-residents from coastal shipping is brought to tax.

1.19.3.2 The Ministry, during the exit conference, agreed with the audit recommendation.

Compliance issues

1.20 Incorrect adoption of tax rates

According to Circular No. 732 dated 20.12.1995 issued by CBDT, the income earned by ships belonging to non-residents engaged in international traffic shall be entitled to relief under DTAA provisions and in case they are engaged in coastal traffic the income earned thereon shall be taxable in India.

1.20.1 In Tamil Nadu, DIT International Taxation Chennai charge, royalty payments (charter hire payments) made by M/s. Poompuhar Shipping Corporation Ltd. and M/s. SICAL Logistics Ltd. to non-residents during the assessment years 2003-04 and 2004-05 were assessed to tax after treating the assessee in representative capacity.

1.20.2 Audit scrutiny revealed that the royalty payments made to non-residents were assessed to tax at lower rates of 10/15 per cent. As these ships were utilised only for coastal traffic i.e. for carriage of goods between ports in India and not in international traffic, the income arising to non-residents would be taxable under normal provisions of the Income Tax Act. Thus, the tax leviable would be @ 20 per cent as specified in section 115A. Omission to invoke 115A resulted in short levy of Rs. 14.36 crore.

Miscellaneous issues

1.21 Incorrect deduction for payments made outside India without TDS

Section 195 provides that any person responsible for paying to a non-resident any sum chargeable under the Act, shall deduct tax at source at the time crediting the payment. Section 9(vii) provides that income by way of fees for technical services payable to a non-resident is deemed to accrue or arise in India. Section 40(a) (i) provides that any interest, royalty, fee for technical services or other sum payable outside India or to a non-resident shall not be allowed as deduction in computing the business income, if tax is not deducted at source or after deducting it is not paid to Government account.

In the case of West Asia Maritime Ltd. v. Income Tax Officer, the ITAT held that hire charges paid by Indian charterers for hiring ships

25[2008] 297 ITR (AT) 202 (Chennai)
on Bare-Boat Charter-cum-Demise (BBCD) basis to a non-resident are taxable in India as ‘royalty’ and hence liable for TDS. Further, in the case of *Poompuhar Shipping Corporation Ltd. v. Income Tax Officer, International Taxation II* 26 (relating to the assessment year 2003-04), the ITAT held that payment on account of time charter agreement on ‘ship’ constituted ‘payment for equipment’ and is to be treated as ‘royalty’ and hence liable for TDS.

1.21.1. In Tamil Nadu, CIT III Chennai charge, the assessments of a company **M/s. Poompuhar Shipping Corporation Ltd.,** for the assessment year 2004-05 and 2005-06 were completed after scrutiny/summary in March 2006 and December 2007 respectively. Audit scrutiny revealed that the assessee had not deducted tax at source on foreign remittances towards charter hire charges of Rs. 48.42 crore and Rs. 108.10 crore paid during the assessment years 2004-05 and 2005-06 respectively. The omission resulted in underassessment of the said amounts with consequent short levy of tax of Rs. 19.46 crore and Rs. 53.42 crore respectively.

1.21.2 In Tamil Nadu, CIT I Chennai charge, the assessments of a company, **M/s. West Asia Maritime Ltd.,** for the assessment year 2003-04 and 2004-05 were completed after scrutiny in February 2006 (later revised in December 2006) and December 2006 respectively. Audit scrutiny revealed that the assessee had not deducted tax at source on foreign remittances towards charter hire charges of Rs. 20.65 crore and Rs. 62.80 crore paid during the assessment years 2003-04 and 2004-05 respectively. The omission resulted in underassessment of the said amounts with consequent short levy of tax of Rs. 10.34 crore and Rs. 29.96 crore respectively.

1.21.3 In Maharashtra, Mumbai City 5 charge, the assessment of a company, **M/s. Shipping Corporation of India Ltd.,** for the assessment year 2004-05 was completed after scrutiny in December 2006. Audit scrutiny revealed that the assessee had not deducted tax at source of Rs. 23.78 crore on foreign remittance of Rs. 92.81 crore towards bare-boat hire charges and, therefore, the foreign remittance of Rs. 92.81 crore should have been disallowed. Omission to do so resulted in underassessment of Rs. 92.81 crore involving a short levy of tax of Rs. 33.30 crore.

Further, it was seen that in the case of the same assessee, the Income Tax Officer (IT) (TDS), Range 2, Mumbai in an order passed in August 2007 under section 201(1)/201(1A) had confirmed the demand of TDS.

1.21.4 Five similar cases relating to Kerala, Maharashtra and Tamil Nadu charge where foreign remittances had been made towards hire charges for BBCD without deduction of tax at source involving a short levy of Rs. 46.40 crore are given in Appendix 7.

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26 [2008] 297 ITR 219 (Chennai)
1.22 Conclusions and Summary of Recommendations

1.22.1 The reserves created under section 32A (withdrawn from 1.4.1990) are still unutilised and no action has been taken on the same. There appears to be no monitoring mechanism for reserves created under section 33AC. Further, the safeguards for mis-utilisation/non-utilisation of reserve created under section 33AC are inadequate. Since the TTS also has provisions for creation and utilisation of ‘reserves’, it is necessary that a monitoring mechanism be put in place.

1.22.1.1 During the exit conference, the Ministry stated that the new system of ‘internal audit’ and the ‘review and inspection’ by Commissioners of Income Tax would address the monitoring issues raised by audit.

1.22.1.2 The Ministry may like to ensure that the creation and utilisation of reserves is adequately monitored so that the intended purpose is not lost.

1.22.2 The growth in Indian shipping tonnage subsequent to the introduction of the TTS has not kept pace with either the requirements of the Indian overseas shipping or the growth in maritime trade of India. The Ministry, during exit conference, stated that TTS is an internationally accepted best practice for taxing income from shipping. Apart from taxation the performance of the shipping industry is dependent on a host of other factors both domestic and international. The performance of shipping industry in this overall scenario cannot be a reason for modification in the taxation law.

1.22.2.1 The Ministry may review the tonnage tax scheme.

1.22.3 Consequent to amendment to section 10(20), the port trusts became taxable from the assessment year 2003-04. Audit study of the assessments of the port trusts revealed that there was no uniformity in the status accorded to port trusts in the income tax assessments as also the levy of tax. Whereas four port trusts had been accorded the status of ‘charitable trusts’ after repeated appeals, the application of two others are pending approval. Further, there have been moves to corporatise the port trusts. Not only is the contribution of port trusts to the exchequer in the form of income tax is meager, the tax demands raised are locked up in disputes.

1.22.3.1 While accepting the views of audit that ‘ports trusts’ were being assessed differently, the Ministry, during the exit conference, stated that section 2 of the Act has been amended through Finance Act 2008 effective 01.04.2009, by which the term charitable purpose has been redefined to exclude activities in the nature of trade or business carried out for a fee or cess or any other consideration.

1.22.4 Lack of adequate follow up of action after issue of NOC and lack of coordination with the other government authorities viz., port trusts and customs authorities jeopardized the interest of revenue.
1.22.4.1 The Ministry may consider instituting a mechanism so that relevant data from the customs authorities and port authorities are periodically obtained and reconciled with the port clearance certificates issued by the Department.

1.22.4.2 While accepting the audit view during the exit conference, the Ministry stated that the responsibility of ensuring payment of applicable taxes and verifying the port clearance certificate was with the Customs authorities [section 172 (6)]. The Ministry added that it will explore the possibility of establishing online mechanism for coordination with the Customs authorities.

1.22.5 NOCs were being issued even where the applicants had not provided the relevant information and without proper examination of the facts to the detriment of revenue.

1.22.5.1 The Ministry may like to prescribe an appropriate mechanism to ensure that all relevant documents and facts are verified before issue of NOCs.

1.22.5.2 During the exit conference, the Ministry stated that the existing mechanism provides for verification of relevant facts. However, in view of the audit observations, the Ministry agreed to ensure that the facts were checked properly before issue of NOCs.

1.22.6 Port clearance certificates were being issued in a routine manner without actually examining the allowability or otherwise of DTAA relief. Given the complexity of the trade, NOCs are being obtained invoking the nationality of registry of the ship, or flag or shipper or charterer or sub charterer or owner where hundred per cent relief is available to shipping profits under DTAA.

1.22.6.1 The Ministry may like to review the situation so as ensure clarity and reduce complexity in application of DTAA.

1.22.6.2 While agreeing to the audit view, the Ministry, during the exit conference, stated that the assessing officers concerned would be further sensitized on the clauses contained in DTAAs relating to taxation of maritime business.

1.22.7 There is no consistency in the taxation of shipping profits arising to residents of countries where there is no tax on shipping income under the domestic law of those countries. Further, there is no analysis available on the impact of these exemptions on revenue in India.

1.22.7.1 The Ministry may like to conduct a study of the tax exemptions being extended to countries where income from shipping are exempted under domestic laws and the non-residents escape paying taxes both in India and abroad.

1.22.7.2 The Ministry, during the exit conference, stated that DTAAs are intended not only to avoid double taxation but also for other economic interests of the country.
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1.22.8 The Ministry, during the exit conference, stated that freight payments accruing or arising out of India are subject to taxation as per the Income Tax Act. It added that the individual cases would be examined.

1.22.8.1 The Ministry may consider setting up a suitable mechanism for taxation of freight earnings from imports.

1.22.8.2 The Ministry, during the exit conference, stated that freight payments accruing or arising out of India are subject to taxation as per the Income Tax Act. It added that the individual cases would be examined.

1.22.9 It is improbable that all the returns, filed under section 172, from 1961 onwards would be assessed by 31.12.2008. Even if these are processed, possibility of recovery of tax demand, if any, is remote.

1.22.9.1 The Ministry may like to review the situation since the issue relates to non-residents involved in maritime business who do not have a permanent establishment in India.

1.22.9.2 The Ministry, during the exit conference, agreed to ensure that all the returns are processed within the prescribed period.

1.22.10 DTAA relief of hundred per cent was being allowed to foreign ships involved in coastal shipping in contravention of the DTAA. The coordination mechanism for taxation of coastal shipping of non-residents was inadequate.

1.22.10.1 The Ministry may like to institute a mechanism for ensuring coordination with Director General, Shipping so that income derived by non-residents from coastal shipping is brought to tax.

1.22.10.2 The Ministry, during the exit conference, agreed with the audit recommendation.
Chapter II

Review on Deductions of profit and gain from certain undertakings other than infrastructure development undertakings (Deduction under section 80IB of the Income Tax Act, 1961)

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**Highlights**

The assessment records in respect of undertakings availing the benefit of deduction under section 80IB were examined in order to seek assurance that systems and procedures are sufficient and in place to ensure compliance with the provisions of the Act/ Rules, evaluate the degree of compliance by the specified undertakings with the provisions of the Act, quantify the loss of revenue or underassessment and other irregularities due to mistakes in assessment, highlight lacunae or deficiencies, if any, in the administration, law or policy relating to this section.

*(Paragraph 2.2)*

Audit of the selected 4,372 cases during the period of review revealed 1,105 cases of irregularities involving a revenue impact of Rs. 1,510.18 crore.

*(Paragraph 2.6)*

Audit noticed that in the case of M/s. Hindustan Petroleum Corporation Limited, a deduction of Rs. 1,591.51 crore was allowed to VREP II unit even though this unit was not a new industrial undertaking. Thus, the deduction allowed was irregular resulting in short levy of tax of Rs. 575.48 crore.

*(Paragraph 2.7.1.2)*

The inconsistent stand of the Department in the cases of Indian Oil Corporation Limited (IOCL) and Hindustan Petroleum Corporation Limited (HPCL), in allowing deductions in respect of marketing margin has put the revenue of Rs. 535.14 crore from IOCL at risk besides potential revenue losses which the Department could bear in subsequent years not only in these two refineries, but also in respect of other refineries in the country.

*(Paragraph 2.7.2.12)*

Audit observed 87 cases where the deduction under section 80IB was allowed even though activities carried out by the industrial undertakings were not manufacturing activities or were from the items listed in Eleventh Schedule of the Act. This resulted in underassessment of income having revenue impact of Rs. 22.94 crore.

*(Paragraph 2.8.2.2)*

Audit observed 125 cases where the deduction under section 80IB was allowed even though manufacture, production activities were not commenced within the specified time limits as laid down in the Act. This resulted in underassessment of income having revenue impact of Rs. 34.51 crore.

*(Paragraph 2.8.3.2)*

Audit observed 251 cases where the deduction under section 80IB was allowed even though income was not derived from eligible business. This resulted in underassessment of income having revenue impact of Rs. 47.72 crore.

*(Paragraph 2.8.5.2)*
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In housing projects, audit observed that in 99 cases, deduction under section 80IB was allowed even though assesses were not eligible to claim deduction due to various reasons. This resulted in underassessment of income having revenue impact of Rs. 55.43 crore.

(Paragraph 2.9.2)

Audit observed 23 cases where there were mistakes in adoption of correct rates of deduction under section 80IB of the Act. This resulted in underassessment of income having revenue impact of Rs. 104.71 crore.

(Paragraph 2.13.2)

Audit recommends that:

- The Ministry may ensure that the status of an industrial undertaking is ascertained before deduction is allowed.

- The Ministry may reconcile the different stands taken by the Department in respect of deduction on marketing margin in the case of IOCL and HPCL, and escalate the level of appeal to the highest level.

- The Ministry may ensure that judicial pronouncements in respect of manufacturing activities are applied to all similarly placed cases.

- The Ministry may consider issuing instructions so that assessing officers are vigilant in determining the eligibility of the assessee and the time period for applicability of deduction under section 80IB.

- The Ministry may evolve a suitable control mechanism to ensure the conditions as laid down for availing deduction in respect of Housing sector are complied with before allowing deduction in this regard.

- The Ministry may strengthen its control mechanism to ensure the compliance of various provisions and requirements of the Act before allowing deductions under section 80IB of the Act.
Review on Deductions of profit and gain from certain undertakings other than infrastructure development undertakings (Deduction under section 80IB of the Income Tax Act, 1961)

2.1 Introduction

2.1.1 The Income tax Act, 1961 (the Act) has been amended (through successive Finance Acts over the years) mainly to introduce welfare measures, modify or introduce measures to accelerate economic development, provide for certain incentives to selected sectors of the economy and stimulate investment for industrial growth. The Act therefore allows several kinds of exemptions, allowances, deductions, rebates/relief and concessions to tax payers in pursuance of the above objectives. The deductions are those specifically provided under chapter VIA of the Act and applied after arriving at the gross total income, at the rates prescribed under the relevant sections, subject to fulfillment of the conditions prescribed therein. These can be allowed only if there is positive income after setting off losses, if any.

2.1.2 With effect from 1 April 1991, the existing section 80I was modified, and a new section 80IA was inserted which was made applicable to the new industrial undertakings commencing manufacture, production, operation of ship, hotel and cold storage during the period from 1 April 1991 to 31 March 1995. From 1 April 2000, the deduction under section 80IA was restricted to units engaged in infrastructure development, and a separate section 80IB was introduced to enable the assessees engaged in the business other than infrastructure development to claim deduction.

2.2 Objective of the review

The assessment records in respect of undertakings availing the benefit of deduction under section 80IB were examined in order to:

- seek assurance that systems and procedures are sufficient and in place to ensure compliance with the provisions of the Act/Rules.
- evaluate the degree of compliance by the specified undertakings with the provisions of the Act.
- quantify the loss of revenue or underassessment and other irregularities due to mistakes in assessment.
- highlight lacunae or deficiencies, if any, in the administration, law or policy relating to this section.

2.3 Law and procedure

Deductions in respect of profits and gains from certain industrial undertakings other than infrastructure development undertakings [Section 80IB]
2.3.1 The undertakings/sectors, to which the provisions of section 80IB are applicable, are as follows:

i. Industrial undertaking [80IB(3)]
ii. Industrial undertaking in an industrially backward state [80IB(4)]
iii. Industrial undertaking located in notified industrially backward districts 80IB(5)
iv. Owning and operation of ship by an Indian company [80IB(6)]
v. Hotel industry [80IB(7)]
vi. Multiplex theatre [80IB(7A)]

vii. Convention centre [80IB(7B)]

viii. Company carrying on scientific research and development [80IB(8)]
ix. Production or refining of mineral oil [80IB(9)]
x. Developing and building housing projects [80IB(10)]

xi. Setting up and operating cold chains facility for agriculture produce [80IB(11)]

xii. Handling, storage and transportation of food grains and processing, preservation and packaging of fruits and vegetables [80IB(11A)]

xiii. Operating and maintaining hospital in rural area [80IB(11B)]

2.3.2 A few important provisions of the Act in respect of the sectors, which have been highlighted during the course of audit, are discussed below:

2.3.3 Industrial undertaking

To claim benefit of deduction under section 80IB(3), 80IB(4), 80IB(5), an industrial undertaking must satisfy the following basic conditions:

Table no. 1: Conditions to claim benefit of deduction under section 80IB(3), 80IB(4) and 80IB(5)

<table>
<thead>
<tr>
<th>Condition</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Condition 1</td>
<td>It should be a new undertaking.</td>
</tr>
<tr>
<td>Condition 2</td>
<td>It should not be formed by transfer of old plant and machinery.</td>
</tr>
<tr>
<td>Condition 3</td>
<td>It should manufacture or produce articles other than items specified in the Eleventh Schedule.</td>
</tr>
<tr>
<td>Condition 4</td>
<td>Manufacture or production should be started within a stipulated time limit.</td>
</tr>
<tr>
<td>Condition 5</td>
<td>It should employ minimum number of employees as specified under various provisions of the Act.</td>
</tr>
<tr>
<td>Condition 6</td>
<td>Accounts of the undertaking have been audited by an accountant, and the audit report duly signed and verified by such accountant is furnished along with the return of income (Form no. 10CCB).</td>
</tr>
</tbody>
</table>

2.3.3.1 Amount of deduction

Rates of deduction and other conditions as laid down in the Act to claim the deduction are given in the Appendix 8.
2.3.4 Mineral oils

To claim benefit of deduction under section 80IB(9), an industrial undertaking must satisfy the following basic conditions:

1. It should be a new undertaking.
2. It should not be formed by transfer of machinery or plant previously used for any purpose.
3. It should employ minimum number of employees as specified under various provisions of the Act.
4. Accounts of the undertaking have been audited by an accountant, and the audit report duly signed and verified by such accountant is furnished along with the return of income (Form no. 10CCB).
5. It should commence commercial production as follows:

<table>
<thead>
<tr>
<th>Undertaking located in North-Eastern Region</th>
<th>Commencing production of mineral oil Before April 1, 1997</th>
<th>Refining of mineral oil -</th>
</tr>
</thead>
<tbody>
<tr>
<td>Undertaking located anywhere in India</td>
<td>After March 31, 1997</td>
<td>After September 30, 1998</td>
</tr>
</tbody>
</table>

2.3.4.1 Amount of deduction

The amount of deduction to an undertaking which begins commercial production or refining of mineral oil shall be hundred per cent of the profits for a period of seven consecutive assessment years including the initial assessment year.

2.3.5 Developing and building housing projects

An undertaking engaged in development and building housing projects shall be eligible to claim deduction under section 80IB(10) subject to the following:

<table>
<thead>
<tr>
<th>Condition</th>
<th>Condition to claim benefit of deduction under section 80IB(10)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Condition 1</td>
<td>The project should be approved by a local authority before March 31, 2007</td>
</tr>
<tr>
<td>Condition 2</td>
<td>The size of the plot of land should be minimum of one acre.</td>
</tr>
<tr>
<td>Condition 3</td>
<td>The undertaking commences development and construction of the housing project after September 30, 1998 and it should complete construction within 4 years from the end of financial year in which the housing project</td>
</tr>
<tr>
<td>Condition 4</td>
<td>The built-up area of the shops and other commercial establishments included in the housing project shall not exceed 5 per cent of the aggregate built-up area of the housing project or 2000 sq. ft., whichever is less</td>
</tr>
<tr>
<td>Condition 5</td>
<td>The built up area of each residential unit should be subject to the limit of 1000/1500 sq. ft.</td>
</tr>
<tr>
<td>Condition 6</td>
<td>Accounts of the undertaking have been audited by an accountant, and the audit report duly signed and verified by such accountant is furnished along with the return of income (Form no. 10CCB).</td>
</tr>
</tbody>
</table>
2.3.5.1 Amount of deduction

The amount of deduction in the case of an undertaking developing and building housing projects shall be hundred per cent of the profits derived in the previous year relevant to any assessment year from such housing project.

2.4 Scope and audit methodology of the review

2.4.1 Assessment records of both corporate and non corporate assesses along with the supporting audit reports/certificates as required under section 80IB and other sections of the Act were selected for examination. The review was conducted on both summary and scrutiny assessments completed during the financial years from 2004-05 to 2007-08 and till the date of audit. A total of 4,372 cases were examined during the period of review. The basis of selection of cases for audit is given in Appendix 9. The review covered all assessments whether completed after scrutiny or processed in summary manner in respect of industrial undertakings (corporate as well as non-corporate assessees) availing deduction under section 80IB.

2.4.2 Copies of the draft review reports containing audit observations were issued to the respective Chief Commissioners of Income Tax/Commissioners of Income Tax by the Director General/Pr. Directors of Audit/Pr. Accountants General/Accountants General during the period from June 2008 to August 2008.

2.5 Acknowledgement

Indian Audit and Accounts Department acknowledges the cooperation of the Income tax Department in providing the necessary records and information for audit. The draft review was issued to the Ministry in October 2008. An exit conference was held in December 2008 with the Central Board of Direct Taxes (Board) to discuss the results of this review.

The views expressed by them in the exit conference have been appropriately incorporated in this report. The Board accepted the audit recommendations and agreed to address the issues brought out in the review report. The Board stated that case specific replies would follow.

2.6 Audit findings

2.6.1 Audit of the selected 4,372 cases during the period of review revealed 1,105 cases of irregularities involving tax effect Rs. 1,510.18 crore including potential tax effect of Rs. 536.98 crore in the states of Andhra Pradesh, Assam, Bihar, Chandigarh (UT), Chhattisgarh, Delhi, Goa, Gujarat, Haryana, Himachal Pradesh, Jammu & Kashmir, Jharkhand, Karnataka, Kerala, Madhya Pradesh, Maharashtra, Orissa, Punjab, Rajasthan, Tamil Nadu, Uttar Pradesh and West Bengal.

2.6.2 Audit observations with money value of Rs. one crore and above have been discussed either in the paragraphs of this report or highlighted in the appendices. Those below Rs. one crore have not been highlighted individually although their revenue impact has been included in the report.

*Report No. PA 25 of 2009 (Performance Audit)*

2.6.3 Status of deductions in Industrial Undertakings and Housing Sector
2.6.3.1 Audit study revealed that the number of irregularities in Industrial undertakings (section 80IB[3]) and Housing sector (section 80IB[10]) is more than other sectors under section 80IB. Therefore, audit analysed the figures of the total deduction under section 80IB claimed by the assessee, allowed by the Department and deductions as worked out by audit for the assessment years 2003-04, 2004-05, 2005-06 and 2006-07 in these two sectors which are given in Table below.

<table>
<thead>
<tr>
<th>Sector/Section</th>
<th>A.Y.</th>
<th>No. of cases reviewed by audit</th>
<th>Total deduction claimed by the assesses (Rs. In lakh)</th>
<th>Total deduction allowed by the Deptt. (Rs. In lakh)</th>
<th>Total deduction as worked out by audit (Rs. In lakh)</th>
<th>Addition by the Deptt. (Col.4-col. 5) (Rs. In lakh)</th>
<th>Potential addition as per audit (col.4 col. 6) (Rs. In lakh)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Industrial Undertaking /80IB(3)</td>
<td>2003-04</td>
<td>355</td>
<td>42,516.72</td>
<td>29,250.4</td>
<td>17,574.26</td>
<td>13,266.32</td>
<td>24,924.46</td>
</tr>
<tr>
<td></td>
<td>2004-05</td>
<td>457</td>
<td>30,113.58</td>
<td>24,013.79</td>
<td>18,003.06</td>
<td>6,099.79</td>
<td>12,110.52</td>
</tr>
<tr>
<td></td>
<td>2005-06</td>
<td>362</td>
<td>13,466.18</td>
<td>10,676.39</td>
<td>7,018.24</td>
<td>2,789.79</td>
<td>6,447.94</td>
</tr>
<tr>
<td></td>
<td>2006-07</td>
<td>115</td>
<td>4,745.26</td>
<td>4,628.28</td>
<td>3,823.21</td>
<td>116.98</td>
<td>922.05</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>1,289</strong></td>
<td><strong>90,841.74</strong></td>
<td><strong>68,568.86</strong></td>
<td><strong>46,418.77</strong></td>
<td><strong>22,272.88</strong></td>
<td><strong>44,422.97</strong></td>
<td></td>
</tr>
<tr>
<td>Housing Sector/80IB(10)</td>
<td>2003-04</td>
<td>44</td>
<td>8,117.73</td>
<td>6,826.41</td>
<td>3,575.91</td>
<td>1,291.32</td>
<td>4,541.82</td>
</tr>
<tr>
<td></td>
<td>2004-05</td>
<td>95</td>
<td>19,179.45</td>
<td>16,765.66</td>
<td>7,929.06</td>
<td>2,413.79</td>
<td>11,250.39</td>
</tr>
<tr>
<td></td>
<td>2005-06</td>
<td>128</td>
<td>21,639.47</td>
<td>16,047.86</td>
<td>7,736.14</td>
<td>5,591.61</td>
<td>13,903.33</td>
</tr>
<tr>
<td></td>
<td>2006-07</td>
<td>67</td>
<td>12,501.69</td>
<td>11,500.32</td>
<td>10,245.62</td>
<td>1,001.37</td>
<td>2,256.07</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>334</strong></td>
<td><strong>61,438.34</strong></td>
<td><strong>51,140.25</strong></td>
<td><strong>29,486.73</strong></td>
<td><strong>10,298.09</strong></td>
<td><strong>31,951.61</strong></td>
<td></td>
</tr>
</tbody>
</table>

Graph. 1: Status of deduction in Industrial Undertakings Sector

Graph. 2: Status of deduction in Housing Sector
2.6.3.2 Thus, it will be observed from the status of deductions claimed by the assessee, allowed by the Department and worked out by audit, that there is potential for further realisation of revenue.

2.6.4 Status of deductions in Refinery Sector

Audit examination of assessment records in respect of three oil companies namely Hindustan Petroleum Corporation Limited (HPCL) and Indian Oil Corporation Limited (IOCL) and Kochi Refineries Limited having oil refineries namely Visakh refinery, Panipat refinery, Gujarat refinery and Kochi refinery threw up issues having wide ramification. Deduction was being allowed to Visakh refinery (HPCL) even though the same was not a new industrial undertaking resulting in short levy of tax of Rs. 575.48 crore. Inconsistent stand in the cases of IOCL and HPCL in respect of deduction in respect of marketing margin has put the revenue of Rs. 535.14 crore from IOCL at risk. The impact may not be limited to only these two oil companies, but could have consequential effect on all such similarly placed units.

2.6.5 Analysis of mistakes in assessment

2.6.5.1 Out of 1104 cases of mistakes/irregularities noticed, 711 cases pertained to scrutiny assessment and 393 cases were processed in summary manner. Thus, 64 per cent of mistakes noticed were from scrutiny assessment.

Audit recommends that the Ministry may strengthen its internal control mechanism so as to ensure that the issues as brought out in this report are addressed during assessment proceedings.

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1 Total number of irregularities observed is 1105. However, one case pertains to the format of Form no. 10CCB which does not belong to assessment proceedings.
2.7 Production or refining of mineral oil

2.7.1 Deductions to industrial undertakings not being new

The amount of deduction to an undertaking which begins commercial production or refining of mineral oil, covered under section 80IB(9) shall be hundred per cent of profits for a period of seven consecutive assessment years subject to fulfillment of the prescribed conditions. The conditions, inter-alia, stipulate that the industrial under taking is not formed by splitting up or reconstruction of a business already in existence and by transfer to a new business of plant and machinery previously used for any purpose. However, if the value of the transferred assets does not exceed 20 per cent of the total value of the machinery or plant used in the business, the condition is deemed to have been satisfied.

Meaning of ‘Formed’

The word ‘formed’ is intended to connote that the body of the company or its shape did not come up in consequence of transfer of machinery and plant used previously for business purposes.

‘Splitting up of business’

The expression “splitting up of business already in existence” indicates a case where the integrity of business earlier in existence is broken up and different sections of the activities previously conducted are carried on independently.

‘Reconstruction of a business’

There must be a emergence of a new physically separate unit which may exist on its own as a viable industrial unit. An undertaking is formed out of the existing business if the physical identity with the old unit is preserved. Further, the new industrial undertaking must be an integrated unit by itself.

2.7.1.1 Audit observed in one refinery that the deduction under section 80IB(9) was allowed for three assessment years even though no new industrial undertakings was formed. This resulted in underassessment of income having revenue impact of Rs. 575.48 crore in Maharashtra. The case is discussed below.

2.7.1.2 In Maharashtra, CIT1 Mumbai charge, the assessments of a company, M/s. Hindustan Petroleum Corporation Ltd., for the assessment years 2002-03, 2004-05 and 2005-06 were completed after scrutiny in March 2005, November 2006 and December 2007 respectively after allowing a deduction of Rs. 133.12 crore, Rs. 793.88 crore and Rs. 664.51 crore under section 80IB. Audit examination revealed that Visakh Refinery was in operation since May 1957 and the VREP II was an expansion/reconstruction of the existing Visakh Refinery for the purpose of increasing the capacity from 4.5 Million Metric Tonnes Per Annum (MMTPA) to 7.5 MMTPA. The expanded unit was commissioned during financial year 1999-2000 and the commercial

\(^2\) Records for the assessment year 2003-04 were not produced by the Department.
production commenced during financial year 2000-01. Audit noticed that no new or physically separate unit emerged as a result of expansion as is the requirement of the Act to claim deduction. Further, VREP II was not registered as a separate entity under the Factories Act, Central Excise and Sales Tax Acts, and the Indian Explosive Act. Even the storage facilities, in the pre-expansion and expanded units, were inseparably common and not identifiable separately. Thus, VREP II not being a physically separate independent industrial undertaking, but a unit formed by reconstruction of Visakh Refinery which was already in existence, and many of the facilities were being commonly shared, it was not eligible for claiming deduction under section 80IB. As such, deduction of Rs. 1,591.51 crore allowed was irregular which resulted in short levy of tax of Rs. 575.48 crore in these three assessment years besides the revenue loss which has already occurred during previous assessment years outside the scope of the review.

The Department in its reply (September and November 2008) stated that i) VREP II unit is a highly technically advanced unit and is capable of processing varieties of crude, and it consists of newly set up processing facilities, ii) VREP II unit is an independent unit which can process crude oil separately and manufacture petroleum products as processes are not dependent on the older process unit of the refinery, iii) the various parameters like non registration under Central Excise Act, Sales Tax Act, Indian Explosive Act, separate approval from the Ministry of Petroleum, common storage and dispatch of finished goods etc are not sufficient and strong reasons to outweigh the report of Engineers India Limited (EIL) wherein it was stated that the facilities provided under VREP-II were adequate to independently process crude oil at the rate of 3 MMTPA. Various parameters as noted by audit could be relevant for commercial purposes and not for deciding the technical issue whether the two refineries are independent of each other.

The Department’s reply is not acceptable in view of the following:

The Department has emphasized in its reply that VREP II unit is an independent unit which can process crude oil separately and manufacture petroleum products as processes are not dependent on the older process unit of the refinery. This is, however, only one of the parameters to avail tax exemption. As per the conditions defined by the Supreme court in its judgement in the case of Textile Machinery Corporation Limited vs Commissioner of Income Tax (107 ITR 195), new industrial undertaking is not only required to be an integrated/independent unit by itself but also needs to be a separate and distinct entity. The physical identity of the new unit must not be preserved with the existing unit, and new industrial unit must be separate physically from the old one, the capital of which and the profits thereon are ascertainable. New undertaking can be carried on separately without complete absorption and losing their identity in the old business. Separate books of accounts are to be kept by the new undertaking. Audit, however, observed that VREP II was not a separate and distinct entity as explained in the following paragraphs.

1. Barring the capability of independent operation of the refinery process units, the two units are not physically separate as VREP II was not registered as a separate entity under the Factories Act, Central Excise and Sales Tax Acts, and the Indian Explosive Act. Existing license issued by various statutory authorities for existing Visakh refinery were modified to accommodate the expanded capacity of the Visakh refinery.

2. VREP II unit does not generate its own sales invoice and sales are recorded for the Visakh refinery as a whole. VREP I unit is not eligible to claim tax exemption as its tax holiday period is already over. The sale of two units (one eligible, and one not eligible) is a combined one, thereby, indicating that the identity of the VREP II is yet linked to VREP I.
3. As per Annual Report of Hindustan Petroleum Corporation Limited for the year 2006-07, there are only two refineries viz Mumbai refinery (capacity of 5.5 MMTPA) and Visakh refinery (capacity of 7.5 MMTPA). The Department’s plea that VREP I and VREP II are two refineries is not correct.

4. Crude intake lines and storage is common for VREP I and VREP II. Dispatch of finished products is also shared.

5. EIL in its report (August 2008) has stated that while constructing VREP II, various existing facilities/utilities were augmented and revamped indicating VREP II was not a new refinery.

Thus, it would be observed that VREP II is not a separate and distinct entity and is carrying out its operations while preserving its identity with VREP I in the old business in view of the facts explained above. There is only one refinery in Visakhapatnam known as Visakh refinery consisting of VREP I and VREP II units sharing many common facilities and utilities.

*Audit recommends that the Ministry may ensure that the status of an industrial undertaking is correctly ascertained before deduction is allowed.*

### 2.7.2 Inconsistent decisions of the Department in respect of refinery profits

Deduction under section 80IB(9) is to be allowed in respect profits and gains which have been derived out of refining of mineral/crude oil. Audit observed that in two refineries, Department has taken different stands on the issue as to whether marketing margin is to be added or not to the refinery profit for the purpose of allowing deduction under this section. Marketing margin, if added to the refinery profit, will inflate the profits and result in higher amount of deduction under section 80IB. The issue has its impact on the entire refinery sector. The case highlighting the inconsistent decision of the Department on the said issue, is discussed below:

#### 2.7.2.1 In Maharashtra, CIT 10 (1) Mumbai charge, the assessment of a company, M/s. Indian Oil Corporation Limited, for the assessment years 2004-05 and 2005-06 was completed after scrutiny in October 2006 and October 2007. Audit examination revealed that in the scrutiny assessments, the Department disallowed 80IB deductions to the extent of marketing margin as included in the profit of Panipat refinery and AU-V unit of Gujarat refinery. Total deduction disallowed was Rs. 1,469 crore in the two assessment years (assessment year 2004-05: Rs. 335.42 crore, assessment year 2005-06: Rs. 1,133.58 crore).

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3 Market margin is the profit derived by the marketing division of the assessee on the products manufactured by the refinery unit and transferred to the marketing division of the assessee at a fixed price.
2.7.2.2 The Department stated the following reasoning for disallowing the assessee’s claim of deduction under section 80IB in respect of profit received from Marketing Division:

2.7.2.3 “While computing refinery profit, the sale price can be one which is fetched by any refinery when selling its products to any other oil marketing company or refinery. The market price of refined products can be taken as the one which any other refinery would fetch on the product concerned. It may be noted that IOCL has, apart from selling products of its refineries, purchased refined products from various other companies.”

2.7.2.4 “The products from refineries of other companies are purchased by the assessee corporation (IOCL) at ‘Refinery Transfer Price’ (RTP) which is periodically agreed at by oil industry and is based on Import Parity Price (IPP). Even IOCL transfers its refined products to marketing or other divisions on RTP. And thus, it is clear that the market value for the purpose of 80IB deduction must be taken as RTP and so there is no case for inclusion of marketing profits in the refinery profit for 80IB deduction claim.”

2.7.2.5 Thus, the claim of Rs. 335.42 crore (assessment year 2004-05) and Rs. 1,133.58 crore (assessment year 2005-06) being marketing margin/profit was rejected by the assessing officer, and added back to the assessee’s income.

2.7.2.6 Audit, however, observed that the Department has allowed deduction under section 80IB in respect of marketing margin to M/s. Hindustan Petroleum Corporation Ltd., for the assessment year 2004-05. A paragraph in this regard on irregular consideration of marketing margin in the case of a Visakh Refinery for claiming 80IB deduction was printed in the Report of the Comptroller and Auditor General of India for the year ended March 2007 (PA 7 of 2008) as para no. 2.8.2.1 in Chapter II ‘Review on Appreciation of Third Party Reporting/Certification in Assessment Proceedings’. Gist of the para is as follows:

2.7.2.7 In Maharashtra, CIT1 Mumbai charged the assessment of a company, M/s. Hindustan Petroleum Corporation Ltd., for the assessment year 2004-05 was completed after scrutiny in November 2006. The assessee had claimed a deduction of Rs. 793.88 crore in respect of Vishak Refinery - VREP II Project. During audit examination, it was observed that while working out the deduction under section 80IB, an amount of Rs. 279.55 crore on account of marketing margin pertaining to marketing division was also considered. As the marketing division is i) not an industrial undertaking under the definition of section 80IB and ii) is involved in trading activities (converting the bulk produced by the refinery into retailable lots and selling it in retail markets), the profit earned by the marketing division is only a trading profit and not a profit derived out of manufacturing activities. Thus consideration of marketing margin for claiming deduction under section 80IB was irregular. However, this amount was not disallowed, resulting in excess deduction of Rs. 279.55 crore under section 80IB, involving short levy of tax of Rs. 110.82 crore.

4 Profit derived by the refinery out of its refining activities was Rs. 514.33 crore i.e. 14 per cent of its cost of operations
2.7.2.8 The Ministry in its reply (August 2008) to the PAC had stated that transfer from one division of the company to another is not a sale under the Sales of Goods Act as no one can sell to himself. The book entries reflecting inter division transfer is at a fixed rate from refinery division to marketing division is an internal accounting/control mechanism of the assessee which cannot give rise to any profit. Profit arises only when goods are sold by the marketing division to outsiders. Therefore the entire profit on the products manufactured by the eligible refinery unit viz. Vishakh Refinery is admissible for computation of deduction under section 80IB. This was also the view of the Bombay High Court in the assessee’s own case for the assessment year 1989-90 vide its order dated 24-07-2006 which has become final.

2.7.2.9 Further, in response to a PAC question as to what approach was being adopted by the Department in other refineries in respect of marketing margin while allowing deduction under section 80IB, the Ministry stated that the Department was following the judgement of the Bombay High Court in this regard.

2.7.2.10 The Ministry’s reply is not tenable as it would be seen that in case of M/s. Indian Oil Corporation Ltd., the Department had not allowed the deduction in respect of marketing margin. The Department had taken the same view as was taken by audit in the paragraph 2.7.2.7 cited above. Interestingly, assessments in the case of Indian Oil Corporation Ltd. were finalised after the date (24 July 2006) of Bombay High Court’s judgement. This implies concurrence with the Audit’s view that deduction is not to be allowed on marketing margin. It is also mentioned that the Board’s instruction no. 2 dated 24 October 2005 stating that the escalation of level of appeal from the High Court to the Supreme Court where tax effect exceeds Rs. 10 lakh was also not followed even though the Department was itself convinced about the fact that marketing margin is not to be considered for allowing deduction as would be observed from subsequent developments explained in the paragraph below.

2.7.2.11 IOCL filed an appeal with the CIT(A) in November 2006 stating that the assessing officer had erred in excluding marketing margin from the profits eligible for deduction under section 80IB. In support of its claim, IOCL quoted the judgement of Bombay High Court dated 24 July 2006 in the case of HPCL. CIT (A) in its decision dated 24 March 2008 placing reliance on this judgement has stated, for assessment year 2004-05, that the company would be eligible for deduction under section 80IB on profit derived from products manufactured which stands included in the marketing margin. The Department has filed a second appeal with ITAT dated 26.5.2008. For assessment year 2005-06, the appeal to CIT(A) is pending.

2.7.2.12 Thus inconsistent stand of the Department in the cases of IOCL and HPCL, has put the revenue of Rs. 535.14 crore from IOCL at risk for the two assessment years, besides potential revenue losses which the Department will bear in subsequent years not only in these two refineries but also in case of other refineries in the country.

5 IT @ of 35 per cent + surcharge @ 2.5 per cent + Education cess @ 2 per cent on the total deductions disallowed by the Department for the assessment year 2004-05 and 2005-06.
Audit recommends that the Ministry may ensure that level of appeal is escalated to the highest level or the relevant provisions of the Act amended in cases having such wide ramifications so as to have complete clarity leaving no scope for inconsistencies in the assessment proceedings.

2.7.2.13 In the exit conference, the Board stated that in view of different judgements of different jurisdictional High Courts, it was difficult to have a uniform decision by the assessing officers of the different states. Audit, however, pointed out that the issue raised in the audit observation pertained to the same state and same jurisdictional High Court. Board accepted the audit recommendation and stated that the issue would be resolved on finalisation of appeal in due process of law.

2.7.3 Income not derived from eligible business reckoned for computation of deduction under section 80IB

2.7.3.1 As per section 80IB, deductions under the section is admissible only in respect of the profits and gains derived by an assessee from the industrial undertaking which manufactures or produces articles or things. The deduction has to be strictly construed, and the language of the enactment prevents the extension of the benefits to income which is merely incidental or ancillary to the industrial undertaking but which does not arise from and out of it. In the case of composite business, relief is confined only to profits of industrial undertaking. Further, for determining the quantum of deduction, profit and gains of the eligible business shall be computed as if such profit and gains were the only source of income of the assessee during the relevant previous year.

2.7.3.2 Audit observed in one case in Kerala where the deduction under section 80IB was allowed even though income was not derived from eligible business. The case is discussed below:

2.7.3.3 In Kerala, CIT Kochi charge, the assessment of a company, M/s. Kochi Refineries Ltd., (since transferred to CIT, Mumbai on 10.9.2007) for assessment year 2002-03 was completed after scrutiny in December 2004 determining the income at Rs. 111.83 crore after allowing a deduction of Rs. 12.44 crore under section 80IB. Consequent to an appellate order, the assessment was revised in October 2005 determining the income at Rs. 105.32 crore. Audit examination revealed that while allowing deduction, ‘other income’ aggregating to Rs. 11.43 crore (interest, miscellaneous receipts etc.) was considered. As the other income of Rs. 11.43 crore was not derived from industrial activity, the assessee was not eligible for deduction under 80IB to that extent. The inclusion of other income was therefore not in order and resulted in excess deduction of Rs. 3.43 crore with consequent tax effect of Rs. 2.16 crore including interest. The Department accepted and rectified the mistake in October 2007.

2.8 Industrial undertakings

2.8.1 Deductions to industrial undertakings not being new

Under section 80IB, where the gross total income of an assessee includes any profits and gains derived from any business as specified under this section, there shall be
allowed, in computing the total income of the assessee, a deduction from such profits and gains deduction in respect of profits and gains of an amount equal to such percentage and for such number of assessment years as specified under this section. This section applies to any industrial undertaking which is not formed by splitting up or the reconstruction of a business already in existence. Further, industrial undertaking should not be formed by transfer of old plant and machinery. However, if the value of the transferred assets does not exceed 20 per cent of the total value of the machinery or plant used in the business, the condition is deemed to have been satisfied.

2.8.1.1 Audit observed 26 cases where the deduction under section 80IB was allowed even though these were not new industrial undertakings. This resulted in underassessment of income having revenue impact of Rs. 19.58 crore in Andhra Pradesh, Assam, Jammu and Kashmir, Maharashtra, Punjab and West Bengal. Out of these, two cases are discussed below.

2.8.1.2 In Jammu and Kashmir, CIT J & K charge, assessment of a firm, M/s. Sun Pharmaceutical Industries, for the assessment year 2005-06 was completed after scrutiny in December 2007. Audit examination revealed that assessee was a partnership firm in which M/s. Sun Pharmaceutical Industries Limited, another company, was having 95 per cent share. Further, out of total value of plant and machinery amounting to Rs. 9.05 crore, plant and machinery valuing Rs. 7.26 crore, being 80 per cent of the total plant & machinery, was transferred from M/s. Sun Pharmaceuticals Industries Ltd. during the financial year 2003-04 and 2004-05. As the assessee firm was formed out of splitting up of an existing company (M/s. Sun Pharmaceutical Industries Limited), and the value of the transferred assets exceeded the limit of 20 per cent, assessee was not eligible for allowance of deduction under section 80IB of the Act. Omission resulted in short levy of tax of Rs. 8.63 crore.

2.8.1.3 In Maharashtra, CIT Central 1 Mumbai charge, assessments of an individual, Smt. Madhu Gupta proprietor of M/s. Photo Film Industries, for the assessment years 2002-03, 2003-04 and 2004-05 were completed after scrutiny in March 2005, March 2006 and December 2006 respectively after allowing a deduction of Rs. 8.18 crore $^6$, Rs. 1.36 crore and Rs. 4.41 crore under section 80IB respectively in respect of the unit located at Pondichery. Audit observed the following in this regard:

2.8.1.4 The assessee had not filed the mandatory audit report in form no. 10CCB as prescribed under section 80IB and Rule 18BBB along with the return of income for the assessment years 2002-03, 2003-04 and 2004-05. Further, during the assessment for the assessment year 2002-03, the assessing officer denied the claim under section 80IB stating that the business of Photo Film Industries was a mere reconstruction of the business of M/s. G G Photo Ltd., which was already in existence. CIT (Appeal) also upheld (January 2006) the decision of assessing officer with regard to disallowance of deduction under section 80IB. However, on the assessee’s appeal, the ITAT, Mumbai Bench allowed (May 2007) for the assessment year 2002-03, the claim in full.

$^6$Relief was allowed by ITAT
2.8.1.5 Audit observed that as the mandatory audit report had not been furnished in respect of any of the three assessment years, the assessee was not eligible for deduction. As such, in audit’s opinion, the department should have escalated the level of appeal against the decision of ITAT in view of the facts that (i) mandatory audit reports not furnished, (ii) revenue impact involved was Rs. 6.19 crore including interest, and as per Board’s instruction no. 2 dated 24 October 2005, where the tax effect involved is Rs. 4 lakh and above, the Department is to file an appeal with the High Court under section 260A of the Act, (iii) decision of assessing officer disallowing deduction was based on sound reasoning, and the same was also upheld by the CIT (Appeal).

2.8.1.6 The Department accepted (January 2008) the audit observation and stated that remedial action has already been taken for the assessment year 2004-05 by reopening the assessment under section 147 of the Act in respect of non submission of mandatory audit report, and remedial action for the assessment years 2002-03 and 2003-04 were being examined.

Thus, the basic conditions, for granting deductions under section 80IB to an industrial undertaking viz (i) it should be a new undertaking and not formed by splitting up, or the reconstruction, of a business already in existence, and (ii) it should not be formed by transfer of old plant and machinery beyond the limit of 20 per cent, have been violated in these cases.

Audit recommends that the Ministry may ensure that detailed examination to ascertain the status of an industrial undertaking is made before deduction is allowed.

2.8.2 Industrial undertakings involved in non-manufacture activities or production of articles as listed in the Eleventh Schedule

2.8.2.1 In order to claim deduction under section 80IB, an Industrial undertaking should manufacture or produce any article or thing (not being an article or thing specified in the list in the Eleventh Schedule).

Meaning of Manufacture

If by application of labour and skill an object is transformed to the extent that it is commercially known differently, manufacture has taken place. The moment there is a transformation into a new commodity having its own character, use and name, whether it be the result of one process or several processes, “manufacture” takes place.

2.8.2.2 Audit observed 87 cases where the deduction under section 80IB was allowed even though activities carried out by the industrial undertakings were not of manufacturing or were from the items as listed in Eleventh Schedule of the Act. This resulted in underassessment of income having revenue impact of Rs. 22.94 crore in Andhra Pradesh, Bihar, Chhattisgarh, Gujarat, Himachal Pradesh, Karnataka, Kerala, Maharashtra, Tamil Nadu and West Bengal. Out of these, three cases are discussed below and three cases are given in Appendix 10.

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7 Assessment year 2002-03 Rs. 3.51 crore, Assessment year 2003-04 Rs. 0.59 crore, Assessment year 2004-05 Rs. 2.09 crore
2.8.2.3 In Maharashtra, CIT 23 Mumbai charge, the assessments of a firm, **M/s. Marmo Classic**, for the assessment years 2003-04 and 2004-05 were completed after scrutiny in December 2005 after allowing a deduction of Rs. 5.34 crore and Rs. 10.58 crore respectively in respect of the industrial unit located at Silvassa. Audit examination revealed that the assessee was engaged in the activity of cutting of marble slabs and tiles. It has been judicially held that mining of lime stone and marble blocks and cutting and sizing them are not manufacturing activity, and assessee was not entitled to special deduction. Since the assessee was not engaged in the activity of manufacture and production of articles or things, it was not eligible for deduction under section 80IB and the deduction allowed was incorrect. The irregular deduction aggregating Rs. 15.92 crore resulted in revenue impact of Rs. 7.23 crore including interest. The Department in its reply (October 2008) stated that the process involved in converting marble blocks into smaller pieces of marble slabs and tiles was cleaning with water, dressing manually and mechanically correcting of natural flaws by chemical analysis, polishing and sizing, which are necessary to make marble blocks into marketable commodity of small slabs and tiles. These end products are distinct and separate from the original marble blocks. Hence, the process amounted to manufacture and the deduction was correctly allowed. The reply is not tenable as the process described by the department is converting marble blocks into smaller pieces is only a treatment given to the product, and this does not amount to manufacture. This view is supported by Supreme Court and High Court as detailed below:

In the case of Lucky Minmat Pvt Ltd vs CIT [245 ITR 830], the Supreme Court held that if the assessee is engaged in the business of mining of limestone and marble blocks and thereafter cutting and sizing the same before being sold in the market, it does not amount to manufacture. The Supreme Court upheld the order of the Rajasthan High Court [226 ITR 245] which had clarified the word ‘Manufacture’ as under:

“The Manufacture implies a change, but every change is not manufacture although every change in the article is the result of the treatment, labour and manipulation. To bring about the change qualifying as manufacture some thing more is necessary and that something is transformation i.e. a new different article, having a distinct name, character or use, must emerge”. In the assessee’s case, from the first stage to the last stage the nature of article continues to be the same i.e. marble.

Audit also observed that in a similar case of M/s. Inani Marbles and Industries Ltd., assessed in CIT 2 Mumbai charge, the 80IB deduction for the assessment year 2004-05 was disallowed in December 2006 by the department on the same grounds.

2.8.2.4 In West Bengal, CIT Central I Kolkata charge, the assessments of a company, **M/s. J.L Morison Ltd.**, for the assessment years 2001-02 to 2006-07 were completed after scrutiny in March 2004, March 2005, March 2006, October 2006, March 2007 and March 2008 respectively. The assessee was engaged in manufacturing of cosmetics and dental care products which are listed in the Eleventh Schedule. Since the assessee was neither an undertaking located at backward State, nor a small scale industrial undertaking (SSI), the deduction was not admissible. Mistake in allowing deduction thus

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8 Lucky Minmat P Ltd vs CIT, 245 ITR 830 (SC)
resulted in cumulative underassessment of income of Rs. 5.31 crore involving undercharge of tax of Rs. 1.66 crore for assessment years 2001-02 to 2004-05, Rs. 32.51 lakh for assessment year 2005-06 and Rs. 46.12 lakh for assessment year 2006-07 leading to cumulative undercharge of tax of Rs. 2.44 crore including interest in six years.

2.8.2.5 In Maharashtra, CIT 24 Mumbai charge, the assessments of a firm, M/s. Silvasa Wooden Drums, for the assessment years 2004-05 and 2005-06 were completed after scrutiny March 2006 and March 2007 respectively and the return for the assessment year 2006-07 was processed in summary manner in March 2008. A deduction of Rs. 78.00 lakh, Rs. 1.55 crore and Rs. 2.68 crore for the respective assessment year under section 80IB was allowed to the assessee in respect of its unit located at Silvasa. Audit examination revealed that the assessee was engaged in galvanizing steel tape and cold rolled coils/strips. It has been judicially held that the process of galvanizing does not result in the manufacture or production of new goods as such and an assessee running the business of galvanizing was not entitled to deduction. Since the assessee was not engaged in manufacturing or producing articles the allowance of deduction aggregating to Rs. 5.01 crore was irregular involving revenue impact of Rs. 1.95 crore.

The Department in its reply (August 2008) stated that as the assessee was engaged in the business of manufacturing and galvanizing steel tapes and CR strips, and galvanizing was not done for outsiders but was done for regular business activities, deduction has been rightly allowed. The reply is not acceptable as the assessee’s activity is decoiling cold rolled steel strips, cutting it to a smaller size and galvanizing it. The process of cutting CR strips to smaller size does not amount to manufacture as no new product different from its components has emerged.

Thus, deductions have been allowed to Industrial undertakings which were not carrying out manufacturing activities.

Audit recommends that the assessing officers ensure that judicial pronouncements in respect of manufacturing activities are applied to all similarly placed cases.

2.8.3 Manufacture or production not started within a stipulated time limit

2.8.3.1 To claim deduction under section 80IB, industrial undertaking should commence manufacture or production of article or things or operate cold storage plant or plants between April 1, 1991 and March 31, 1995.

2.8.3.2 Audit observed in 125 cases where the deduction under section 80IB was allowed even though manufacture or production activities were not commenced within the specified time limits as laid down in the Act. This resulted in underassessment of income having revenue impact of Rs. 34.51 crore in Andhra Pradesh, Bihar, Chandigarh, Delhi, Gujarat, Karnataka, Maharashtra, Rajasthan, Tamil Nadu, Uttar Pradesh and West Bengal. Out of these, two cases are discussed below and five cases are given in Appendix 11.

9 CIT vs. Hindustan Metal Refining Works (P) Ltd. 128-ITR-472 (Cal)
In Chandigarh, CIT I charge, assessment of a company, M/s. Bhushan Limited, for the assessment years 2003-04 and 2004-05 was completed after scrutiny in January 2005 and January 2006. Audit examination revealed that the assessee had claimed and was allowed deduction of Rs. 19.80 crore. Since the assessee had started production activity on 1 March 1985 well before 1 April 1991, it was not eligible for deduction. The irregular amount of deduction aggregating to Rs. 19.80 crore resulted in short levy of tax of Rs. 8.75 crore including interest.

In Delhi, CIT VI charge, assessment of a company, M/s. Tina Overseas Limited, for the assessment year 2004-05 and 2005-06 were completed after scrutiny in November 2006 and March 2007 after allowing deduction of Rs. 3.72 crore and Rs. 2.45 crore under section 80IB for its units at Panipat and Chennai respectively. Audit examination revealed that the assessee had claimed deduction in respect of Panipat unit (started its operation w.e.f. 1 August 2001) and Chennai unit (started w.e.f. 20 December 2000) respectively under section 80IB(4). Further, deduction under section 80IB(4) is available only if an industrial undertaking is located in industrially backward State specified in the Eighth Schedule of the Act. However, Panipat unit and Chennai unit come under the States of Haryana and Tamil Nadu which are not industrially backward States as per Schedule Eight of the Act. As such, assessee was not eligible to claim deduction under section 80IB(4). For units located in Panipat and Chennai, deduction can be availed under section 80IB(3) only, but, assessee was not even eligible to claim deduction under this section as the assessee had started its operations in December 2000 and August 2001 which was not within the period stipulated under this section viz 1 April 1991 to 31 March 1995. Thus, deduction of Rs. 3.72 crore and Rs. 2.45 crore were irregular resulting in short levy of tax of Rs. 2.87 crore including interest.

Thus deductions have been granted under section 80IB in respect of cases where manufacture or production has not started within the time limits as specified in the Act.

Audit recommends that the instructions may be issued in this regard so that assessing officers are vigilant in determining the time period for applicability of deduction under section 80IB.

2.8.4 Non employment of specified number of employees

2.8.4.1 To claim deduction under section 80IB industrial undertaking, Section 80IB of the Act provides that the undertaking employs 10 or more workers in a manufacturing process carried on with the aid of power, or employs 20 or more workers in a manufacturing process carried on without the aid of power.

2.8.4.2 Audit observed in 13 cases where the deduction under section 80IB was allowed even though specified number of employees was not employed. This resulted in underassessment of income having revenue impact of Rs. 5.97 crore in Bihar, Delhi, Gujarat, Jammu and Kashmir, Jharkhand and Uttar Pradesh. Out of these, two cases are discussed below.
2.8.4.3 In Delhi, CIT IV charge, assessment of a company, M/s. Global Business India Pvt. Limited, for the assessment year 2003-04 was completed after scrutiny in March 2006 determining an income of Rs. 1.37 crore after allowing a deduction of Rs. 7.25 crore under section 80IB of the Act. Audit examination revealed that 15 workers were employed in factory at Agartala. Further examination revealed that during the previous year (2002-03), the assessee had incurred an expenditure of Rs. 0.45 lakh under the head ‘power and fuel expenses’ against the total production of Rs. 35.65 crore (0.013 per cent of the production). Even during previous year (2001-02) relevant to assessment year 2002-03, the assessee had incurred almost the same amount of expenditure (Rs. 0.43 lakh) on power and fuel against the total production of Rs. 13.02 crore (0.03 per cent of the production). The analysis revealed that the expenses on power and fuel did not change/changed very marginally; whereas the production increased by 174 per cent over the same period which is indicative of the fact that power was not the requirement of manufacturing process. Since the company is not working with the aid of power and there are less than 20 workers, the deduction under section 80IB was not admissible. This resulted in incorrect allowance of deduction under section 80IB amounting to Rs. 7.25 crore involving tax effect of Rs. 3.66 crore including interest. Further, the assessee had not furnished the mandatory audit report in Form no. 10CCB. The Department while accepting the audit finding, stated in July 2007 that remedial action was being taken.

2.8.4.4 In Jammu and Kashmir, CIT J & K charge, assessment of an individual, Shri Dhanji Bhai Anandji Bhai, proprietor of M/s. Makson Engineering Export, for the assessment years 2005-06 and 2006-07 was completed after scrutiny in March 2007 and February 2008 after allowing a deduction of Rs. 2.89 crore and Rs. 2.22 crore respectively. Audit examination revealed that the assessee had employed 12 workers in the manufacturing process during the relevant previous years 2004-05 and 2005-06. However, as per Form no. 10CCB, assessee had conducted the manufacturing process without the aid of power, and therefore, he was not eligible for allowance of deduction as the assessee had employed only 12 workers instead of minimum 20 workers as per the above provisions of the Act. This resulted in inadmissible deduction of Rs. 2.89 crore and Rs. 2.22 crore with a corresponding tax effect of Rs. 97.19 lakh and Rs. 74.81 lakh for the aforesaid assessment years.

Thus, Department has allowed deduction under section 80IB even in cases where specified number of employees have not been employed.

The Ministry may ensure that as the information in respect of number of employees and use of power in manufacturing activities is given in the audit report, such information is utilised by the assessing officers and verified from the accounts of the assessee before allowing deductions under section 80IB.

2.8.5 Income not derived from eligible business reckoned for computation of deduction under section 80IB

2.8.5.1 As per section 80IB, deductions under the section is admissible only in respect of the profits and gains derived by an assessee from the industrial undertaking which manufactures or produces articles or things. The deduction has to be strictly construed,
and the language of the enactment prevents the extension of the benefits to income which is merely incidental or ancillary to the industrial undertaking but which does not arise from and out of it. In the case of composite business, relief is confined only to profits of industrial undertaking. Further, for determining the quantum of deduction, profit and gains of the eligible business shall be computed as if such profit and gains were the only source of income of the assessee during the relevant previous year.

2.8.5.2 Audit observed in 251 cases where the deduction under section 80IB was allowed even though income was not derived from eligible business. This resulted in underassessment of income having revenue impact of Rs. 47.72 crore in Andhra Pradesh, Bihar, Chandigarh, Chhattisgarh, Delhi, Gujarat, Haryana, Himachal Pradesh, Karnataka, Kerala, Madhya Pradesh, Maharashtra, Punjab, Rajasthan, Tamil Nadu, Uttar Pradesh and West Bengal. Out of these, two cases are discussed below and five cases are given in Appendix 12.

2.8.5.3 In Maharashtra, CIT 2 Mumbai charge, the assessment of a company, M/s. Tata Chemicals Ltd., for the assessment year 2002-03 was completed after scrutiny in January 2005 after allowing a deduction of Rs. 32.38 crore under section 80IB in respect of Babrala Fertiliser Division located at Badaun District in Uttar Pradesh. Audit examination revealed that the deduction under section 80IB had been computed after taking into account other income aggregating Rs. 241.10 crore from retention price subsidy (Rs. 143.92 crore), escalation subsidy (Rs. 60.89 crore), freight subsidy (Rs. 34.51 crore) and insurance claim (Rs. 1.78 crore) which was not eligible for deduction. After reducing the ineligible income, no balance profit was available for allowing deduction. The deduction of Rs. 32.38 crore allowed was, thus, incorrect resulting in revenue impact of Rs. 16.01 crore including interest.

The Department in its reply (October 2008) stated that the subsidies have a direct nexus to the business carried on by the assessee and therefore forms part of the business income eligible for deduction under section 80IB. The subsidies, though received from Government, are intended to compensate the assessee for the possible loss which the assessee may incur by selling different kinds of fertilizer at Government administrative prices. The reply is not acceptable as it was observed that in the scrutiny assessment for the subsequent assessment years 2003-04 and 2004-05 of the same assessee completed in February 2006 and December 2006 respectively, the 80IB claims in respect of price concession subsidy, product subsidy, sales tax remission were denied by the Department. Further, various court decisions have emphasized that the income of these nature (subsidies from the Government) were to be treated as not derived from the industrial undertaking and hence not eligible for claiming deduction under section 80IB.

2.8.5.4 In Maharashtra, CIT 6 Mumbai charge, the assessment of a company, M/s. Akruti Nirman Ltd., for the assessment year 2004-05 was completed after scrutiny in May 2005 after allowing a deduction of Rs. 8.33 crore under section 80IB. Audit examination revealed that the claim included Rs. 6.34 crore on account of rent received

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10 CIT vs Viswanathan & Co. (261 ITR 737 (Mad))
CIT vs Sterling Foods (237 ITR 579 (SC))
CIT vs Fenner India Ltd (239 ITR 480 (Mad))
which was not eligible for deduction. Omission to disallow Rs. 6.34 crore had a revenue impact of Rs. 2.59 crore including interest.

Thus, incomes which have not been derived from eligible business were reckoned for deduction.

Audit recommends that the Ministry may by appropriate directions ensure that the income, on which deduction is sought by the assessee, is critically analyzed and only that portion of income is considered for deduction which has been derived from eligible sources.

2.9 Housing projects

2.9.1 The amount of deduction in the case of an undertaking covered under section 80IB(10), developing and building housing projects approved before, 31 March 2007 shall be hundred per cent of the profits derived from such housing project subject to fulfillment of all the prescribed conditions. The conditions, inter-alia, stipulate that the undertaking has commenced or commences development on or after 1 October 1998 and completes such construction within 4 years from the end of financial year in which the housing project is first approved or before April 1, 2008, whichever is later. The completion certificate is mandatory for claiming deduction. The size of the plot of land should be of minimum one acre. The residential unit should have a maximum built up area of one thousand square feet in Mumbai or Delhi and one thousand five hundred square feet elsewhere. No shops and commercial establishments were permissible in the project up to assessment year 2004-05, and from assessment year 2005-06 onwards the built up area of shops/commercial establishments should not exceed five per cent of the aggregate built up area of the housing project or two thousand square feet which ever is less.

2.9.2 Audit observed that in 99 cases, deduction under section 80IB was allowed even though assessees were not eligible to claim deduction due to reasons such as i) commencing development/construction in the period other than as specified, ii) creating commercial establishments (not permissible up to assessment year 2004-05) or developing commercial area more than the stipulated norms (assessment year 2005-06 and onwards), iii) non submission of completion certificates, iv) area of the land of housing project being less than one acre, etc. This resulted in underassessment of income having revenue impact of Rs. 55.43 crore in Andhra Pradesh, Assam, Delhi, Gujarat, Haryana, Jharkhand, Madhya Pradesh, Maharashtra, Orissa, Tamil Nadu, and West Bengal. Out of these, six cases are discussed below and nine cases are given in Appendix 13.

2.9.3 In Maharashtra, CIT 3 Pune charge, the assessments of a company, M/s. Runwal Multi Housing Pvt. Ltd., for the assessment years 2003-04, 2004-05 and 2005-06 were completed after scrutiny in March 2006, December 2006 and December 2007 respectively after allowing a deduction of Rs. 3.34 crore, Rs. 3.39 crore and Rs. 5.46 crore under section 80IB. It was observed from the audit report (Form no. 10CCB) that the project was under construction and the mandatory completion certificate from the
local authority was not furnished. Further, the project had commercial units measuring 3,982 square feet which was more than the maximum permissible limit of 2,000 square feet. Thus, the housing project was ineligible for deduction and the allowance of deduction aggregating Rs. 12.19 crore was irregular, having a revenue impact of Rs. 5.97 crore including interest.

2.9.4 In Maharashtra, CIT 1 Mumbai charge, the assessment of a firm, M/s. Dosti Associates, for the assessment year 2003-04 was completed after scrutiny in March 2006 after allowing a deduction of Rs. 11.49 crore under section 80IB. Audit examination revealed that the project had commercial shops. As the provision in respect of shops/commercial establishments was applicable with effect from the assessment year 2005-06 only, the assessee was not eligible to claim education prior to assessment year 2005-06. Thus, incorrect claim of deduction of Rs. 11.49 crore resulted in revenue impact of Rs. 4.22 crore.

2.9.5 In Maharashtra, CIT 2 Thane charge, the assessment of a firm, M/s. Siddhi Real Estate Developers, for the assessment year 2005-06, was completed after scrutiny in October 2007 after allowing a deduction of Rs. 8 crore under section 80IB. Audit examination revealed that the project was not completed and mandatory completion certificate of the project was not furnished. Due to non completion, the project was not eligible for deduction and the allowance of deduction on partially completed buildings was irregular. The incorrect allowance of deduction of Rs. 8 crore had a revenue impact of Rs. 3.83 crore including interest.

The Department in its reply (September 2008) stated that the housing project consisted of 19 buildings and 10 buildings had been completed/developed during the previous year, and hence profits from these buildings had been allowed under section 80IB. It was further stated that the entire project was completed before 31 March 2006. It also stated that the assessee might offer the profit/loss from a housing project either on ‘year to year’ basis or on ‘project completion method’. However, due to the implication of section 5, the Department prefers to tax such assessee on ‘year to year’ basis rather than ‘project completion method’. The reply is not acceptable in view of the following:

• Although the assessee has the option to offer the profit/loss from a housing project on annual basis or on project completion method in the normal course, as per the requirement of section 80IB(10), Rule 18BBB and Form no. 10CCB, the entire project has to be completed and mandatory completion certificate of the project is to be furnished along with the return for claiming deduction under section 80IB. Since entire project was not completed during the previous year 2004-05 relevant to the assessment year 2005-06, allowing of deduction was irregular.

• The Department has stated that the entire project was completed by March 2006. As such, deduction can be allowed only in the assessment year 2006-07 subject to submission of completion certificate.

2.9.6 In Maharashtra, CIT 21 Mumbai charge, the assessment of a firm, M/s. Pathare and Associates, for the assessment year 2004-05 was completed after scrutiny in December 2006 after allowing a deduction of Rs. 7.95 crore under section 80IB. Audit
examination revealed that the project had shops and commercial area measuring 3,974 square feet. As the provision in respect of shops/commercial establishments was applicable with effect from the assessment year 2005-06 only, claiming deduction for commercial establishments built prior to April 2005 was irregular and required to be disallowed. As such, project was not eligible for deduction and the incorrect allowance of deduction of Rs. 7.95 crore resulted in revenue impact of Rs. 3.79 crore including interest. The Department in its reply (August 2008) stated that the assessee’s project consisted of residential units and shops. In the case of the assessee, the shops have been considered as a part of the housing project eligible for exemption under section 80IB(10). It as further stated that provisions of section 80IB have been amended by the Finance (No. 2) Act, 2004 w.e.f 1 April 2005. As such deduction had been correctly allowed. The Department’s reply is not acceptable as the ITAT Mumbai ‘C’ Bench has observed in the case of M/s. Laukik Developers vs DCIT 3, Thane (105 ITD 657) that the construction of shops or commercial place cannot be considered a housing project for the purpose of application of the provisions of section 80IB(10) of the Act. The Tribunal in its order said, “we are unable to accept the argument off the Iq. Counsel for the assessee that since the case pertains to pre-amendment period, the deduction under section 80IB(10) will be available to the assessee even if the shops and other commercial establishments are included in the housing project of the assessee. If this argument of the assessee is accepted, then it shall nullify the very object of introducing the provision of section 80IB(10) in the statute book for promotion of housing activity in the country since there shall be no limit of the total built-up area devoted to construction of shops and other commercial establishments in the housing project of the assessee”.

2.9.7 In Andhra Pradesh, CIT III Hyderabad charge, assessment of a company, M/s. Sainath Estates (P) Ltd., for the assessment year 2002-03 was completed after scrutiny in December 2006 after allowing a deduction of Rs. 6.71 crore under section 80IB (10). Audit examination revealed that the assessee company had not furnished the ‘completion certificate’. In the absence of such certificate the deduction is inadmissible. Incorrect allowance of deduction resulted in short computation of income to the same extent involving a tax effect of Rs. 3.76 crore including interest.

2.9.8 In Maharashtra, CIT 3 Pune charge, the assessment of a company, M/s. Runwal Erectors Pvt. Ltd., for the assessment years 2003-04 and 2004-05 were completed after scrutiny in March 2006 and December 2006 respectively after allowing a deduction of Rs. 2.01 crore and Rs. 2.19 crore under section 80IB. Audit examination revealed that project had shops/commercial establishments. As the benefit of deduction, in respect of these units, was applicable with effect from the assessment year 2005-06 only, claiming deduction for such units built prior to April 2005, was irregular and required to be disallowed. The incorrect claim of deduction of Rs. 4.20 crore resulted in revenue impact of Rs. 2.06 crore including interest.

Thus, deductions have been allowed in cases where assessee were not eligible to claim the same.
Audit recommends that the suitable control mechanism may be evolved to ensure the conditions as laid down for availing deduction in respect of housing sector are complied with before allowing deduction in this regard.

Miscellaneous issues

2.10 Non submission of Audit Report

2.10.1 The deduction under section 80IB is admissible only if the accounts of the undertaking have been audited by an accountant, and the audit report duly signed and verified by such accountant is furnished along with the return of income (Form no. 10CCB).

2.10.2 Audit observed 237 cases where the deduction under section 80IB was allowed even though mandatory audit report was not furnished by the assessee along with the income tax return. This resulted in underassessment of income having revenue impact of Rs. 81.11 crore in Andhra Pradesh, Assam, Bihar, Chandigarh, Chhattisgarh, Delhi, Gujarat, Haryana, Himachal Pradesh, Jharkhand, Karnataka, Madhya Pradesh, Maharashtra, Orissa, Punjab, Rajasthan, Tamil Nadu, Uttar Pradesh and West Bengal. Out of these, three cases are discussed below, and nine cases are given in Appendix 14.

2.10.3 In Uttar Pradesh, CIT Central Kanpur charge, the assessment of a company, M/s. Kothari Products Ltd., for the assessment years 2003-04 and 2004-05 were completed after scrutiny in June 2004 and May 2005 respectively. Audit examination revealed that the assessing officer had allowed deduction under section 80IB in the two assessment years amounting to Rs. 56.01 crore and Rs. 17.70 crore respectively. However, it was observed that the assessee had not submitted the Form no. 10CCB along with the income tax return in the two assessment years. As such, the assessee was not eligible to claim deduction under section 80IB. This involved a tax effect of Rs. 28.44 crore.

2.10.4 In Tamil Nadu, CIT VI Chennai charge, assessment of a firm, M/s. R.K. Industries, for the assessment years 2003-04 and 2004-05 was completed after scrutiny in January 2006 and December 2006 after allowing deduction of Rs. 6.92 crore and Rs. 6.99 crore under section 80IB respectively. Audit examination, however, revealed that the assessee had not filed the requisite mandatory audit certificate in Form no. 10CCB. Hence the assessee was not eligible to claim deduction under section 80IB. This involved a tax effect of Rs. 6.82 crore including interest.

2.10.5 In Maharashtra, CIT 5 Pune charge, the assessments of a company, M/s. Daimler Chrysler Pvt. Ltd., for the assessment year 2004-05 was completed after scrutiny in December 2006. Audit examination revealed that the assessee had not claimed any deduction under section 80IB in the return of income. In the notes filed along with the returns of income, assessee had stated that he was eligible for deduction under section 80IB, but as there was no taxable income during the previous year, the deduction under section 80IB was ‘nil’. Assessee further stated, “if during the assessment proceedings, assessee is determined to have positive income, then assessee submits its claim for deduction under section 80IB”. The assessing officer, during
scrutiny assessment, allowed deduction of Rs. 8.53 crore which was subsequently reduced to Rs. 8.15 crore by a rectification order under section 154 of the Act.

Audit examination revealed that as the assessee had not submitted the requisite audit report in Form no. 10CCB before completion of assessment under section 143 (3), the deduction of Rs. 8.15 crore allowed under section 80IB was irregular. The omission had resulted in incorrect allowance of deduction of Rs. 8.15 crore involving tax effect of Rs. 3.89 crore including interest.

### 2.11. Deduction allowed without setting off brought forward losses

#### 2.11.1 In terms of provision of chapter VIA of the Act, while computing the deduction, the amount of income derived by the assessee has to be computed after taking into account the carried forward losses and unabsorbed depreciation of the earlier years.

#### 2.11.2 Audit observed in 22 cases where while computing the deduction, the amount of income derived by the assessee was computed without taking into account the carried forward losses and unabsorbed depreciation of the earlier years. This resulted in underassessment of income having revenue impact of Rs. 3.57 crore in Assam, Chandigarh, Delhi, Gujarat, Himachal Pradesh, Rajasthan, Tamil Nadu and West Bengal. Out of these, one case is discussed below.

#### 2.11.3 In Assam, CIT II Guwahati charge, the assessment of a company, M/s. Vinay Cements Ltd., for the assessment year 2004-05 was completed after scrutiny in October 2006. Audit examination revealed that the assessee had claimed and was allowed deduction of Rs. 4.98 crore before set off of unabsorbed depreciation and losses of Rs. 22.37 crore to the extent of income available. This resulted in excess allowance of deduction of Rs. 4.98 crore with consequent tax effect (potential) of Rs. 1.49 crore.

### 2.12 Mistakes in computation of income derived from eligible business

#### 2.12.1 Where the gross total income of an assessee includes any profits and gains derived from eligible business, there shall, be allowed, in computing the total income of the assessee, a deduction from such profits and gains of an amount equal to such percentage and for such number of assessment years as specified.

#### 2.12.2 Audit observed in 98 cases there was mistake in computation of income derived from eligible business under section 80IB of the Act. This resulted in underassessment of income having revenue impact of Rs. 21.86 crore in Assam, Bihar, Delhi, Gujarat, Haryana, Himachal Pradesh, Jammu and Kashmir, Karnataka, Kerala, Madhya Pradesh, Maharashtra, Punjab, Rajasthan, Tamil Nadu, Uttar Pradesh and West Bengal. Out of these, two cases are discussed below.

#### 2.12.3 In Jammu and Kashmir, CIT J & K charge, assessment of a firm, M/s. Sun Pharmaceutical Industries, for the assessment year 2005-06 was completed after scrutiny in December 2007. Audit examination revealed that the assessing officer had disallowed deduction on interest income stating that the interest income could not be said to have been derived from the industrial activity and as such did not qualify for deduction under section 80IB (4) of the Act. Accordingly, claim of assessee to the extent of profit attributable to interest income was disallowed and added to the
returned income. However scrutiny of the records revealed that while computing the net taxable income, interest income of Rs. 8.39 crore relating to Dadra unit had not been added to the returned income of the assessee. This resulted in underassessment of income of Rs. 8.39 crore with a corresponding tax effect of Rs. 4.08 crore (including interest) and penalty of Rs. 3.07 crore under section 271(1)(c) of the Act.

2.12.4 In Tamil Nadu, CIT Pondicherry charge, assessment of a firm, M/s. Vinbros and Company, for the assessment year 2002-03 was completed after scrutiny in August 2007. Audit examination revealed that while computing business income the total income was taken as Rs. 31.16 lakh instead of Rs. 3.11 crore after disallowing deduction under section 80IB. This had resulted in short computation of income to the extent of Rs. 2.80 crore involving a tax effect of Rs. 1.69 crore including interest. The department accepted the audit observation and revised (April 2008) the assessment under section 154 of the Income tax Act.

2.13 Adoption of incorrect rates of deduction

2.13.1 Where the gross total income of an assessee includes any profits and gains derived from eligible business under sections 80IB, there shall, in accordance with and subject to the provisions of section 80IB, be allowed, in computing the total income of the assessee, a deduction from such profits and gains of an amount equal to such percentage and for such number of assessment years as specified.

2.13.2 Audit observed in 23 cases there was mistake in adoption of correct rates of deduction under section 80IB of the Act. This resulted in underassessment of income having revenue impact of Rs. 104.71 crore in Andhra Pradesh, Gujarat, Himachal Pradesh, Jammu and Kashmir, Kerala, Rajasthan, Tamil Nadu, Uttar Pradesh and West Bengal. Out of these, two cases are discussed below.

2.13.3 As per section 80IB(4), the amount of deduction in the case of industrial undertaking in an industrially backward State specified in the Eighth Schedule shall be 100 per cent of the profits and gains for five assessment years beginning with the initial assessment year and thereafter 25 per cent (or 30 per cent where the assessee is a company). Further, as per the provisions of section 80IB(14)(c), initial assessment year means the assessment year relevant to the previous year in which the industrial undertaking begins to manufacture or produce articles or things.

2.13.3.1 In Tamil Nadu, CIT III Chennai charge, assessment of a company, M/s. Sterlite Industries (India) Ltd., for the assessment years 2002-03, 2003-04 and 2004-05 was completed after scrutiny in February 2005, March 2006 and December 2006 respectively. Audit examination revealed that according to Form no. 10CCB of Rakholi Unit 11, Silvassa, the date of commencement of operation by the undertaking was 18 March 1998 and the initial assessment year was 1998-99. Hence the fifth year for claim

11Located at Dadra and Nagar Haveli, an industrially backward union territory.
of deduction at 100 per cent under section 80IB was ‘assessment year 2002-03’. From the assessment year 2003-04 onwards, the unit was eligible for deduction at 30 per cent only. However, the assessee company had incorrectly claimed deduction at 100 per cent for this unit during the assessment years 2003-04 and 2004-05. Similarly, in respect of Chinchpada unit 11a the date of commencement of operation as per Form no. 10CCB was 7 June 1996 and the initial assessment year was 1997-98. Hence, the assessment year 2001-02 would be the fifth and final year to claim deduction at 100 per cent and thereafter the assessee was to claim deduction at 30 per cent only. However, the assessee had incorrectly claimed deduction during the assessment years 2002-03 and 2003-04 at 100 per cent instead of 30 per cent. This had resulted in excess claim of deduction of Rs. 527.23 crore involving a tax effect of Rs. 100.57 crore, including interest. The Department accepted (June 2008) the audit observation and agreed to initiate remedial action.

2.13.4 As per section 80IB(3), the amount of deduction would be 30 per cent (where the assessee is a company) of the profit or gain for a period of ten consecutive years beginning with the initial assessment years.

2.13.4.1 In West Bengal, CIT Central II, Kolkata charge, the assessment of a company, M/s. BMW Industries Ltd., for the assessment year 2002-03 was completed after scrutiny in March 2005. Audit examination revealed that the assessee claimed hundred per cent deduction instead of admissible thirty per cent, which was allowed in the assessment. Mistake thus resulted in excess allowance of deduction of Rs. 4.29 crore leading to underassessment of income by an identical amount involving undercharge of tax of Rs. 2.45 crore including interest. In reply the Department accepted (June 2008) the observation and stated that remedial measure under section 147 was being taken.

2.14 Separate accounts not maintained

2.14.1 Section 80IB(13) of Income Tax Act, 1961 read with Rule 18 BBB of Income Tax Rule, provides that in order to claim deduction under section 80IB, a separate audit report is to be furnished by each undertaking or enterprise of the assessee claiming deduction under section 80IB and shall be accompanied by the profit and loss account and balance sheet of the undertaking or enterprise as if the undertaking or enterprise were a distinct entity.

2.14.2 Audit observed in 26 cases assesses had not furnished separate Profit and Loss Account and Balance Sheet in respect of each unit eligible for deduction as if it were a separate entity. In the absence of these accounts, audit could not verify the correctness of the deduction claimed in such cases in Andhra Pradesh, Delhi, Gujarat, Kerala, Punjab and Uttar Pradesh. Out of these, two cases are given below.

2.14.3 In Delhi, CIT III charge, assessment of a company, M/s. Sudhir Genset Limited, for the assessment year 2003-04, 2004-05 and 2005-06 was completed after scrutiny in March 2006, December 2006 and December 2007 after allowing deduction under section 80IB of Rs. 12.57 crore, Rs. 16.49 crore and Rs. 19.11 crore respectively. Audit

11a Located at Dadra and Nagar Haveli, an industrially backward union territory.

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examination revealed that assessee has six units, out of which, four units were eligible for deduction under section 80IB. The assessee was required to furnish separate Profit and Loss account and Balance Sheet in respect of each unit eligible for deduction as if it were a separate entity. However, the assessee had not furnished the separate accounts. In the absence of separate profit and loss account and Balance Sheet, correctness of allowance of deduction under section 80IB amounting to Rs. 12.57 crore, Rs. 16.49 crore and Rs. 19.11 crore in these three assessment years, could not be verified.

2.14.4 The Department in its reply (July 2008) stated that relevant section did not provide for maintenance and furnishing separate Profit and Loss account and Balance Sheet. Reply of the Department is not acceptable as Section 80IA(7) read with Rule 18BBB of the Act stipulates that deduction shall not be admissible unless separate Profit and Loss account and Balance Sheet in respect of each unit eligible for deduction is submitted as if it were a separate entity along with the return of income.

2.14.5 In Kerala, CIT Kottayam charge, assessment of a company, M/s. Malayala Manorama Co. Ltd., for the assessment year 2003-04 and 2004-05 was completed after scrutiny in February 2006 and December 2006 after allowing deduction under section 80IB of Rs. 1.98 crore and Rs. 2.19 crore respectively. Audit examination revealed that the assessee was required to furnish separate profit and loss Account and Balance Sheet in respect of each unit eligible for deduction as if it were a separate entity. However, the assessee had not furnished the separate accounts. Thus, in the absence of separate profit and loss account and Balance Sheet, correctness of allowance of deduction under section 80IB amounting to Rs. 1.98 crore and Rs. 2.19 crore in these two assessment years could not be verified.

Thus deductions have been allowed in the cases where (i) where assessee has not filed mandatory audit report in Form no. 10CCB, (ii) income had been computed incorrectly, (iii) separate accounts had not been furnished, (iv) brought forward losses have not been set off prior to the deduction. Besides, cases have been noticed where incorrect rates of deduction were adopted while allowing deduction.

Audit recommends that the Ministry may ensure that deduction under section 80IB is allowed only in those cases where mandatory audit report has been furnished by the assesses, and strengthen its control mechanism to ensure the compliance of various provisions and requirements of the Act before allowing deductions under section 80IB of the Act.

2.15 Scrutiny norms not followed

2.15.1 As per the scrutiny guidelines issued by the Board annually, the cases where Chapter VIA deduction exceeds the specified limit\(^{12}\), are to be compulsorily selected for scrutiny for the financial years 2004-05, 2005-06 and 2006-07.

\(^{12}\) Rs. 25 lakh or above in Delhi, Mumbai, Chennai, Kolkata, Pune, Hyderabad, Bangalore and Ahmedabad, and Rs. 10 lakh or above in other places.
2.15.2 Audit observed 91 cases which were to be assessed in scrutiny manner, but were, however, processed in summary manner. In the absence of scrutiny assessment, audit was unable to verify correctness of the allowed deduction in such cases. Details of 13 such cases as observed in Assam, Delhi, Haryana, Kerala, Madhya Pradesh, Maharashtra, Punjab, Rajasthan, Tamil Nadu, Uttar Pradesh and West Bengal are given in Appendix 15.

2.16 Format of Form no. 10CCB

2.16.1 Column 18 of the Form no. 10CCB is as follows:

18. Industrial undertakings engaged in manufacture or production or article or things or operation of cold storage plant:

(a) Does the industrial undertaking manufacture or produce any article or thing specified in the Eleventh Schedule (Please specify the article or thing  

(b) If yes, does the manufacturing process use power

☐ Yes ☐ No

2.16.2 Column 18(b) above implies that the question whether the manufacturing process uses power is applicable only to the industrial undertaking manufacturing any article or thing specified in Eleventh schedule. As a result, a number of tax auditors are stating in column 18(b) “not applicable” whereas this is one of the essential conditions (the undertaking employs 10 or more workers in a manufacturing process carried on with the aid of power, or employs 20 or more workers in a manufacturing process without the aid of power) for claiming deduction under section 80IB where industrial undertaking manufacture or produce any article or thing other than specified in the Eleventh schedule.

The Ministry may consider this issue, and suitable changes in Form no. 10CCB be made to make it unambiguous.

Conclusion

Audit has noticed several cases where basic conditions for allowing deduction to industrial undertakings under section 80IB of the Act namely (i) it should be a new industrial undertaking not formed by splitting up or the reconstruction of a business already in existence, (ii) it should manufacture or produce articles, (iii) manufacture or production should be started within a stipulated time limit, (iv) it should employ minimum specified number of employees and (v) submission of mandatory audit report, have been violated. In the case of refineries, audit noticed inconsistent stand taken by the Department in allowing deduction in respect of marketing margin. In the Housing sector, audit observed that deductions were allowed though various conditions which have been laid down in the Act for availing deduction were not followed by the assesseees. Audit also noticed cases where wrong rates of deduction were adopted. The
Report No. PA 25 of 2009 (Performance Audit)

Ministry may consider ways to improve the adherence level of the various basic conditions of the Act and ensure greater compliance with the provisions of the Act before allowing tax holiday under section 80IB.

### Summary of Recommendations

The Ministry may ensure that in-depth analysis is made to ascertain the status of an industrial undertaking before deduction is allowed.

The Ministry may reconcile the different stands taken by the Department in respect of allowing/disallowing deduction on marketing margin in the case of IOCL and HPCL, and escalate the level of appeal to the highest level. Alternatively, the relevant provisions of the Act may be amended.

The Ministry may ensure that judicial pronouncements in respect of manufacturing activities are applied to all similarly placed cases.

The Ministry may consider issuing instructions so that assessing officers are vigilant in determining the eligibility of the assessee and determining the time period for applicability of deduction under section 80IB.

The Ministry may ensure that as the information in respect of number of employees and use of power in manufacturing activities is given in the audit report, such information is utilised by the assessing officers and verified from the accounts of the assessee before allowing deductions under section 80IB.

The Ministry may evolve a suitable control mechanism to ensure that the conditions as laid down for availing deduction in respect of Housing sector are complied with before allowing deduction in this regard.

The Ministry may ensure that deduction under section 80IB is allowed only in those cases where mandatory audit report has been furnished by the assessee.

The Ministry may strengthen its control mechanism to ensure compliance of various provisions and requirements of the Act before allowing deductions under section 80IB of the Act.

The Ministry may consider the suitable changes in the Form no. 10CCB so as to make it unambiguous.

In the exit conference, the Board accepted the audit recommendations and agreed to address the issues brought out in the review report.

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Email:rtichandigarh@gmail.com

F. No.DIT/DTRTI/10-11/____________ Dated:

Schedule for 2 days “Course on Internal Audit” for Officers of CIT (Audit) – I & II, Delhi
From 22.11.2010 to 23.11.2010

<table>
<thead>
<tr>
<th>Course Director</th>
<th>Smt. Punam K. Sidhu, Director of Income Tax, DTRTI, Chandigarh, M. No: 94173-35758</th>
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<tbody>
<tr>
<td>Course Counselor</td>
<td>Sh. Mahender Singh, Addl. Asstt. Director of Income Tax, DTRTI, Chandigarh, M. No: 94161-50141</td>
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<td>Sh. Muneesh Rajani, Addl. Asstt. Director of Income-tax, MST Unit, Delhi, M. No. 99683-11859</td>
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Venue: Integrated Training Hall, East Block-II, Level-IV, Vivekananda Marg,
R. K. Puram, New Delhi-110 066

SCHEDULE

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<td>10.00 AM</td>
<td>Inauguration</td>
<td>Shri Milap Jain, CCIT, Delhi-I</td>
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<td>to 10.00 AM</td>
<td>Overview, Checklist for Audit Parties &amp; Important Instructions for Audit</td>
<td>Mrs. Punam K. Sidhu, DIT, DTRTI, Chandigarh</td>
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<td>II</td>
<td>10.45 AM</td>
<td>Audit of company cases</td>
<td>Shri A.K. Manchanda, CCIT, Delhi-V</td>
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<td></td>
<td>to 12.00 Noon</td>
<td>Section 80A, 80AB, 80AC. Case Law. Gross Total Income and Total Income, Sec 80IA, 80IB, Computation of deduction, period of admissibility,</td>
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<td>II</td>
<td>01.30 PM</td>
<td>Chapter VIA Deduction – case studies and case law. Special provisions for cases covered u/s 10A and 10B with case studies.</td>
<td>Shri A.K. Manchanda, CCIT, Delhi-V</td>
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<td>01.30 PM to 02.15 PM</td>
<td><strong>Lunch Break</strong></td>
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<td>III</td>
<td>02.15 PM to 03.30 PM</td>
<td>Audit of company cases Examination of audited accounts and audit report of the company, auditors note, Directors Report, foot notes to P&amp;L account, Balance sheet</td>
<td>Mr. Avinash Gupta, CA</td>
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<td>IV</td>
<td>03.45 PM to 06.00 PM</td>
<td>Audit of company cases 44AB report, and issues to be looked for in scrutiny assessments including sections 14A, 40(a)(ia), TDS etc, Common mistakes in assessment and Case Studies to cover such mistakes</td>
<td>Shri Rajesh Kedia, Addl. CIT</td>
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<td>I</td>
<td>09.30 AM to 10.00 AM</td>
<td>Review / Brain storming &amp; library session</td>
<td>Mrs. Punam K. Sidhu, DIT, DTRTI, Chandigarh</td>
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<td>Law and assessment procedure of Transfer Pricing / International Taxation cases.</td>
<td>Shri S.P. Singh, ex-IRS</td>
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<td>Audit of Search &amp; Seizure Cases</td>
<td>Shri. Sunil Chopra, CCIT (Retd.)</td>
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<td>Law and assessment procedure of exemption cases.</td>
<td>Shri P. V. Rao, DIT(Exemption)</td>
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<td>Audit of company cases Special provisions for MAT – Section 115JB, Section 115 O, Tax on distribution of profits by domestic companies.</td>
<td>Mr. Girish Ahuja, CA, New Delhi</td>
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<td>V</td>
<td>03.45 PM to 05.00 PM</td>
<td>Issues related to Carry forward and set-off of brought forward losses, depreciation, capital gains, bad debts and provisions/reserves etc.</td>
<td>Mr. Girish Ahuja, CA, New Delhi</td>
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<td>05.00 PM</td>
<td><strong>Valediction</strong></td>
<td>Mrs. Anita Kapur, IRS, DGIT (Admn.) / Shri. Jawahar Thakur, ICAS, Principal CCA, CBDT</td>
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