

## For Attention of members carrying out tax audit u/s 44AB of the Income-tax Act, 1961. - (10-09-2010)

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Attention of members is invited towards the changes in the Guidance Note on tax Audit under section 44AB of the Income-tax Act, 1961 approved subsequent to the publication of the Supplementary Guidance Note, issued by the erstwhile Fiscal Laws Committee, as a part of the publication "Guidance Note on Audit of Fringe Benefits under the Income-tax Act, 1961" in 2006.

The Fifth Edition of the Guidance Note on Tax Audit under section 44AB of the Income-tax Act, 1961 incorporating the law as amended by the Finance Act, 2005 was published in September, 2005. Subsequently, a supplementary Guidance Note has been published on the amendments made by the notification No. 208/2006 dated 10th August, 2006 issued by the Central Board of Direct Taxes in Form No. 3CD.

Subsequent to the publishing of the above Supplementary Guidance Note, the Finance Act, 2007 has made amendments in section 40A(3). New Rule 6DD was inserted in the Income-tax Rules by notification No. 208/2007 dated 27.6.2007 w.e.f. A.Y. 2008-09.

The Council thereupon approved some more changes subsequent to the publication of the Supplementary Guidance Note. These may be taken into consideration while reading in the Guidance Note on Tax Audit [2005 Edition] and the Supplementary Guidance note on Tax Audit [2006 Edition published along with the Guidance Note on Audit of Fringe Benefits under the Income-tax Act, 1961].

For convenience of members the clauses wherein there have been changes are listed hereunder and the full text which forms part of the Guidance to members is available at <http://220.227.161.86/20408announ11236a.pdf>. Please note that some changes approved relating to fringe benefits have not been given here since they are no longer relevant.

1. Clause No. 12(a) and (b) of Form 3CD Para No. 23 of the Guidance Note[2005 Edition]
2. Clause 17(h) of Form 3CD Para 35 of the Guidance Note (Subsequent changes have been made in section 40A(3) by the Finance Act, 2008 and Finance (No. 2) Act,

2009 and also in Rule 6DD. These changes may have an effect on the computation of the amount to be reported but no further guidelines in this regard is considered necessary)

3. Clause 17(l) of Form 3CD
4. Clause 17A in Form 3CD - Amount inadmissible under section 23 of the Micro, Small and Medium Enterprises Development Act, 2006.
5. Select issues in accounting for state level VAT. (These do not represent the views of the Council but are based on the original draft prepared by Indore Branch of the CIRC of the Institute.)

In this connection, we would also like to invite the attention of members towards the announcement dated 12.12.2008, in the light of which from the A.Y.2010-11, an internal auditor of an assessee cannot be appointed as his tax auditor. [Click here for Announcement](#) and [further clarification](#) regarding non- applicability of the same only for tax audit relating to financial year ending 31st March,2009 in certain cases.

## Internal Auditor cannot be appointed as a Tax Auditor - (12-12-2008)

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The Council in its 281st meeting held from 3rd October, 2008 to 5th October 2008 at New Delhi considered an issue arising from the Guidance Note on Tax audit under section 44AB of the Income-tax Act,1961 as to "Whether the internal auditor of an assessee, being an individual chartered accountant or a firm of chartered accountants can be appointed as his tax auditor".

***The Council decided that an internal auditor of an assessee, whether working with the organisation or independently practising chartered accountant or a firm of chartered accountants, cannot be appointed as his tax auditor***

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***The Council decided that an internal auditor of an assessee, whether working with the organisation or independently practising chartered accountant or a firm of chartered accountants, cannot be appointed as his tax auditor***

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1. Clause No.12(a) and (b) – Para No.23 of the Guidance Note (2005 Edition)

23(a) Method of valuation of closing stock employed in the previous year.

(b) Details of deviation, if any, from the method of valuation prescribed under section 145A and the effect thereof on the profit or loss

This clause requires the details regarding method of valuation of closing stock employed in the previous year and the details of deviation, if any, from the method of valuation prescribed under section 145A and the effect thereof on the profit or loss.

There is no change from paragraphs from 23.1 to 23.17. After that, the following paragraphs are being added.

23.18 The input State-Level Value Added Tax (VAT) paid on purchases cannot be included in the cost of purchases. Where the tax paid on inputs is available for set-off against the tax payable on sales or is refundable, it is in the nature of taxes recoverable from taxing authorities. The Accounting Standard (AS) 2 “Valuation of Inventories” issued by the ICAI deals with “cost of inventories” and “cost of purchases”. As per para 6 and 7 of the said AS-2, the cost of purchases cannot include duties and the taxes which are subsequently recoverable from the taxing authorities. Hence the input tax which is refundable, should not be included in the cost of purchases.

23.19 The Input State-Level VAT, to the extent it is refundable, will not form part of the cost of the inventory. The inventory of inputs is to be valued at net of the input tax which is refundable. If the inputs are obtained from the dealers who are exempt from the VAT, the actual cost of purchase should be considered as a part of cost of inventory.

23.20 A dealer may purchase certain common inputs which are to be used for making taxable sales as well as for making exempt sales. In such a case, the dealer, on the date of purchase, should estimate inputs expected to be

used for making taxable sales and for making exempt sales. The dealer should recognize VAT credit only in respect of those inputs which are expected to be used for making taxable sales and no VAT credit should be recognized in respect of inputs expected to be used for making exempt sales. Subsequently, in case the actual use is different from the estimated use, the dealer should pass an appropriate adjustment entry for the same. Similarly, in the case of stock transfer/consignment sale of goods out of the State where VAT credit is available only to the extent of a certain portion of input tax paid, the dealer should make an estimate of the expected stocks transfers/ consignment sales and account for accordingly.

23.21 VAT is collected from the customers on behalf of the VAT authorities and, therefore, its collection from the customers is not an economic benefit for the enterprise. It does not result in any increase in the equity of the enterprise. Accordingly it should not be recognized as an income of the enterprise. Similarly, the payment of VAT should not be treated as an expense in the financial statements of the enterprise. Therefore it should be credited to an appropriate account, say, 'VAT Payable Account'. In case the VAT has not been charged separately but has made a composite charge, it should segregate the portion of sales which is attributable to tax and should credit the same to 'VAT Payable Account' at periodic intervals. The amount of VAT payable adjusted against the VAT Credit Receivable (Capital Goods) Account and amounts paid in cash will be debited to this account. The credit balance in VAT Payable Account at the year-end should be shown on the 'Liabilities' side of the balance sheet under the head 'Current Liabilities'. It is important to note that where the assessee is enjoying tax holiday under the relevant state law as a result of which the liability to pay is deferred for a period of more than one year then it should be reflected as a long term liability.

23.22 Section 145A of the Income Tax Act provides that the valuation of purchase and sales of goods and inventory for the purpose of computation of income from business or profession shall be made on the basis of method of accounting regularly employed by the assessee but this shall be subject to certain adjustments. Therefore, it is not necessary to change the method of valuation of purchase, sale and inventory regularly employed in the books of account. The adjustment provided for in this section should be made while

computing the income for the purpose of preparing the return of income. Therefore the recommended method for accounting of VAT will not result in non-compliance of section 145A of the Income Tax Act.

23.23 The adjustments envisaged by section 145A will not have any impact on the trading account of the assessee. In other words both under exclusive method of accounting and inclusive method of accounting, the gross profit in the trading account will remain the same. The same is illustrated for a trading concern and a manufacturing concern as follows:

#### Trading Concern

Three items purchased @ Rs.3.00 lakhs per item. VAT on purchase @ 10%. There is no opening stock.

Two items sold @ Rs.4.50 lakhs per item. VAT on sales @ 10%

#### The Trading Account on "EXCLUSIVE METHOD"

Particulars	Quantity	Rate	Amount	Particulars	Quantity	Rate	Amount
To Opening Stock			-	By Sales	2	4,50,000	9,00,000
To Purchases	3	3,00,000	9,00,000	By Closing Stock	1	3,30,000	<u>3,00,000</u>
To GP			<u>3,00,000</u>				
			<u>12,00,000</u>				<u>12,00,000</u>

**The Trading Account on "INCLUSIVE METHOD"**

Particulars	Quantity	Rate	Amount	Particulars	Quantity	Rate	Amount
To Opening Stock			-	By Sales	2	4,95,000	9,90,000
To Purchases	3	3,30,000	9,90,000	By Closing Stock	1	3,30,000	3,30,000
Less: VAT credit availed on cost of goods sold			<u>60,000</u>				
			<u>9,30,000</u>				
VAT paid on sales			90,000				
Gross Profit			<u>3,00,000</u>				_____
			<u>13,20,000</u>				<u>13,20,000</u>

The statutory adjustments required under section 145A can be explained by the following example:

Sl. No.	Particulars	Increase in profit (Rs.)	Decrease in profit (Rs.)
1.	VAT on Purchase		90,000
2.	VAT on Sales	90,000	
3.	VAT on Closing Stock	30,000	
4.	VAT paid on sales		90,000
5.	VAT credit availed on cost of goods sold		_____
		<u>60,000</u>	
		<u>1,80,000</u>	<u>1,80,000</u>

The net impact on Profit & Loss Account is NIL.

The computation of total income would appear as under:-

Profit as per Profit & Loss account as per books of account	Rs.300,000
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Add: Adjustments required under section 145A

1.	VAT on Sales	Rs. 90,000	
2.	VAT on Closing stock	Rs. 30,000	Rs.1,20,000
			<b>Total</b> <b>4,20,000</b>

Less:

1.	VAT credit Receivables (Input) A/c		<u>Rs.90,000</u> 3, 30,000
2.	Deductions under section 43B on the assumption that the amount is paid on or before the due date of filing of the return of income in respect of :-		
	a) VAT on closing stock of raw material		Rs.30,000
		<b>Profit</b>	<b>3,00,000</b>

In the above example ,assuming that the assessee has opening stock of Rs.3,30,000 on which input tax rebate of Rs.30,000/- is available and the VAT has become applicable for the first time, then the comparative position will be as under:-

#### The Trading Account on “EXCLUSIVE METHOD”

Particulars	Quantity	Rate	Amount	Particulars	Quantity	Rate	Amount
To Opening Stock	1	3,30,000	3,30,000	By Sales	2	4,50,000	9,00,000
Less Input tax rebate			30,000				
			<u>3,00,000</u>				
To Purchases	3	3,00,000	9,00,000	By Closing Stock	2	3,00,000	6,00,000
To Gross Profit			<u>3,00,000</u>				
<b>Total</b>			<b><u>15,00,000</u></b>				<b>15,00,000</b>

### The Trading Account on “INCLUSIVE METHOD”

Particulars	Quantity	Rate	Amount	Particulars	Quantity	Rate	Amount
To Opening Stock	1	3,30,000	3,30,000	By Sales	2	4,95,000	9,90,000
To Purchases	3	3,30,000	9,90,000	By Closing Stock	2	3,30,000	6,60,000
			<u>13,20,000</u>				
Less: VAT credit availed on cost of goods sold			60,000				
			12,60,000				
VAT paid on sales			90,000				
Gross Profit			3,00,000				
			16,50,000				16,50,000

The statutory adjustments required under section 145A can be explained by the following example:

Sl. No.	Particulars	Increase in profit (Rs.)	Decrease in profit (Rs.)
1.	VAT Recovered on Opening Stock		30,000
2.	VAT on Purchase		90,000
3.	VAT on Sales	90,000	
4.	VAT on Closing Stock	60,000	
5.	VAT paid on sales		90,000
6.	VAT credit availed on cost of goods sold	60,000	
		<u>2,10,000</u>	<u>2,10,000</u>

The net impact on Profit & Loss Account is NIL.

The computation of total income total income would appear as under:-

Profit as per Profit & Loss account on the basis of exclusive method Rs.3,00,000

Add: Adjustments required under section 145A

1.	VAT on sales	Rs. 90,000	
2.	VAT on closing stock	Rs. 60,000	Rs.1,50,000
		<b>Total</b>	<b>4,50,000</b>

Less:

1.	VAT credit Receivables (Input) A/c		<u>Rs. 90,000</u>
			<u>3,60,000</u>
2.	Deductions under section 43B on the assumption that the amount is paid on or before the due date of filing of the return of income in respect of :-		
	a) VAT on closing stock of goods		Rs. 60,000
		<b>Profit</b>	<b><u>3,00,000</u></b>

### Manufacturing concern

The following information is considered in the case of a manufacturing concern:-

Opening stock of raw material 50 units	@ Rs.100 per unit
Purchases of raw material 300 units	@ Rs.100 per unit
Sales 250 units	@ Rs.150 per unit
Manufacturing expenses	Rs.3,000
Closing stock of raw material	50 units
Closing stock of finished goods	50 units
VAT rate on purchases and sales	4%

**Manufacturing Account on “EXCLUSIVE METHOD”**

Particulars	Qty	Rate	Amount	Amount	Particulars	Qty	Rate	Amount
Opening Stock	50	100	5,000		By Sales	250	150	37,500
Purchase of raw materials	300	100	30,000		By closing stock of finished goods	50	110	5,500
<b>Total</b>	<b>350</b>	<b>100</b>	<b>35,000</b>					
Less: Closing Stock of raw material	50	100	5,000					
Raw material Consumed (C) = (A) – (B)	300			30,000				
To manufacturing expenses	300	10		3,000				
To VAT on finished goods sold				0				
To gross profit				10,000				
<b>Total</b>				<b>43,000</b>	<b>Total</b>			<b>43,000</b>

**Manufacturing Account on “INCLUSIVE METHOD”**

Particulars	Qty	Rate	Amount	Amount	Particulars	Qty	Rate	Amount
Opening Stock	50	104	5,200		By Sales	250	156	39,000
Purchase of raw materials	300	104	31,200		By closing stock of finished goods	50	114	5,700
<b>Total</b>	<b>350</b>	<b>104</b>	<b>36,400</b>					
Less: Closing Stock of raw material	50	104	5,200					
Less; VAT on Raw Material Consumed	300	4	1,200					
Raw material Consumed (C) = (A) – (B)	300	100		30,000				
To manufacturing	300	100		3,000				
To VAT on finished goods sold	250	6		1,500				
To VAT included in finished goods on account of inclusion of VAT in the raw material value	50	4		200				
To gross profit				10,000				
<b>Total</b>				<b>44,700</b>	<b>Total</b>			<b>44,700</b>

The valuation of finished goods includes the raw material cost and the manufacturing expenses. The raw material costs is taken at Rs.100 per unit in the exclusive method and Rs.104 in the inclusive method.

It will be seen from the above that the gross profit is the same both under the inclusive and the exclusive method. Further, the closing stock of raw materials includes the appropriate VAT. But the VAT is not includible in the closing stock of finished goods since the incidence of VAT arises only on sale. However, VAT on raw material included in the finished goods has also been included in the value of closing stock of finished goods.

The statutory adjustments required under section 145A can be explained by the following example:

Sl.No.	Particulars	Increase in Profit (Rupees)	Decrease in Profit (Rupees)
1.	Increase in cost of opening stock of raw material on inclusion of VAT		200
2.	Increase in purchase on account of inclusion of VAT.		1,200
3.	Increase in sales of finished goods on inclusion of VAT.	1,500	
4.	VAT paid on sale of finished goods as a result of its inclusion in sales		1,500
5.	Increase in closing stock of raw material on inclusion of VAT	200	
6.	Accounting of VAT credit availed and utilized on raw material consumed in payment of VAT on finished goods, accounted on the basis of raw material consumed.	1,200	
7.	Increase on account of VAT included in finished goods on account of inclusion of VAT in the raw material value	200	
8.	Increase in VAT on closing stock of finished goods on account of inclusion of VAT in the raw material value		200
<b>Total</b>		<b>3,100</b>	<b>3,100</b>

The net impact on the Profit & Loss Account is NIL.

The computation of total income total income would appear as under:-

Profit as per Profit & Loss account on the basis of exclusive method		Rs.10,000
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Add: Adjustments required under section 145A

1.	VAT on sales	Rs. 1,500	
2.	VAT on closing stock of raw material	Rs. 200	
3.	VAT included in finished goods on account of inclusion of VAT in the raw material value	<u>Rs. 200</u>	Rs.1,900
	<b>Total</b>		<b>11,900</b>

Less:

1.	VAT credit receivables (Input) A/c	<u>Rs.1,200</u>	
			<u>10,700</u>

2. Deductions under section 43B on the assumption that the amount is paid on or before the due date of filing of the return of income in respect of :-

a)	VAT on sales (1500-1200)	Rs. 300	
b)	VAT on closing stock of raw material	Rs. 200	
c)	VAT included in finished goods on account of inclusion of VAT in the raw material value	<u>Rs. 200</u>	<u>700</u>
	<b>Profit</b>		<b>10,000</b>

## 2. Clause 17(h) of Form 3CD Para 35 of the Guidance Note

*“Subsequent changes have been made in section 40A(3) by the Finance Act, 2008 and Finance (No. 2) Act, 2009 and also in Rule 6DD. These changes may have an effect on the computation of the amount to be reported but no further guidance in this regard is considered necessary”*

35. (h) amount inadmissible under section 40A(3) read with rule 6DD and computation thereof;

(A) *whether a certificate has been obtained from the assessee regarding payments relating to any expenditure covered under section 40A(3) that the payments were made by account payee cheques drawn on a bank or account payee bank draft, as the case may be, [Yes/No]*

(B) *amount inadmissible under section 40A(3), read with rule 6DD [with break-up of inadmissible amounts];*

[Clause 17(h)]

Following is the full guidance for clause 17(h)

Statutory provision upto A.Y. 2007-08

35.1 Section 40A(3) as amended by the Taxation Laws (Amendment) Act, 2006 w.e.f. 13<sup>th</sup> July, 2006 provides that 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 drawn on a bank or account payee bank draft 20% of such expenditure shall not be allowed as deduction except in certain cases and circumstances. The cases and circumstances in which payment of a sum exceeding Rs.20,000/- in cash or otherwise than an account payee cheque drawn on a bank or account payee bank draft is allowable are specified in Rule 6DD. The details regarding the payments made in cash or otherwise than by account payee cheques drawn on a bank or by account payee bank drafts are to be stated under this clause.

### Statutory provision w.e.f. A.Y. 2008-09

- 35.2 The Finance Act, 2007 has substituted sub-section (3) for the existing sub-section (3) of section 40A w.e.f. A.Y. 2008-09.
- 35.3 The provisions of the newly substituted sub-section (3) of section 40A have three limbs. In the first limb, where the assessee incurs any expenditure in respect of which he makes a payment in a sum exceeding rupees twenty thousand otherwise than by an account payee cheque drawn on a bank or account payee bank draft no deduction would be allowed in respect of such expenditure. This is in contrast to the last applicable up to A.Y. 2007-08 where under only 20% of such expenditure would be disallowed. Under the second limb, where the assessee claims the expenditure as a deduction on the basis of the principle of accrual and in the subsequent year he makes payment in respect of such expenditure otherwise than by an account payee cheque drawn on a bank or account payee bank draft, such payment shall be deemed to be the profits and gains of business or profession chargeable income-tax as income of the subsequent year if the amount of payment exceeds rupees twenty thousand. However, the third limb provides that no disallowance would be made if the payment is made even otherwise than by an account payee cheque drawn on a bank or account bank draft in respect of cases prescribed under rule 6DD. Notification No.208/2007 dated 27.6.2007 has inserted new rule 6DD w.e.f. A.Y. 2008-09.
- 35.4 The auditor will now have to verify the payments made otherwise than by an account payee cheque drawn on a bank or an account payee bank draft regarding expenditure allowed for any earlier year. Such amount will be required to be reported in sub-para (B) of para 17(h)
- 35.5 The provisions of section 40A(3) as amended by the Taxation Laws (Amendment) Act, 2006 are not applicable for the A.Y. 2006-07. They are applicable from 13<sup>th</sup> July, 2006. The certificate required under Item (A) of sub-clause (h) is based upon the amended provisions of section 40A(3). So far as A.Y. 2006-07 is concerned the tax auditor may state that clause (A) is not applicable. However, the tax auditor has to verify

whether the law contained in section 40A(3) as applicable for A.Y. 2006-07 has been complied with by the assessee. Although the reporting requirement is not strictly applicable for the previous year 2005-06 and also for the period from 1.4.2006 to 12<sup>th</sup> July, 2006, it is always desirable that the tax auditor should obtain suitable certificate as per the applicable law and keep it in his audit working papers file.

35.6 In respect of A.Y. 2007-08 the reporting requirements under sub-clause (h) can be divided into two parts. In respect of the period commencing from 1<sup>st</sup> April, 2006 and ending on 12<sup>th</sup> July, 2006 the amended provisions of section 40A(3) are not applicable. Therefore, in respect of that period there is no reporting requirement under item (A) of sub-clause (h). In respect of the period commencing from 13<sup>th</sup> July, 2006 and ending on 31<sup>st</sup> March, 2007 and the subsequent financial years the reporting requirements of item (A) have to be complied with.

35.7 The particulars may be furnished in the following form:

Sl. No.	Nature and particulars of expenditure	Date of Payment	Amount paid otherwise than by an account payee cheque drawn on a bank or account payee bank draft	Total amount of expenditure	Remarks

35.8 There may be practical difficulties in verifying the payments made through crossed/account payee cheque or bank drafts. If no proper evidence for the verification of the payment by the crossed/account payee cheque or draft is available, such a fact could be brought out by appropriate comments in the following manner applicable to the relevant assessment year.

In respect of A.Y. 2006-07.

*“It is not possible for me/us to verify whether the payments in excess of Rs.20,000 have been made otherwise than by crossed cheque or bank draft as the necessary evidence is not in the possession of the assessee”.*

In respect of A.Y. 2007-08

*For the period commencing from 1<sup>st</sup> April, 2006 and ending with 12<sup>th</sup> July, 2006, it is not possible for me/us to verify whether the payments in excess of Rs.20,000 have been made otherwise than by crossed cheque or bank draft as the necessary evidence is not in the possession of the assessee and for the period commencing from 13<sup>th</sup> July, 2006 and ending on 31<sup>st</sup> March, 2007, it is not possible for me/us to verify whether the payments in excess of Rs.20,000 have been made otherwise than by account payee cheque or account payee bank draft, as the necessary evidence is not in the possession of the assessee.*

In respect of A.Y. 2008-09 and onwards.

*“It is not possible for me/us to verify whether the payments in excess of Rs.20,000 have been made otherwise than by account payee cheque or account payee bank draft as the necessary evidence is not in the possession of the assessee”.*

35.9 The earlier sub-clause (h) required furnishing of the amount inadmissible under section 40A(3) read with rule 6DD along with computation. The amended sub-clause requires disclosure of amount inadmissible under section 40A(3) read with rule 6DD with the break-up of inadmissible amount.

35.10 Wherever possible individual items of inadmissible expenses may be given. However, where, in view of the large volume of transactions it is not possible to give individual items of inadmissible amounts, the tax auditor may furnish such details under broad heads of accounts.

- 35.11 For the purpose of furnishing the above particulars, the tax auditor should obtain a list of all cash payments in respect of expenditure exceeding Rs.20,000 made by the assessee during the relevant year which should include the list of payments exempted in terms of Rule 6DD with reasons. This list should be verified by the tax auditor with the books of account in order to ascertain whether the conditions for specific exemption granted under clauses (a) to (l) of Rule 6DD are satisfied. Details of payments which do not satisfy the above conditions should be stated under this clause.
- 35.12 Items of expenditure in respect of which specific exemption has been given under Clauses (a) to (l) of Rule 6DD are not required to be stated under this clause.

3. The appropriate guidance approved by the Council in regard to clause 17(l) of the Form No.3CD is as under:-

“40. Clause 17(l) - Amount of deduction inadmissible in terms of section 14A in respect of the expenditure incurred in relation to income which does not form part of the total income;

40.1 This clause was inserted by the notification number 208/2006 dated 10th August 2006. Section 14A was inserted in Chapter IV – Computation of total income by the Finance Act, 2001 with retrospective effect from 1.4.1962 i.e. A.Y. 1962-63. Accordingly, for the purposes of computing the total income under Chapter IV of the Act, no deduction shall be allowed in respect of expenditure incurred by the assessee in relation to income which does not form part of the total income under the Act. The Finance Act, 2002 added a proviso to section 14A to the effect that nothing contained in the section shall empower the Assessing Officer either to reassess under section 147 or pass an order enhancing the assessment or reducing a refund already made or otherwise increasing the liability of the assessee under section 154, for any assessment year beginning on or before the first day of April, 2001.

40.2 The Finance Act, 2006 has inserted sub-sections (2) and (3) w.e.f. A.Y. 2007-08. Under sub-section (2) the Assessing Officer shall determine the amount of expenditure incurred in relation to such income, which does not form part of the total income under the Act. Such determination should be in accordance with the method as may be prescribed. Such power of the Assessing Officer can be exercised only when he, having regard to the accounts of the assessee, is not satisfied with the correctness of the claim of the assessee.

40.3 Sub-section (3) provides that the provisions of subsection (2) shall also apply in relation to a case where an assessee claims that no expenditure has been incurred by him in relation to income which does not form part of the total income under this Act.

40.4 The expenditure which is relatable to the income which does not form part of the total income is not allowed as a deduction in terms of section 14A of the Act.

Such income are dealt with in Part III- Incomes Which Do Not Form Part Of Total Income. Section 10 deals with Incomes not include in total income. Sections 10A to 10C deals with the special provisions in respect of the specified undertakings. In general an assessee may have besides his business income, income from agriculture which is exempt under sub-section (1), share of profit in a partnership firm which is exempt under sub-section (2A), income from dividends referred to in section 115-O which is exempt under sub-section (34), long term capital gains on the transfer of equity shares which is exempt under sub-section (38) etc. In all such cases the expenditure relating to the income which is not included in total income is inadmissible under section 14A. In case of an investment in a partnership firm, while the interest and the salary received by the partner are taxable, the share of profit is exempt. The amount of inadmissible expenditure depends on the facts and circumstances of each case.

40.5 The Central Board of Direct Taxes, has through Income-tax (Fifth Amendment) Rules, 2008 inserted a new Rule 8D which lays down the method for determining the amount of expenditure in relation to income not includible in total income. Sub-rule (1) of Rule 8D provides that having regard to the accounts of the assessee of a previous year, if the Assessing Officer is not satisfied with the correctness of the claim of expenditure made by the assessee or with the claim made by the assessee that no expenditure has been incurred, in relation to income which does not form part of the total income under the Act for such previous year, he shall determine the amount of such inadmissible expenditure in accordance with the method of computation laid down in sub-rule (2) of Rule 8D.

Sub-rule (2) of Rule 8D provides for the method of computation of the expenditure in relation to income not forming part of the total income. The disallowance shall be the aggregate of the following:

- (i) the amount of expenditure directly relating to income which does not form part of total income;
- (ii) in a case where the assessee has incurred expenditure by way of interest during the previous year which is not directly attributable to any particular income or receipt, an amount computed in accordance with the following formula, namely :

$$A \times \frac{B}{C}$$

Where A = amount of expenditure by way of interest other than the amount of interest included in clause (i) incurred during the previous year;

B = the average of value of investment, income from which does not or shall not form part of the total income, as appearing in the balance sheet of the assessee, on the first day and the last day of the previous year;

C = the average of total assets as appearing in the balance sheet of the assessee, on the first day and the last day of the previous year;

iii) an amount equal to one-half per cent of the average of the value of investment, income from which does not or shall not form part of the total income, as appearing in the balance sheet of the assessee, on the first day and the last day of the previous year.

“Total Assets” for the purpose of Rule 8D shall mean, total assets as appearing in the balance sheet excluding the increase on account of revaluation of assets but including the decrease on account of revaluation of assets.

40.6 The method prescribed under sub-rule (2) of Rule 8D is applicable when the Assessing Officer is not satisfied with the correctness of the claim of expenditure made by the assessee or with the claim made by the assessee that no expenditure has been incurred. Normally this situation would arise at the time of assessment i.e. after the tax audit has been completed and the return has been filed. Therefore, at the time of tax audit the tax auditor will have to verify the amount of inadmissible expenditure as determined by the assessee. The method under sub-rule (2) of Rule 8D is to be adopted by the Assessing Officer when he is not satisfied with the amount as determined by the assessee. Rule 8D does not mandate that the assessee should necessarily compute the disallowance as per the method prescribed under sub rule (2). Therefore, the assessee may or may not adopt the same.

40.7 It is primarily the responsibility of the assessee to furnish the details of amount of deduction inadmissible in terms of section 14A i.e. in respect of the

expenditure incurred in relation to income, which does not form part of the total income. The tax auditor shall examine the details of amount of inadmissible expenditure as furnished by the assessee. While carrying out such examination the tax auditor is entitled to rely on the management representation. However, attention is invited to para 5 of Standard on Auditing -580, "Representation by Management" (earlier known as Auditing and Assurance Standard-11) which is as under:-

"During the course of an audit, management makes many representations to the auditor, either unsolicited or in response to specific enquires. When such representations relate to matters which are material to the financial information, the auditor should;

- (a) seek corroborative audit evidence from sources inside or outside the entity;
- (b) evaluate whether the representations made by management appear reasonable and consistent with other audit evidence obtained, including other representations; and
- (c) consider whether the individuals making the representation can be expected to be well informed on the matter."

40.8 The tax auditor will verify the amount of inadmissible expenditure as estimated by the assessee with reference to established principles of allocation of expenditure based on logical parameters like proportion of exempt and taxable income recorded, turnover, man hours spent to earn the relevant income etc. For allocation of interest between taxable and non-taxable income, the quantum of investment, the period and the rate of interest are generally the relevant factors to be considered. This requires proper estimates to be made by the assessee. The tax auditor is required to audit such estimates. Attention is invited to Standard on Auditing - 540 (earlier known as AAS-18) "Audit of Accounting Estimates". In accordance with this Standard the auditor should adopt one or a combination of the following approaches in the audit of such accounting estimates:

- review and test the process used by the assessee to develop the estimate;
- use an independent estimate for comparison with that prepared by the assessee; or

- review subsequent events which confirm the estimate made.

40.9 An assessee may claim that no expenditure has been incurred by him in relation to income which does not form part of the total income under the Act. Even in such a case the provisions of section 14A will apply. Accordingly, the tax auditor is required to verify such contention of the assessee.

40.10 As stated before the method prescribed under sub-rule (2) of Rule 8D is to be adopted by the Assessing Officer when he is not satisfied with the correctness of claim made by the assessee. As per clause (i) of sub-rule (2) the expenditure which is directly relatable to income which does not form part of total income is inadmissible expenditure. Besides such expenditure there may be expenditure such as interest, which is relatable to both taxable and non-taxable income which needs to be properly allocated while calculating the inadmissible amount. Interest which, can be directly attributable to any particular income or receipt chargeable to tax needs to be excluded while determining the inadmissible amount. Clause (ii) of sub-rule (2) of rule 8D deals with allocation of interest which, is not directly attributable to any particular income or receipt. However the variable A used in the formula in clause (ii) of sub- rule (2) is said to be equal to the amount of expenditure by way of interest other than the amount of interest included in clause (i) incurred during the previous year. It may be seen that what is proposed to be allocated as per clause (ii) is interest which is not directly attributable to any particular income or receipt. Therefore, variable A is the amount of expenditure by way of interest other than the amount of interest directly attributable to any non taxable income as per clause (i) and also interest which may be directly attributable to any taxable income. Interest on term loan may be an example of such interest which is generally related to taxable income and is therefore excluded.

40.11 The broad principles enunciated in para 16.3 may be kept in mind while verifying the amount of inadmissible expenditure. After verifying the amount of inadmissible expenditure, if the tax auditor:

- (a) is in agreement with the assessee, he should report the amount with suitable disclosures of material assumptions, if any.
- (b) is not in agreement with the assessee with regard to the amount of expenditure determined, he may give:

- A qualified opinion:

A qualified opinion can be given when the auditor is of the opinion that the effect of any disagreement with the assessee is not so material and pervasive as to require an adverse opinion or limitation on scope is not so material and pervasive as to require a disclaimer of opinion.

- An adverse opinion:

The auditor in rare circumstances may come across a situation where the impact of his disagreement about the computation of such inadmissible expenditure is so material and pervasive that it affects the overall opinion. In such a case the tax auditor may give an adverse opinion.

- The disclaimer of opinion:

When the assessee has neither provided the basis nor the supporting documents, for the claim of such inadmissible expenditure, then due to limitation on the scope of auditors work, the auditor can give disclaimer of opinion.”

#### 4. Guidance on Clause 17A in the Form No.3CD

##### 38A. Clause 17A- Amount inadmissible under section 23 of the Micro, Small and Medium Enterprises Development Act, 2006

This is a new clause inserted by the Central Board of Direct Taxes through its Notification No. 36/2009 dated 13-4-2009, in the Form No.3CD in Appendix II of the Income-tax Rules, 1962 .

The tax auditor is required to state the amount of interest inadmissible under section 23 of the Micro, Small and Medium Enterprises Development Act, 2006. The Micro, Small and Medium Enterprises Development Act, 2006 (MSME Act) is an Act to provide for facilitating the promotion and development and enhancing the competitiveness of micro, small and medium enterprises and for matters connected therewith or incidental thereto.

Section 23 of the MSME Act lays down that an interest payable or paid by the buyer, under or in accordance with the provisions of this Act, shall not for the purposes of the computation of income under the Income-tax Act, 1961 be allowed as a deduction.

The inadmissible interest has to be determined on the basis of the provisions of the MSME Act. Section 16 of the MSME Act provides for the date from which and the rate at which the interest is payable. Accordingly, where a buyer fails to make payment of the amount to the supplier, as required under section 15, the buyer shall , notwithstanding anything contained in any agreement between the buyer and the supplier or any law for the time being in force, be liable to pay compound interest with monthly rests to the supplier on that amount from the appointed date or, as the case may be, from the date immediately following the date agreed upon, at three times of the bank rate notified by the Reserve Bank.

Section 15 of the MSME Act, requires the buyer to make payment on or before the date agreed upon in writing, or where there is no agreement in this behalf, before the appointed day. It also provides that the period agreed upon in writing shall not exceed forty five days from the day of acceptance or the day of deemed acceptance.

Section 22 of the MSME Act provides that where any buyer is required to get his annual accounts audited under any law for the time being in force, such buyer shall furnish the following additional information in his annual statement of accounts, namely:-

- i. The principal amount and interest due thereon (to be shown separately) remaining unpaid to any supplier as at the end of each accounting year.
- ii. The amount of interest paid by the buyer in terms of Section 16, along with the amount of payment made to supplier beyond the appointed date during each accounting year.
- iii. The amount of interest due and payable for the delay in making payment (which have been paid but beyond the appointed day during the year) but without adding the interest specified under this Act.
- iv. The amount of interest accrued and remaining unpaid at the end of each accounting year; and
- v. The amount of further interest remaining due and payable even in the succeeding years, until such date when the interest dues as above are actually paid to the small enterprise, for the purpose of disallowance as a deductible expenditure under section 23.

Where the tax auditor is issuing his report in Form No.3CB, he should verify that the financial statements audited by him contain the information as prescribed under section 22 of the MSME Act. If no disclosure is made by the auditee in the financial statements he should give an appropriate qualification in Form No.3CB, in addition to the reporting requirement in clause 17A of Form No. 3CD.

The tax auditor while reporting in respect of clause 17A should take the following steps:

- (a) The auditor should seek information regarding status of the enterprise i.e. whether the same is covered under the Micro, Small and Medium Enterprises Development Act, 2006. Where the information is available and has been disclosed the same should be reported as such in Form No. 3CD.

Where the information is not available the auditor should also mention the same in the Form No.3CD.

- (b) Since Schedule VI and Section 22 of the Micro, Small and Medium Enterprises Development Act, 2006 requires disclosure of information, the tax auditor should cross check the disclosure made in the financial statements.
- (c) Obtain a full list of suppliers of the assessee which fall within the purview of the definition of "Supplier" under section 2(n) of the Micro, Small and Medium Enterprises Development Act, 2006. It is the responsibility of the auditee to classify and identify those suppliers who are covered by this Act.
- (d) Review the list so obtained.
- (e) Verify from the books of account whether any interest payable or paid to the buyer in terms of section 16 of the MSME Act has been debited or provided for in the books of account.
- (f) Verify the interest payable or paid as mentioned above on test check basis.
- (g) Verify the additional information provided by the auditee relating to interest under section 16 in his financial statement.
- (h) If on test check basis, the auditor is satisfied, then the amount so debited to the profit and loss account should be reported under clause 17A.

Where the tax auditor, upon due verification, finds that the auditee has neither provided for nor paid any interest payable under the MSME Act, the no amount is inadmissible under section 23 of MSME Act. In such a case 'Nil' can be reported against clause 17A.

A question may come up, as to what would be disallowance, in case the auditee is liable to pay any interest under MSME Act, but he has not provided the interest in his accounts. In such a case, there can be no disallowance, as he has not claimed the same in his accounts. But whenever he pays and claim such interest, the same

will be disallowable in year of payment. In case the auditee has adopted mercantile system of accounting, the non-provision may affect true and fair view and the auditor should give suitable qualification.

The relevant extracts of the MSME Act are as follows:

“appointed day” means the day following immediately after the expiry of the period of 15 days from the day of acceptance or the day of deemed acceptance.

“day of acceptance” means the day of actual delivery of the goods or the rendering of service or where any objection is made in writing by the buyer regarding the acceptance of goods or services within 15 days from the day of delivery of goods or rendering of services, the day on which the objection is removed by the supplier.

“day of deemed acceptance” means , where no objection is made in writing by the buyer regarding acceptance of goods or services within fifteen days from the day of deliver of the goods or rendering of services, the day of the actual delivery of goods or the rendering of services.

“Buyer” means who so ever buys any goods or receives any services from the supplier for a consideration.

“Supplier” means a micro or small enterprise, which has filed a memorandum with the authority referred to in section 7(1)(a).

“Micro Enterprise” means:

- a) In case of enterprises engaged in the manufacture or production of goods pertaining to any industry specified in the first schedule to the Industries(Development and Regulation) Act, 1951 an enterprise, where the investment in plant and machinery does not exceed twenty five lakh rupees;
- b) In case of enterprises engaged in providing or rendering services, an enterprise, where the investment in equipment does not exceed ten lakh rupees.

“small enterprise” means:

- a) In case of enterprises engaged in the manufacture or production of goods pertaining to any industry specified in the first schedule to the Industries(Development and Regulation) Act, 1951 an enterprise, where the investment in plant and machinery is more than twenty five lakh rupees but does not exceed five crore rupees.
- b) In case of enterprises engaged in providing or rendering services, an enterprise, where the investment in equipment is more than ten lakh rupees but does not exceed two crore rupees;

“Medium enterprise” means

- a) In case of enterprises engaged in the manufacture or production of goods pertaining to any industry specified in the first schedule to the Industries(Development and Regulation) Act, 1951 an enterprise, where the investment in plant and machinery is more than five crore rupees but does not exceed ten crore rupees.
- b) In case of enterprises engaged in providing or rendering services, an enterprise, where the investment in equipment is more than two crore rupees but does not exceed five crore rupees;

## 5. Select Issues in Accounting for State-Level VAT

*“The views expressed in these issues do not represent the views of the Council of the ICAI. These issues have been collected, classified and analyzed by the Fiscal Laws Committee based on the original draft prepared by Indore Branch of the Central Regional Council of the Institute”.*

1. How should the Value Added Tax (VAT) be accounted for?

The Institute of Chartered Accountants of India (ICAI) has issued Guidance Note on Accounting for State- level Value Added Tax – GN(A) 19 (Issued 2005). The objective of this Guidance Note is to provide guidance in respect of accounting for various aspects of State-level Value Added Tax, including accounting for credit/set-off available for input- tax paid on purchases and accounting for VAT payable on sales.

2. To which class of the assesseees is this guidance note applicable?

The accounting treatment recommended in this guidance note is applicable in case of all the assesseees who are required to account for the VAT. The accounting treatment regarding the VAT credit is recommended only in situation where the VAT credit is available. Accordingly the recommended VAT credit treatment is not applicable in cases where no VAT credit is available such as for:-

- (i) Dealers (assesseees) not registered under VAT, or
- (ii) Dealers having turnover below the threshold limit as fixed under the State law no VAT, and opting for composition scheme, or
- (iii) Dealers engaged in the works contract and opting to pay tax by way of composition, or
- (iv) Purchase of goods from unregistered dealers.

3. Can the Input Tax paid on purchases be included in the cost of purchases?

No. Where the tax paid on inputs is available for set-off against the tax payable on sales or is refundable, it is in the nature of taxes recoverable from taxing authorities. The Accounting Standard (AS) 2 "Valuation of Inventories" issued by the ICAI deals with "cost of inventories" and "cost of purchases". As per para 6 and 7 of the said AS2 the cost of purchases cannot include duties and the taxes which are subsequently recoverable from the taxing authorities. Hence the input tax which is refundable should not be included in the cost of purchases.

4. How should the input tax on purchases be accounted for?

The amount of tax paid on purchase of inputs/ supplies and available for VAT credit should be debited to a separate account, say, VAT Credit Receivable (Inputs) Account. As and when VAT credit is actually utilized against VAT payable on sales, appropriate accounting entries will be required to record the adjustment, i.e. VAT Credit Receivable (Inputs) Account should be credited with a corresponding debit to the account maintained for the tax payable on the sales. The debit balance in VAT Credit Receivable (Inputs) Account at the year- end, should be shown on the "Assets" side of the balance sheet under the head "Loans and Advances".

5. What is the accounting treatment for the input tax on purchases which are to be used for making taxable sales as well as exempt sales?

An assessee may purchase certain common inputs which are to be used for making taxable sales as well as for making exempt sales. In such a case, the assessee, on the date of the purchase, should estimate inputs expected to be used for making taxable sales and for making exempt sales. The assessee should recognize VAT Credit only in respect of those inputs which are expected to be used for making taxable sales and no VAT credit should be recognized in respect of inputs expected to be used for making exempt sales. Subsequently, in case the actual use is different from the estimated

use, the assessee should pass an appropriate adjustment entry for the same. Such an adjustment will not be a prior period item.

6. Can the tax paid on purchases of capital goods, which is refundable in nature be included in the cost of purchases of such capital goods?

As per para 9.1 of the Accounting Standard (AS) 10, Accounting for Fixed Assets, issued by the ICAI, provides that the cost of the fixed assets should include the non-refundable taxes or levies. Since the VAT tax is in the nature of a refundable tax, it cannot be included in the cost of the capital goods.

7. What is the Accounting Treatment for VAT credit on capital goods?

The VAT credit on capital goods may or may not be available immediately. To the extent VAT Credit is available immediately, the amount in respect of thereof should be debited to an appropriate account, say, "VAT Credit Receivable (Capital Goods Account)" and the balance which is not available immediately should be debited to another appropriate account, say "VAT Credit Deferred (Capital Goods) Account". Subsequently, when the balance credit or a part thereof becomes available, the appropriate adjustment for the same should be made, i.e. the amount of credit becoming available should be credited to 'VAT Credit Deferred (Capital Goods) Account' with a corresponding debit to "VAT Credit Receivable (Capital Goods) Account". Depreciation should be charged on the original cost of the fixed asset excluding the VAT Credit.

8. What is the accounting treatment for liabilities adjusted from VAT credit receivable balance?

All liabilities adjusted out of the VAT credit receivable balance should be credited to the VAT Credit Receivable (Inputs) Account or VAT Credit Receivable (Capital Goods) Account. The corresponding debit for the same should be given to the account maintained for recording VAT liability on sale, say, "VAT Payable Account", if the liability of VAT payable on sales has been met by using the balance in the said account.

9. What is the treatment if the amount utilized pertains to disallowance / withdrawal of VAT?

If the amount utilized pertains to disallowance/ withdrawal of VAT credit taken on purchase of inputs made during the year, the same should be added to the cost of inputs. Appropriate adjustments in that case should be while valuing inventory of the inputs. If the amount adjusted pertains to disallowance / withdrawal of credit in respect of purchases made in earlier years, the accounting treatment would depend on whether the said inputs/ supplies are available ins stock or not. If they are not available i.e. , these have already been sold, the disallowance/ withdrawal should be debited to profit and loss account and treated as expense of the current year., It these are still lying in stock the amount should be added to the cost of inputs.

10. What is the treatment if the amount utilized pertains to disallowance / withdrawal of VAT Credit on capital goods?

If the amount utilized pertains to disallowance / withdrawal of VAT Credit on capital goods, the same should be added to the cost of the relevant fixed asset. For accounting purposes, depreciation on the revised unamortized depreciable amount should be provided prospectively over the residual useful life of the asset. In case the fixed asset no linger exists, the relevant amount should be written-off in the profit and loss account with an appropriate disclosure. If the amount of VAT credit disallowed on capital goods is standing to the debit of VAT Credit Deffered (Capital Goods) Account and has not been transferred to VAT Credit Receivable (Capital Goods) Account, the account to be credited would be the VAT Credit Deferred (Capital Goods) Account.

11. What is the treatment for refund of Input Tax?

Any refund of input tax received in what so ever manner, should be credited to the VAT Credit Receivable (Inputs) Account or VAT Credit Receivable (Capital Goods) Account.

12. What is the impact of Input Tax for Valuation of inventory?

The Input tax will not form part of the cost of the inventory. The inventory of inputs is to be valued at net of the input tax which is refundable. If the inputs are obtained from the dealers who are exempt from the VAT, the actual cost of purchase should be considered as a part of cost of inventory.

13. What is the treatment for VAT Credit on Goods lying in stock at the inception of the VAT Scheme?

VAT Credit is available in respect of tax-paid goods lying in stock at the inception of the VAT Scheme. The amount of VAT credit available in respect of opening stock should be credited to "VAT Credit Available on Opening Stock Account" at the inception of the VAT Scheme. The corresponding debit of this amount should be given to 'VAT Credit Receivable (Inputs) Account' if the VAT credit is available immediately. In the Profit and Loss Account the amount of 'VAT Credit Available on Opening Stock' should be shown as a deduction from the value of opening stock.

14. What is the accounting treatment for Output Tax i.e. VAT on Sales?

VAT is collected from the customers on behalf of the VAT authorities and, therefore, its collection from the customers is not an economic benefit for the enterprises. It does not result in any increase in the equity of the enterprise. Accordingly it should not be recognized as an income of the enterprise. Similarly, the payment of VAT should not be treated as an expense in the financial statements of the enterprise. Therefore it should be credited to an appropriate account, say, 'VAT Payable Account'. In case the VAT has not been charged separately but has made a composite charge. It should segregate the portion of sales which is attributable to tax and should credit the same to 'VAT Payable Account' at periodic intervals. The amount of VAT payable adjusted against the VAT Credit Receivable (Capital Goods) Account and amounts paid in cash will be debited to this account. The credit balance in VAT Payable Account at the year-end should be shown on the 'Liabilities' side of the balance sheet under the head 'Current Liabilities'. It is important to note that where the assessee is enjoying tax holiday under the relevant state law as a result of which the liability to pay is deferred for a

period of more than one year then the should be reflected as a long term liability.

15. Will the treatment mentioned above result in non-compliance with the provisions of section 145A of the Income Tax Act?

Section 145A of the Income Tax Act provides that the valuation of purchase and sales of goods and inventory for the purpose of computation of income from business or profession shall be made on the basis of method of accounting regularly employed by the assessee but this shall be subject to certain adjustments. Therefore, it is not necessary to change the method of valuation of purchase, sale and inventory regularly employed in the books of account. The adjustment provided for in this section can be made while computing the income for the purpose of preparing the return of income. Therefore the recommended method for accounting of VAT will not result in non-compliance of section 145A of the Income Tax Act.

16. Please explain by way of illustration how the adjustments for accounting are to be done and how the exclusive method will be tax neutral.

The examples given in the Guidance Note (Revised 2007) on tax audit under section 44AB of the Income-tax Act, 1961 are reproduced hereunder:

## CASE I

The position of a trading concern is as under:-

1.	Opening stock of goods		NIL
2.	Purchases	Rs. 9,00,000	
	VAT on purchases		10%
3.	Sales		Rs.9,00,000
	VAT on sales		10%
4.	Closing stock		Rs.3,00,000
5.	VAT unpaid at the end of the year		Rs.30,000

The recording of the above transactions in the books of accounts will be as under:

(i)	Purchases A/c	Dr.	9,00,000	
	VAT Credit Receivable (Input) A/c	Dr.	90,000	
	To Sundry Creditors			9,90,000
(ii)	Sundry Debtors A/c	Dr.	9,90,000	
	To Sales A/c			9,00,000
	To VAT on Sales A/c			90,000
(iii)	VAT on Sales A/c	Dr.	90,000	
	To VAT Credit Receivable (Input) A/c			90,000

Based on the above transactions the trading account on “Exclusive basis” will appear as under as per the books of account:

### The Trading Account on “EXCLUSIVE METHOD”

Particulars	Quantity	Rate	Amount	Particulars	Quantity	Rate	Amount
To Opening Stock			-	By Sales	2	4,50,000	9,00,000
To Purchases	3	3,00,000	9,00,000	By Closing	1	3,00,000	<u>3,00,000</u>

				Stock			
To GP			<u>3,00,000</u>				
			<u>12,00,000</u>				<u>12,00,000</u>

Upon making adjustments as required under section 145A of the Income-tax Act, 1961 the trading account on inclusive basis will appear as under:-

### The Trading Account on "INCLUSIVE METHOD"

Particulars	Quantity	Rate	Amount	Particulars	Quantity	Rate	Amount
To Opening Stock			-	By Sales	2	4,95,000	9,90,000
To Purchases	3	3,30,000	9,90,000	By Closing Stock	1	3,30,000	3,30,000
Less: VAT credit availed on cost of goods sold			<u>60,000</u>				
			<u>9,30,000</u>				
VAT paid on sales			90,000				
Gross Profit			<u>3,00,000</u>				_____
			<u>13,20,000</u>				<u>13,20,000</u>

It will be seen from the above that the gross profit is the same both under the inclusive and the exclusive method.

The tax auditor should explain the deviations as required by clause 12(b) of Form No.3CD as under :-

	(Rupees) Increase in Profit	(Rupees) Decrease in Profit
VAT on Purchase		90,000
VAT on Sales	90,000	
VAT on Closing Stock	30,000	
VAT paid on sales		90,000
VAT credit availed on cost of goods sold	60,000	
	<u>1,80,000</u>	<u>1,80,000</u>

The net impact on profit and loss account is NIL.

## CASE II

The following position of a trading concern (with opening stock) is as under:-

1.	Opening stock of raw material	Rs. 3,00,000
	VAT on opening stock	Rs. 30,000
2.	Purchases	Rs. 9,00,000
	VAT on purchases	10%
3.	Sales	Rs.9,00,000
	VAT on sales	10%
4.	Closing stock	Rs. 6,00,000
	VAT on closing stock	Rs.60,000

The recording of the above transactions in the books of account will be as under:

(i)	Purchases A/c	Dr.	9,00,000	
	VAT Credit Receivable (Input) A/c	Dr.	90,000	
	To Sundry Creditors			9,90,000

(ii)	Sundry Debtors A/c	Dr.	9,90,000	
	To Sales A/c			9,00,000
	To VAT on Sales A/c			90,000
(iii)	VAT on Sales A/c	Dr.	90,000	
	To VAT Credit receivable (Input) A/c			90,000

Based on the above transactions the trading account on “Exclusive basis” will appear as under:

**The Trading Account on “EXCLUSIVE METHOD”**

Particulars	Quantity	Rate	Amount	Particulars	Quantity	Rate	Amount
To Opening Stock	1	3,30,000	3,30,000	By Sales	2	4,50,000	9,00,000
Less Input tax rebate			30,000				
			3,00,000				
To Purchases	3	3,00,000	9,00,000	By Closing Stock	2	3,00,000	6,00,000
To Gross Profit			<u>3,00,000</u>				
<b>Total</b>			<u><b>15,00,000</b></u>				<b>15,00,000</b>

Upon making adjustments as required under section 145A of the Income-tax Act, 1961 the trading account on inclusive basis will appear as under:-

**The Trading Account on “INCLUSIVE METHOD”**

Particulars	Quantity	Rate	Amount	Particulars	Quantity	Rate	Amount
To Opening Stock	1	3,30,00 0	3,30,00 0	By Sales	2	4,95,00 0	9,90,00 0
To Purchases	3	3,30,00 0	9,90,00 0	By Closing Stock	2	3,30,00 0	6,60,00 0
			<u>13,20,00</u>				
Less: VAT credit availed on cost of goods sold			60,000				
			12,60,00				
VAT paid on sales			90,000				
Gross Profit			3,00,00				
			16,50,00				16,50,00

It will be seen from the above that the gross profit is the same both under the inclusive and the exclusive method.

The tax auditor should explain the deviations as required by clause 12(b) of Form No.3CD as under :-

Sl. No.	Particulars	Increase in profit (Rs.)	Decrease in profit (Rs.)
1.	VAT Recovered on Opening Stock		30,000
2.	VAT on Purchase		90,000
3.	VAT on Sales	90,000	
4.	VAT on Closing Stock	60,000	
5.	VAT paid on sales		90,000
6.	VAT credit availed on cost of goods sold	60,000	
		2,10,000	2,10,000

The net impact on Profit & Loss Account is NIL.

CASE III

The following position of a manufacturing concern is as under:-

Opening stock of raw material 50 units	@ Rs.100 per unit
Purchases of raw material 300 units	@ Rs.100 per unit
Sales 250 units	@ Rs.150 per unit
Manufacturing expenses	Rs.3,000
Closing stock of raw material	50 units
Closing stock of finished goods	50 units
VAT rate on purchases and sales	4%

The recording of the above transactions in the books of accounts will be as under:

(i)	Purchases A/c	Dr.	30,000	
	VAT Credit Receivable (Input) A/c	Dr.	1,200	
				To Sundry Creditors
				31,200
(ii)	Sundry Debtors A/c	Dr.	39,000	
				To Sales A/c
				To VAT on Sales A/c
				1,500
(iii)	VAT on sales A/c	Dr.	1,500	
				To VAT Credit receivable (Input) A/c
				To VAT payable A/c
				1,200
				300

(Assuming the balance of Rs. 300 (1500-1200) is unpaid)

Based on the above transactions the trading account on "Exclusive basis" will appear as under:

**Manufacturing concern**  
The Trading Account on "EXCLUSIVE METHOD"

Particulars	Qty	Rate	Amount	Amount	Particulars	Qty	Rate	Amount
Opening Stock	50	100	5,000		By Sales	250	150	37,500
Purchase of raw materials	300	100	30,000		By closing stock of finished goods	50	110	5,500
Total	350	100	35,000					
Less: Closing Stock of raw material	50	100	5,000					
Raw material Consumed (C) = (A) – (B)	300			30,000				
To manufacturing expenses	300	10		3,000				
To VAT on finished goods sold				0				
To gross profit				10,000				
Total				43,000	Total			43,000

Upon making adjustments as required under section 145A of the Income-tax Act, 1961 the trading account on inclusive basis will appear as under:-

**The Trading Account on “INCLUSIVE METHOD”**

Particulars	Qty	Rate	Amount	Amount	Particulars	Qty	Rate	Amount
Opening Stock	50	104	5,200		By Sales	250	156	39,000
Purchase of raw materials	300	104	31,200		By closing stock of finished goods	50	114	5,700
<b>Total</b>	<b>350</b>	<b>104</b>	<b>36,400</b>					
Less: Closing Stock of raw material	50	104	5,200					
Less; VAT on Raw Material Consumed	300	4	1,200					
Raw material Consumed (C) = (A) – (B)	300	100		30,000				
To manufacturing expenses	300	10		3,000				
To VAT on finished goods sold	250	6		1,500				
To VAT included in finished goods on account of inclusion of VAT in the raw material value	50	4		200				
To gross profit				10,000				
<b>Total</b>				<b>44,700</b>	<b>Total</b>			<b>44,700</b>

It will be seen from the above that the gross profit is the same both under the inclusive and the exclusive method. Further, the closing stock of raw materials includes the appropriate VAT. But the VAT is not includible in the closing stock of finished goods since the incidence of VAT arises only on sale. However, VAT on raw material included in the finished goods has also been included in the value of closing stock of finished goods.

The tax auditor should explain the deviations as required by clause 12(b) of Form No.3CD as under :-

Sl.No.	Particulars	(Rupees) Increase in Profit	(Rupees) Decrease in Profit
1.	Increase in cost of opening stock of raw material on inclusion of VAT		200
2.	Increase in purchase on account of inclusion of VAT.		1,200
3.	Increase in sales of finished goods on inclusion of VAT.	1,500	
4.	VAT paid on sale of finished goods as a result of its inclusion in sales		1,500
5.	Increase in closing stock of raw material on inclusion of VAT	200	
6.	Accounting of VAT credit availed and utilized on raw material consumed in payment of VAT on finished goods accounted on the basis of raw material consumed.	1,200	
7.	Increase on account of VAT included in finished goods on account of inclusion of VAT in the raw material value	200	
8.	Increase in VAT on closing stock of finished goods on account of inclusion of VAT in the raw material value		200
<b>Total</b>		<b>3,100</b>	<b>3,100</b>

The net impact on the Profit & Loss Account is NIL.