

For the kind attention of members

Guidance Note on Tax Audit Under
Section 44AB of the Income-tax Act, 1961

Changes approved subsequent to the publication of the Supplementary Guidance Note.

1. Form No.3CD was extensively amended by Notification No.208/2006 dated 10th August, 2006. The Supplementary Guidance Note on Tax Audit under section 44AB of the Income-tax Act, 1961 was published in 2006 as a part of the Guidance Note on Audit of Fringe Benefits under the Income-tax Act, 1961.
2. Subsequent to the publishing of the 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.
3. It was also necessary to give guidance in respect of valuation of purchases, sales and inventory under section 145A of the Income-tax Act in the context of Value Added Tax introduced by the State Government.
4. The Finance Act, 2007 has also amended the provisions relating to the fringe benefit tax.
5. Consequent changes have been made in the Guidance Note on Tax Audit under section 44AB of the Income-tax Act, 1961 which have been approved by the Council.
6. The following changes be read in the Guidance Note on Tax Audit [2005 Edition], the Guidance Note on Audit of Fringe Benefit under the Income-tax Act and the Supplementary Guidance Note on Tax Audit [2006 Edition]

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 exempts 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	3,00,000	<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>				
			9,30,000				
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

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
			Total
			4,20,000

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
		Profit	3,00,000

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				
			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>				
Total			<u>15,00,000</u>				15,00,000

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	
		2,10,000	2,10,000

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
	Total	4,50,000
Less:		
1. VAT credit Receivables (Input) A/c		<u>Rs. 90,000</u> 3,60,000
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 goods		Rs. 60,000
	Profit	<u>3,00,000</u>

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
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

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	5700
Total	350	104	36,400					
Less: Closing Stock of raw material	50	104	5,200					
Less; VAT on Raw Material Consumed	300	4	1200					
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				
Total				44,700	Total			44,700

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
Total		3,100	3,100

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
	Total		11,900

Less:

1.	VAT credit receivables (Input) A/c		<u>Rs.1,200</u> 10,700
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>
	Profit		10,000

The following paragraph 35 in the existing guidance note will be renumbered appropriately at the time of printing.

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. 13th 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 13th 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 12th 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 1st April, 2006 and ending on 12th 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 13th July, 2006 and ending on 31st 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 1st April, 2006 and ending with 12th 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 13th July, 2006 and ending on 31st 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.

INCOME-TAX ON FRINGE BENEFITS

Amendments made by the Finance Act, 2007

The Finance Act, 2007 now excludes any expenditure on distribution of samples free of cost or at a concessional rate from "Sales promotion including publicity". Therefore, the exemption is now not restricted to only distribution of free medical samples but is extended to distribution of all samples. Further, expenditure on advertisement by way of display of products have also been excluded from "Sales promotion including publicity" and hence exempt from levy of FBT. These amendments are effective from A.Y. 2008-09.

The Finance Act, 2007 has extended the liability to fringe benefit tax to stock options also.

Accordingly, a new clause (d) has been inserted in section 115WB(1) to provide for levy of FBT on the value of any specified security or sweat equity shares allotted or transferred, directly or indirectly, by the employer free of cost or at concessional rate to his employees, including former employees. Specified security means "securities" as defined in section 2(h) of the Securities Contracts (Regulation) Act, 1956 and includes employees' stock option. Sweat equity shares means equity shares issued by a company to its employees or directors at a discount or for consideration other than cash for providing know-how or making available rights in the nature of intellectual property rights or value additions, by whatever name called. A new clause (ba) has been inserted in section 115WC(1), in order to prescribe the value of such specified security or sweat equity shares. The value of specified security or sweat equity shares, for the purpose of levy of FBT, shall be the fair market value of such security or shares on the date on which the option vests with the employee, as reduced by any amount actually paid by, or recovered from, the employee in respect of such security or shares. The fair market value means the value determined in accordance with the method as may be prescribed by the CBDT. "Option" means a right but not an obligation granted to an employee to apply for the specified security or sweat equity shares at a pre-determined price. Consequently, the proviso to section 17(2)(iii) has been omitted. So far, the value of any benefit provided by a company free of cost or at a concessional rate to its employees by way of allotment of shares, debentures or warrants,

directly or indirectly under any Employees' Stock Option Plan or Scheme of the company offered to such employees was an exempt perquisite. Now, it is a taxable fringe benefit.

A new section 115WKA has been inserted for the purpose of enabling the employer to recover the FBT in respect of any specified security or sweat equity shares from the employees. If sweat equity shares are allotted or transferred, directly or indirectly, by an employer on or after 1.4.2007, it shall be lawful for the employer to vary the agreement or scheme under which such specified security or sweat equity shares has been allotted or transferred. The agreement or scheme can be modified so as to recover from the employee, the FBT, to the extent to which such employer is liable to pay the FBT in relation to the value of fringe benefits provided to the employee and determined in the specified manner. This amendment is effective from A.Y. 2008-09.

Advance tax liability in respect of fringe benefits [Section 115WJ(2) to (5)]

- (i) Under section 115WJ(2), quarterly payment of advance fringe benefits tax, equal to 30% of the value of fringe benefits paid or payable during each quarter, is required to be made by an assessee, on or before the 15th day of the month following such quarter. The advance tax payable for the quarter ending on 31st March is payable by 15th of March. This was causing genuine hardship to the assessees since specific computations were required to be made for each quarter. Further, the FBT return also required information on a quarterly basis.
- (ii) The existing sub-section (2) of section 115WJ has been substituted to remove this difficulty. The new sub-section (2) requires payment of advance tax on the value of fringe benefits paid or payable in a financial year in the same manner as payment of advance income-tax. Accordingly, advance FBT will be payable in four installments in the case of companies in the following manner:

Due date of installment	Advance tax payable
On or before 15 th June	Not less than 15% of such advance tax.
On or before 15 th	Not less than 45% of such advance tax, as reduced

September	by the amount, if any, paid in the earlier installment.
On or before 15 th December	Not less than 75% of such advance tax, as reduced by the amount or amounts, if any, paid in the earlier installment or installments.
On or before the 15 th March	The whole amount of such advance tax as reduced by the amount or amounts, if any, paid in the earlier installment or installments.

Similarly, non-corporate assesseees shall be liable to pay advance tax on the value of fringe benefits paid or payable in a financial year in three installments in the following manner –

Due date of installment	Advance tax payable
On or before the 15 th September	Not less than 30% of such advance tax.
On or before the 15 th December	Not less than 60% of such advance tax, as reduced by the amount, if any, paid in the earlier installment.
On or before the 15 th March	The whole amount of such advance tax as reduced by the amount or amounts, if any, paid in the earlier installment or installments.

Therefore, computation of value of fringe benefits on a quarterly basis is no longer required for payment of advance FBT.

- (iii) Interest for deferment of advance FBT in the case of corporate assesseees [Section 115WJ(3)]

In case of corporate assesseees, simple interest (calculated as per the table given below) is payable in case of failure to pay advance tax before the due date of any installment or shortfall in the advance tax paid vis-à-vis advance tax due in any installment –

	Rate of Interest	Amount on which interest is payable
(1)	1% per month for 3 months	15% of advance tax payable minus advance tax paid on or before 15 th June.
(2)	1% per month for 3 months	45% of advance tax payable minus advance tax paid on or before 15 th September.
(3)	1% per month for 3 months	75% of advance tax payable minus advance tax paid on or before 15 th December.
(4)	1%	100% of advance tax payable minus advance tax paid on or before 15 th March.

- (iv) Interest for deferment of advance FBT in the case of non-corporate assessees [Section 115WJ(4)]

In the case of non-corporate assesses, simple interest (calculated as per the table given below) is payable in case of failure to pay advance tax before the due date of any installment or shortfall in the advance tax paid vis-à-vis advance tax due in any installment –

	Rate of Interest	Amount on which interest is payable
(1)	1% per month for 3 months	30% of advance tax payable minus advance tax paid on or before 15 th September.
(3)	1% per month for 3 months	60% of advance tax payable minus advance tax paid on or before 15 th December.
(4)	1%	100% of advance tax payable minus advance tax paid on or before 15 th March.

- (v) Where an assessee has failed to pay the advance tax payable by him during a financial year or where the advance tax paid by him is less than 90% of the tax assessed under sections 115WE, 115WF or 115WG, the assessee shall be liable to pay simple interest @1% per month for every month or part of a month, from 1st April next following such financial year to

the date of assessment of tax under sections 115WE or 115WF or 115WG [Section 115WJ (5)]. (Effective from 1.6.2007)

Guidance for audit: The tax auditor has to verify whether the value of the fringe benefit in respect of sweat equity shares and specified securities allotted by the employer to its employees including former employees has been computed in accordance with the provisions of section 115WC(1)(ba).

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 India 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 longer 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 Deffered (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 Stock	1	3,00,000	<u>3,00,000</u>
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>				
			9,30,000				
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	
	1,80,000	1,80,000

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	3	3,00,000	9,00,000	By	2	3,00,000	6,00,000

Purchases				Closing Stock			
To Gross Profit			3,00,000				
Total			15,00,000				15,00,000

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	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
			13,20,000				
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

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	<u>60,000</u>	
		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			37,500
	To VAT on Sales A/c			1,500
(iii)	VAT on sales A/c	Dr.	1,500	
	To VAT Credit receivable (Input) A/c			1,200
	To VAT payable A/c			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	5700
Total	350	104	36,400					
Less: Closing Stock of raw material	50	104	5,200					
Less; VAT on Raw Material Consumed	300	4	1200					
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				
Total				44,700	Total			44,700

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
Total		3,100	3,100

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