

Chapter V: Internal Control

5.1 Introduction

Internal control is necessary to improve policy formulation and implementation. An effective system of internal controls serves as a means to obtain reasonable assurance that the steps and action undertaken by the ITD meet their established goals and objectives. We have tried to highlight the control issues of the ITD by checking records available at the CsIT³⁰ relating to the Firms.

ITD did not carry out inspections/quarterly reviews of records maintained for the Firms diluting the importance of monitoring.

5.2 Monitoring

Section 119 of the Act provides that CBDT may, from time to time, issue such orders, instructions and directions to other income tax authorities as it may deem fit for proper administration of the Act, and such authorities and all other persons employed in the execution of this Act, shall observe and follow such orders, instructions and directions of CBDT.

It is thus, imperative that all officers employed in the execution of these statutes shall observe and follow any orders, instructions and directions issued by CBDT for proper tax administration. Brief of some of the instructions issued by the CBTD are given in Box 5.1.

Box 5.1: Instructions regarding inspection

- a. *Instruction no. 16/2008 dated 04 November 2008:* CsIT are required to carry out inspections of Range Offices & Circle Offices under their control and submit inspection report.
- b. *Instruction no. 15/2008 dated 04 November 2008:* Each CIT is required to review the assessment of the DCsIT/ACsIT and make at least three assessments of each DCsIT/ACsIT per quarter. Similarly, Range Officers are required to review the assessment done by ITOs in their range and to make specific comments on at least three assessments of each ITO per quarter.

We found deficiencies in monitoring by ITD which are as follows:

- a. In West Bengal, the inspections carried out by CIT-Central-III and CIT-XI, Kolkata for FY 11 did not translate into productivity as the deficiencies pointed out in inspection reports were continued in inspection report of next year also. We also found that CsIT and Range Officers reviewed less number of assessment orders as against the

³⁰ Two CsIT taken for evaluation for each state.

limit prescribed in the instructions, thus diluting the control activities of the ITD.

- b. In CIT-Bhubaneswar (for FY 13), CIT-Cuttack (for FY 12 and FY 13) and their Range Offices, the Commissioners as well as Range Officers did not carry out inspection in their subordinate offices.
- c. In Tamil Nadu CIT-VIII Chennai and CIT-Coimbatore, there was no monitoring/ controlling mechanism at the level of CIT regarding the issue of notices sent to non filers and stop filers.
- d. In Bihar CIT-II Patna charge, assessment records of **M/s. Uma Shankar Singh** for AY 09 revealed that CIT-II Patna had carried out quarterly review and sought compliance report from AO on certain observations. However, the AO did not take any action, neither did he furnish compliance report on the observations made by CIT-II Patna.

Therefore, instructions issued by CBDT from time to time are not being followed by Range Officers and Circle Officers properly.

ITD did not maintain prescribed records properly which resulted in ineffective control mechanism.

5.3 Deficiencies in maintenance of Registers

Documentation of procedure and maintenance of registers for various functions of the ITD and its updation are essential for effective control mechanism (see Box 5.2).

Box 5.2: Instructions regarding maintenance of registers

- a. *Instruction no. 1/2009 dated 12 February 2009:* Jurisdictional AOs and designated AOs are required to maintain register of action taken on AIR information in the prescribed format which should be inspected every quarter by Range head and the CIT concerned.
- b. *Para 2.4.1 of Chapter 14 of Manual of Office Procedure (MOP)-Vol.-I, 2003:* Each AO has to maintain a Grievance Register in the proforma prescribed in Annexure I.

We found deficiencies in maintenance of registers, which are as follows:

- a. In Gujarat, the Grievance Registers were not maintained properly. The columns like 'Code No.', 'Nature of Disposal' etc. were not included in the Register. Scrutiny of Personal Deposit (PD), Account Cash Book, PD Ledger Account and the correspondence folder revealed that the monthly balance statement from the bank was not obtained and reconciled with the balance in the Cash Book. We also found a

discrepancy in the closing balance as per Cash Book and Bank Book records for an amount of ₹ 4.82 lakh. In Gujarat CIT-Valsad charge, the Arrear Demand & Collection register (ADCR) was not updated/rectified resulting in excess credit of ₹ 22 lakh to the assessee.

- b. In Uttar Pradesh and Uttarakhand, registers such as Advance Tax Register, Annual Information Return (AIR) and references to Valuation Cell Register were either not maintained or not updated.
- c. In Karnataka and West Bengal, Demand & Collection Register were not updated and register of action taken on AIR was not maintained at all.
- d. In Himachal Pradesh charge, in eight units, no register to utilize the AIR information were maintained and in one unit, it was not put up to the Addl. CIT for quarterly verification/monitoring.

Non maintenance of prescribed registers to ensure comprehensive recording of the transactions defeated the very objective of the system, hence diluting the internal control mechanism of the ITD.

ITD did not give importance to their internal audit as it was neither conducted nor did it cover the Firms assessment records.

5.4 Internal Audit

The objective of internal audit inter alia includes checking whether procedures and terms prescribed by the ITD are adequate and the instructions issued and procedures prescribed by CBDT are being duly implemented. Role of internal audit is also to exercise vigilance for prevention of mistakes and to improve quality of assessment by reducing the errors and omissions.

The deficiencies in conducting internal audit were as follows:

- a. In Uttar Pradesh, the internal audit was not being conducted regularly for FY 11 and FY 12.
- b. In Andhra Pradesh, out of 35 units selected for audit, internal audit was not conducted in 7 units and partly completed in 11 units.
- c. In Odisha, CIT-Bhubaneswar charge, we found that none of the assessment records had the evidence of audit conducted by Internal Audit Party (IAP).

- d. In West Bengal, internal audit did not check the assessments completed relating to the Firms in assessment charges under CIT XI & CIT Central III Kolkata during the period FY 11 to FY 13.
- e. In Uttarakhand, CIT-Dehradun charge, we found that IAP did not check any assessment records during FY 13.

The above deficiencies indicate lapses in the internal control mechanism of the ITD.

ITD did not effectively utilize the information available in the Tax Audit Reports issued by Accountants (third party) against the Firms which resulted in income escaping assessment.

5.5 Incorrect/incomplete certification by Chartered Accountants

The Tax Audit Report issued by an accountant is one of the tools in the hands of the ITD for deciding the correctness of the income and deductions claimed by the assessee. CBDT in order to ensure that the assessee, accountant and AO comply with the various provisions of the Act, had issued *Instruction No. 1959 and 1976 in January 1999 and November 1999* respectively. 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 AO 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.

Section 44AA requires compulsory maintenance of books of accounts by different categories of taxpayers and section 44AB requires the audit of accounts of any person carrying out any business or profession, by an accountant if the total turnover/gross receipts of the business or profession for the previous year exceed ₹ 40 lakh or ₹ 10 lakh respectively. The deficiencies in third party reporting are given in Box 5.3.

Box 5.3: Illustrative cases on deficiencies in third party reporting

- a. In Odisha, CIT-Bhubaneswar charge, we noticed that provisions of section 44AA of the Act were not complied with in respect of M/s. S. M. Enterprises. In Karnataka, CIT-Hubli charge, AO completed the assessment of a Firm **M/s. A. A. Logistics** for AY 09 under scrutiny and for AY 10 & AY 11 under summary manner. We noticed that the provisions of section 44AA and section 44AB of the Act were not complied with and no action had been initiated in this regard to levy penalty u/s 271A and 271B of the Act. On being pointed out, the ITD accepted the audit observation for AY 09 and levied the penalty under section 271A of the Act.

- b.** In Andhra Pradesh, CIT-Tirupati charge, we found in two cases that the 'Third Party' had reported/certified identical details³¹ in respect of two assessee Firms indicating incorrect reporting by the Chartered Accountant.
- c.** In West Bengal, we found in two cases that the 'Third Party' failed to report correctly regarding compliance of TDS provisions and in one case, they did not quantify the 'Telephone & Motor Car Expenses' despite the expenses being debited to Profit & Loss Account.
- d.** In Maharashtra CIT-Thane charge, in the case of **M/s. Shree Varad Vinayak Developers** for AY 11, the assessee had furnished the Tax Audit Report for AY 10 wherein the tax auditor had reported on non-deduction of TDS on ₹ 59 lakh. But the AO failed to reopen and assess the return for the AY 10 by scrutiny to add back the amount of ₹ 59 lakh to income. This resulted in loss of revenue by ₹ 18.23 lakh.
- e.** In Karnataka, out of 1,265 Firms test checked, we found 250 Firms having 867 Partners did not mention PAN of Partners in form 3CD report.
- f.** In Punjab, we found that the assessee had not furnished the form 3CD report as per the section 44AB. Further, AO did not levy penalty nor issued notice to the assessee for non-compliance of provisions.

In this connection, a reference is also invited to 'Review on Appreciation of Third Party Reporting/ Certification in Assessment Proceedings'³² wherein recommendation had been made to ensure that AOs critically examine the Tax Audit Reports along with the connected records and take action in terms of instruction number 1959 in cases where inaccurate information have been furnished by tax auditors. CBDT had accepted the recommendation. However, keeping in view the recurrence of similar instances, the recommendation is reiterated.

5.6 Effectiveness of survey in tax administration

The provisions of the Act empower the AO to scrutinize the returns and the statements filed in order to determine the income and to collect tax. The examination of books of accounts and verification of the facts presented by the assessee are the primary jobs of the AO. In this context, the power of survey serves the following two important purposes viz (i) ITD's determination to reach out and obtain information about the assessee and his income earning activities, and (ii) meaningful selection of cases for scrutiny by collecting information about various trades and trade practices.

³¹ For hire charges and labour welfare expense.

³² Chapter-2 of CAG's report no. PA 7 of 2008.

In Haryana, we found that information obtained during the survey was not utilized in assessment for the computation of total income involving tax effect of ₹ 4.14 lakh.

Thus the AOs are not making effective use of the information collected during the surveys while making assessments.

5.7 Selection for scrutiny

CBDT issues instructions every year which lay down the procedure for selection of assessments for compulsory scrutiny under various categories. As per the CBDT's norms for compulsory scrutiny and Computer Aided Selection for Scrutiny (CASS) norms, the returns of all the builders following project completion method are required to be selected for compulsory scrutiny.

We found two cases in Maharashtra wherein the cases were not considered for assessment under scrutiny manner in spite of a reduction in the income with respect to previous year (see Box 5.4).

Box no.5.4: Illustrative case on non-selection under scrutiny assessment

In Maharashtra in CIT-XXII Mumbai charge for the last three AYs 09, 10 and 11, in case of **M/s. Raja Construction** we noticed that the Firm was assessed under summary despite there being a reduction of income of ₹ 118 lakh in AY 10 compared to AY 09. The Firm has shown taxable income of ₹ 157.41 lakh, ₹ 39.93 lakh and ₹ 70.68 lakh respectively during the above AYs, however, the case was not selected for scrutiny.

ITD did not recover/write off of arrear demands against the defaulting Firms leading to loss of revenue.

5.8 Recovery/Write-off of arrear demand

Under the provision of section 226(5) of the Act, the AO or Tax Recovery Officer (TRO) may, if so authorized by the CCIT or CIT by general or special order, recover any arrears of tax due from an assessee by distraint and sale of his movable/immovable property in the manner laid down in the schedule. Further, Chapter 13 of the Manual of Office Procedure of the ITD specifies that when tax demands remain irrecoverable in spite of exercise of powers of recovery under the Act, the option of "write off of arrears" should be considered. The powers to sanction write off of revenue have been delegated by the Central Government to the Income Tax Authorities. All the CITs have full powers to write off irrecoverable balance of Income Tax, Wealth Tax etc. subject to a report to the next higher authority.

If an assessee fails to pay the amount of tax of demand, within one month from the date of receipt of notice, the AO shall initiate the proceeding of recovery of such demand by distraint warrant and sale of movable/immovable properties of the assessee. He should also report such matters to higher authorities/CsIT and TROs for taking prompt/proper action along with proceedings of initiation of penalty u/s 221(1) for non-payment of such amount of demand notice.

We found cases where provisions for recovery/write off of demands were not followed.

- a. In Haryana charge, arrear of tax demand of ₹ 125.81 lakh were outstanding against the defaulting Firms for more than 3 years in eight cases. Further, in Punjab charge, arrear of tax demand outstanding against defaulting Firms amounted to ₹ 282.01 lakh and in Jammu & Kashmir charge, total arrears of ₹ 813.15 lakh were outstanding for more than three years. However, in no case, recourse to proceedings laid down in the Act had been initiated.
- b. We also found in Assam CIT-II Guwahati charge for the AY 10 in case of **M/s. GM Coke Holding** that AO raised demand notice of ₹ 257.35 lakh which was also confirmed by the CIT(A) but did not follow up further action for recovery. ITD also did not initiate any requisite penalty proceedings for default in payment of demand tax.
- c. In Uttar Pradesh, we noticed that the AO did not partially write off/write-off the arrear demand despite demands amounting to ₹ 25,630 lakh and ₹ 2,961 lakh pertaining to Kanpur and Agra respectively being outstanding for more than three years in respect of FY 11, 12 and 13. We also found in CIT-Allahabad that a demand of ₹ 115.04 lakh created after scrutiny assessment for AY 10 in respect of **M/s. Gajraj Chemicals** was not followed up for recovery.
- d. In Kerala CIT-II, Kochi charge, we found that although tax arrears amounting to ₹ 209.11 crore (all assesseees) was outstanding at the end of March 2013, the AO did not take any coercive action for recovery of the same.
- e. In Gujarat, we found in seven cases that outstanding demand was recovered without charging interest u/s 220(2) of the Act having a tax effect of ₹ 53.85 lakh.

It is evident from the above illustrations that internal control at the level of AO and TRO is weak and not being monitored at appropriate level.

5.9 Others

- a. According to CBDT's *Instruction no.7/2002 of August 2002*, refunds determined, where administrative approval is necessary before issue of refund, should be issued within 30 days from the date of determination of refunds. In West Bengal under CIT-XI Kolkata charge, we noticed that Range Offices took considerable time of more than two months in granting administrative approval for refund. In twelve cases, similar approval was accorded after the aforesaid prescribed date.
- b. In Uttar Pradesh CIT-Ghaziabad charge, we noticed in two cases that the Online Tax Accounting System had created a fictitious demand without recognizing the credit for tax deposited.
- c. In Gujarat, we found that settlement of grievances was pending for more than three years in respect of four cases and for less than three years for eight cases. The ITD accepted (July 2013) the observation and replied that the pendency shown by audit is being attended to.
- d. We observed in Gujarat CIT-Valsad charge that in the case of Firm **M/s. J. K. Brothers**, irregular allowances of carry forward of losses amounting to ₹ 17.20 lakh was granted due to non-synchronization of total income shown under ITD system software with the total of various head of income entered by the users.
- e. In Andhra Pradesh we noticed that out of 474 stop-filers and 3202 non-filers in respect of Firms the ITD issued notices to only 114 assessees. In Karnataka ITD did not issue any notice nor levied any penalty to the 1748 non-filers.

5.10 Recommendations

We recommend that

- a. ITD may strengthen its internal control and monitoring mechanism to ensure compliance with the instructions, rules, circulars and provisions of the Act. The Ministry may also take appropriate action against the third parties for incorrect certification in Tax Audit Report and may make concerted efforts required for recovery of arrears or write-off of irrecoverable arrears.

- b. ITD may ensure that all required registers are maintained by their field units which may be checked for compliance by the Internal Audit Party.

The Ministry replied (March 2014) that DIT (Organisation & Management Services) has prescribed certain set of registers to be maintained and it has been enabled in electronic form in ITD application.

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