

TAX AUDIT - REPRESENTATION, AUDIT RISKS AND DISCLOSURES

By R. Sundararajan, FCA
29th October 2014
SIRC of ICAI

Quick summary – Information required for tax audit may be categorized as follows:

Basic Facts

- Clause 1 to 11, 13 ,14, 37-39,

Items of Income

- Clauses 12 , 16 ,24 & 25

Items of Expense

- Clauses 15,18,20 & 21

Deductions

- Clause 19, 32 & 33

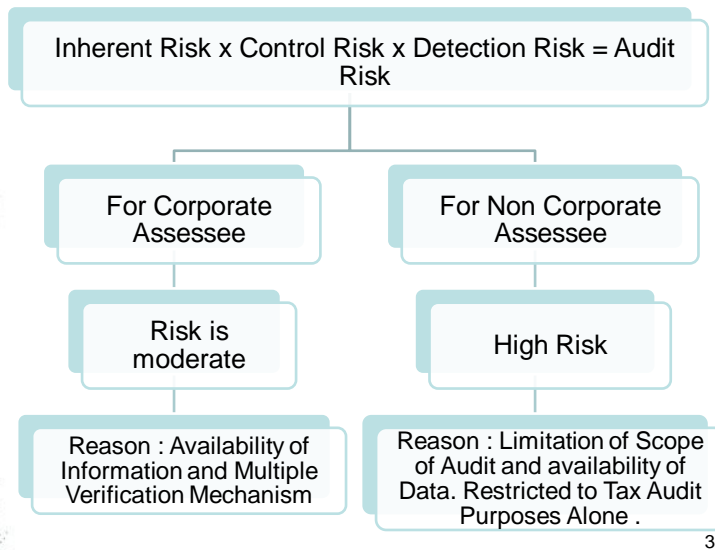
Overall Checks

- Clauses 35 & 40

Legacy Items

- Clause 17, 22,23, 26 to 31, 34 , 36, 41

Audit Risks



3

Written Representations

➤ Need

Limitations

- ✓ In Scope of Audit
- ✓ In Time frame
- ✓ In the availability and supply of Information.
- **Clauses where Written representation from Clients is warranted**
- Clause 4 of Part A – Indirect Tax Liability
- Clause 9 of Part B- Name of Partners / PSR/ Change in both.
- Clause 10 Change in Nature of Business especially for Non Corporate assessee not subject to tax audit in the preceding previous year
- Clause 11: List of Books of accounts maintained and its location.
- Clause 13: Method of accounting followed in preceding previous year especially for Non Corporate assessee.
- Clause 16 : Amounts not credited to Profit and loss account of the nature specified in the sub clauses
- Clause 18 : Depreciation Clause - the date of put to use of assets, Usage of assets – Personal / Official, Basis of providing depreciation in case of cash basis of accounting. Etc



Written Representations

Clause 21(d) : All Payments made during the year were made by account payee cheque

Clause 21 (h) : Amount of Expenses related to Exempt income u/s 14A

Clause 22 :Details regarding the MSMED creditors.

Clause 31(a) : No loan has been taken or accepted otherwise than by account payee cheque.

Clause 32(a) : The e filing portal requires additional information regarding the order no. the same to be received from the management

Clause 32 (b): Change in Shareholding pattern

Clause 33: Section wise details of deductions if any admissible under Chapter VIA or Chapter III (especially in cases where Sole Proprietor having varied lines of business and only business activity requires tax audit)

Clause 35 : Principal items of goods traded, the balances of opening stock, purchases, sales and closing stock

Clause 38, 39 and 41 – Details of Cost audit, Excise audit and Special Audit u/d 72A to be obtained (**Upto the date of Tax Audit report**)

Clause 41- Pending Demands

5



Disclosures

NEED

- For Mutually Agreed Clauses (Statutory Compliance information as required in the relevant clauses, Provision for gratuity disallowed u/s 40A(7), Details of payments under sec 40A(2) (b)
- For Mutually disagreed clauses to the extent of relevancy and Materiality where disclosures alone is made and not Modified Audit opinion is required.
- Eg - Clause 4 of Part A – Indirect Tax Liability
- Liability of Contingent Nature
- Any item of expenditure debited to the P&L Account is not of capital nature but there is possibility of holding such a view, furnish details with your views on the same.
- Any amount of profit chargeable to tax under section 41 and computation thereof.
- Amounts deemed to be profits and gains under section 33AB or 33ABA or 33AC etc

6

Audit Disclaimer - Need

Wherever, Limitation on Scope is material

Sufficient or appropriate information/ evidence not obtained

Cases requiring Disclaimer of Opinion (for the below mentioned items if the impact is so material the auditor can provide qualified opinion too)

Clause 11 (a) - Proper Books of accounts as required under Rule 6F not Maintained

Clause 11(c) Documents necessary to verify the reportable transaction were not made available

Clause 12 : Computation of Profits and gains assessable on presumptive basis has not been verified by us

Clause 13: The extent of impact on the profitability due to change in method of accounting/ valuation of stock is not ascertainable.

Clause 21 (d) : Whether all the payments made during the year are through account payee cheques or not could not be verified as the necessary evidence is not in the possession of the assessee

Clause 22 :Creditors under MSMED not ascertainable

Clause 27 (b) Prior Period Expenses are not ascertainable from the books of accounts

7

Audit Disclaimer

Clause 31(a) It is not possible to verify whether loans or deposits have been taken or accepted otherwise than by an account payee cheque or account payee bank draft, as the necessary evidence is not in the possession of the assessee' – **Relevance in today's banking environment ???!**

Clause 32 : Speculative losses: As in the case of 50 C/43 CA/56, etc. the transactions reflected in the accounts audited alone has been reported.

Clause 37-39: Reports of other audits were not made available

Clause 40: GP ratio is not ascertainable from the financial statements prepared by the assessee

Clause 40 : When previous year was not audited, to report clearly that the same was extracted from previous year figure and not audited by the current year auditor.

8

Qualified Opinion

Disagreement with the management is so Material and pervasive

Sample Clauses

Clause 29 :Fair Market value of the shares u/s 56(2) is not ascertainable.

Clause 21 (h) : Amount of Income related to exempt income u/s 14A is not ascertainable

Clause 34 Applicability of Chapter XVII B and BB and Interest liability u/s 201(1A) and 206C(7)

Clause 34 TDs returns could not be verified with the books of accounts

Records necessary to verify the personal nature of expenses is not maintained by the assessee

Proper Stock records are not maintained by the assessee

Valuation of stock is not possible

9

Analysis of Clauses

1. Clause 4 Applicability of Indirect Taxes

MRL : List of Indirect Taxes Applicable to the assessee with the registration numbers / ID nos.

Action : If the tax auditor opines that Indirect Tax is applicable but the assessee has not registered- the same to be disclosed.

Sr. No	Relevant Indirect Tax Law which requires registration	Place of Business / Profession / Service unit for which registration in place / or applied for (or) Regn nos (or) Identification Nos
--------	---	--

Possible Value Additions at time of audit:

Indicate if

- ✓ . Activity amounts to manufacture of excisable goods or provision of taxable services?
- ✓ . Requirement to take registration under excise or service tax where wrongly claiming exemption, such as SSI exemption on branded goods.
- ✓ . The excise duty/service tax/customs duties or VAT being paid at wrong rate.

10



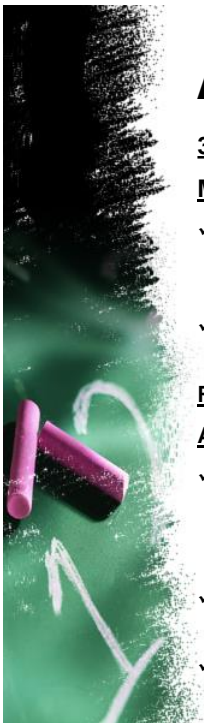
Analysis of Clauses

2. Clause 9 Name of the partners and Profit sharing ratio.

MRL: Partnership Deed and representation from the assessee

Action: If there is any change in the relevant PY, the same to be disclosed

11



Analysis of Clauses

3. Clause 10 : Nature of Business

MRL:

- ✓ Corporate Assessee – Reference can be made to the **Directors report / Notes forming part of FS. Segment reporting, Quantitative details** of CY with PY
- ✓ Non Corporate Assessee Not Subject to Tax audit in the preceeding previous year.

Risk : Detection Risk

Action :

- ✓ The tax auditor should make proper enquiries, review the minutes of meeting (if made available), director's report, etc and if any defaults or change in the nature of business or profession eg from manufacturer to trader etc is found the same to be reported.
- ✓ In case of Business reorganization , if similar activity is carried out , no reference required
- ✓ If any line of activity is hived off , the same may also be reported

12



Analysis of Clauses

4. Clause 11 : Books of Account:

MRL :

- ✓ List of Books of accounts maintained(electronic and non electronic format.
- ✓ Location at which the said books of accounts are maintained.

Action : Disclosure : **List of books** with the location of maintenance (location of server).

- ✓ If the assessee **has not maintained** proper books of accounts to enable 3CD reporting , the same to be **qualified**.
- ✓ Corporate assessee - **necessary forms are filed with ROC**
- ✓ The **Nature of documents (? !)** examined should also be reported as per the New format .
- ✓ **Qualification :** Documents necessary to verify the reportable transaction were not made available.

13



Analysis of clauses

5. Clause 12 : Whether the P&L A/c includes any profits and gains assessable on presumptive basis?

Reporting Format:

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

Consider Disclaimer:

The computation of this profit has not been verified by us.

14



Analysis of Clauses

6. Clause 13 & 14 : Method of Accounting and Valuation of Stock

MRL:

- Written Confirmation from the assessee as to the method of accounting followed. Especially in case of Non corporate assessee not subject to audit in the preceding previous year

Reporting Format:

1. The method followed by the assessee to be reported.
2. As per the revised report , **the impact on profit** due to change in method of accounting to be disclosed.
3. If it is not possible to quantify the change in method of accounting, appropriate disclosure should be made
4. *The auditor should **report** deviation from section 145A and also the effect on profit / loss.*

15



Analysis of Clauses

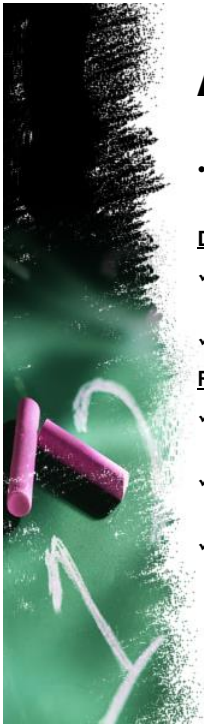
Relevant Issues

- ✓ Does Change in accounting policy amount to change in method of accounting ?????
- ✓ Where Closing Inventories are valued at Market price (being lower than cost), should excise duty be added to such amount for complying with sec 145A????

Qualification:

- ✓ Proper Stock records are not maintained by the assessee
- ✓ Valuation of Closing Stock is not possible.
- ✓ Yield/ Percentage of wastage is not ascertainable.

16



Analysis of Clauses

- **Clause 17 : Details of assets sold at lesser than Registration value to be furnished.**

Detection Risk :

- ✓ If the transactions are not covered in the books that are audited, reporting will be difficult.
- ✓ Further personal transactions are not audited in normal course.

Reporting:

- ✓ Coverage to be clearly reported and non verification of personal bank accounts to be disclaimed clearly.
- ✓ The details of the property with the consideration received or accrued and the value adopted or assessable for such property to be disclosed.
- ✓ Auditor would have to apply professional judgment as to what constitutes land or building for e.g. whether leasehold right / development rights / TDR / FSI etc would fall under this provisions or not, would require to be evaluated based on facts & circumstances of transactions

17



Analysis of Clauses

- **Clause 20 : 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. (Sec 36 (1) (ii))**

MRL: Written Confirmation from assessee as to the contract with any specified employees.

Reporting Format:

- The requirement is only in respect of disclosure, the tax auditor is not expected to express an opinion about the allowability or otherwise.
- Furnish details of any sum received.
- Furnish details of due date of payment and actual dates of payment and the amount paid out of the amount received from employees

18



Analysis of Clauses

Clause 21 : Amounts Debited to Profit and Loss accounts in the nature of Capital , Personal, advertisement expenditure, incurred at clubs, Penalty for Violation of law

Written Confirmation from the assessee as to the extent of non applicability of the above clause to be obtained.

General Tests to be applied to determine whether a particular expenditure is of the above nature.

Qualification: Records necessary to verify the personal nature of expenses not maintained by the assessee.

19

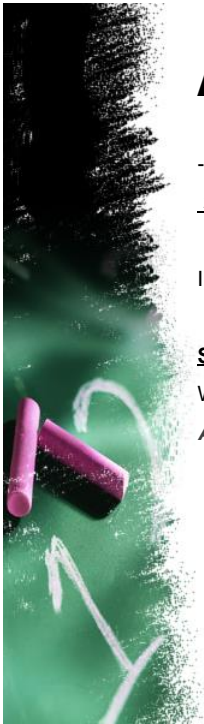


Analysis of Clauses

Clause 21 (b) Amounts inadmissible under Sec 40(a)

- Effectively to report whether debited to P & L account or not.
- Expanded the scope and reporting format
- General Disclaimer (Sample)
- Considering the diverse nature and volume of transactions in respect of which tax is deductible at source on payments covered by the provisions of Section 40(a), in the case of the Assessee, the disclosure given under this clause is based on the exceptions noted in the course of verification by the auditors on a test check basis and the information provided by the Assessee. As per such verification and information provided , no amounts are inadmissible under this clause.
- In the opinion of the Company, month end provision for expenses which are reversed at the beginning of the next month are not liable for deduction of tax at source as such provisions are made only for the purpose of preparation of financial statements in accordance with group policies and as per applicable accounting principles/ standards.

20



Analysis of Clauses

- Clause 21 (d)

Sec 40 A (3)

Declaration from assessee obtained hitherto is removed from report.

Impact – Increased Audit Responsibility – MRL Still has to be obtained

Sec 40 A(3A) – New addition

Written Confirmation from the assessee for the above also to be obtained.

Also a Representation Letter from the assessee to be obtained.

21



Analysis of Clauses

- Clause 28 (New Addition)

To report if the assessee has received any property, being share of a company in which the public are not substantially interested, without consideration or for inadequate consideration as referred to in sec 56 (2) (vii)

Purpose :

To cover the transactions of shares issue at lesser than fair value in closely held companies

Which was hitherto not taxed

Issues :

If the transactions are not covered in the books that are audited, reporting will be difficult. **(as in clause relating to property sale)**

Further personal transactions are not audited in normal course.

Solution :

Coverage to be clearly reported and non verification of personal bank accounts to be disclaimed clearly.

22

Analysis of Clauses

Clause 29 New addition

- **Whether during the previous year the assessee received any consideration for issue of shares which exceeds the fair market value of the shares as referred to in section 56(2)(viib) of the IT Act, if yes, details of the same to be furnished.**

- *Applicable to Companies issuing shares at premium*
- *Premium in excess of FMV is taxable as income in view of amendment*

Issues :

- *FMV determination is an issue*
- *Added responsibility on auditor*

➤ Exception :

The shares issued by way of FDI wherein Discounted Cash flow method is used may not be attracted.

23

Analysis of Clauses

Clause 31 (a) : Particulars of each loan or deposit in an amount exceeding the limit specified in section 269SS taken or accepted during the previous year :--

Comprehensive MRL has to be obtained.

Also a disclaimer has to be made for insufficient proof availability in respect of cases not examined – Test check.

Practical Issues :

If the total of all loans/deposits from a person exceed Rs.20,000/- but each individual item is less than Rs.20,000/-, the information will still be required to be given????

Sale proceeds collected by the selling agent will be considered as loan or deposit ??????

A current account is not excluded from the definition of the term “deposit” ????????

Advance received against agreement of sale of goods is considered as a loan or deposit. = Will be interesting in view of Companies Act 2013

24



Analysis of Clauses

Clause 31 (b) : Sec 269 T

Loan or deposits discharged by means of transfer entries constitute repayment of loan or deposits otherwise than by account payee cheques or account payee bank drafts. Hence, such entries have to be reported under this clause.

Practically, it may not possible to verify each payment, reflected in the bank statement, as to whether the payment/ acceptance of deposits or loans has been made through account payee cheque, demand draft, pay order or not,

should obtain suitable Representation Letter from the assessee to the effect that the payments/ receipts referred to in section 269SS and 269T were made by account payee cheque drawn on a bank or account payee bank draft as the case may be.

Where the reporting has been done on the basis of the certificate of the assessee, the same shall be reported as an observation in clause (3) of Form No. 3CA and clause (5) of Form No.3CB, as the case may be.

25



Analysis of Clauses

Clause 34 : Reporting of Compliance under Chapter XVII B and XVII BB

- **34 (a)** Revised format implies entire disclosure requirement and not restricted to non compliance alone.
- The information Provided in Clause 34 should tally with the disallowances reported u/s 40(a) in clause 21(b) to the extent applicable
- **34(b)** Whether the assessee has furnished the statement of tax deducted and collected within the prescribed time. If not, Please furnish the details (Non compliance alone)
- **34(c)** Details about the Interest paid Under Sec 201(1A) and 206 C(7) – Amount of interest Payable, paid , Date of Payment.
- **Audit Process**

Verification of the existence of procedures relating to deduction and remittance of tax

Perusal the expenditure account for identifying transactions which require deduction of tax at source.

Clear disclaimer as to the extent of Test Check has to be made, as given earlier. 26



Analysis of Clauses

3. Practical Issues

- ✓ 100% Verification of all the expenditure accounts is not possible
- ✓ Determining the gross value liable for TDS for Salary
- ✓ Determination of Amounts of nature specified in case where an single ledger contains both Material and labour contracts
- ✓ Whether the Gross value to be considered before or after Service tax , since the TDs is not calculated on service tax portion as per the recent amendment, if so will be short deduction on face of disclosure made.

27



Analysis of Clauses

Clause 41 : Details of demand raised or refund issued

- ✓ The tax auditor should obtain a **copy of all the demand/ refund orders** issued by the governmental authorities during the previous year
- ✓ It may be noted that even though the demand/refund order is issued during the previous year, **it may pertain to a period other than the relevant previous year**. In such cases also, reporting has to be done under this clause.
- ✓ If there is any adjustment of refund against any demand, the auditor shall also report the same under this clause.
- ✓ Representation letter to be obtained

28

Conclusion (Challenges) of tax audit

- Voluminous transactions
- Insufficient time & remuneration
- Compliance of too many Statutes
- Conclusion based on audit working papers
- Documentations to be preserved – PEER REVIEW



ALL THESE IMPLY AND DRIVE US TOWARDS :-

DISCLAIMERS, QUALIFICATIONS AND REPRESENTATIONS

**THESE ARE NOT PROTECTORS BUT INSULATORS AGAINST
AUDIT RISKS !!!**

LIKE ANY OTHER RISK, AUDIT RISK ALSO CANNOT BE ERADICATED
BUT ONLY CAN BE MITIGATED !!!

29



**THANKS
FOR
LISTENING**



R SUNDARARAJAN, FCA, DISA (ICAI)

Sundararajan Associates

sundar @sunca.in

30