

## Chapter II

### Review on Appreciation of Third Party Reporting/ Certification in Assessment Proceedings

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## Highlights

Audit reviewed the assessment records of corporate and non corporate assesseees (excluding who are salaried) with a view to i) 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 as required under the Act, ii) determine the extent to which the assessing officers have evaluated and utilised information provided in prescribed reports while completing assessments, and iii) 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.

**(Paragraph 2.2)**

In the review, 168 units were covered. Audit of these units revealed 2874 cases of irregularities with a value of Rs. 849.16 crore and revenue impact of Rs. 665.67 crore (including penalty of Rs. 41.52 crore).

**(Paragraph 2.6.1)**

### System issues

Audit noticed 237 cases where the assessing officer did not rely on the particulars given in the tax audit reports, and made additions in income having revenue impact of Rs. 183.49 crore. However, no action was taken to report such cases in terms of CBDT instruction no. 1959 and section 288 of the Act.

**(Paragraph 2.7.2)**

Audit noticed 665 cases where the assessing officers did not take action to make additions or disallowances although there were omissions in the tax audit reports. This resulted in underassessment of income with a revenue impact of Rs. 425.44 crore.

**(Paragraph 2.8.1)**

Audit noticed that in 233 cases, the assessing officers did not utilise the information available in the tax audit reports/certificates while finalising assessments, involving revenue impact of Rs. 228 crore.

**(Paragraph 2.9.1)**

The internal control mechanism in the Department to ensure that (i) the audit reports/certificates were complete and provided sufficient and requisite information to the assessing officer, (ii) information which is provided in the audit reports is being effectively utilised by the assessing officers and (iii) cases are selected for scrutiny assessment on the basis of the tax audit reports, is not effective.

**(Paragraph 2.11.18)**

### **Compliance issues**

Audit noticed non submission of accountant's reports/certificates by the assessee in 102 cases involving revenue impact of Rs. 11.42 crore.

**(Paragraph 2.13.1)**

### **Audit recommends that**

- The Ministry may ensure taking of action in terms of instruction no. 1959 and section 288 of the Act, in cases where inadequate/inaccurate information have been furnished in the tax audit reports.
- The Ministry may issue instructions to ensure that assessing officers critically examine the tax audit reports along with the connected records and other available evidence so as to make an independent assessment in each case.
- The Ministry may ensure that information as available from the tax audit reports/certificates is effectively utilised in finalising the assessments.
- The Ministry needs to strengthen its internal control and monitoring mechanism to ensure compliance with the instructions, rules, circulars and provisions of the Income Tax Act, 1961.
- The Ministry may ensure that necessary tax audit reports/certificates have been furnished by the assessee before allowing deductions and determination of tax.

**(Paragraph 2.15)**

**Review on Appreciation of Third Party Reporting/Certification  
in Assessment Proceedings**

## **2.1 Introduction**

**2.1.1** With a view to discourage tax avoidance and tax evasion and to ensure that the books of accounts of the assessee faithfully reflect the income of the tax payer and that claims for deduction are correctly made, the Income Tax Act, 1961 (Act), under its various provisions, provides for reporting/certification through the audit of accounts and audit reports from an accountant. Central Board of Direct Taxes (Board) circular no. 387 dated 6 July 1984 explains the rationale for such compulsory audit of accounts as under:

**2.1.2** “Accounts maintained by companies are required to be audited under the Companies Act, 1956. Accounts maintained by co-operative societies are also required to be audited under the Co-operative Societies Act, 1912. There is, however, no obligation on other categories of taxpayers to get their accounts audited. A proper audit for tax purposes would ensure that the books of accounts and other records are properly maintained, that they faithfully reflect the income of the taxpayer and claims for deduction are correctly made by him. Such audit would also help in checking fraudulent practices. It can also facilitate the administration of tax laws by a proper presentation of the accounts before the tax authorities and considerably save the time of the assessing officer in carrying out routine verification like checking correctness of totals and verifying whether purchases and sales are properly vouched. The time of the assessing officer thus saved, could be utilised for attending to more important investigational aspects of a case.”

**2.1.3** Thus, accountants have been mandated to be facilitators for the Income tax Department in administering the provisions of the Act correctly. The tax audit report/certificates issued by them serve as a valuable reference guide for the assessing officers while making assessments. The criticality of the information provided by the accountant in the form of tax audit reports can be gauged from the fact that 98 percent<sup>1</sup> of the assessments are completed in a summary manner, relying on the information given in the return of income and accompanying documents.

**2.1.4** However, the tax audit report issued by an accountant, is only a tool in the hands of the Department while deciding the correctness of the income and deductions claimed by the assessee. The assessing officer is expected to make an independent judgment while finalising the assessment and can require the assessee to justify his claims with reference to records and evidence. In *Goodyear India Ltd. vs CIT* [2000] {112 Taxman 419}, while deciding on whether the ITO should insist upon production of records or details in spite of a tax audit report under section 44AB, Delhi High Court held, “such a broad proposition cannot be laid down. No

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<sup>1</sup> Chapter II of the Audit Report of the C&AG of India on Direct Taxes of 2007

doubt, sanctity is to be attached to the audit report given by a qualified chartered accountant. Merely because an audit report is available there is no fetter on the power of the ITO to require the assessee to justify its claim with reference to records, materials and evidence. Such a power is inherent in an assessing officer in the scheme of the Act.”

## **2.2 Objective of the review**

The review seeks to examine the scheme of third party reporting/certification with a view to:

**2.2.1** 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 as required under the Act

**2.2.2** determine the extent to which the assessing officers have evaluated and utilised information provided in prescribed reports while completing assessments

**2.2.3** determine the adequacy and relevance of the formats of the tax audit reports as provided in the Act

**2.2.4** 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

## **2.3 Law and procedure**

**2.3.1** The Income Tax Act as well as the Income Tax Rules provide for audit of accounts and audit reports by an accountant in specific cases as listed in **Appendix 3**. These tax audit reports entitle the assessee to a number of exemptions, deductions etc. under the various provisions of the Act. The forms in which such tax audit reports are to be prepared, have been prescribed under the respective Income Tax Rules. Some of the important sections of the Act requiring such reports/certificates have been elaborated below.

**2.3.2** Section 44AB of the Income Tax Act, 1961, requires the audit of accounts of any person carrying out any business or profession, by an accountant if the total sales, turnover or gross receipts of the business for the previous year exceed Rs. 40 lakh, or if the gross receipts in profession for the previous year(s) exceed Rs. 10 lakh. The obligation of the assessee to get his accounts audited by an accountant and to furnish the tax audit report in the prescribed form is to be met before the specified date i.e. October 31 of the relevant assessment year. However, assessees covered under section 44AB who are expected to file annexure-less returns<sup>2</sup> are required to furnish the tax audit reports under section 44AB or any other documents only on demand by the authorities.

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<sup>2</sup> Income-tax (7<sup>th</sup> Amendment) Rules, 2006 vide notification no. S.O.1163 (E) w.e.f. 24 July 2006

**2.3.3** For the purpose of this section “accountant” means a chartered accountant within the meaning of the Chartered Accountant Act, 1949.

**2.3.4** The report of audit of the accounts of a person required to be furnished under section 44AB shall be in Form no. 3CA in the case of a person who carries on a business or profession and who is required to get his accounts audited by or under any other law<sup>3</sup>. In the case of any other person carrying on a business or profession, it shall be in Form no. 3CB. The particulars which are required to be furnished under section 44AB shall, in the case of a person carrying on a business or profession, be in Form no. 3CD.

**2.3.5** Under section 44AB, the accountant is required to report whether the balance sheet and the profit and loss account/income and expenditure account are in agreement with the books of accounts maintained by the assessee, and whether in his opinion, the said accounts provide a true and fair view of the state of affairs and profit/loss of the assessee. Comments/discrepancies/inconsistencies, if any, are also required to be reported.

**2.3.6** Important particulars which are required to be furnished under section 44AB in Form no. 3CD are as follows:

- Amounts not credited to the profit and loss account.
- Particulars of depreciation allowable as per the Income Tax Act, 1961.
- Any sum received from employees towards contributions to any provident fund or superannuation fund; and the due and actual dates of payment to the concerned authorities.
- Amounts debited to the profit and loss account, being:-
  - Expenditure of capital nature
  - Expenditure of personal nature
  - Expenditure by way of penalty or fine for violation of any law for the time being in force
  - Particulars of any liability of a contingent nature
- In respect of any sum referred to in section 43B dealing with certain deductions admissible on actual payment basis only, particulars of the crystallisation of the liability and actual payment/non payment.
- Particulars of income or expenditure of prior period credited or debited to the profit and loss account.
- Particulars of loan or deposit taken or accepted/repaid in an amount exceeding the limit specified in section 269SS/269T otherwise than by an account payee cheque or bank draft.

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<sup>3</sup> Companies Act, 1956, Co-operative Societies Act, legislation governing various statutory organisations, etc.

- Details of brought forward loss or depreciation allowance to the extent available.
- Whether the assessee has complied with the provisions of Chapter XVII-B regarding deduction of tax at source and regarding the payment thereof to the credit of the Central Government. If the said provisions have not been complied with, full details thereof are to be given.

### **2.3.7 Penalty provision**

Section 271B provides that if any person fails to get his accounts audited in respect of any previous year(s) or furnish a report of such audit as required under section 44AB, the assessing officer may levy a penalty equal to one-half percent of the total sales/turnover or of the gross receipt in case of a profession, in such previous year(s) or a sum of Rs. one lakh, whichever is less.

### **2.3.8 Audit reports/certificates required to claim deductions/pay tax under minimum alternate tax (MAT)**

**2.3.8.1** Sections 10A and 10B provide for deduction of profits derived by a newly established undertaking in a free trade zone or a newly established hundred percent export oriented undertaking from the export of articles or things or computer software. The deduction is admissible only where the assessee furnishes in the prescribed form<sup>4</sup>, along with the return of income, the report of an accountant certifying that the deduction has been correctly claimed in accordance with the provisions of the section.

**2.3.8.2** Section 80IB provides deduction where the gross total income of an assessee includes any profit and gains derived from certain industrial undertakings<sup>5</sup> other than infrastructure development undertakings. The deduction is admissible only where the accounts of the undertaking for the previous year have been audited by an accountant, and the assessee furnishes along with his return of income, the report of such audit in the prescribed form<sup>6</sup> duly signed and verified by such accountant.

**2.3.8.3** Section 115JB of the Act provides that in the case of a company if the income-tax, payable on the total income is less than seven and one-half<sup>7</sup> percent of its book profit, such book profit shall be deemed to be the total income of the assessee and the tax payable by the assessee on such total income shall be the

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<sup>4</sup> Form nos. 56F and 56G

<sup>5</sup> An industrial undertaking including cold storage, a ship, a hotel, multiplex theatre, convention centres, scientific and industrial research and development, commercial production and refining of mineral oil, developing and building housing projects, handling, storage and transportation of food grains

<sup>6</sup> Form no. 10CCB

<sup>7</sup> 10 percent with effect from the assessment year 2007-08

amount of income-tax at the rate of seven and one-half<sup>8</sup> percent. Every company, to which this section applies, is to furnish a report in the prescribed form<sup>9</sup> from an accountant certifying that the book profit has been computed in accordance with the provisions of this section along with the return of income.

### **2.3.9 Penal provision**

**2.3.9.1** Board's instruction no. 1959 issued in January 1999 provides that cases where the information given in the tax audit report is incomplete or non committal, should be taken up by the CIT to see if these reflected any professional negligence on the part of the accountant signing the tax audit report whereupon action is to be taken as per section 288 of the Act.

**2.3.9.2** Section 288 provides that if any person who is a legal practitioner or an accountant is found guilty of misconduct in his professional capacity by an authority entitled to institute disciplinary proceedings against him, an order passed by that authority shall have effect in relation to his right to attend before an income tax authority as it has in relation to his right to practice as a legal practitioner or accountant, as the case may be.

### **2.4 Scope and audit methodology of the review**

**2.4.1** Assessment records of both corporate and non corporate assesseees (excluding those who were salaried) along with the supporting audit reports/certificates as required under section 44AB 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 2006-07 and till the date of audit. A total of 168 units were covered during the period of review. The basis of selection of the units and records for audit is given in **Appendix 4**.

**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 2007 to August 2007.

### **2.5 Acknowledgement**

**2.5.1** 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 2007. An exit conference was held in December 2007 with the Board to discuss the results of this review. The views expressed by them in the exit conference have been appropriately incorporated in this report.

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<sup>8</sup> 10 percent with effect from the assessment year 2007-08

<sup>9</sup> Form no. 29B



## **2.6 Audit findings**

**2.6.1** Audit of the selected 168 units during the period of review revealed 2874 cases of irregularities with a value of Rs. 849.16 crore and revenue impact of Rs. 665.67 crore (including penalty of Rs. 41.52 crore) in the states of Andhra Pradesh, Assam, Bihar, Chandigarh (UT), Delhi, Goa, Gujarat, Haryana, Himachal Pradesh, Jharkhand, Karnataka, Kerala, Madhya Pradesh, Maharashtra, Orissa, Punjab, Rajasthan, Tamil Nadu, Uttar Pradesh and West Bengal.

**2.6.2** Audit observations<sup>10</sup> with money value exceeding Rs. one crore 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.

## **System issues**

### **2.7 Action not taken for furnishing of inadequate information in tax audit reports**

**2.7.1** Under section 44AB, the tax auditor has to certify the correctness of the accounts of the assessee with reference to the requirements indicated in various clauses of Form no. 3CD. These clauses contain particulars of certain pertinent information which would enable/facilitate proper determination of the assessee's income. Further, an assessee is required to obtain audit reports/certificates in the prescribed form from the accountant in order to avail of exemptions/deductions under various other sections of the Act. Since the auditor is required to furnish true and correct information, such information should aid the assessing officer in finalising the assessment.

**2.7.2** Audit noticed that, in 237 cases in Andhra Pradesh, Bihar, Delhi, Himachal Pradesh, Karnataka, Kerala, Madhya Pradesh, Maharashtra, Orissa, Punjab, Rajasthan, Tamil Nadu, Uttar Pradesh and West Bengal, the assessing officer did not rely on the particulars given in tax audit reports, and made additions in income having revenue impact of Rs. 183.49 crore. Of these, eight cases are given in **Table no. 2.1** below and four other cases are given in **Appendix 5**.

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<sup>10</sup> Other than penalty cases for non filing of the tax audit report as discussed in paragraph no. 2.11.15

(Rs. in lakh)

**Table no. 2.1: Inadequate information in tax audit reports resulting in additions made by assessing officers**

Sl. no.	Name of the Assessee/CIT Charge	Assessment year	Type/date of assessment	Details of the additions made by the department due to non acceptance of particulars as given in the audit reports.	Revenue impact
1	Hindustan Lever Ltd. <b>CIT 1, Mumbai</b>	2002-03 2003-04 2004-05	Scrutiny December 2006 March 2006 December 2006	Deduction under section 80IB recomputed <sup>11</sup> by the department and reduced from Rs. 2491.45 crore to Rs. 2350.37 crore.	5086.00
2	Oracle India Pvt. Ltd. <b>CIT V, Delhi</b>	2002-03	Scrutiny March 2005	Expenditure of capital nature not reported in audit report, and irregular deduction under section 80IA <sup>12</sup> and 10A <sup>13</sup> report disallowed by the department.	2740.00
3	Tata Motors Ltd. <b>CIT 2, Mumbai</b>	2004-05	Scrutiny December 2006	Provision for warranty of Rs. 64.40 crore was not disclosed in the tax audit report. It was but brought to tax by the department during scrutiny.	2310.00
4	Cuttack Gramya Bank (Co-operative society) <b>CIT, Cuttack</b>	2005-06	Scrutiny January 2006	Brought forward loss of Rs. 39.79 crore was reported in the tax audit report. However, actual brought forward business loss was worked out to Rs. 25.50 crore by the assessing officer.	448.15
5	M/s MP State Textile Corporation <b>CIT, Bhopal</b>	2003-04 2004-05	Scrutiny March 2006 December 2006	Deduction in respect of prior period expenditure and excise penalty of Rs. 5.36 crore were not reported in the tax audit report. It was disallowed by the assessing officer.	323.40
6	M/s Indore Dugdha Sangh sahakari Maryadit <b>CIT, Indore</b>	2004-05	Scrutiny December 2006	Provision for interest, interest not actually paid and prior period expenses of Rs. six crore were not reported in the tax audit report. The expenditure was disallowed by the department.	198.00
7	The Catholic Syrian Bank Ltd. <b>CIT, Thrissur</b>	2000-01 2001-02	Scrutiny December 2006	The assessing officer added back Rs. 1.99 crore for the assessment year 2001-02 and Rs. 1.19 crore for the assessment year 2000-01 respectively, towards provision for contribution to approved pension fund, which was not paid by the assessee by the due date. The amount which was inadmissible under section 43B (b) was not reported in Form no. 3CD.	191.76

<sup>11</sup> Owing to re-allocation of expenses by the department on account of head office, interest, research and development, advertisement etc.

<sup>12</sup> assessee company was merely duplicating the products manufactured by M/s Oracle Corporation USA which does not amount to manufacturing/ production of article/things as per provisions of section 80 IA

<sup>13</sup> assessee was not eligible for the deduction as one unit was formed by splitting/reconstruction of other unit

Sl. no.	Name of the Assessee/CIT Charge	Assessment year	Type/date of assessment	Details of the additions made by the department due to non acceptance of particulars as given in the audit reports.	Revenue impact
8	M/s IIT Capital Services P Ltd. <b>CIT 8, Mumbai</b>	2004-05	Scrutiny November 2005	Interest of Rs. 3.74 crore not actually paid by the assessee was not reported in the tax audit report. The amount was disallowed, and brought to tax by the Department during scrutiny.	134.00

**2.7.3** Thus, the intention of the Act in providing for audit of accounts of the assessee to ensure that deductions claimed by the latter are correct was not fulfilled in these cases. Although the necessary additions/disallowances were made by the assessing officers without relying on incorrect information in the tax audit reports, records produced to audit did not indicate whether any further action has been taken to report these cases in terms of Board's instruction no. 1959 and section 288 of the Act.

**2.7.4** *Audit recommends that the Ministry may ensure that action is taken in terms of instruction no. 1959 and section 288 of the Act, in cases where inadequate/inaccurate information have been furnished in the tax audit reports.*

**2.7.5** In the exit conference, the Board accepted the audit recommendation.

## **2.8 Inadequate disclosure in tax audit reports not acted upon by assessing officers**

**2.8.1** Audit observed in 665 cases that the assessing officers did not take action to make additions or disallowances although there were omissions in the tax audit reports. This resulted in underassessment of income having revenue impact of Rs. 425.44 crore in Andhra Pradesh, Assam, Bihar, Chandigarh, Delhi, Goa, Gujarat, Haryana, Himachal Pradesh, Jharkhand, Karnataka, Kerala, Madhya Pradesh, Maharashtra, Orissa, Punjab, Rajasthan, Tamil Nadu, Uttar Pradesh and West Bengal. Out of these, 17 cases are discussed below and 16 other cases are given in **Appendix 6**.

**2.8.2** Where the gross total income of an assessee includes any profit and gains derived from a specified industrial undertaking other than infrastructure development undertakings, 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 in this section. The deduction shall, however, not be admissible unless the accounts of the undertaking for the previous year relevant to the assessment year for which the deduction is claimed have been audited by an accountant.

**2.8.2.1** In Maharashtra, CIT 1, Mumbai charge, the assessment of a company, **M/s Hindustan Petroleum Corporation Ltd.**, for the assessment year 2004-05 was completed after scrutiny in November 2006. Audit examination revealed that

the assessee had claimed a deduction of Rs. 793.88 crore in respect of Vishakh Refinery – VREP II Project. During audit examination, it was observed that while working out the deduction in the tax audit report<sup>14</sup>, an amount of Rs. 279.55 crore on account of marketing margin was also considered, which was not attributable to the activities of the industrial undertaking (Vishakh Refinery VREP II Project). Market margin is the profit derived by the marketing division of the assessee on the products manufactured by the refinery unit viz. Vishakh Refinery, and transferred to the marketing division of the assessee at a fixed price. 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.<sup>15</sup> 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.

**2.8.3** Under clause 13 of Form no. 3CD, amounts not credited to the profit and loss account, but which fall within the scope of profits and gains of business or profession, or any other item of income, are required to be disclosed. Such amounts of income, which have not been credited to profit and loss account, are required to be added back to the income and brought to tax.

**2.8.3.1** In Delhi, CIT V charge, the assessment of a company, **M/s National Fertilizers Ltd.**, for the assessment year 2002-03 was completed after scrutiny in March 2005. Audit examination revealed that while computing the income, the assessee had not taken into consideration the interest income of Rs. 120.95 crore which had accrued as a result of an arbitration award in its favour. The tax audit report did not mention this fact, nor was the amount added back by the assessing officer during scrutiny assessment. This resulted in underassessment of income of Rs. 120.95 crore and consequent short levy of tax of Rs. 60.66 crore including interest.

**2.8.3.2** On the matter being pointed out by audit, the Department added back (February 2006) the interest accrued at the rate of five percent per annum for the assessment year 2003-04. However, it did not take corrective measures to add back the interest income of Rs. 120.95 crore which had accrued up to assessment year 2002-03.

**2.8.3.3** In Delhi, CIT VI charge, the assessment of a company, **M/s The State Trading Corporation of India Ltd.**, for the assessment year 2004-05 was completed after scrutiny in October 2006. Audit examination revealed that the interest income accruing to the assessee on term deposits worked out to Rs. 35.26

<sup>14</sup> In Form no. 10CCB, under section 80IB of the Act

<sup>15</sup> Profit derived by the refinery out of its refining activities was Rs. 514.33 crore i.e. 14 percent of its cost of operations

crore as per the balance sheet, yet only Rs. 7.25 crore was credited in the profit and loss account. The fact was also not reported in the tax audit report. The omission on the part of the assessing officer to bring the balance interest income to tax resulted in underassessment of income of Rs. 28.01 crore with potential revenue impact of Rs. 10.05 crore. The Department stated (June 2007) that necessary statutory notice had been issued to the assessee.

**2.8.4** Capital expenditure is not allowable in computing business income. Particulars of amounts debited to the profit and loss account being expenditure of capital nature, are required to be disclosed in Form no. 3CD [clause 17(a)].

**2.8.4.1** In Assam, CIT, Dibrugarh, Assam charge, the assessment of a company, **M/s Kitply Ind. Ltd.**, for the assessment year 2005-06 was processed in summary manner in November 2005. Audit examination revealed that the assessee had debited 'extra ordinary loss' of Rs. 170.43 crore in the profit and loss account on account of non recoverable loans and advances. The 'Notes to Account' indicated that the amount was treated as extraordinary loss considering the loans and advances as non current asset (capital nature). Audit observed that the deduction on account of loss was not allowable as loans and advances were borne on the capital account. This was, however, not reported in the tax audit report. Thus, allowance of incorrect deduction of Rs. 170.43 crore by the Department resulted in excess carry forward of loss by like amount involving potential revenue impact of Rs. 59.65 crore.

**2.8.4.2** The Department has accepted (March 2007) the audit observation.

**2.8.5** Where in the case of an assessee, being a company, the income-tax payable on the total income as computed under this Act is less than seven and one-half<sup>16</sup> percent of its book profit, such book profit shall be deemed to be the total income of the assessee and the tax payable by the assessee on such total income shall be the amount of income-tax at the rate of seven and one-half<sup>17</sup> percent. Book profit means the net profit as shown in the profit and loss account, as increased by the amount set aside as provisions for meeting liabilities other than ascertained liabilities. Every company, to which this section applies, shall furnish a report in the prescribed form<sup>18</sup> from an accountant certifying that the book profit has been computed in accordance with the provisions of this section along with the return of income.

**2.8.5.1** In Maharashtra, CIT 1, Mumbai charge, the assessments of a company, **M/s Reliance Infocomm Ltd.**, for the assessment year 2005-06 was processed in summary manner in February 2007. Audit examination revealed that while working out the book profit and minimum alternate tax in Form no. 29B, provision for bad and doubtful debts of Rs. 235.75 crore was not added back to the net profit

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<sup>16</sup> 10 percent with effect from the assessment year 2007-08

<sup>17</sup> 10 percent with effect from the assessment year 2007-08

<sup>18</sup> Form no. 29B

resulting in short computation of book profit by Rs. 235.75 crore with consequent short levy of tax by Rs. 18.49 crore.

**2.8.6** Any amount payable to a contractor or sub-contractor, being resident, for carrying out any work, on which tax is deductible at source and such tax has not been deducted or, after deduction, has not been paid during the previous year, shall not be deducted in computing the income. Such inadmissible expenditure is required to be disclosed under clause 17(f) of Form no. 3CD.

**2.8.6.1** In Andhra Pradesh, CIT, Tirupati charge, the assessment of a firm, **M/s Ramakrishna Reddy**, for the assessment year 2006-07 was processed in summary manner in January 2007. Audit examination revealed that the assessee paid Rs. 34.38 crore towards a sub-contract on which tax at source was not deducted and remitted under section 194C of the Act. This was not reported in the tax audit report. As the assessee failed to deduct tax at source, the assessing officer should have disallowed the expenditure of Rs. 34.38 crore. The omission to do so resulted in underassessment of income of Rs. 34.38 crore with consequential revenue impact of Rs. 13.19 crore including interest. The observation was not accepted by the Department on the ground that it was processed under summary assessment. The Department's reply is not tenable as mistakes arising from summary assessments conferring otherwise un-entitled benefits to the assessee and prejudicial to the interest of revenue could be rectified under the powers separately available to the assessing officers under the Act.

**2.8.7** Payment of any tax, duty, interest from loan or advance from bank is to be allowed as deduction, only if such amounts have actually been paid in the previous year. Particulars of the liability of such expenses and actual payment/non payment thereof are required to be reported in Form no. 3CD [Clause 21].

**2.8.7.1** In Tamil Nadu, CIT I, Chennai charge, assessment of a company, **M/s Tamilnadu Cement Corporation Ltd.**, for the assessment year 2002-03 was completed after scrutiny in March 2005. During the previous year, the assessee had claimed a deduction of Rs. 27.61 crore on account of sales tax payment. Audit examination, however, revealed that the amount had not actually been paid, but was shown as a liability as on 31 March 2002 under the head 'Sales Tax Deferred & Interest Loan'. In the 'Notes to Accounts', it had been stated that the company had deferred the payment of sales tax for the financial year 2001-02. A proposal for converting this amount into a subsidy/long term loan had been submitted to the Government of Tamil Nadu for consideration. As such, the expenditure of Rs. 27.61 crore was not admissible under the Act. This was, however, not reported in the tax audit report. The omission on the part of the assessing officer to disallow this amount resulted in underassessment of income by Rs. 27.61 crore with consequent revenue impact of Rs. 9.12 crore and potential revenue impact of Rs. 3.55 crore.

**2.8.7.2** On the matter being pointed out, the Department replied (May 2007) that if the sales tax was routed through the profit and loss account, then disallowance would not arise. Reply of the Department is not tenable in view of the fact that expenditure on account of sales tax, even if it is routed through profit and loss account, is allowable on actual payment basis only.

**2.8.8** In order to avail of depreciation, it has to be ensured that i) the asset is owned by the assessee, ii) the asset is used for the purpose of business or profession and iii) the asset is used during the relevant previous year. Particulars of depreciation allowable as per the Income-tax Act, description of asset/block of assets, rate of depreciation etc. are required to be disclosed in Form no. 3CD [Clause 14].

**2.8.8.1** In Rajasthan, CIT Ajmer charge, the assessment of a company, **M/s Ajmer Vidyut Vitran Nigam Ltd.**, for the assessment year 2002-03 was completed after scrutiny in January 2005. Audit examination revealed that fixed assets valuing Rs. 122.40 crore were non-existent as reported in the statutory auditor's report for the year 2001-02, but this was not reported in the tax audit report. However, depreciation of Rs. 30.60 crore on these assets was allowed by the department in contravention of the provisions of section 32 of the Act, involving revenue impact of Rs. 10.92 crore. It was further observed that the assessing officer in the scrutiny assessment in March 2006 for the assessment year 2003-04 had disallowed the depreciation on account of such non-existing assets.

**2.8.9** A deduction of such profits and gains as are derived by a hundred percent export oriented undertaking from the export of articles or things or computer software for a period of 10 years, shall be allowed from the total income of the assessee. The deduction, however, shall not be admissible unless the assessee furnishes in the prescribed form<sup>19</sup>, along with the return of income, the report of an accountant certifying that the deduction has been correctly claimed in accordance with the provisions of this section. However, in computing the total income of the assessee, no loss shall be carried forward or set-off where such loss relates to any of the relevant assessment years ending before the 1 April 2001.

**2.8.9.1** In Maharashtra, CIT 6, Mumbai charge, assessment of a company, **M/s Century Textile Industries Ltd.**, for the assessment year 2004-05 was completed after scrutiny in November 2006. Audit examination revealed that unabsorbed depreciation of export oriented units of Rs. 22.85 crore pertaining to assessment year 1999-2000 was allowed to be carried forward by the Department in contravention of section 10B (6)(ii) of the Act. This fact was also not reported in the tax audit report. The omission resulted in irregular carry forward of unabsorbed depreciation of Rs. 22.85 crore having potential revenue impact of Rs. 8.20 crore.

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<sup>19</sup> Form no. 56F and 56G

**2.8.10** Expenditure on account of liability of a contingent nature is not allowable. Particulars of any liability of a contingent nature are required to be disclosed in Form no. 3CD [Clause 17(K)].

**2.8.10.1** In Tamil Nadu, CIT I, Chennai charge, assessment of a company, **M/s HTL Ltd.**, for the assessment year 2005-06 was processed in summary manner in November 2006. Audit examination revealed that Rs. 17.43 crore was debited towards provision for liquidated damages and provision for non-moving inventory, which being an expenditure of contingent nature was required to be disallowed. This was not reported in the tax audit report. Failure on the part of the Department to disallow the contingent expenditure resulted in underassessment of income of Rs. 17.43 crore with consequent potential revenue impact of Rs. 6.38 crore.

**2.8.11** Seven other cases are given in **Table no. 2.2** below:

(Rs. in lakh)

**Table no. 2.2: Inadequate disclosure in tax audit reports not acted upon by assessing officers**

Sl. no.	Name of the assessee/ CIT charge	Assessment year(s)	Type/date of assessment	Details of non/inadequate disclosure in tax audit report and omission on the part of the department in making additions to taxable income	Revenue impact	Department's reply
1	M/s Invensys India Pvt. Ltd. <b>CIT IV, Delhi</b>	2002-03	Scrutiny March 2005	Information in respect of prior period expenditure of Rs. 14.76 crore, although available in the 'Notes to Accounts', was not reported in the tax audit report. The department also did not disallow such expenditure.	526.98	The department accepted (February 2007) the audit observation.
2	M/s Kalahandi Anchalik Gramya Bank <b>CIT, Sambalpur</b>	2006-07	Summary November 2006	Business loss beyond eight years, of Rs. 12.62 crore, has been reported in tax audit report but the department failed to disallow such excess loss.	416.00	Reply has not been received (November 2007).
3	M/s Tata Infotech Ltd. <b>CIT 7, Mumbai</b>	2004-05	Scrutiny December 2006	While working out the deduction under section 10A in Form no. 56F, the expenditure incurred on the delivery of software outside India was reduced from export turnover as well as the total turnover. There is, however, no provision in the Act for reducing this expenditure from the total turnover.	397.00	Reply has not been received (November 2007).



Sl. no.	Name of the assessee/ CIT charge	Assessment year(s)	Type/date of assessment	Details of non/inadequate disclosure in tax audit report and omission on the part of the department in making additions to taxable income	Revenue impact	Department's reply
4	M/s Lionbridge Technologies P. Ltd. <b>CIT 8, Mumbai</b>	2003-04 2004-05	Scrutiny June 2006 December 2006	While working out the deduction under section 10A in Form no. 56F, the expenditure incurred in foreign currency for providing technical services outside India, foreign travel expenses and communication expenses of Rs. 5.50 crore and Rs. 21.28 crore was irregularly considered.	388.21	The Department stated (May 2007) that the definition of total turnover as per section 80HHE was considered. Reply of the Department is not tenable since there is no enabling provision under the Act to make such an adjustment to the total turnover.
5	M/s National Hydroelectric Power Corporation Limited <b>CIT, Faridabad</b>	2004-05	Scrutiny December 2006	Assessee while computing the taxable income under section 115JB, claimed irregular deduction on account of exempt interest income of Rs. 48.49 crore on long term loans though the said exemption was effective from November 2004 relevant to the assessment year 2005-06.	373.00	Reply has not been received (November 2007).
6	M/s Bannari Amman Sugars Ltd. <b>CIT I, Coimbatore</b>	2004-05	Scrutiny December 2006	Purchase tax on cane, and cane cess pertaining to 2002-03 had been converted into loan. This amount was, however, claimed as deduction under section 43B. As the actual payment of the said statutory obligations had not been made, allowance of the deduction under section 43B of the Act was irregular.	294.00	The Department replied (April 2007) that since the purchase tax and cane cess were collected by the Commercial Taxes Department, it could be allowed under section 43B. Reply is not tenable as Board had issued a

						notification permitting this specifically in respect of sales tax only and not other taxes/cess levied by the Commercial Taxes Department.
7	M/s Eonour Technologies <b>CIT I, Chennai</b>	2002-03	Scrutiny March 2005	Out of the total export turnover of Rs. 66.58 crore, the assessee had received only Rs. 22.81 crore towards export proceeds, and had obtained permission from the RBI for Rs. 7.30 crore to be realised later. Thus, the claim under section 10A should have been restricted to Rs. 30.11 crore only. However, the claim was incorrectly made based on the total export turnover of Rs. 66.58 crore. This resulted in excess deduction under section 10A of Rs. 5.85 crore.	293.00	Reply has not been received (November 2007).

**2.8.12** Thus, the intention of the Act in introducing compulsory audit so that the income tax returns faithfully reflect the income of the taxpayer and claims for deduction are correctly made was not achieved in these cases. The departmental officers also failed to notice these errors and omissions and take corrective action while finalising the assessments.

**2.8.13** *Audit recommends that the Ministry may issue instructions to ensure that assessing officers critically examine the tax audit reports along with the connected records and other available evidence so as to make an independent assessment in each case.*

**2.8.14** In the exit conference, the Board accepted the audit recommendation.

## **2.9 Information not utilised by the assessing officers**

**2.9.1** Audit noticed 233 cases in which the assessing officers failed to utilise the information available in the tax audit reports/certificates while finalising assessments, involving revenue impact of Rs. 228.01 crore, in Andhra Pradesh, Assam, Bihar, Chandigarh, Delhi, Goa, Gujarat, Haryana, Himachal Pradesh, Jharkhand, Karnataka, Kerala, Madhya Pradesh, Maharashtra, Orissa, Punjab, Rajasthan, Tamil Nadu, Uttar Pradesh and West Bengal. Thirteen cases are discussed below and six other cases are given in **Appendix 7**.

**2.9.2** Income chargeable under the head “Profits and gains of business or profession” shall be computed in accordance with either cash or mercantile system of accounting regularly employed by the assessee. In cases where the mercantile system of accounting has been employed by the assessee, deduction in respect of prior period expenditure is not to be allowed. Particulars of such income or expenditure of prior period credited or debited to the profit and loss account are required to be disclosed in Form no. 3CD [Clause 22].

**2.9.2.1** In Delhi, CIT I charge, the assessment of a company, **M/s Bharat Sanchar Nigam Ltd.**, for the assessment year 2002-03 was completed after scrutiny in February 2005. Audit examination revealed that as per the tax audit report, assessee had made adjustments of prior period expenses of Rs. 332.19 crore which included prior period depreciation of Rs. 192.88 crore. However, the Department, while taking cognizance of the prior period adjustments, failed to consider the prior period depreciation of Rs. 192.88 crore as reported in the tax audit report, and the same was not added back in computation, with a potential revenue impact of Rs. 68.86 crore.

**2.9.3** No loss shall be carried forward for more than eight assessment years immediately succeeding the assessment year for which the loss was first computed. Details of brought forward loss or depreciation allowance, to the extent available, are to be disclosed in Form no. 3CD [Clause 25].

**2.9.3.1** In Delhi, CIT IV charge, the assessment of a company, **M/s Hotline CPT Ltd.**, for the assessment year 2003-04 was completed after scrutiny in February 2006 determining a loss of Rs. 122.67 crore. In the tax audit report, the accountant had reported year wise details of unabsorbed depreciation and brought forward loss totaling Rs. 151.32 crore. Audit examination revealed that in the previous year, assessee had a business profit of Rs. 0.84 crore, and the assessing officer instead of adjusting the unabsorbed business loss to the extent of business profit for the assessment year 2003-04 i.e. Rs. 0.84 crore and determining the income as ‘nil’, allowed the assessee to incorrectly adjust the entire brought forward loss and unabsorbed depreciation of Rs. 151.32 crore, and completed the assessment at a loss of Rs. 122.67 crore<sup>20</sup>. The mistake resulted in irregular set off of unabsorbed business loss and consequent over assessment of loss involving potential revenue impact of Rs. 42.93 crore.

**2.9.3.2** The Department has accepted (July 2007) the audit observation.

**2.9.4** No person shall take or accept/repay from/to any other person, any loan or deposit otherwise than by an account payee cheque or bank draft if the amount of such loan or deposit is twenty thousand rupees or more. Non-compliance of these provisions attracts penalty, a sum equal to the amount of the loan/deposit taken or

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<sup>20</sup> Rs. 151.32 crore (unabsorbed losses and depreciation) less Rs. 0.84 crore (business profit during the previous year) less Rs. 27.81 crore (expenditure disallowed by the assessing officer).

repaid. Particulars to this effect are required to be disclosed in Form no. 3CD [Clause 24].

**2.9.4.1** In Tamil Nadu, CIT I, Chennai charge, assessment of a company, **M/s DSQ Software Ltd.**, for the assessment year 2003-04 was completed after scrutiny in March 2006. Audit examination revealed that in Form no. 3CD, the accountant had reported that Rs. 31.85 crore was paid otherwise than by account payee cheque/demand draft to another party. Though the case was completed after scrutiny, yet no details were called for to establish reasonable grounds for payment other than through account payee cheque/demand draft. The assessee was thus liable for penalty of Rs. 31.85 crore under section 271E, equal to the amount of deposit repaid.

**2.9.4.2** When this was pointed out, the Department in its reply stated (April 2007) that the case had been referred for initiating penal proceedings under section 271E to the Additional Commissioner of Income Tax.

**2.9.4.3** In Maharashtra, CIT 8, Mumbai charge, assessment of a company, **M/s World Wide Commodities Trade P. Ltd.**, for the assessment year 2004-05 was completed after scrutiny in December 2006. Audit examination revealed that loans of Rs. 4.77 crore were repaid otherwise than by account payee cheque or draft as per the tax audit report. The assessee was thus liable for penalty of Rs. 4.77 crore under section 271E, equal to the amount of deposit repaid.

**2.9.5** Any sum, received by the assessee from any of his employees towards contributions to any provident fund or superannuation fund, shall be allowed as deduction if such sum is credited by the assessee to the employee's account in the relevant fund on or before the due date. Particulars to this effect are required to be disclosed in the Form no. 3CD [Clause 16].

**2.9.5.1** In Gujarat, CIT II, Ahmedabad charge, assessment of a company, **M/s Gujarat State Road Transport Corporation**, for the assessment year 2004-05 was completed after scrutiny in March 2006. Audit examination revealed that as per the tax audit report, assessee had deposited employees' contribution of Rs. 23.04 crore beyond the due date of deposit. However, the same was not disallowed at the time of scrutiny assessment resulting in underassessment of income by Rs. 23.04 crore, involving revenue impact of Rs. 8.27 crore.

**2.9.5.2** In West Bengal, CIT I, Kolkata charge, assessment of a company, **M/s Indian Iron and Steel Company**, for the assessment year 2004-05 was completed after scrutiny in November 2006. Audit examination revealed that as per the tax audit report, the assessee had deposited employees' contribution of Rs. 19.03 crore beyond the due date of deposit which was not allowable. However, this was not added back at the time of scrutiny assessment resulting in underassessment of income by Rs. 19.03 crore involving revenue impact of Rs. 6.83 crore.

**2.9.6** Capital expenditure is not allowable in computing business income. Particulars of amounts debited to the profit and loss account being expenditure of capital nature are required to be disclosed in Form no. 3CD [clause 17(a)].

**2.9.6.1** In Tamil Nadu, CIT I, Chennai charge, assessment of a company, **M/s Ford India Ltd.**, for the assessment year 1999-2000 was completed after scrutiny in November 2006. Audit examination revealed that while disallowing capital expenditure as reported in tax audit report, the figures were adopted incorrectly by the assessing officer. As against the actual amount of Rs. 28.42 crore to be disallowed, only Rs. 2.84 crore was disallowed resulting in underassessment of income by Rs. 25.58 crore with a potential revenue impact of Rs. 9.72 crore.

**2.9.7** Any amount payable to a contractor or sub-contractor, being resident, for carrying out any work, on which tax is deductible at source and such tax has not been deducted or, after deduction, has not been paid during the previous year, shall not be deducted in computing the income. Such inadmissible expenditure is required to be disclosed under clause 17(f) of Form no. 3CD.

**2.9.7.1** In Andhra Pradesh, CIT II, Hyderabad charge, the assessment of a company, **M/s Cesma-Hua Kok-Tiong Seng-Neo Construction (India) P. Ltd.**, for the assessment year 2005-06 was processed in summary manner in March 2006. Audit scrutiny revealed that the assessee had claimed an expenditure of Rs. 84.54 crore towards sub-contracts and consultancy services. However, it was observed from the tax audit report that TDS was deducted on Rs. 70.75 crore only. Thus, tax was not deducted at source on the payments of Rs. 13.79 crore made to sub-contractor/consultant. Therefore, the total payment of Rs. 13.79 crore was required to be disallowed. The omission to do so resulted in underassessment of income of Rs. 13.79 crore with consequential short demand of tax of Rs. 5.93 crore including interest. The observation was not accepted by the Department on the ground that the assessment had been processed in a summary manner. The Department's reply is not tenable as mistakes arising from summary assessments conferring otherwise un-entitled benefits to the assesseees and prejudicial to interest of revenue could be rectified under the powers separately available to the assessing officers under the Act.

**2.9.8** Five other cases are given in **Table no. 2.3** below:

(Rs. in lakh)

<b>Table no. 2.3: Information not utilised by the assessing officers</b>						
<b>Sl. no.</b>	<b>Name of the assessee/CIT charge</b>	<b>Assessment year(s)</b>	<b>Type/date of assessment</b>	<b>Nature of mistake</b>	<b>Revenue impact</b>	<b>Department's reply</b>
1	Pfizer Pharmaceuticals Ltd. <b>CIT 8, Mumbai</b>	2004-05	Scrutiny December 2006	The Department allowed set off of losses of Rs. 28.05 crore and carry forward of loss of Rs. 12 crore. However, as per the tax audit report, the assessee had brought forward loss of Rs. 26.78 crore only for assessment years 2000-01 and 2001-02 resulting in excess allowance of carry forward of loss.	430.57	Reply has not been received (November 2007).
2	North Delhi Power Ltd. <b>CIT V, Delhi</b>	2003-04	Scrutiny February 2006	Energy tax of Rs. 8.45 crore was not paid by the assessee till the date of filing of the return. Despite this being reported in the tax audit report, the Department did not add back this amount to the income of the assessee.	310.65	Reply has not been received (November 2007).
3	Metropolitan Transport Corporation Ltd. <b>CIT III, Chennai</b>	2003-04	Summary November 2003	As per the tax audit report, remittances of Rs. 8.40 crore into the provident fund were made beyond the due dates. Failure on the part of the Department to add back the said remittances resulted in underassessment of income.	308.88	Reply has not been received (November 2007).
4	Star Agro Marine Exports (P) Ltd. <b>CIT III, Chennai</b>	2005-06	Summary October 2005	Contingent liabilities though reported in the tax audit report but not disallowed by the assessing officer.	307.28	Returns were processed in summary manner. The reply is not tenable as mistakes arising from summary assessments conferring otherwise un-entitled benefits to the assessee and prejudicial to interest of revenue could be rectified under the powers separately available to the assessing officers under the Act.

Sl. no.	Name of the assessee/CIT charge	Assessment year(s)	Type/date of assessment	Nature of mistake	Revenue impact	Department's reply
5	Sailee Developers P. Ltd. CIT 9, Mumbai	2005-06	Summary March 2007	Loan of Rs. 1.80 crore was repaid otherwise than by account payee cheque or draft as per the Tax Audit Report in contravention of the provisions of section 269T attracting penalty under section 271E. However, penalty was not levied.	180.24	Reply has not been received (November 2007).

**2.9.9** Thus, the objective behind audit of accounts under various provisions of the Act was not achieved as the information emerging out of the tax audit reports was not utilised by the assessing officers while finalising assessments in these cases.

**2.9.10** *Audit recommends that the Ministry may ensure that information as available from the tax audit reports is effectively utilised in finalising the assessments.*

**2.9.11** In the exit conference, the Board accepted the audit recommendation.

## **2.10 Incomplete/non-committal comments in the tax audit reports**

**2.10.1** The tax audit reports are to be signed by a chartered accountant within the meaning of the Chartered Accountants Act, 1949. The chartered accountant while signing the report has to indicate his membership number/certificate of practice number. Audit observed in 1029 (**Appendix 8**) cases that either the tax audit reports had not been signed or the membership number had not been given.

**2.10.2** Where the assessee incurs any expenditure in respect of which payment is made in a sum exceeding Rs. 20,000 otherwise than by an account payee cheque/bank draft, 20 percent of such expenditure shall not be allowed as deduction except in certain cases and circumstances. Further, no person shall take or accept/repay from/to any other person, any loan or deposit otherwise than by an account payee cheque or bank draft if the amount of such loan or deposit is Rs. 20000 or more. Non-compliance of these provisions attracts a penalty equal to the amount of the loan/deposit taken or repaid. Particulars of such cases are required to be disclosed in Form no. 3CD [Clause 17(h), Clause 24].

**2.10.2.1** Audit examination revealed that in 431 cases (**Appendix 9**), accountants had stated that they were not able to verify if expenditure in excess of Rs. 20000 was incurred or whether loans or deposits were taken or accepted otherwise than by an account payee cheque/bank draft as the necessary evidence was not available with the assessee.

**2.10.3** It would be seen from the above that in a large number of cases, accountants have been commenting that they are not in a position to verify the mode (account payee cheque/bank draft or otherwise) of payments made in the absence of necessary evidence with the assessee. However, with effect from 10 August 2006<sup>21</sup>, the accountant is required to indicate in Form no. 3CD whether a certificate has been obtained from the assessee regarding payments relating to any expenditure/taking or accepting loan or deposit, or repayment of the same through account payee cheque/bank draft.

**2.10.4** *Audit recommends that the Ministry may consider evolving a mechanism to ensure that assessing officers test check such receipts/payments by the assessees and utilise penal provisions where required.*

## **2.11 Internal Control**

**2.11.1** In order to ensure that the assessee, accountant and assessing officer comply with the various provisions of the Act, Board had issued instruction no. 1959 and 1976 in January 1999 and November 1999. These instructions contain detailed procedures for effective utilisation of information available in the tax audit reports while finalising assessments. Compliance with these instructions are discussed below:

**2.11.2** At the time of completion of assessment after detailed scrutiny under section 143(3), the assessing officer may again examine the tax audit report thoroughly 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.

**2.11.3** Audit observed in 233 cases (paragraph 2.9) though relevant information was available in the audit reports, yet it was not utilised while finalising the scrutiny assessment by the assessing officers.

**2.11.4** Audit also observed 665 cases of inadequacies/omissions in the tax audit reports which were not detected by the assessing officers. Failure of the assessing officers in detecting such omissions/inadequacies in the tax audit reports (paragraph 2.8.1) and consequently not disallowing inadmissible deductions is indicative of the fact that tax audit reports are not being evaluated effectively.

**2.11.5** All cases where the information provided in the tax audit report is incomplete or such non-committal replies are furnished so as to render the remarks or the report meaningless should be reported by the assessing officer to the CIT. The matter thereafter be taken up by the CIT to see if the case reflects any professional negligence on the part of the accountants signing the audit report. Action for initiation of disciplinary proceedings in terms of section 288 of the Act

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<sup>21</sup> Income tax (Ninth Amdt.) Rules, 2006,



should be immediately taken by the CIT with the approval of CCIT as the case may be.

**2.11.6** Audit observed that in 237 cases, errors and omissions in the audit reports were noticed by the department (paragraph 2.7.2). Further, as discussed in paragraph 2.10, 1460 cases of incomplete/non-committal comments in the tax audit reports have been noticed. However, as per records available to audit, no action had been taken by the Department in terms of instruction no. 1959, 1976 and section 288 of the Act in respect of mistakes/inadequacies noticed in the audit reports.

**2.11.7** A “Control Register of tax audit cases under section 44AB” should be maintained by assessing officers as per format prescribed in Annexure ‘A’ (**Appendix 10**) to the instruction no. 1976 dated 3.11.99. The maintenance of this register 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, (iii) penalty proceedings under section 271B for failure to get accounts audited or furnishing report of such audit and (iv) irregularities in tax audit report.

**2.11.8** Based on the information furnished/records produced it was observed that the “Control register of tax audit cases under section 44AB” was not being maintained in 19 states<sup>22</sup> (**Appendix 11**). The control register was being maintained in some circles in states of Kerala, Madhya Pradesh and West Bengal. In Andhra Pradesh, Punjab and Uttar Pradesh, the Department has replied that henceforth the register would be maintained.

**2.11.9** Audit reports are required to be examined to see if it contained any credible information on the basis of which cases can be picked up for assessment under section 143(3).

**2.11.10** Audit observed that five cases<sup>23</sup> were processed in summary manner (paragraph 2.9) which should have been picked for scrutiny after examining the tax audit reports. Not considering the information disclosed in the tax audit reports resulted in underassessment of income involving revenue impact of Rs. 15.68 crore.

**2.11.11** Further with the introduction of e-filing of returns and the new annexure-less forms, an assessee is not required to attach tax audit report/certificate by accountant along with the return, which are now to be furnished only on demand by the authorities. This would impact the use of information available in the tax audit report for selecting cases for scrutiny.

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<sup>22</sup> The Department has furnished information in respect of 19 states only till date

<sup>23</sup> Paragraph no. 2.9.7.1 (Rs. 5.93 crore), 2.9.8: Table no. 2.3: Sl. no. 3 (Rs. 3.09 crore), Sl. no. 4 (3.07 crore), Sl. no. 5 (Rs. 1.80 crore), Appendix 7: Sl. no. 1 (Rs. 1.79 crore)

**2.11.12** *Audit recommends that the Ministry may consider a suitable mechanism for linking the information available in the tax audit reports with the new annexure-less forms.*

**2.11.13** In the exit conference, the Board stated that the issue would be examined.

**2.11.14** Where the tax audit reports are not filed or filed late; penalty is to be levied promptly.

**2.11.15** Audit observed that in 109 cases (**Appendix 12**), tax audit reports were either not filed or were filed late. Penalty of Rs. 80.05 lakh has not been levied.

**2.11.16** The assessing officer is required to submit a quarterly progress report in the prescribed format as per Annexure 'B' (**Appendix 13**) to the instruction no. 1976 to report on progress on tax audit cases under section 44AB.

**2.11.17** Audit observed that such "quarterly progress reports" were not being submitted by a majority of the assessing officers. Information given/records produced to audit indicated that the return was being submitted only in certain circles in the states of Gujarat and Karnataka.

**2.11.18** Thus, the internal control mechanism in the Department to ensure that (i) the audit reports/certificates were complete and provided sufficient and requisite information to the assessing officer, (ii) information which is provided in the audit reports is being effectively utilised by the assessing officers and (iii) cases are selected for scrutiny assessment on the basis of tax audit reports, is not effective.

**2.11.19** *Audit recommends that the Ministry strengthens its internal control and monitoring mechanism to ensure compliance with the instructions, rules, circulars and provisions of the Income Tax Act, 1961.*

**2.11.20** In the exit conference, the Board accepted the audit recommendation.

### **Compliance issues**

#### **2.12 Variation between inadmissible expenditure as per assessee and as per audit report**

**2.12.1** In Kerala, CIT, Trichur charge, assessment of a company, **M/s The Kerala State Financial Enterprises Ltd.**, for assessment year 2004-05 was completed after scrutiny in December 2006. Audit examination revealed that Rs. 18.70 crore debited to the profit and loss account on account of provision for doubtful debts was taken as inadmissible expenditure by the assessee himself in computation of his taxable income but such disallowance was not indicated in the tax audit report.

**2.12.2** In Kerala, CIT, Trichur, charge, the assessment of company, **M/s Catholic Syrian Bank Ltd.**, for the assessment year 2000-01 and 2001-02 was completed after scrutiny in December 2006. Audit examination revealed that though Rs. 10.56 crore debited to the profit and loss account on account of provision for tax was taken as inadmissible expenditure by the assessee himself in computation of his taxable income, it was not reported as inadmissible in the tax audit report.

**2.12.3** In Kerala, CIT, Cochin charge, in the assessment of a local authority, **Cochin Port Trust**, for the assessment year 2003-04, it was noticed that the assessee had filed a revised return, offering for assessment interest income of Rs. 9.32 crore which was initially incorrectly credited to the balance sheet instead of the profit and loss account. Similarly, by another revised return, the assessee had reduced its claim for depreciation by Rs. 26.73 lakh. Audit examination revealed that the mistakes in the accounts, though rectified by the assessee, were not highlighted in the tax audit report.

### **2.13 Non submission of tax audit reports/certificates by the assessee**

**2.13.1** Audit noticed non submission of accountant's reports/certificates by the assessee in 102 cases involving short levy of tax of Rs. 11.42 crore in Andhra Pradesh, Assam, Goa, Gujarat, Himachal Pradesh, Jharkhand, Karnataka, Kerala, Madhya Pradesh, Maharashtra, Orissa, Rajasthan, Tamil Nadu, Uttar Pradesh and West Bengal. Two cases are illustrated below:

**2.13.2** Where in the case of an assessee, being a company, the income-tax, payable on the total income as computed under this Act is less than seven and one-half<sup>24</sup> percent of its book profit, such book profit shall be deemed to be the total income of the assessee and the tax payable by the assessee on such total income shall be the amount of income-tax at the rate of seven and one-half<sup>25</sup> percent. Every company, to which this section applies, shall furnish a report<sup>26</sup> in the prescribed form from an accountant certifying that the book profit has been computed in accordance with the provisions of this section along with the return of income.

**2.13.3** In Maharashtra, CIT 1, Mumbai charge, the assessments of a company, **M/s Reliance Infocomm Ltd.**, for the assessment years 2004-05 was completed in scrutiny manner in December 2006. While computing income for the assessment year 2004-05, the assessee stated that since book profit was negative, minimum alternate tax (MAT) was not applicable. The assessee had not furnished the certificate of the accountant in Form no. 29B along with the return.

**2.13.3.1** Audit examination, however, revealed that provisions for bad and doubtful debts of Rs. 436.26 crore was not added to the net loss (Rs. 390.31 crore) to arrive at a book profit. Thus, omission to add back the said provisions resulted

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<sup>24</sup> 10 percent with effect from the assessment year 2007-08

<sup>25</sup> 10 percent with effect from the assessment year 2007-08

<sup>26</sup> Form no. 29B

in understatement of book profit by Rs. 45.95 crore with consequent short levy of tax by Rs. 3.53 crore. It was further observed that while computing the income of the assessee in the normal course, this provision had been added by the assessing officer to calculate the income.

**2.13.4** In Maharashtra, CIT 1, Pune charge, assessment of a company, **M/s Brahma Bazaz Hotel Ltd.**, for the assessment year 2004-05 was processed in summary manner in August 2006. Audit examination revealed that the assessee had book profits of Rs. 12.15 crore, and was liable to pay tax under section 115 JB of the Act. However, neither was the certificate in Form no. 29B taken from the accountant and submitted as required, nor was the tax paid, resulting in revenue loss of Rs. 1.11 crore including interest.

**2.13.4.1** The Department stated (April 2007) in respect of M/s Brahma Bazaz Hotel Ltd. that the assessment was processed in summary manner. However, remedial action would be initiated.

**2.13.5** *Audit recommends that the Ministry may ensure that necessary tax audit reports/certificates have been furnished by the assessee before allowing deductions and determination of tax.*

**2.13.6** In the exit conference, the Board accepted the audit recommendation.

## **2.14 Conclusion**

**2.14.1** Audit has noticed several cases of (i) tax audit reports with inadequate/inaccurate information which was not verified at the time of assessment and (ii) where information available in the tax audit reports were not effectively utilised while finalising assessments. Thus, in these cases, the intention of the Act in introducing compulsory audit/certification by third parties so that books of accounts faithfully reflect the income of the taxpayer and that the claims for deductions are correctly made, has not been fulfilled. Ministry may consider ways to improve the quality of tax audit reports/certificates to ensure greater compliance with the provisions of the Act, as also reiterate its instructions to assessing officers to appropriately evaluate and utilise the information in tax audit reports while finalising assessments. Further, the internal control mechanism in the Department to monitor compliance with provisions of the Act and its instructions on compulsory audit of accounts and audit reports/certificates, as also evaluation and utilisation of the information in these reports, is ineffective. The internal control mechanism as well as the monitoring mechanism in the Department may be made more effective for ensuring compliance with the instructions of the Department.

## **2.15 Summary of recommendations**

**2.15.1** *The Ministry may ensure taking of action in terms of instruction no.1959 and section 288 of the Act, in cases where inadequate/inaccurate information have been furnished in the tax audit reports.*

**2.15.1.1** In the exit conference, the Board accepted the audit recommendation.

**2.15.2** *The Ministry may issue instructions to ensure that assessing officers critically examine the tax audit reports along with the connected records and other available evidence so as to make an independent assessment in each case.*

**2.15.2.1** In the exit conference, the Board accepted the audit recommendation.

**2.15.3** *The Ministry may ensure that information as available from the tax audit reports/certificates is effectively utilised in finalising the assessments.*

**2.15.3.1** In the exit conference, the Board accepted the audit recommendation.

**2.15.4** *The Ministry may consider evolving a mechanism to ensure that assessing officers test check transactions of Rs. 20000 or more and utilise penal provisions where required.*

**2.15.5** *The Ministry may consider a suitable mechanism for linking the information available in the tax audit reports with the new annexure-less forms.*

**2.15.5.1** In the exit conference, the Board stated that the issue would be examined.

**2.15.6** *The Ministry needs to strengthen its internal control and monitoring mechanism to ensure compliance with the instructions, rules, circulars and provisions of the Income Tax Act, 1961.*

**2.15.6.1** In the exit conference, the Board accepted the audit recommendation.

**2.15.7** *The Ministry may ensure that necessary tax audit reports/certificates have been furnished by the assessee before allowing deductions and determination of tax.*

**2.15.7.1** In the exit conference, the Board accepted the audit recommendation.