MIZORAM VAT AUDIT MANUAL

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CHAPTER - 1

INTRODUCTION

The goal of an efficient tax administration is to ensure voluntary compliance. Voluntary compliance involves the tax payer carrying out all the requirements imposed by the tax law without direct intervention by the tax department using a system of self assessment.

1.01 Self- Assessment

Self assessment is the backbone of VAT administration. VAT envisages self assessment because of the in-built self policing mechanism. The tax-payer is responsible for determining his own tax liability and timely payment of his tax. This is the most important difference with the old Sales Tax System where all cases were assessed every year by the tax department. Under VAT, assessment is not a routine matter. On the contrary, it is more in the nature of an exception than a general rule.

In the system of Self assessment there is always a possibility that the assessee may underreport his VAT liability on the presumption that he may never be caught, as his case may not come up for auditing. According to IMF, if true self-assessment cannot be implemented, the country is not ready for the VAT and should defer its plans.

1.02 Conditions for effective self assessment system

- Simple & understandable tax laws,
- Good information services to the taxpayer to make the VAT dealers aware of their obligations,
- Simple & easy procedures for registration, return filing, payment and refund,
- Maintenance of proper accounts & records by all VAT dealers,
- Prompt & effective mechanism to detect stop filers and proper action against such defaulters,
- Effective system of audit targeted at the 'risk' category of dealers supplemented by physical check,
- Effective penalties for non compliance,
- Simple & effective controls which reduce the scope for fraud,
- Prompt resolution of disputes.

1.03 Conditions for Self assessment under section 29 of the MVAT Act, 2005

- All monthly/quarterly tax returns and the annual return or revised returns must be filed within prescribed time with payment of admitted tax & interest.

- In case of a dealer having gross turnover more than forty lakhs rupees, the annual return must be accompanied by the audit report from a qualified Accountant.

1.04 Audit Assessment

An efficient tax administration encourages voluntary compliance. To promote voluntary compliance, deterrence levels need to be high so that evasion cannot be practiced with impunity. The audit function of the tax administration can play a crucial role in setting the level of deterrence.

According to a study made by IMF, if VAT audit is weak, VAT administration will also be weak and VAT revenue will soon decline once tax payers realise there is no effective audit by the tax department.

The success of VAT mainly depends on the effectiveness of audit mechanism which, in turn, depends on the quality of the information available to the auditors, which in turn depends on the efficient and intelligent gathering of the information from the taxpayers and other sources.

1.05 What is audit assessment?

The essential philosophy of audit assessment is that this audit is based on the scrutiny of business records of the assessee to ascertain whether the dealer is paying correct amount of tax as per law. This is a more systematic form of audit wherein the tax auditors are required to gather basic information about the assessee and analyze them to find out vulnerable areas before conducting the actual audit.

A VAT audit is a selective review of the tax payer's books and records, including year end-statement, balance sheet and profit and loss accounts, to ensure that the major areas of purchases, sales and stocks are substantially correct. Further, at every stage of audit, the assessee is consulted. This makes audit user-friendly. It does not mean the assessment of each and every dealer. Selection of cases for audit is done as per different parameters.

1.06 White Paper on Audit assessment

As per the White Paper, there will be audit assessment as per following guidelines:-

* Correctness of self-assessment will be checked through a system of Departmental Audit.
* A certain percentage of the dealers will be taken up for audit every year on a scientific basis.
* This Audit Wing will remain de-linked from tax collection wing to remove any bias.
* The audit team will conduct its work in a time bound manner and audit will be completed within six months.
* The audit report will be transparently sent to the dealer also.

1.07 When can audit assessment be resorted to u/s 31 of the MVAT Act, 2005

* On selection made by the Prescribed Authority on the basis of prescribed criteria or on random basis;
* When Prescribed Authority is not satisfied with:
  - the correctness of any return, or
  - any claim of exemption,
  - input tax credit,
  - Genuineness of any declaration or evidence.
* If Prescribed Authority believes that detail scrutiny of the case is necessary;
* When a provisional assessment is made.

1.08 Assessments- modes thereof:

The Mizoram VAT Act, 2005 provides for following types of assessment:

(a) Provisional assessment u/s 30
(b) Self assessment u/s 29
(c) Audit assessment u/s 31
(d) Best judgment assessment u/s 31(6)
(e) Assessment of un-registered dealer's u/s 32
(f) Assessment of escaped turnover u/s 34

1.09 Provisional Assessment

Conditions u/s 30 of the MVAT Act

* Failure to furnish monthly/quarterly tax return before the due date i.e. within 21 days of the succeeding month;
* Tax returns filed by the dealer are incomplete and incorrect; and
* Failure to furnish corrected return as required after scrutiny of returns u/s 33(2).

1.10 Best Judgment Assessment

Conditions u/s 31(6) of the AVAT Act

* Failure to furnish annual return;
* Incorrect annual return filed knowingly;
* Failure to comply with notice u/s 36(3)-absent at business premises during audit or non functioning of the dealer from such premises
* Failure to maintain accounts.

1.11 Assessment of unregistered dealers

Conditions u/s 32 of the MVAT Act

* The dealer must have been liable to pay tax;
* He must have failed to get himself registered;
* Period of limitation - 5 Years.

1.12 Escape Assessment

Conditions u/s 34 of the MVAT Act

* The dealer must have been assessed ;

* The turnover must have
  - escaped assessment,
  - been under assessed,
  - been assesses at lower rate,
  - subjected to wrongful deduction,
  - subjected to any wrongful tax credit

* Period of limitation - 8 Years.

1.13 What a system of compliance means

a) Registration of VAT dealers

This provides the basis for the control of VAT dealers. It identifies those dealers who have an obligation to account for VAT and brings them under the control of the administration. The registration requirements must be enforced rigorously and the A VAT Act, 2003 provides penalties for failure to apply for registration

b) VAT return

The VAT return is the most important form in VAT administration. It provides the basis for the audit of the VAT dealer and the means for collecting the tax. The first essential aspect in any VAT administration is that the filing of returns is strictly enforced on all dealers and the tax declared is collected. Failure to take in these areas renders VAT audits ineffective.

c) Maintaining books of account and records

As VAT is levied by reference to the financial transactions of the business, adequate books of account and records must be kept by dealers to enable the Tax Department to check and confirm that the registered dealers have complied with their legal obligations to maintain proper accounts and a record of the goods involved in the business. The MVAT Act, 2005 and the Rules define the requirements and the Law provides for effective penalties for a failure to comply.

d) Tax invoices

The tax invoice is a crucial document in the operation and control of a VAT system The tax invoice establishes the VAT liability of the seller of taxable goods and most importantly is also the authority for a buyer to claim a credit for the tax paid on input and without which effective compliance cannot be achieved. The AVAT Act, 2003 defined the requirements and conditions related to the issue of the invoices and provides for penalties for non-compliance.

e) Access to books, records and documents

For verification of VAT returns to be effective, access to books and records is essential. Some VAT dealers will attempt to hide records, which may contain evidence of VAT evasion. The MVAT Act, 2005 provides the Tax Department with the powers of access to premises and records, and the power to copy and seize books, computers and goods. It also provides for penalties for a failure to fulfill these obligations.

1.14 Purpose of audit

The purpose of audit is to determine the correct tax liability of a dealer. The audit is designed to get at the bottom of various activities of a dealer and to check if the dealer has paid due taxes and has issued tax invoices in accordance with law.

An audit under VAT differs from an audit by a Chartered Accountant. VAT audit is a selective review of the tax payers books and records, including year end-statement, balance sheet and profit and loss accounts, to ensure that the major areas of purchases, sales and stocks are substantially correct, not that the taxpayer has filed a perfect return An error can be found in almost every return but often, its significance is not really material

The usual audit is limited to the significant issues of the latest year Only is unusual cases where the attempt to evade tax is substantial and deliberate, the audit should be extended to the preceding four years.

The objectives of audit are:

(a) to visit all registered dealers at their principal place of business and subject them, their records and their activities to checks and credibility test to ensure the completeness and accuracy of the declared tax. The dealers' expectation of such a visit has preventive and deterrent effects. The preventive effect is the extent to which audit visits prevent dealers from continuing to under-declare their liability. The deterrent effect is the extent to which dealers decide not to avoid or evade because they are aware of control activity and fear detection. The avoidance, although legal, may need to be reported;

(b) to direct activities within the audit to the areas of the greatest revenue or potential revenue risk. For very large dealers it is not expected that all aspects of their activities will be covered on a single visit Consequently, officers controlling the largest taxpayers should plan checks across the totality of the business within a one or two year period, (i.e, a control cycle);

(c) to allocate the available audit officers to the selective audit of dealers. The basis for selection is the apparent revenue risk of the individual dealer, and the frequency and duration of the visits are determined by the degree of difficulty and risk perceived;

(d) to conduct audits that are seen, generally, as fair and reasonable; &

(e) to correct misunderstanding and errors.

1.15 Types of audit visits

(a) Advisory Audit Visits: It is desirable that advisory visits should be made to most dealers as soon as practical after registration for VAT. These visits are intended to assist dealers in understanding the operation of VAT, to explain their legal obligations under the VAT law and to clarify any areas of confusion of misunderstanding. It reasonably satisfies the 'educational' needs of the dealer

(b) Desk audits: In some cases it may be appropriate only to carry out an examination of the dealer’s records in the office without visiting the business premises. Desk audit is the examination of the dealers' returns etc. in the office and if necessary, comparing them with other dealers of comparable size and activity. However, these desk audits should normally be restricted to dealers registered under the Composition of Tax scheme.

(c) Partial Audits: When it is necessary to verify certain transactions of a particular dealer, a partial audit may be done. These audits are meant to ensure, primarily, that the statutory provisions of VAT are being complied with, that records of purchases and sales are correctly complied from original documents, that monthly return for selected months correspond with the totals in the records of purchases and sales and that the total under the different columns for the month are correct and the records accurately reflect the business operations. If the investigating officer detects what he thinks may be an evidence of fraud, he may report, so that a full audit may be made. Partial audit may be ordered under several circumstances such as

(i) to find out the veracity of certain information or allegations received about an assessee,

(ii) if volume and value of imports are not commensurate with the sales,

(iii) where the monthly tax paid by the dealer shows an unusual decline,

(iv) excessive stock transfer compared to the normal standards,

(v) Inter-state sales to unregistered dealers show a-rising trend.

Basically any deviation from his normal pattern of business should invite partial audit.

(d) Issue oriented audits: This should be directed at verifying certain issues. It is suspected that on a particular issue a large number of cases have occurred, it would be necessary to go through many returns and find out if on that issue there has in fact been a misreporting. After that the cases can be picked up for full audit.

(e) Full Audits: Some dealers may be selected for full audit. All taxable activities of the dealer are evaluated under the full audit. Consequently, this type of audit is most extensive and therefore time consuming.

(f) VAT refund audits: A pre-refund audit should be undertaken for all first refund claims; audits of further refund claims should be carried out selectively based on perceived risk. Refund audits should focus on verifying the refund for the period covered by the claim and should normally last no longer than one day.

(g) Large Dealer Audits: For the largest registered dealers, the audit should be conducted by a specialist team of officers who have received enhanced training in system based audit techniques. They will have an understanding of the expected audit problems likely to be found at large dealers especially using computerized accounting systems.

(h) Fraud Investigation: It is not audit in a routine manner. Investigation is carried out in case of fraud, evasion and misuse of credit facilities. In these cases penal action will normally be taken. This will be generally taken up by specially trained officers of investigating agencies like Central Section, Range Offices and Bureau.

1.16 Frequency of audit

The frequency of audit refers to the average audit cycle which depends on (i) the size of the tax payer base (ii) the number of audit staff and (iii) the average time taken to complete the audit. This also depends on the selection pattern.

1.17 Selection for Audit

Audit visits have to be preceded by a sound selection of cases for audit. Audit, by its very nature, is selective. A certain percentage of dealers should be selected for audit every year. The selection has to be done impartially and on a scientific basis. The selection of taxpayers for audit should help maximize tax effectiveness. It should consider parameters such as economic activity, sales, volume, reported annual mark up and discrepancies resulting from cross checking information system. The VAT software itself should take care of the selection process.

Considering the above, it may be useful to divide all the assesses as corporate and others. It may be useful to follow the following pattern for practical purposes.

(1) It should be about 30% for the dealers in Corporate Division and for the rest it will be about 20% in one year. So corporate should be audited once in three years.

(2) The selection of the above percentage may be on the basis that about 75% of the audit cases may be selected on the basis of risk analysis, that is, high risk tax payers and the other 25% will be on random basis. The risk analysis will depend on various factors. Selection can be based on the following selection criteria:

(a) Gross turnover exceeding rupees 5 crores in a year;

(b) Input tax credit exceeding a limit of rupees 10 lakh annually;

(c) Inter state sale/zero rated sales exceeding rupees 25 lakh annually;

(d) Refund claim exceeding rupees I lakh annually;

(e) Fall in gross turnover compared to last year;

(f) Fall in payment of tax compared to last year;

(g) Sales disproportionate to purchases;

(h) Output tax disproportionate to input tax;

(i) Stock disproportionate to sales;

(j) Mismatch of transactions of sale and purchase etc;

Apart from the above, the selection can also be made in following cases:

(a) industrial units enjoying sales tax exemption remission,

(b) dealers whose ratio of inter-state sales to total sales is significant, specially when the dealer's purchase is shown to be inside Mizoram which entitles him to claim input tax credit,

(c) dealers dealing in commodities which are more prone to evasion of tax e.g. ready-made garments, plywood, spare parts, iron & steel, footwear, spices etc.

<u>(d) dealers against whom departments like Central Excise, Income Tax etc have booked cases,</u>

(e) dealers whose turnover involves substantive changes in trade practices- e.g. excessive stock transfers, material decline in inter-state purchases, material increase in exports/sales to exporters,

(f) dealers having substantial transit sales,

(g) dealers from the database formed on the basis of periodical information compiled from Courier/Cargo Agencies (including Railways), transporter, clearing and forwarding agents, warehouses etc. The details gathered through this will be transferred to the dealers' folder for being considered for selection for audit,

(h) refund cases arising in the cases of export and interstate sale where full refund of input tax paid is provided for,

(i) dealers with complex transactions e.g. a mixture of exports, sales of exempted goods, branch transfers, incentives etc.

A detailed examination of the annual accounts of a dealer's business can give some indication of possible evasion and assessment of profitability of the business. It should be borne in mind that a business which is not showing a normal profit margin constitutes a greater revenue risk. The reason for a low margin may be suppression of sales.

(3) However because of limited staff and the possibility of some type of dealers not being in a position to avoid tax substantially, the Commissioner may order them to be audited to a lower extent, say, 5 to 10 per cent

The above norm is applicable to full audit. For partial audit there is no norm. It will be done on an ad hoc basis, whenever need is felt.

1.18 Coverage of Audit

A full audit should cover the latest fiscal year, and 4 years, if serious anomaly is detected in first year.

1.19 Special approach for audit of large taxpayers

Large taxpayers are small in number but they pay the largest amount of tax. It is, therefore, necessary to cover such large assesses with much more care and attention. The audit should not only be thorough but also penetrating. The auditors should be well trained in reading books of accounts so that they can go beyond the corporate veil. Audit of large taxpayers should be oriented towards detecting tax evasion committed when they misinterpret the law. Large taxpayers are unlikely to engage in gross evasion, such as making uninvoiced sales or falsifying the value of their inventories; among other reasons, their own organization and accounting system would not permit this. They, therefore, resort to certain subtle methodologies possibly known to just a handful of people in their organization. It is also not advisable to devote unduly large share of the audit time for large taxpayers. Many countries use too much of their audit time for large taxpayers but that is not he optimum utilization of time from the point of view of revenue. It is the medium and small taxpayers who also commit many offences evading revenue. If they are not sufficiently covered by audit terms, the resultant loss of revenue will be more than the percentage of tax given by them. In some countries, due to more attention being diverted to medium and small taxpayers, the increase in revenue has been substantial.

1.20 Officers' Powers & Responsibilities etc.

Section 31 deals with VAT audit assessment which vests the power for conducting audit vested in Assessing Authority. Section 2(4) defines Prescribed Authority as any person appointed to assist the Commissioner of Taxes to whom all or any of the power of the Commissioner for levy and collection of tax is delegated u/s 3(2) of the MVAT Act. As per Rule 6 of the MVAT Rules, 2005 for the purpose of audit assessment U/S 36 the Prescribed Authority can be an officer not below the rank of Superintendent of Taxes. The Commissioner of Taxes, Assam vide its Notification No. CTS-2/20051172 dated 28.04.2005 has specified the Assistant Commissioner of Taxes and Superintendent of Taxes as the Prescribed Authority for this purpose.

Before visiting any registered dealer it is essential that officers are aware of their basic legal powers and dealer's obligations to comply with the relevant parts of the VAT legislation.

Officer's Powers:

(a) To register a dealer on his failure to apply for registration [section 21];

(b) To do the provisional/audit/best judgment assessment [section 30/31/31(6)];

(d) To require the production of records and books of account [section 59(1)];

(e) To make inspection of records, goods and cash at any place of business [section 59(2)];

(f) To seize books of accounts when the officer believes that the dealer is evading or trying to evade tax [section 59(3)];

(g) To enter and search at any place of business [section 59(4)];

Officer's Responsibilities:

(a) Officers authorized to conducts audit shall adhere to the instructions contained in this manual;

(b) The authorized officer should identify himself and show his authorization to the VAT dealer before commencing the audit;

(c) The officer should be impartial and apply the law in a uniform manner;

(d) The officer should ensure that any information obtained in the course of that audit relating to the VAT dealer is treated in strict confidence;

(e) The officer should ensure that in the areas covered on the audit visit, tax has been properly accounted for;

(f) The officer should ensure that the VAT dealer is treated in a courteous manner and is provided with the opportunity to respond to queries raised by the officer;

(g) The VAT dealer should be provided with a full and proper 5explanation of any under declaration of tax identified.

Dealer's legal obligations:

(a) To register under MVAT Act [section 21];
(b) To display the VAT certificate [rule 12];
(c) To display sign board [rule 59];
(d) To furnish information about change in registration particulars [section 27];
(e) To submit tax returns and annual return and make payment of tax [section 29];
(f) To maintain adequate· records [section 55];
(g) To issue Tax Invoices to another registered dealer [section 56];
(h) To quote registration number [section 58];
(i) To get the accounts audited from a qualified accountant [section 59]

1.21 The structured approach to audit:

Work must be planned in such a way so that an audit takes full account of available information, assesses the action required and is carried out systematically as follows.

- Planning an audit programme,
- Arranging an appointment,
- Carrying out pre-visit preparation,
- Performing an initial interview,
- Recording the information obtained,
- Assessing information, including identifying potential risks, to decide the checks to be applied,
- Examining activities and records, testing and verifying the information found,
- Recording the checks made and their results,
- Verifying the business transactions and related declarations in the tax returns,
- Taking any corrective action like issuing / raising an assessment,
- Recording the work performed.

CHAPTER - 2

PREPARATION FOR AUDIT

Preparation for audit is vital, no matter what kind of audit is going to take place.

2.01 Arrangement for Audit visit

As per rule 22(2) a notice in Form 20 has to be served on the dealer before Audit visit.

But there are certain general points to be borne in mind before making audit visits:

(a) The visiting officers shall first contact the person in authority (director, manager, partner, proprietor etc.) by telephone if possible and havtt1he note book ready,

(b) Arrange with the dealer a mutual time and date for the visit,

(c) Explain that the audit is to be conducted at the normal principal place of business,

(d) Inform the registered dealer exactly what records and books of account will be verified and any specific persons responsible for the maintenance of the books and accounts that will need to be interviewed. If necessary remind the dealer that he has a legal obligation to provide these facilities,

(e) Enter the details of all these arrangements in the audit note book,

(f) Confirm the arrangements for the visit to the dealer in a letter specifying any particular records or persons that you require to be available. Where possible this letter should be sent one week in advance of the planned visit,

(g) Audits resulting from urgent references and intelligence information should be carried out without prior warning /notification. However, this type of visit should be the exception rather than the rule and should only be made on the express instruction of the Senior Audit Officer;

2.02 Pre-visit checks

The officers should:

(a) Study the information available in the concerned dealer's records to see whether there are any special features of the activities of the dealer to be Iooked into during audit visits;

(b) Study the actual returns if the information found therein to be inadequate for audit purposes. The rate of tax and the schedule in which the each goods falls can be ascertained only if the name of the commodity is shown. The correctness of the input tax credit, . output tax due etc. can be ascertained only based on the classification of commodity. As VAT is a tax on commodities, the omission in the return is of serious nature:

(c) Study the information available from other sources;

(d) Obtain basic information about how the dealer operates;

(e) Acquire basic knowledge about the nature of the trade or industry. In the case of a manufacturing concern, the officers should study the manufacturing activities involved, the raw materials used, the input out put ratio etc.;

(f) Refer to reports of previous audit visits to see whether any aspects identified on previous visits need to be pursued;

(g) Gain an understanding about the way the accounting system operates and ascertain if the dealer is maintaining computerized accounts, the systems of accounting and the software which has been used by the dealers and how to retrieve the data of the assessee from the computer

From the computer/records in the office, a summary of dealer's activities or profile of the assesse should be prepared as given in FORMAT I.

Assessee's Proflle:

1. Name and address of the dealer,

2. Registration No under the AVAT Act and the CST Act etc.,

3. Nature of dealer's business activities and items dealt in,

4. Gross turnover, Taxable turnover and quantum of tax involved in the period under audit If the sales or purchases of the dealer have been fluctuating the auditor should try and establish the reason It may be that the dealer has seasonal movements in his trade; however, it could indicate that the VAT figures are being manipulated,

5. Nature of sales with special emphasis on zero-rated sales i.e. export and inter state sales,

6. Stock transfer of goods,

7. Amount of input tax credit and its utilisation in the period,

8. Nature of compliance in respect of payment of tax,

9. Reliability of returns submitted in last few years,

10. Notes on mode of transportation of goods,

11. Notes on mode of storage of goods,
1 2. Details of imports from other states,

13. Details of imports from outside India,

14. Particulars gathered from check post,

15. Input/output ratio,

<u>16. Audit report - if the dealers turnover is in excess of 40 lakh certificate from a Qualified Accountant under the Income Tax Act and the AVAT Act can be examined,</u>

17. Matters outstanding from a previous audit -any issue outstanding from the previous audit should be dealt with,

18. Any cross verification of transactions received from other officers, if outstanding or information received from other sources,

19. In case of a manufacturing unit the officers should study the manufacturing activities involved, the raw materials used, the input out put ratio etc. For example in case of coke manufacturing unit, the input output ratio (in qnty) is 1 ton coal = 0.55 ton coke.

Necessary data for this may be gathered from the Department of Industries and Commerce. The officer thereafter should see whether the unit is enjoying sales tax incentives and if so, whether it has obtained Eligibility Certificate and Certificate of Authorisation or Certificate of Entitlement The period and the monetaly limit of exemption and period of availment and the amount enjoyed and time left of availment and the unexpired amount of exemption should be carefully examined,

20. Adverse report, if any, in possession.

Note: Although it is not possible to prescribe fixed criteria to judge the reliability of return, some indicative factors are enumerated below:

· Any sudden change in the nature of business,

· Growths in turnover of sales and tax payable during the period,

· Growth in turnover of sales but fall in tax payable during the period,

· Significant rise in non-revenue yielding transactions like stock transfer export, high-sea sales etc.,

· Inconsistency in import and payment of tax,

· Input tax credit always being grater than the output tax,

· Noticeable change in the composition of total purchases i.e. imports & local purchase and vice versa registered & unregistered,

· Increase in inter-State sales,

· Showing huge stock in hand and still effecting purchase and claiming input tax credit

From the profile of the assessee, the audit party should form an idea about the following aspects before it starts the actual audit

(a) Credibility of the dealer's returns- Do they appear reasonable? If not, which area needs attention- huge purchases or Iow sales?

(b) The volume of zero rates sales e.g. export, inter-state sales and branch transfer to other States. Is the same realistic?

(c) Whether input tax credit as claimed is commensurate with the local purchases?

(d) In respect of a dealer enjoying industrial sales tax concession, whether sales as stated by the dealer commensurate with the production capacity i.e. installed capacity of the plant & machinery?

(e) Outstanding tax payment;

(t) Outstanding problems from previous visits. Have these been resolved?

A detailed examination of the annual accounts of a dealer's business can give some indication of possible evasion and assessment of probability of the business.

2.03 What an audit officer should take with him during an audit visit

An audit officer should carry following items with him during an audit visit:

a) Identification Card,

b) Registered dealer's summary/folder,

c) Any cross-reference received from other office & third party information,

d) Pen and audit notebook,

e) VAT Act and VAT Rules,

f) VAT Audit Manual,

g) Spare copies of VAT Forms/ Notices,

h) Calculator.

The audit officer should remember to always secure his Identification Card, Registered dealer's summary/folder and the VAT audit Verification Manual when at a dealer's premises. On no account are the manual/findings to be left where the contents may be seen by the dealer or his representative.

2.04 Guidelines for keeping good notebooks

The VAT audit is the final link in the chain of VAT administration. If VAT audit is seen to be ineffective, then non-compliance by way of under-reporting tax due will grow and tax evasion will become a major problem in revenue collection.

Keeping good notebooks is and essential component of an effective VAT audit. The recollection of facts and, in particular, figures, is substantially diminished after a few hours let alone a few days.

It is important that before using any form of notebook that the following points are considered:

· The notebook is bound, making if difficult for pages to become loose and drop out,

· The pages should be individually numbered,

· A list of basic questions should be stuck at the back of the book to act as an aide memoire,

· An index of cases should be maintained at the front of the book.

When the above points have been considered, the auditor should get into a routine when writing up his notebook at the dealer's premises. The following points should be observed:

· Use the prepared basic questions as the start point for the interview and all other questions should come from these answers,

· Start each visit with the dealer’s details, date, where the visit took place, the time it started and subsequently finished and who was interviewed,

· Write all entries neatly as it may be some time until they are referred to Remember other people may need to read them,

· Never, under any circumstances, remove pages from the notebook. If there are mistakes, leave them in the book and cross them out so the original error can be seen alongside the new answer or point.

It provides a record of what was said between the dealer and the officer in answer to the officer's questions, The auditor's notebook should be completely confidential and should not be shown or copied to the dealer. The notebook will be regarded as a security document.

CHAPTER-3

METHOD OF CONDUCTING AUDIT

3.01 Introduction

It is neither expected of nor is it practically possible for an officer to cover every details of a dealer's account in course of only one visit. Audit is an ongoing activity, which is built up over days. By recording what is found in one visit, the next visit can pick up from where the last one left off. Over a period a full picture of the business will emerge and to achieve this objective it is essential that a full report of the work performed is properly recorded. The officer is required to prepare a record of the checks made by him. For example, the checks require examination of a proportion of sales invoices. If this check establishes a high error rate, in-depth checks can extend this examination to further examination of additional transaction invoices and scrutiny of sales orders and sales accounts.

3.02 Action on arrival at the registered dealer's premises

On arrival at the dealer's premises the following procedure should be followed:

a) Remember to bear in mind the safety requirements at the premises;

b) Make contact initially with a responsible person - e.g. the sole proprietor, a partner or a director;

c) Ascertain, with the responsible person, nature and scope of the business activities and compare them with the details held in the dealer's folder;

d) Ascertain the general organization of the business. It may be helpful for subsequent audits if a diagram showing the basic structure of the business is included as part of the audit visit report;

e) The person contacted should be asked to confirm whether the dealer’s information available with the officer, is correct;

f) The person in authority should be asked to nominate a person responsible for the maintenance of accounts and filing of returns to furnish the audit officers with the required information;

g) Ensure that all the records and accounts requested in the pre-visit letter have been made available and that all requested personnel are available;

h) The officer should ascertain the problems, if any, faced by the dealer in complying with the provisions of law and should attempt to help the dealer with genuine problems. The officer should not also give answers on issues if he is not sure about the correct answer. In such cases the officer should arrange to give answers in due course.

The actual procedure to be followed during audit visit may vary from trade to trade and from industry to industry depending on the purpose of the visit, size of the business, manufacturing process involved, complexity of the accounts kept, reputation of the dealer etc, which the audit officers may finalize, in consultation with the seniormost officer or in-charge of the group.

3.03 Interviewing a dealer on an audit visit

a) The purpose of interviewing the dealer is to obtain information about his business and the accounting records. For this reason it is essential that the interview be conducted with the dealer and not a representative.

b) In some large businesses this may not be practical, as the director's may have delegated responsibility for the accounts to another person. However, where practical the business owner should be interviewed to ascertain the workings of the business and if he does not keep the records, then the appropriate person should be interviewed on this matter.

c) If the person keeping the records is purely a bookkeeper, then it is important to establish who supplies the information that he writes into the records.

d) This could be very important at a large stage if there is an allegation of fraud as the bookkeeper can only enter into the records the figures that have been supplied to him.

e) Some examples of basic questions are set out later in this chapter and should be used for every audit inspection. Supplementary questions will follow from these and can be tailored to the particular type of business that is being audited.

f) It is important to ask basic questions as a matter of routine as dealers will become used to this and it also gives the auditor confidence in his interviewing skills. An auditor who is prepared for his interview will appear more professional to the dealer and therefore command more respect.

g) If the auditor presents his questioning in a random unstructured manner he will not only miss asking vital questions but furthermore, he will appear unprofessional in front of the dealer.

h) The interview should be conducted in a relaxed manner. It is not an interrogation and if this is how it is presented to the dealer he will undoubtedly be guarded in his answers. A relaxed structured interview will encourage the dealer to discus his business and consequently produce the answers the auditor required.

i) The auditor should not, accept vague answer to a specific question. If the dealer appears unsure of something, the question should be asked again in a different way.

3.04 Structuring the interview

a) The interview with the VAT dealer should flow logically through the following headings:

1. Personal details of the interviewee and his business

2. Accounting structure

3. VAT knowledge

4. Knowledge of VAT obligations

b) The questions auditors should be asking should be structured to gain information. It is therefore better to being the questions with an "open" style:

. Who

. Why

· When

. Where

· What

· How

c) Questions started in this way will encourage the VAT dealer to talk and the auditor will probably get answers to other questions when he gives his answers.

d) "Closed" questions are usually answered with a "yes" or "no" and do not further the interview.

e) If there are two auditors at the interview, the auditor writing the notes of the interview should listen carefully to the questions and answers and ensure that he records them correctly.

A good interview will:

. ESTABLISH THE NORMAL
. QUESTION THE ABNORMAL

3.05 Basic questions

The following are examples of basic questions that should be used as a template for interviews with dealers:

· What are the VAT dealer contact details?
· What are his responsibilities in the business?
· Who is the accountant?
· What is the accounting system (in full) ?
· What books and records are kept (in full)?
· Other records kept (for additional credibility checks)
· Who completes the records?
· What are the main business activities?
· What are the other business activities?
· How many branches / godowns does the business have?
· What are the principal outputs?
· What are the principal inputs?
· Who are the main customers?
· Who are the main suppliers?
· Who puts the figures on the VAT returns? Ifnot the VAT dealer, does that person receive the information from the dealer?
· Does he understand VAT as it applies to his business?
· Does the VAT dealer understand that all sales must be declared on the VAT return?
· Does the VAT dealer understand that all purchased must be genuine?
· Are all sales and purchases correctly declared on the VAT returns?
· Does the VAT dealer have any exempt sale or any exempt transactions?
· In case of exempt sale or exempt transactions, has he restricted input tax credit eligible to him?
· Are there any purchase returns or sale returns within 6 month-period9f sale?
· Has the VAT dealer opted for composition?
· Does he understand that it is an offence to render false VAT returns?

3.06 Basic checks

Basic checks represent a scheme of essential questions intended primarily to ensure that the information held about registered dealers is accurate and up to date, and that dealers are kept informed on VAT matters. It follows, therefore, that the basic checks must be carried out on every audit verification visit. In carrying out these checks the officer will acquire broad information about the type and organization of the business, nature of the dealer and the method of accounting. This will form a basis for the general review and risk assessment of the business.

It may be noted that all auditing checks should be completed on the basis of test-checking and sampling techniques. Risk areas of over claims of input tax or under-declaration of output tax should have been identified prior to the visit. The test checks should commence in the risk areas by selecting a particular tax period.

The basic checks, which are mandatory, to be undertaken are:-

(i) Check on registration particulars, business activities & non business activities

(a) check that the VAT Certificate is displayed;

(b) the particulars on VAT registration application form, as amended by any subsequently important changes, should be checked for correctness;

(c) Ask whether there have been any changes in the business that affect the VAT registration or other aspects of the tax that have not been disclosed to the department, e.g.:

- In the name, constitution or ownership of the company/firm; or

- In the range of goods sold, etc.;

(d) In case of any change, the dealer should be asked to immediately apply for amendment in the Certificate of Registration;

(e) A check on effective date of registration (first visits only). The officer should ensure that the dealer has been registered and accounted for tax from the date on which he was liable to be registered;

(f) It is particularly important that the correctness of names is established. In the case of incorporated companies, confirm the details of any important changes by inspecting the Certificate of Incorporation;

(g) It is important, for both security and accuracy, that confirmation is obtained in writing where there is a change to:

- the name of the commodities that the dealer deals in;
- bank account number; and
- telephone number and mobile number, if any;

(h) Any change of ownership or control or influx of new managerial staff must be of interest to the officer. He should endeavour to ascertain the reasons for such changes bearing in mind the possibility that the underlying motive may be evasion and tax fraud;

(i) The officer should also enquire whether the registered dealer carries on any other business activity;

(j) Immediately after the visit the important changes should be advised to the registration section in the department;

(k) Ascertain at an early stage whether or not the dealer has non-business activities/other sources of income, and note the same on Summary of Dealer's Activities accordingly;

(l) Ensure that:

· the dealer appreciates the difference between business and non-business activities;

· that the dealer is aware that any tax incurred on purchases relating to non-business activities is not recoverable; and

· that where appropriate, an apportionment of input ax is carried out.

(ii) Structure of the business

(a) Record on the Summary of Dealer's Activities the structure and organization of the I business, if complex, this may be easier to record on a separate sheet using a flowchart, if possible;

(b) Record details of branches, whether the dealer has:

· opened any branches/other premises; or · altered the activities of any branches/ other premises;

(c) It is also important to record the methods of cash control i.e. who cashes up, who does the banking, who records daily gross takings and when, the number, make and model numbers of electronic tills etc;

(d) Record details of audit trails, create flowcharts where this would be helpful, etc., noting the Summary of Dealer's Activities accordingly;

(e) Where relevant, opening hours for the various premises should be recorded;

(f) Record Maximum Retail price (MRP) of main categories of positive rated goods for future use in a possible mark-up exercise.

(iii) Accounting System

(a) The dealer should be questioned to establish what-type of records are maintained;

(b) To gain an understanding of the method of accounting employed, the audit trail- the flow of the data to transactions- should be established;

(c) The officer should check whether the dealer's accounting system as required U/S 59 r/w rule 35:-

i) Records all taxable purchases on the basis of following segregation:

First, on the basis of tax rates, say 4%,12.5% etc.;

Next, on the basis of purchases-whether imported or local purchases m respect of every tax rate;

Thirdly, in case of locally purchased goods, on the basis of availability of input tax credit on purchase, i.e. whether the goods has been purchased from registered dealers against tax invoice or it is otherwise;

ii) Records all taxable sales on the basis of following segregation:

First, on the basis of location of sales i.e. sales made within the State and made otherwise e.g. inter-state sales, export, sale outside the State etc.;

Secondly, in the case of locally sold goods, on the basis of tax rates;

Thirdly; on the basis of sales made to a registered dealer against tax invoice and otherwise (in respect of locally sold goods taxable at a particular rate of tax).

Note 1: Format appended to this manual, which gives the break-up of purchases & sales as mentioned above, can be profitably used in this regard, with suitable modifications.

Note 2: Annexure A to return in Form 5 may also been seen.

iii) Records purchase and sale of exempted goods;

iv) Records input tax and output tax on the basis of rate of taxes, say 4% input tax ale, 12.5% input tax alc etc;

v) Reflects the total purchases and total sales made under each tax rate and total ·tax paid on such purchases and total tax charged on such sales at the end of each tax period;

vi) Keeps a Value Added Tax (VAT) account showing month-wise details of total output tax, total input tax, total purchase tax, Central Sales Tax, reverse tax, net tax payable, tax paid and the input tax credit due for refund or carry forward to the subsequent return period, if any;

vii) Records, in case of a manufacturing concern,

purchase of capital goods,

purchase of inputs, tax rate wise, purchase wise whether imported or local, in case of local purchase break up of purchase from registered dealer and unregistered dealer; ,

use of inputs in manufacture of exempted goods,

use of inputs in manufacture of taxable goods,

goods manufactured,

manufacturing account,

goods sold,

stock of inputs, consumables, packing materials, fuel, and finished products and bye-products, if any.

Note 2 : Annexure III to annual return in Form 14 may also been seen.

viiI) Records the date, invoice number, name of supplier, tax payer identification number (TIN) of domestic supplier, value of purchases and tax credit in the Purchase book or account;

ix) Records if the buyer is a registered taxpayer, his name, tax payer identification number (TIN) and sale value and tax charged;

x) Records in detail the input tax calculations where the dealer is making both taxable and tax free sales;

xi) Retains original tax invoices for purchases. on which tax has been charged, datewise;

xii) Retains invoices for purchases made without charge of Value Added Tax in date order;

xiii) Keeps copies of tax invoices related to taxable sales in date and numerical order;

xiv) Keeps invoices related to exempt sales in date and numerical order;

xv) Keeps credit and debit notes issued and received in date and numerical order;

xvi) Keeps bank records including statements, cheque book counter foils and pay-in-slips;

xvii) Records all forms of expenditure and income;

(d) The officer should investigate and get explanations of any obvious omission or irregularity in the VAT account;

(e) The officer should find out whether or not there are internal/external auditors;

(f) If a computerized accounting system is in use it must comply with the basic record keeping requirements and is able to produce hard copy of any document on request as well as extracts of data on computer media if this required for advanced audit testing.

(g) The auditor should also ask for the followings:

order file,

business correspondence files,

Statutory registers & declaration forms;

Daily stock register (previously known as RG I),

other relevant records under the Central Excise Act in case of a manufacturing concern

the price list & brochure of the goods etc.

(iv) Adequacy of the Dealers' records

(a) Confirm as far as practicable that the dealer's records cover all aspects of the business;

(b) Confirm whether the dealer's accounting arrangements ensure (or will ensure) that:

· Tax is properly accounted for on all business activities including capital assets/ scraps etc.;

· Tax paid on goods received is properly recorded;

· A dealer with business and non-business activities does not treat as input tax the VAT on purchases for non-business purposes;

· Only input tax which is properly deductible is claimed;

· If the dealer is partly exempt, taxable and exempt outputs are clearly distinguished;

· Credit notes received, or issued, are separate~y' identified in the appropriate input and output records; ',.." · The records are comprehensive, arid the VAT account is properly set up and maintained.

· In order to check the accuracy of the day books and subsidiary records, both for input tax and output tax, and to gain an understanding of the method of accounting employed, a few items in these records should be traced back through invoices to orders etc. and forward to ledger accounts, cash books etc. A few purchase and copy sales invoices are to be selected to check that they have been properly included in the inputs and outputs records respectively. Generally these checks should be made for a particular tax period;

Any apparent deficiencies in the records should be pointed out to the dealer, confirmed in writing and a note made on the visit report form that this has been done.

(v) Imports/Exports and Inter-State Movements

Record on the Summary of Dealer's Activities whether the dealer imports and/or exports goods and/or acquires from or delivers to other State. An estimate of the percentage of inputs and outputs accounted for by each 'should also be recorded.

(vi) Principal outputs and inputs

(a) Ascertain as far as possible the main supplies by the business categorized by rates of VAT, i.e.:

· What are the principal outputs/inputs at each positive rate?
· What are the principal outputs/inputs at a zero-rate?
· What are the principal exempt outputs/inputs?
· What other, if any, outputs/inputs are there? (i.e. outside the scope)

(b) Record rate of tax and the schedule in which the each goods falls are very important to ascertain the correctness of the input tax credit, output tax due etc.

(c) Record the information on the Summary of Dealer's Activities, by percentage and/or description;

(vii) Auditing of inputs & input tax

Business purchases (inputs) provide the logical starting point for a VAT audit. In case of traders, input refers to the goods purchased for re-sale in the course of business. In case of manufacturers, input refers to the goods purchased for use in the manufacturing process, such as -plant and machinery, raw materials and packing materials.

Input tax is the tax paid inside the State of Assam on purchases of goods (inputs) made from a registered dealer for resale or for use in the manufacturing.

(a) The audit officer should select the tax period to be checked and thereafter should obtain all record of purchases, as below:

records of all taxable purchases made inside the state,

records of all out of state purchases,

records of all imports from outside the country,

records of all non-taxable purchases,

records of purchases of all tax-paid goods,

records of all inward branch transfers.

(b) The officer should obtain the break-up of purchases as below:

on the basis of rate of taxes,

on the basis of purchases, whether imported or local, and

on the basis of availability of input tax credit on purchase, i.e. whether the goods has been purchased from registered dealers against tax invoice or it is otherwise, ill case of locally purchased goods.

Note: FORMAT II given in the manual may kindly be referred to.

(c) Compare & check purchase accounts with tax returns following the procedure mentioned below:

· Obtain the ledger book; from the index of accounts in the ledger, arrive at the page of, say, "4% Local Purchase account";

· Compare & check the monthly total of, say, "4% Local Purchase account" with the figure pf 4% local purchases shown in the return (against which the dealer claims input tax credit);

· Compare the month-wise total of other purchases e.g. "4% Imported Purchase a/c", "12.5% Local Purchase a/c", "12.5% Imported Purchases a/c" etc. as contained in the respective head of accounts with the figures disclosed in the tax returns in the similar fashion;

· Check the credit side of purchase account to see whether there is any entry with regards to purchase return or any other adjustment. Also check whether the purchase return is recorded in a separate account;

· In case of any discrepancy, note down the details and seek explanation from the dealer and if needed do further investigation;

Note: Inter-state purchase/ receipt of goods is dealt separately in the manual.

(d) Compare & check Input Tax account with tax returns following the procedure mentioned below :

· Open the ledger book, see the index and arrive at "4% Input Tax account";

· Check whether input tax credit is brought forward correctly from previous year's record, if any. Alternatively it can be reflected in the VAT account;

· Compare & check the monthly total of"4% Input Tax account" with the figure of 4% Input Tax shown in the tax returns;

· Cross-check whether the amount obtained by applying 4% rate on the 4% amount of local purchases, tallies with the 4% input tax amount;

· Compare & check the month-wise total of"12.5% Input Tax account" and input tax of any other rate as contained in the respective head of accounts with the figures of input tax credit disclosed in the tax returns in a similar fashion;

· Check the credit side of the individual input tax credit account to ascertain whether there is any adjustment in the amount on account of return of goods or for other reasons;

(e) Compare & check VAT account with Input Tax account following the procedure mentioned below:

· Open the ledger book, see the index and arrive at VAT account;

· Check whether input tax credit is brought forward correctly from previous year's record, if any. Alternatively it can be reflected in the appropriate input tax credit account;

· Compare & check whether the monthly total of "4% Input Tax account" is taken to the debit side of the "VAT account";

· Compare & check whether the month-wise total of "12.5% Input Tax account" and input tax of any other rate as contained in the respective head of accounts is debited to the "VAT account" in the similar fashion;

Note : Some dealers may maintain only VAT account instead of separate input tax and output tax account in which case the verification has to be done accordingly.

(f) Check purchases with reference to source documents like Tax invoice. debit note, credit note etc.

Scrutiny of Input Invoices: Purchases invoices examined should be examined to see that:

The tax invoices in original are available,

The tax invoices show the amount of tax separately,

The date of invoices fall within the accounting period,

The invoices are made out in the name of the dealer,

They relate to goods consistent with the purpose of the business,

They contain the details required to be shown on tax invoices under the VAT legislation,

The tax is correctly calculated,

Pro- forma invoices have not been used to substantiate claims for deduction of input tax:

Note 1: Check whether the dealer has made any local purchase of goods from an industrial unit enjoying remission. It may be noted that the dealer is not eligible for input tax credit on inter-state sales of goods made out of goods purchased from an industrial unit enjoying remission [see notf. No. FTX.57/2005/53 dt.30.03.2007]

Note 2. Verifications of debit note or credit note is dealt separately in the manual.

(g) Check that input tax is not claimed for non-eligible purchases

An audit officer should ensure that input tax credit is not claimed in respect of non-eligible purchases, which are listed below :

(i) purchase of any goods which are meant for use as fuel, lubricants and stores in the manufacturing process [see definition of raw materials in section 2(38)]

(ii) purchase of any goods, specified in the Fourth Schedule [section 14(1)/14(6)0)];

(iii) purchase of any goods, specified in the Fourth Schedule, which are meant for resale [section 14(3)];

(iv) purchase of any taxable goods which is used as raw material for manufacture of goods specified in the Fourth Schedule [section 14(3)(d)];

(v) purchase of goods which are used as container or materials for packing of Fourth Scheduled goods [section 14(3)(e)];

(vi) purchase of goods used in manufacture or packing of exempted goods specified in the First Schedule [section l4(6)(a)];

(vii) purchase of any goods and crude oil used in the refining of any petroleum products specified in any Schedule [proviso to section 14(6)(a)];

(viii) purchase of any goods which is used as fuel in generation of energy [section 14(6)(k)];

(ix) purchase of any vehicle or air-conditioner for use in business [section 14(6)(m)/ 14(6)(0)];

(x) Purchase of goods used as free sample or gift or for personal use [section 14(6)(d)];

(xi) Purchase made from an unregistered dealer [section 14(6)(c)];

(xii) Purchase made from a dealer provisionally registered [section 14(6)(c)];

(xiii) Purchase made from a dealer whose certificate of registration is suspended [section 14(6)(c)];

(xiv) Purchase made from a dealer who opts for a lump sum tax [section 14(6)(c)];

(xv) Purchase made in the course of inter state trade or from outside the State, or from outside the county;

(xvi) Purchase made by a dealer who opts for lump sum (composite) tax [section 14(6)(c)];

(xvii)Purchase of goods, made from an industrial unit enjoying remission, which are sold in course of inter-state trade or commerce;

(h) Check whether input tax already availed without entitlement has been reversed or not

Under VAT regime, a dealer is permitted to take the credit of the input tax in the month/quarter during which the goods are so purchased against tax invoice. If such goods are subsequently used for the purposes other than resale or manufacture, the input tax credit, which has so already been availed of, has to be reversed, during the period in which such ineligible or impermissible use has taken place.

An audit officer should check whether the dealer has reversed input tax credit in the following cases provided he availed tax credit:

(i) goods used as free sample or gift or for personal consumption [Sections 14(6)(d)];

(ii) goods stolen or lost or destroyed or not sold for any reason including natural calamity [Sections 14(6)(e)];

(iii) goods remaining in stock at the time of closure of business[Sections 14(6)(g)/ 14(9)];

(iv) goods remaining in stock at the time of cancellation of registration certificate [Sections
14(9)(b)];

(v) goods returned to the selling dealer [Sections 14(9)(e)];

(vi) tax charged in excess of tax due provided the purchaser receives a credit note from the seller [Sections 14(9)(g)];

(vii) goods sent outside the state on stock transfer basis. The input tax credit to the extent of notional central sales tax liability, which would have been payable had the goods been sold to registered dealer in course of inter-state trade, would have to be reversed [Sections 14(6)(h)];

(viiI) goods used as raw materials in the manufacture of taxable goods sent out on stock transfer basis. For reasons of stock transfer the input tax credit equal to notional CST liability on the corresponding purchase turnover of the raw materials shall have to be reversed [Sections 14(6)(i)]; and

(ix) the excess input tax credit already claimed.

The audit officer should fl.1rther check whether the dealer has reduced the amount of input tax credit on account of reversal and whether has he given due effect of such reversal in the respective input tax account and ultimately in the VAT account in the period in which such ineligible use of goods takes place [section 14(8)/ Rule 12] .

It may be noted that in case of reversal of input tax, the amount of tax so reversed is added back to the cost of purchase.

(i) Issue cross reference in case of suspicious tax invoices, large input tax claim etc.

The audit officer should issue cross reference advices to the tax officer having jurisdiction on selling dealers to verify the authenticity of transactions particularly in case of suspicious tax invoice, invoices having a substantial claim of input tax etc.

Note: This part has been separately dealt in the Annexure 1.

(j) Check whether the dealer has any purchase tax liability on account of purchase from unregistered dealers

Note: This part has been separately dealt in this manual.

(k) Check the purchase of capital goods

(i) Obtain the break-up of purchases of capital goods on the basis of purchases, I whether imported or local; .

(ii) In respect of capital goods purchased from other state:

Check whether such capital goods is transported on the strength of Road Permit issued by the tax department;

Check the correspondence, quotation, purchase order, invoice, consignment note etc. in respect of such imported capital goods;

Check whether the purchase of capital goods is duly debited to capital goods account in the ledger;

Check whether any declaration form like "C" form has been issued to out-state supplier against such imported capital goods;

Check the details evidence of payment;

(iii) In respect of capital goods purchased within the state:

Check whether the input tax credit on purchase of capital goods has been claimed in respect of following non-eligible purchases:

(a) capital goods purchased for being used in the manufacture of goods specified in the Fourth Schedule [u/s l4(3)(d)] ;

(b) purchased capital goods are specified in the negative list of capital goods in the Seventh Schedule of the AVAT Act. The list, inter alia, includes vehicles of all types, office equipment, furniture, capital goods used in exploration of crude oil & natural gas and in refmery.

Check whether the capital goods has been purchased from a registered dealer against tax invoice;

Compare & check whether the "Capital goods/relevant assets account" in the ledger has been debited with the tax invoice amount;

Check correspondence, quotation, purchase order, etc. in respect of such local purchased capital goods;

Check the details evidence of payment;

Compare & check the amount of tax shown in the tax invoice has been debited to "Input tax on capital goods account";

Check whether the amount debited in the "Input tax on capital goods" has been claimed as input tax in the tax return by way of adjustment in the input tax credit, of course on the basis of 36 equal installments;

(viii) Auditing of outputs and output tax

The term output means the goods sold by a dealer. Output tax is the tax charged by a registered dealer in respect of goods sold by him.

(a) The audit officer should select the tax period to be checked and thereafter should obtain all record of sales, as below:

records of all taxable sales made inside the state,

records of all zero rated sales such as export sales, inter-state sales etc.

records of all inter-state stock transfer to depot! commission agents,

records of sales of exempted goods,

records of sales of all tax-paid goods,

(b) The officer should obtain the break-up of sales as below:

on the basis of location of sales i.e. sales made within the State and made otherwise e.g. inter-state sales, export, sale outside the state etc.;

on the basis of tax rates, in case of locally sold goods;

on the basis of sales made to a registered dealers against tax invoice and otherwise (in respect of locally sold goods taxable at a particular rate of tax).

Note : FORMAT II appended to this manual, which gives the break-up of purchases & sales as mentioned above, can be profitably used in this regard, with suitable modifications.

(c) Compare & check Sales accounts with tax returns following the procedure mentioned below:

. Obtain the ledger book, see the index and find "4 % Local Sales (Tax Invoice/ Regd. dealer) account";

· Compare & check the monthly total of "4% Local Sales (Tax Invoice) account" with the figure of 4% local sales shown in the return. The figures may not tally. The reason is simple, because the 4% sales shown in the return includes sales made to registered dealers against tax invoice as well to sales made to unregistered dealers/consumers against retail invoice. Therefore, with the figure of the monthly total of"4% Local Sales (Tax Invoice) account", the monthly total figure of"4% Local Sales (unregd.) account" will be added and then the aggregate sales figure of shall be compared with the returned figure;

· Compare the month-wise total of other sales as contained in the respective head of accounts with the figures disclosed in the tax returns in the similar fashion;

· Check the debit side of sales account to see whether there is any entry with regards to sales return or any other adjustment. Also check whether the sales return is recorded in a separate account;

· In case of any discrepancy, note down the details and seek explanation from the dealer and if needed do further investigation;

Note: Inter-state sales/stock transfer of goods is dealt separately in the manual.

(d) Compare & check Output tax account with tax returns following the procedure mentioned below:

· Open the ledger book, see the index and arrive at "4% Output Tax account";

· Compare & check the monthly total of"4% Output Tax account" with the figure of 4% Output Tax shown in the tax returns. The audit officer should note that monthly total of"4% Output Tax account" shall consist of tax on
(a) "4% Local Sales (Tax Invoice) account",
(b) "4% Local Sales (unregistered.) account"

· Cross-check whether the amount obtained by applying 4% rate on the aggregate of 4% local sales, tallies with the 4% output tax amount;

· Compare & check the month-wise total of"12.5% Output Tax account" and output tax of any other rate as contained in the respective head of accounts with the figures of output tax disclosed in the tax returns in the similar fashion;

· Check the debit side of the individual output tax account to ascertain whether there is any adjustment in the amount on account of return of goods or for other reasons;

(e) Compare & check VAT account with Output Tax account following the procedure mentioned below:

· Open the ledger book, see the index and get at "VAT account";

· Compare & check whether the monthly total of"4% Output Tax account" is taken to the credit side of the "VAT account";

· Compare & check whether the month-wise total of"12.5% Output Tax account" and output tax of any other rate as contained in the respective head of accounts is credited to the "VAT account" in the similar fashion;

(f) Scrutiny of sales with reference to source documents like Tax invoice, debit note, credit note etc.

The copy sales invoices examined are to be scrutinized to see that:-

They are issued in a sequential series and there are no gaps in serial numbers;

They are entered in the books in the same month as the date of the invoice;

They contain the details required to be shown on tax invoices under the VAT legislation;

Tax is being calculated and charged at the correct rate on the correct value;

When several copies of sales invoices are prepared the officer is to ascertain the purpose and disposal of each copy, and confirm that all copies are clearly distinguishable from original tax invoices. If practical copy invoices should have the printed endorsement "This is not a Tax Invoice~"

Note : Verifications of debit note or credit note is dealt separately in the manual.

(g) Check the purchase tax liability

Note: This part has been separately dealt in the manual.

(h) Check the tax liability on sales of scraps/unserviceable goods/assets etc

The auditor should find out whether any condemned vehicle or scrap etc has been sold by the dealer during the period under audit. It can be found from verification of cash book, accounts in the ledger or the Profit & loss Account and schedule of assets attached to the Balance Sheet.

If any such sale has been made, it is to be seen whether output tax on such sale has been accounted for/credited in the output tax account referable to such special category of sale and whether the amount in such output tax account has been duly transferred to the credit side of VAT account or not.

Note :The annexure IV appended to the Annual VAT Return contains provision for adjustment in output tax to meet such contingencies.

(ix) Partial exemption (i.e. dealers making both taxable and exempt sales)

The officer should ascertain whether the dealer has exempt outputs and if so must give special attention to certain aspects when dealing with such dealers. Particular questions to ask are:-

(a) Is he correctly identifying taxable (including zero-rated) and exempt sales?

(b) Is the value of taxable and exempt sales recorded and totaled in every tax period?

(c) Does he understand which input tax can never be deducted (i.e. non-deductibles).

(d) If he is required to carry out an annual adjustment, are the calculations being made correctly and the necessary adjustments made in the VAT account?

(e) Do his records adequately show how deductible input tax, and any necessary adjustments, has been calculated?

(f) Is there evidence of the use of a tax avoidance scheme? If so the details should be reported to the supervising officer.

(x) Check on bank accounts etc.

(a) The officer should ascertain at an early stage what bank accounts are used for the business and the usual procedures for deposit, withdrawal and transfer of funds;

(b) Sample checks should be made of bank statements to ensure that the details shown in the basic records agree with amounts recorded as being deposited or withdrawn.

(xi) Repayment dealers

Where the input tax regularly exceeds his output tax (e.g. in the case of exporters) particular attention should be given to the records and accounts to ensure any repayment returns are legitimate.

(xii) Risk areas

(i) In the light of pre-visit preparation, the officer should note any areas of risk and special or unusual features identified on previous visits.

(il) These factors should be borne in mind during the initial fact-finding stage of the visit for later action during risk assessment.

3.07 General review

The purpose of the general review is to probe over a wide front to test whether the VAT account is a reliable statement of the dealer's tax liability and/or entitlement to credit.

The information obtained in carrying out the basic check will have provided a background against which the general review can be undertaken. It will give some indication of where any risk to the revenue lies and the areas which may need further in depth checking.

The following outlines an approach which will enable some conclusions to be drawn as to the likely creditability of the dealer's activities.

(1) Inspection of premises, equipment and stock, and dealer's lifestyle

> (a) The inspection of business premises, in order to form some idea of the nature and extent of activities being carried on, is of paramount importance.
>
> (b) Most dealers are unlikely to object to the officer inspecting their premises if the officer explains that the inspection is a normal part of the audit process and is designed to avoid having to ask the dealer a lot of detailed questions about the operation of the business. Given the right approach, some will offer to show the officer around.
>
> (c) However, if the dealer refuses to allow inspection the officer should remind the dealer that he has legal powers to inspect under Section 59 of

the MVAT Act and that a refusal constitutes an offence under the VAT law. It is, therefore, important to approach this aspect tactfully though with firmness when necessary. If the dealer maintains his refusal the officer should report the circumstances to his supervising officer.

(d) Observe and attempt to assess the scale of activity with particular regard to:

· The type of plant and equipment;

· The stocks of raw materials;

· The goods used in course of manufacture;

· The stock of furnished goods;

· Deliveries taking place; and

· Use of subsidiary records/documents for comparison with the level of business as shown in the accounts and with the total deductible input tax being claimed.

(e) In carrying out the inspection of business premises the officer should be alert or on the lookout for activities which are outside the dealer's established business activity or which may not be reflected in the accounts of the business. Consider the possibility, that unrecorded supplies of taxable goods are being made. Indications may be the types of equipment installed and vehicles operated, etc.

(f) Note the trading hours, the number of counters aria people serving, the number, location and type of tills, (including those apparently not in use), the method of payment, and the dealer's arrangements for cash controL Record these details on the Summary of Dealer's Activities.

(g) Consider the dealer's lifestyle-is this in keeping with the level of declared income? Are there any signs of materiality that seem unaffordable?

(2) Examination of Annual Accounts

(a) Annual accounts may also be called Final Accounts or Annual Reports etc. but they all outline the income and expenditure of a business for a given period. The majority will cover the preceding 12 months but some may be for longer periods.

· The complexity of a business will be reflected in its accounts; therefore a large company will have a more complicated set of annual accounts than a small retail business.

· Some taxable dealers/entities like companies are required to prepare a Profit and Loss Account and Balance Sheet under the Companies Act, and for Income Tax and lor Central Excise purposes. These must be submitted to the Registrar of Companies.

· Examination of annual accounts in an essential feature of an audit visit, and it is important to ensure when making the appointment that, where these accounts are prepared, they will be available for inspection.

(b) The general Review of a dealer's activities is to include an examination and critical analysis of the final accounts of the company. This analysis can be made more effective by the use of relevant accounting ratios.

· No figure is significant in isolation; the value of a ratio is that it expenses simply in one number the result of a comparison between 2 figures. Ifis a practical aid to the study of relationships, and the critical analysis of final accounts is directed towards the study of structural relationships and the establishing of trends.

. Accounting ratios are indicative, not conclusive. They provoke questions, but do not provide answers. The officer must seek answers to the questions so raised, confirming or modifying, conclusions in the light of all that is seen of the business 'on the ground'.

. It is not possible to lay down absolute standards or limits within which the various ratios can be taken as being acceptable or safe~ It is therefore important that the officer should have regard to the trend of the ratios, over a period of time, and that positive explanations of any significant variations observed should be sought.

Note: The ratio analysis has been shown separately in the Annexure 2.

(c) Details of annual accounts should be recorded in FORMAT m provided for this purpose, to allow comparison to be made with previous years, and the identification of trends. These forms will provide assistance towards the reconciliation of the tax declarations on the periodic VAT returns to the audited annual accounts.

Section A:

This section analysis the trading accounts for consecutive years, and provides a comparison of performance. Trend and ratios can be established from this comparison, which should be borne in mind when examining the dealer's records.

Section B:

This section enables a year on year comparison of trends in trading assets, and liabilities and also enables observations of the dealer's lifestyle.

In examining the annual accounts the officers should consider what reliance can be placed on them e.g. has the chartered accountant made any qualifying remarks in the notes to the accounts?

(d) Analysis of annual accounts is not to be carried out for its own sake; it is vitally important to keep the revenue objectives clearly in mind, and to consider the significance of each item in the accounts in relation to these objectives. For example, officers examining the annual accounts of small retailers whose stated gross profits cast doubt upon the accuracy of their recorded gross takings should not spend time in elaborate analysis of those accounts. Examining the record of gross takings to determine their creditability could be more profitable. This will entail concentration on the prime records, judicious questioning of the dealer, comparison of purchase prices with marked or listed selling prices, stock consideration etc.

(e) **Trading account:** A trading account is normally prepared for every business which buys and sells goods. The significant features in a typical trading account are the totals of sales, purchases and opening and closing stocks of goods. From these figures the gross profit is determined.

The following checks are suggested:-

. Have the opening balances in trading account been verified from previous year's record.

· Compare sales figures in the trading account for appropriate tax periods with the sales records and with the record from which tax output figures are posted to the VAT returns and investigate any discrepancies.

· Compare volume of purchases in the trading account for appropriate tax periods with the purchase records and with the record from which the total value of the inputs is posted to the VAT returns and investigate any discrepancies. The two may not correspond to the same degree as should outputs because, of the inputs declared on the VAT return, some will relate to capital items, etc. which will appear in the balance sheets rather than in the trading account therefore, to obtain a better comparison, the figures from the two sources will need to be consolidated.

· Consider whether the stock figures shown agree roughly with observation s made during inspection of premises.

· Compare opening and closing stocks and get an explanation for any abnormal increase or decrease. Be aware that in unexplained increases in stock levels may indicate suppression. Because of the limited ~ime available for audit visits, officers should not undertake physical stock checkS "unless there are clear indications that significant under declarations have occurred.

· Obtain quantitative details of opening stock, purchases, sales and closing stock and arrive at the average value/ price by dividing the value by the quantity wherever possible. This will give an insight to the stock valuation and whether the dealer has valued the closing stock higher than the market price;

· Observe business trends by comparing current figures with those for preceding and earlier years. The reason for any changing patterns of trade should be ascertained.

· The officer should relate average stocks to cost of goods sold to arrive at an estimated stock turn period and consider whether this is reasonable, bearing in mind the amount of activity seen to be taking place and any seasonal variation in trade.

If the amount of activity suggests that 'stock is being turned over more rapidly than is indicated by the trading account, there is a possibility of material suppression of sales.

· The amount paid in manufacturing wages should be compared with purchases and sales and considered in relation to the number of employees apparently engaged in manufacturing and related activities, bearing in mind the possibility that if sales are suppressed the dealer may also understate wages figures to give credibility to the trading account.

Check::-

· How much has been manufactured and sold;
· What the product is;
· Whether the statement is compatible with the details declared on the VAT return;
· Whether the production of goods is reasonable in proportion of consumption of power/fuel
· Whether the correct tax rates have been applied to the goods supplied; and
. The statement of assets to see if any assets have been bought and/or sold during the period. If major plant has been sold has the tax been accounted for, etc?

In order to see these details clearly it may be necessary to examine the final balance sheet rather than the annual accounts, which may only show consolidated amounts under each heading rather than the breakdown details shown in the balance sheet.

In some companies e.g. manufacturers and large retailers, management reports/ internal audit reports may be produced at regular intervals. These documents, although designed for management purposes, will give breakdowns of e.g. manufacturing costs, number and description of units produced, number sold, selling price etc. If such documents are used tax officials should request sight of them. They can give a useful check on mark-ups, total output tax due for the period, input tax claims etc.

(f) The Profit and Loss account

Scrutiny of the profit and loss account may reveal items of expenditure which will throw further light on the trading activities. Some items may serve as a guide to the source of expenditure, e.g. expenses borne in connection with imports; or to the volume of business as a whole, e.g. payments to transporters. On the other hand they may reveal the existence of sales on which output tax is not being provided. Each item is to be considered in turn and particular attention is to be paid to new items of expenditure.

(g) Balance sheets

(i) General: The balance sheet will provide further information on the size and nature of the business which will help to complete the picture of the dealer for the officer. Although cases where there are signs of possible insolvency are to be reported, financial difficulty is in itself a secondary consideration.

What is of greater revenue significance is the inference that may be drawn from the fact that a business is being carried on without signs of financial difficulty, despite the fact that the balance sheet sh9wS a state of continuing insolvency. If a business is apparently running consistently at a loss there may be other sources of income which have not been disclosed. In such circumstances there are grounds for suspicion which point to the need for deeper research. The market value of fixed assets, (plant, goodwill etc) is of secondary significance in considering the financial position. A good indication of solvency will be gained by balancing current assets (stocks, trade debtors, cash etc) against current liabilities (trade creditors, bank overdrafts etc).

(ii) Disposal of equipment, fixtures and fitting: Sharp fluctuations in the value of fixed assets will be of interest in connection with possible disposals of equipments, fixtures and fittings. If such disposal is not apparent in the accounts or in the general ledger the dealer is to be asked whether items of equipment etc have been sold and if so where the tax has been accounted for. Any substantial change in the value of fixtures and fittings is a matter to be questioned in case goods have been disposed of without accounting for output tax. If equipment is 'sold' in part exchange against the receipt of new equipment, two transactions have taken place and output tax arises on the full disposal value of the item exchanged. If new cars have been acquired for business use, it is to be confirmed that input tax had not been deducted in respect of them.

(iii) General or nominal ledger: The individual accounts in any general or nominal ledger are to be inspected. These will throw further light on the dealer's activities and may reveal under-declared items.

(iv) Auditor's adjustments: When a chartered accountant audits the dealer's accounts, the officer is to ascertain the auditor's method of making adjustments, inspect the auditor's record of errors and omissions, and ensure any necessary adjustments to the VAT account have been made.

(3) Supplementary or alternative checks

If annual accounts are not customarily prepared, or if there is reason to doubt the validity of the annual accounts produced, the following checks are suggested:

· Purchase and sale day book totals may be compared with totals in nominal ledgers or other principal records;

· Purchases for a given period may be compared with sales;

· Stock accounts or stock taking records may be, ~ompared with purchases and sales records; -

· Periodical analyses showing the quantities of each line purchased or sold may be examined;

· The total number of individual components purchased for manufacture over a given period may be compared with outputs of the final commodity;

· Purchases over a given period may be compared with payments to suppliers as shown in the cash book or elsewhere over the same period allowing for any period of credit taken;

· Central excise records such as Personal Ledger Account (PLA), monthly returns, stock accounts, excise duty account, which can be compared with the quantities and values reflected in the value of inputs and outputs; or

· Cost accounting records that would give a picture of the manufacturing costs and quantities inputs and outputs.

(4) Small companies/dealers

Some dealers will not have a statement of annual accounts. They may have simply a statement of gross income and expenditure for the year. Where a more comprehensive breakdown of the year's trading pattern is shown it is possible to:

(a) note miscellaneous items of income and make further checks to ensure that tax has been correctly applied and accounted for; and

(b) note sales and purchases of assets:

· Has the dealer bought a new car and claimed input tax?

· Have there been sales of assets or part-exchange on which tax has not been accounted for?

3.08 Credibility

There is no single or arithmetical method of assessing the credibility of all dealers VAT declarations.

How the officer assesses credibility will depend on what has been revealed in the process of applying the basic checks and the analysis of the general review. In testing credibility the officer is attempting to apply an appropriate objective test of the VAT declaration by using audit techniques such as cash reconciliation, mark up exercises, parts to labour or commodity specific tests.

After conducting the general review the officer should draw some conclusions as to the credibility of the registered dealer and the business accounts; as part of this process the following points should be considered:-

(a) Whether the picture shown in the annual accounts appears reasonably consistent with what has been actually observed;

(b) What reliability can be placed on the annual accounts themselves;

(c) The reason for any fall or sharp increase in turnover;

(d) The reason for any increase in purchases;;

(e) Whether there is satisfactory explanation for a low or reduced rate of gross profit;

(f) Taking into account the nature of trade and the type of dealer, the likelihood of both inputs and outputs having been suppressed so that gross profit remains apparently constant;

(g) The reason for any change in the patterns of trading;

(h) The reason for a changing trend, or sudden marked change in tax payments;

(i) The reason for any marked change in the proportions of outputs at the different tax rates;

G) The apparent integrity of the registered dealer and whether he is possibly or definitely suspect;

(k) The aspects of the dealer's activities that is likely to be most worthy of detailed examination.

In the light of conclusions drawn from completing the basic and the general review the officer should decide whether or not a more detailed examination of the records is necessary. If the officer is reasonably satisfied with the credibility and viability of the business he should conclude the visit.

Where he is not satisfied in any case where there is suspicion that the tax has been understated, the officer is to proceed to examine in-depth the particular aspect or aspects of the business which appear most likely to be subject to error or irregularity e.g. sales/purchases/ imports/exports. These checks are normally it may be concentrated in a particular tax period or periods but occasionally it may be necessary to explore every field of activity.

It is important to note that credibility cannot be tested by the general comparison of mark ups achieved by dealers in similar trade classifications when these have not been tested at the under audit. Information on input/output ratios and tax performance ratios should be used with caution and should not be used as a sole test of credibility. This data provides crude indicators that may be useful but it should be born in mind that a dealer suppressing 50% of purchases and 50% of sales will produce ratios that are the same as for a similar honest dealer.

3.09 In-depth checks

On the audit visit an officer is working towards an objective test of the dealer's tax declaration and this can be achieved by various means, the most obvious being through such techniques as mark-ups, parts to labour etc.

At its simplest in-depth checking can be established by using basic records outside the recognised accounting system, e.g. delivery notes, job cards diaries etc., and checking that the transactions are captured by the prime records and ultimately the VAT account.

In depth credibility is not tested by comparing invoices to .day-books as, in essence, this only tests the accuracy of the clerk transcribing the information. In addition, credibility is not established by general remarks on mark ups in certain activity classifications or sectors if when they have not been tested at the dealer concerned.

Inputs always constitute an area of revenue risk by way of over deductions. With output the risk is highest at the point when the tax "sticks" with the buyer - i.e. when sales are made to unregistered dealers or consumers. In-depth checks should concentrate on extended checks on inputs and outputs.

1. Extended check on inputs

The objective of this check is to ensure that the registered dealer is not over claiming input tax and conversely, to try to ascertain whether purchases are being suppressed or misdescribed as expenses in conjunction with suppressed sales.

Selected input tax entries should be compared to supporting purchase invoices particular attention being paid to large or unusual items or from unfamiliar sources and suppliers.

The following checks on input tax deduction should be considered:-

~ A number of purchase invoices should be examined and compared with the purchase Day Book or purchase account or other subsidiary records from which deductible input tax is posted to the "Input Tax account" or "VAT account" to test the system;

it) A number of purchase invoices should be examined and compared with the output! sale invoice to find out the mark-up/margin of the dealer;

ill) The checks undertaken under the basis checks should be extended;

iv) Individual tax invoices should be examined closely to detect whether alterations have been made to inflate the input tax shown on them;

v) The officer should be on the look-out for duplicate invoices. When a tax invoice has been lost, the dealer should have obtained a duplicate copy from the supplier. Such a copy should bear the supplier's clear statement on the face of the invoice as per MVAT and the dealer must obtain prior approval from his tax authority as per MVAT Rule 32 (10) before claiming the benefit of input tax;

vi) A physical check on high value items should be considered; ~.

viI) Check that input tax is not being claimed for any non-eligible items. For example, stores, fuels, lubricants for use in manufacturing process, vehicle for use in the business etc;

viiI) Check that the inputs of goods are consistent with the business;

ix) Examine carefully invoices from associated/sister business concern and businesses with whom the dealer has close links;

x) Special attention should be given to invoices from known suspect businesses (e.g. bogus invoices, items misdescribed, quantities overstated);

xi) Consider sending references to the Departmental Officer responsible for dealer's suppliers where there is reason to suspect fictitious or incorrect invoices;

xii) Where the dealer claims that goods have been lost, destroyed or stolen, he should produce evidence of claims on insurance companies, notification to the police etc;

xiii) Particular attention should be given to credit notes. When a supplier grants a credit note to a registered customer, the effect is to reduce the customer's entitlement to input tax deduction for the period in which the credit is issued. To confirm whether input tax credits have been correctly and fully posted and whether the input tax figure in the VAT account has been properly adjusted, credit notes should be compared with purchase day books or any other similar records. The officer should also confirm that where goods are returned they have been returned to stock and the stock balance adjusted. Again consider sending cross references;

xiv) Watch out for the dealer who might suppress inputs in order to avoid tax on outputs.

Checks and comparisons should be made on purchase orders, delivery notes and purchase invoices. Total purchases over a period should be compared with payments made to suppliers shown in ledgers, cash books, cheque counterfoils or elsewhere;

xv) Check evidence of payments for goods to confirm the bona fides of the tax invoices to which they relate by examination of bank statements, check counterfoils;

xvi) Check stock on hand and capital goods for evidence that goods shown in purchase records are on hand;

xviI) Check stock statement furnished to the tax department with the stock statement furnished to the Bank and note the discrepancy and study the VAT implication;

xviII) Check manufacturing records to establish goods in purchase records have gone into production;
xix) Check delivery records to establish goods in purchase record have been delivered, if the goods are not in stock and there is no evidence that the goods have gone into production;

xx) Check annual accounts for purchases of capital goods, verify it with purchase invoice and consider possible disposal of used capital goods where output tax could be due;

XXI) If felt necessary, obtain the details of selected big creditors including the creditor enjoying tax remission scheme as per the FORMAT IV given in the manual.

The risk of collusion between the customer and supplier should not be overlooked particularly where they are associated in some way.

Note : Annexure 3 which deals with the evaluation of internal control system of the assessee with regards to purchase; sales, wages, stocks & spares, power etc can be profitably used.

2. Extended checks on outputs

Extended checks on outputs ensure that all tax on outputs of goods are properly accounted for in the VAT Account for the period in which the tax point occurred.

Errors may occur through carelessness, ignorance of requirements, incorrect interpretation of complex or borderline liability issues. There may also be cases of fraud, especially of suppression and misdescription.

The following checks should be considered:

i) Items should be selected from customers' orders: worksheets, packing slips, consignment notes, delivery records, etc. and traced forward to the VAT account via sales invoices, sales day books, sales ledgers, cash books;

ii) Checks should be made on items in the cash books and accounts in the general or nominal ledger to ascertain whether there are taxable activities which are not reflected in the VAT account. Total outputs over a period can be compared with bank lodgments;

iii) Copies of sales invoices and other output documents should be inspected to see that they have been posted correctly to output records and that the tax has been properly carried to the VAT account;

iv) Checks should be made to see if there are any omissions in the sequence of invoices issued and the dealer should be asked to account for any missing numbers;

v) Officers should be particularly alert for invoices, delivery or receipt books lying about which appear to be additional to those in use;-

vi) The officer should judge the extent to which concentrated checks on VAT liability are to be made basing his judgment on the complexity of the dealer's activities. With such considerations in mind, the officer should scrutinize an extended range of invoices to confirm that VAT is being charges at the correct rates. In this extended check, the officer should also confirm that tax is being charged on the correct of suppliers;

vii) The eligibility of exempted and zero-rated sales should be examined. The officer should ask himself "Does this transaction make commercial sense?"

The officer should look for evidence that the goods exist (purchase, manufacture etc.)

The officer should look for evidence of physical delivery of the goods and evidence of payment etc.

viii) Deliberate misdescription may occur in any trade and there may be collusion to misdescribe goods or services. The officer should examine goods, orders, correspondence and specification etc. for signs of mis-description;

ix) When there are exempt outputs, the officer is to check that satisfactory arrangements are made for arriving at the total in each tax period and that the amount of deductible input tax is correctly calculated;

x) Checks on the disposal of assets/ scraps/ byproducts should be made to ensure that output tax has been accounted for;

xi) Ensure that where goods have been produced or acquired by the dealer and they are applied to a purpose that is not part of the business, (e.g. applied to private use or given away) the output tax has been accounted for;

xii) Registered dealers should keep records of all credits allowed to customers ensure accuracy of their own tax returns. Officers are to satisfy themselves that any tax credits issued are genuine, and select a few items, particularly those involving substantial amounts of tax, to check that output tax on the original supply was properly brought to account. Officers should bear in mind the possibility of fraud involving completely false credit, and in any case suspicion or doubt, cross reference requesting validity of the credit, should be sent to the officer responsible for visiting the customers concerned;

xiii) Establish the basis of discounts and promotional offers;

xiv) Check whether any sale has been made on F.O.R. destination basis;

xv) Check the basis for accounting for tax on sale or return arrangements, and returnable packaging;

xvi) Where used, check till roles to the record of daily gross takings;

xvii) Check bank statement, paying-in records to attempt to establish that as a minimum receipts are reflected on the level of sales declared;

xviii) If felt necessary, obtain details of selected big debtors as per **FORMAT V** given in the manual.

Note: Annexure 3 which deals with the appraisal of internal control system of the assessee with regards to purchase, sales, wages, stocks & spares, power etc can be profitably used.

3.10 AUDITING OF SPECIAL FOCUS AREAS:

1. Inter-state sales made from Mizoram

Section 3 of the CST Act deals with inter-state sale or purchase. Section 6(1) is the charging section which creates liability to pay tax on inter-State sales.

Clause (a) of section 3 of the Central Sales Tax Act speaks of sale occasioning the inter-state movement of goods. To put it simply, in order to be an inter-state one, a sale transaction must have three ingredients (i) sale (ii) inter-state movement and (iii) linkage or bondage between such inter-state movement and sales.

Clause (b) of section 3 however speaks of sales during transit. Under this clause also, a sale transaction in order to be an inter-state one, must have three ingredients: (i) **sale** (ii) **time of sale** - such sale must take place during transit i.e during continuation of inter-state movement, and (iii) **mode of sale** - such sale must take place by transfer of documents of title.

In respect of inter-state sales, full input tax credit is available. Therefore, such transactions should be considered as vulnerable (prone to evasion of tax).

The following checks should be considered:

(i) Check whether the dealer is registered under section 7(1) of the CST Act?

(ii) Check whether inter-state sale really exists?

(ill) Check whether the inter-state movement of goods, occurred in pursuance of contract of sales or was any linkage or nexus between the sale and movement of goods which is the linchpin of the inter-state sale? Check whether there was an obligation to transport the goods outside Mizoram either on the seller or on the buyer?

(iv) Check whether the goods have physically moved out of the state. This can be verified with the help of the documentary evidence of inter-state movement like consignment notes/railway receipts etc?

(v) Check whether the dealer's claim of concessional rate of tax for inter state sales are supported by original portion of declaration Form "C" as required by section 8(4) and rule 12 (1) of the CST (R&T) Rules and rule 8(2) of the CST (Assam) Rules?

It is settled law that the production of declaration in Form 'C' is not conclusive of the inter-state character of a transaction. [Ref: (1968) 21 STC 350 (Mad) and (2004) 136 STC 379(Gau)].

(vi) Check whether the goods sold by the selling dealer are included in the registration certificate issued to the purchasing dealer? This can be verified with reference to the Certificate of Registration of the purchasing dealer. It is the responsibilities of the selling dealer to ensure that the goods sold by him are included in the registration certificate issued to the purchasing dealer. [Ref: (1966) 18 STC 222 (SC)].

(vii) Check whether the purchasing dealer is registered dealer under the CST Act on the date when the transaction of sale takes place?

(viii) Have the expenses up to the time of delivery been included in sales turnover. Check should be made whether the sale has been made on RO.R destination basis in which case it is the total consideration including freight etc. which is liable to be taxed. In case of FOR Destination, the contract is for delivery at buyer's place and till then the risk continues to remain with the seller. [Case ref: Hindustan Sugar Mills Ltd. reported in [1979] 43 STC 13 (SC)]

(ix) Check whether the dealer, effecting inter-state sales maintains the register and voucher as required under rules 4(1), 4(2) and 4(3) of the CST (Assam) Rules as mentioned below:

- Sale Register,

- True account of day to day purchases sales, deliveries and stock of each kind of goods, .

- A voucher showing name of seller and Purchaser, sale price, quantity, description of goods, mode of despatch & delivery of goods,

- Each voucher is serially numbered.

(x) Check whether the inter-state sales of goods has been made out of locally bought goods or out of imported goods. The distinction is very important in view of availability of input tax credit.

(xi) Check if the dealer has made inter-state sales of goods bought from an industrial unit enjoying remission. It may be noted that the dealer is not eligible for input tax credit on inter-state sales of goods made out of goods purchased from an industrial unit enjoying remission [see Notf. No. FTX.5712005/53 dt.30.03.2007]

(xii) If felt necessary, a statement of inter-state sales may be obtained as per FORMAT VI given in the manua1.

2. Inter-state stock transfer to outside Mizoram

If a dealer sends goods to his branch in other State, it is not a sale as he cannot sell to himself. Similarly, if he sends goods to his agent in other State who stocks goods on behalf of the dealer, it is also not a sale. There is no transfer of property when goods are despatched to branch or to an agent and hence there is no liability to pay tax under the CST Act. These transactions are popularly known as "Stock transfer" or "branch transfer" or "depot transfer". Since there is not tax on such transactions, the dealers try to show even genuine sales to third parties as transactions of this type i.e. stock transfer.

Section 6A of the CST Act, 1956, which deals with such transactions, provides that when a dealer claims that transfer of goods outside State is not a sale, he has to prove that the transaction is a stock transfer and not a sale and for this purpose he has to produce a declaration from the branch/agent from other State in Form "F'. If "F" Form is not produced, the transfer will be treated as sale.

The following checks should be considered:

(a) Checking the admissibility of input tax credit & reversal thereof:

Partial input tax credit is allowable for tax paid on purchases of goods which are sent to other State on "stock transfer" basis;

(i) In case of a trader who makes stock transfer, benefit of input tax credit is available only when input tax credit exceeds the notional CST liability that would have been payable had the sales been made to registered dealer [Section 14(6)(h) of the AVAT Act].

For example, if a trader pays VAT amounting Rs. 1,250/- calculated @ 12.5% on his purchases ofRs. 10,000/- and he sends goods on stock transfer basis (assuming at same value), the amount of input tax credit is restricted to Rs. 850/- only after deducting the notional CST liability of Rs.400/- calculated @ 4% from the total amount of tax paid on· such purchases. Whereas, if the goods so purchased are taxable at 4%, the dealer is not entitled to avail input tax credit for the reason that the tax paid on purchases is equal to the notional CST liability.

It follows that if the input tax credit is less than or equivalent 4% in the first year, no input tax credit shall be available.

Therefore, if a dealer has taken the benefit of input tax credit in respect of full amount of input tax credit on purchase of goods, which are subsequently sent outside the State on stock transfer, the input tax credit to the extent of notional CST liability will have to be reversed.

(ii) If a manufacturer makes an inter-state stock transfer, as per provision of section 14 (6) (i) of the AVAT Act, he shall be entitled for input tax credit only if the input tax credit (ITC) is in excess ·of the tax that would have been payable under Central Sales Tax Act had the raw material been sold to a registered dealer. In other words, if the ITC is less than or equivalent 4% in the first year, no input tax credit shall be available. -

If the raw material used is taxed at 12.5% in the State than 8.5% of the tax amount has to ascertained which is fully admissible and then the remaining 4 % has to be apportioned between the taxable and exempt transactions i.e. stock transfer if a part of the stock is sent outside the State and part is sold inside the State.

However where the entire stock of manufactured goods is transferred out side the State, the remaining 4% is not available for ITC.

Therefore, if the manufacturer has already availed ITC at the time of purchase of raw materials and the finished goods are sent outside on stock transfer, the input tax credit equal to CST liability on the corresponding purchase turnover shall have to be reversed.

(b) Checking the admissibility of exemption in respect of branch transfer:

(i) Check "Stock/Goods Transfer Note" which is usually prepared in case of despatch of goods to branch! depots other than to a commission agent.

(ii) Check if buyer is known or identified before removal of goods from factory, in which case it is not really a stock transfer.

(iii) Whether such stock transfer is supported by the original copies of 'F' Forms [Section 6A of the CST Act, Rule 12(5) of the CST (R&T) Rules, Rule 8-E(2) of the CST (Assam) Rules].

(iv) Whether 'F' Form covers the transfer made during within one calendar month and whether the same has been submitted within 3 months of the end of the period.

(v) Whether such stock transfer is supported by evidence of despatch like copies of Consignment Notes or Railway Receipts.

(c) Checking the admissibility of exemption in respect of stock transfer to commission agent:

In the case of consignment sales, verify the following particulars / documents:

(i) a register showing the name and full address of the agent to whom goods were consigned [Rule 4(4) of the CST (Assam) Rule];

(ii) Description, quantity and value of the goods dispatched for sale on each occasion;

(iii) Contract, if any, in writing entered into between the principal and agent;

(iv) Copies of bills issued by the agents to purchases in other States;

(v) Copies of patties/ account sales rendered by the agent to the principal from time to time showing the gross amount of the bills and deductions such as commission, incidental charges etc. the net amount remitted to the principal;

(vi) Attested extract of the ledger maintained by the agent for each of the principal;

(vii) Copy of the railway receipt or lorry receipt, as the case may be, under which the goods were despatched outside the State;

(viii) Copy of the authorization sent to the non-resident agent for the sale of goods consigned;

(ix) Register showing the date and mode of remittance of the amount to the principal;

(x) Check if buyer is known or identified before removal of goods from factory, in which case it is not really a stock transfer;

(xi) Whether such stock transfer is supported by the original copies of 'F' Forms [Section 6A of the CST Act, Rule 12(5) of the CST (R&T) Rules, Rule 8-E(2) of the CST (Assam) Rules];

(xii) Whether 'F?'Form covers the transfer of goods made within one calendar month and whether the same has been submitted within 3 months of the end of the period.

Note 1: It may be noted that the rule uses the word 'transfer' and hence the question of sale of the goods transferred at the destination is of no relevance.

Note 2 : It should be remembered that stock transfer can only be of standard goods which can be purchased off the shelf. There can be legally no stock of tailor made goods or non standard goods made for a specific customer [Ashok Leyland's case (2004)134 STC 473(SC)].

Note 3 : If felt necessary, a statement of stock transfer containing the particulars given in FORMAT VII may be obtained, with suitable modifications.

Supplementary checks: In addition to the above legal requirements, the following checks should be undertaken:

(i) Are there any firm orders from the agents? If that is so, then it may be pointer to the possibility of the transaction being sale;

(ii) Check the correspondence files with the commission agent;

(iii) Check whether the Principal raises sale invoice on the commission agents. It is important to note that in an agency ·relationship, the principal prepares and sends a pro-forma invoice with the consignment. The pro-forma invoice contains all the particulars of an invoice. But a pro-forma invoice is fundamentally different from an invoice because an invoice serves as a demand for payment of the price whereas a pro-forma invoice does not make the agent responsible to pay the amount named as the transaction is not a sale and hence the word pro-forma is used;

(iv) Check whether the principal despatches the goods either against bank draft or cheque drawn for full invoice value;

(v) Check whether the principal debits the account of commission agents in its books of accounts with the full value of the invoice on despatch of goods and credits the account of the commission agents on receipt of the payment;

(vi) Check whether the principal accounts for the unsold stock lying with the commission agents at the end of the year in his books of accounts;

(vii) Check whether the principal accounts for or books the sales in its books of accounts at the time when the goods despatched are billed by it on commission agents. Sales can be recognized in the accounts of the principal, only after the sale of goods by the consignee/agent to the third party and that too, after getting the confirmation of sales from the agent. It is pertinent to mention that the Accounting Standard (AS 9) which is mandatory, Para 2 Cd) of Part A of the appendix to the said Accounting Standard states that in case of consignment sales i.e. a delivery is made whereby the recipient undertakes to sell the goods on the behalf of the consignor/principal, revenue should not be recognized until the goods are sold to a third party;

(viii) Check whether the principal accounts for the sales in its books of accounts at the price at which the goods were transferred to commission agents;

(ix) Check whether the principal has no concern with the actual price consideration at which the goods were in fact sold by its commission agents to their customers;

(x) Check whether the agent has rendered account sales along with the copies of sale bills at periodic intervals to the principal;

(xi) Check whether the risk in goods remains with the principal because risk usually follows property;

(xii) Check whether the goods are sent against a certain and pre-determined price consideration which can only happen in case of a sale;

(xiii) Check whether the principal issues any credit notes in respect of goods returned by the commission agents or in respect of goods damaged in possession of the commission agents;

(xiv) Check whether the principal deducts any income tax on the ~ount of commission paid to commission agent;

Note: The audit officer before treating any consignment transfer as an inter-state sale, should ensure that each and every transaction be examined [case ref: Tata Engineering case (1970)26 STc.354{SC)]~

(d) Check the applicability of tax on purchase in case of stock transfer:

Section 12 of the AVAT Act provides for levy of tax on purchases in certain circumstances.

In case of inter-state stock transfer; tax on purchase is leviable if the following conditions are fulfilled:

(i) There must be purchase of goods taxable under MVAT Act;

(il) Such goods must be purchased inside the State;

(iii) Such goods must be purchased by a dealer in course of business;

(iv) Such purchases must be made from unregistered dealers without payment of VAT.

If all the above four conditions co-exist and

(a) If such purchased goods are stock transferred to other State in the same form, or

(b) If such purchased goods are consumed in the manufacture of taxable goods and such finished taxable goods are stock transferred outside the State.

Tax on purchase as per the rate prescribed in the Schedules is leviable on the gross turnover of purchase of such goods.

Therefore, in case of stock transfer made by a trader, check should be made whether the taxable goods are purchased inside the State from unregistered dealers without payment of tax and if it is so, whether the dealer has paid the tax on purchase of goods sent outside Mizoram. In case of a manufacturing concern making inter state stock transfer of finished goods, it should be checked whether any raw material has been I purchased in Assam from unregistered dealers without payment of tax and whether the such dealer has paid the tax on purchase of such goods consumed in the manufacture of finished goods sent outside Assam. .

3. Exports

If a sale is export sale, no tax on such sales is leviable under the CST Act as the charging section 6(1) levies tax on inters state sales only.

Section 5 of the CST Act deals with sales in course of export. Under section 5(1) of the CST Act) sale in course of export can be of two types: (a) sale which occasions (causes) the export meaning thereby that the sale and export should constitute part of an integrated activity. (b) sale effected by the transfer of documents of title to goods after they have crossed the custom frontiers of India. Normally this kind of sale is rare in exports as exports are made against firm contract.

Penultimate sale (last but one sale) in course of export: Indirect export or sale preceding the export sale is also considered as deemed export uls' 5(3) on fulfillment of following conditions:

(a) There must have been pre-existing agreement or order to sell the specified goods to a foreign buyer;

(b) The last sale must have taken place after the agreement or order with the foreign buyer was entered into;

(c) The sale must have been made for the purpose of complying with agreement or order in relation to export;

(d) Same goods which are sold in penultimate sale must have been exported;

(e) The exporter must submit Form H (as prescribed under the CST (R& T) Rules) to the dealer who is supplying goods for export if such sale is in course of inter state trade or commerce otherwise the exporter must give Form 56 (as prescribed under Rule 37 of the AVAT Rules) to the selling dealer if such sale is an intra-state penultimate sale.

Export sales are zero rated under section 9 of the MVATAct meaning thereby that no tax on such sales is leviable but the tax paid on purchase of inputs is refundable, of course subject to an exception of Fourth Scheduled goods.

Therefore, exports should be considered an especially vulnerable area. They provide a major field for evasion.

Some of the suggested checks are:

(a) Checking the admissibility of input tax credit:

(i) Check whether the dealer has availed of any input tax credit in respect of export of any goods specified in the Fourth Schedule of the MVAT Act, 2005 which are otherwise ineligible for such credit.

(ii) How much input has actually been used in the exported goods?

(b) Check for evidence that the goods stated to have been exported actually exist:

· Inspection of premises- is similar goods on display?

· Purchase records - are similar goods purchased regularly? If not, send a reference.

· Typical products - are they regular lines?

· Are the goods clearly identified and described on all documents?

Once satisfied that the goods exist, ascertain where they were delivered:

· Directly to the port from which they are to be exported, or

· To an address within the State for onward transportation to the port.

In the latter case evidence of the onward transportation must be produced.

(c) In case of direct export, the following documents can be examined:

(i) Order placed by the foreign buyer,

(ii) Agreement with the foreign buyer,

(iii) letter of credits issued by the overseas bank of the foreign buyer,

(iv) bill of exports or Custom clearance certificate,

(v) shipping Bill or invoices,

(vi) packing lists duly endorsed by the custom authority,

(vii) evidence of actual export in the form of Bill lading! Airway Bill/ Consignment Note,

(viii) Foreign Exchange Realisation Certificate issued by the banker in support of the proof that foreign currency has actually been received, and

(ix) ARE-I (Application for refund export submitted before the excise authorities by a manufacturer).

In case of export to Nepal, the order received from the buyer, individual challan countersigned by the custom authority evidencing the actual export, Lorry Receipts or Consignment Notes, Bill of Exports duly endorsed by the Custom Authority containing the Registration Number of each vehicle and the challan/bill numbers and the evidence of payment etc. may be examined.

In case of export to Bhutan, the order received from the buyer, individual challan countersigned by the custom authority evidencing the actual export, Lorry Receipts or Consignment Notes, Exemption Certificate duly issued by the Royal Government of Bhutan containing the challan/bill numbers which in turn covers the individual vehicle number and the evidence of payment etc. may be examined.

(d) In case of penultimate sale in course of export:

(i) if such penultimate sale is inter-state one :

- Chronology of export events to check whether the last sale has been made after receipt of the export order or not,

- verify whether the dealer had received any 'H' Form from exporters,

- if so, verify whether the goods mentioned in Form H are the same as the goods that are exported,

- verify the evidence of actual export in the form of Bill of lading! Airway Bill! Consignment Note,

- check letter of credit, and agreement from foreign buyer to ascertain the genuineness of the export claim;

- Check the evidence of payment.

It may be noted that a copy of the bill of lading to prove the export must be attached to this Form. Form H has to be submitted to the first assessing authority at the time of assessment. Rule 10(b) of the CST (R&T) Rules makes the same "manner" applicable to the prescribed export certificates as have been prescribed for "C" Form of declaration.

(ii) if such penultimate sale is intra-state one:

- Chronology of export events to check whether the last sale has been made after receipt of the export order or not,

- verify whether the dealer had received any Form 56 under the AVAT Rule from the exporter,

- if so, verify whether the goods mentioned in Form 56 are the same as the goods that are exported,

- verify the evidence of actual export in the form of Bill of lading/ Airway Bill! Consignment Note,

- check letter of credit, and agreement from foreign buyer to ascertain the genuineness of the export claim,

- check the evidence of payment.

(e) Other checks :

(i) Whether the document produced is original? Photocopy documents are not acceptable as evidence of exportation. In case of any doubt as to the validity of any document, a reference should be sent to the Customs at the port of exportation, as necessary.

(ii) Other questions to consider are:

· Are all the goods descriptions, including weight, value and quantity, the same on all documents?

. Were the goods delivered abroad?

. Are the goods of a kind to be easily marketable if diverted to the domestic market?

(iii) Where exports of goods are substantial, and particularly where newly registered dealers are receiving a first audit visit, officers should consider whether the volume of exports is in keeping with the capacity of the business to handle it.

Audit of refund in case of export

Section 44 of the MVAT Act provides for provisional refund arising on account of export sales against furnishing of a bank guarantee pending audit of such export claim. According to Rule 62 of the MVAT Rules, the dealer has to make an application. After final audit assessment, the bank guarantee shall be released.

Alternatively, the dealer can make an application for refund in Form 43 within 30 days.

The application shall be accompanied by the following documents:

(a) Order placed by the foreign buyer,

(b) Agreement with the foreign buyer,

(c) Letter of credits issued by the overseas bank of the foreign buyer,

(d) Shipping Bill or invoices,

(e) Custom clearance certificate,

(f) Bill of lading/Airway Bill/Consignment Note,

(g) Evidence of payment,

(h) "H' Form etc.

In addition to the above prescribed documents, the Prescribed Authority can also verify other evidences as may be required which may include Foreign Exchange Realisation Certificate issued by the banker in support of the proof that foreign currency has actually been received and ARE-I (Application for refund export submitted before the excise authorities by a manufacturer).

The Prescribed Authority shall arrange for tax audit within one month and shall sanction the refund claimed within 90 days.

4. Tax on Purchase payable under VAT

· Check whether there are purchases from unregistered dealer of taxable goods inside Assam which have been:

sent to other state on branch transfer/ consignment sales,

used as input in the manufacture of exempted goods,

used as input in the manufacture of taxable goods sent on branch transfer/ consignment sales.

Where such goods are identified, ensure that the tax has been accounted for by applying the tax rate in the MVAT Act, 2005 to the purchase value. Where VAT has not been accounted for, raise a demand.

· Note: Purchases from dealers under composition scheme should not be considered as purchase from un-registered dealers.

· Where the goods purchased from unregistered dealers are processed and one of the byproducts is sold IqGally and the other by-product is sent on a stock-transfer, or a part of the finished goods is sold locally and the remaining is sent on stock transfer, the value for VAT is to be calculated on the proportionate purchase value of the goods on which the VAT liability accrued.

Proportionate purchase value = Total purchase X stock transfer

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Gross turnover (local sales+ stock transfer)

Illustration: Bamboo purchased from un-registered dealers is used in manufacture of paper which is sold locally and is also sent on stock transfer.

The purchase value of bamboo = Rs. 9,00,000/-

The sale value of paper . = Rs. 4,00,000/-

Stock transfer value of paper = Rs. 2,00,000/-

Proportionate purchase value of bamboo on which purchase tax is payable

$$= \frac{900{,}000 \times 200{,}000}{600{,}000}$$

= Rs. 300,000/-

5. Industrial unit enjoying tax incentives

(i) Industrial unit enjoying tax incentives at the introduction of VAT

Under the Assam Industries (Sales Tax Concession) Scheme, 1997, which was basically an exemption scheme, all local purchases of input and sales of finished goods manufactured by the eligible unit were exempt from local sales tax and central sales tax.

Maximum limit of exemption was fixed with reference to percentage of fixed capital investment. If the unit reaches the admissible amount before the time limit fixed, it will not be eligible for incentive thereafter.

,The unexpired time limit and the un-availed monetary ceiling of the existing industrial unit enjoying sales tax exemption have been allowed to be carried forward under the VAT regime by way of conversion of exemption into a remission scheme.

The notable difference is that the unit und~f remission scheme will pay tax on purchase of raw materials and charge tax on sales of finished goods and will,issue tax invoice to maintain the VAT chain.

The suggested checks are:

Pre VAT Period i.e. before 01105/2005:

Check whether the unit possesses Certificate of Eligibility from Industry Department under the Assam Industries (Sales Tax Concession) Scheme, 1997;

Check whether the unit possesses Certificate of Authorization under the 1997, Scheme;

Check whether the unit filed Annual return & monthly statements under the AGST Act, 1993 and the CST Act, 1956;

Check whether the unit also filed return in Form VIII under Assam Industries (Sales Tax Concession) Scheme, 1997;

Post VAT Period after 01105/2005:

Confirm whether the exemption under 1997 scheme has been converted into remission for the balance/unexpired amount and whether the balance/unexpired period has been extended by multiplying with 917.

Check whether the unit has applied for Certificate of Entitlement ,of the Assam Industries (Tax Remission) Scheme 2005 ;

Check whether the unit possesses Certificate of Entitlement from Tax Authority;

Check whether the unit has been filing tax returns in Format IV and annual return in Format V of the Assam Industries (Tax Remission) Scheme, 2005;

Check whether the unit has been filing return under the C ST Act, 1956;

Check the input and input tax credit of the unit as per the guidelines mentioned in this manual;

Check the output and output tax as per the detail guidelines given separately in this manual;

Check whether the correct rate of tax has been applied on sales by the unit;

Check whether any input tax credit has been claimed in respect of manufacturing of goods taxable at the first point of sale under the Fourth Schedule (which is otherwise ineligrble);

Check whether the unit has been paying 1% of the tax due under the AVAT Act and the CST Act.

Check whether the unit enjoying remission, has been mentioning the number and date of Certificate of Entitlement in the invoice issued by it along with a declaration that the goods sold by it are covered by the remission scheme [see notf. No. FTX.57/2005/53 dt.30.03.2007];

Check whether the unit is claiming any transport subsidy, if so, whether any sale has been shown on F.O.R. destination basis;

(n) Industrial unit commencing production & enjoying tax incentives after the introduction of VAT

The new industrial unit which commences its commercial production after introduction of VAT i.e. 1st May, 2005 and the existing unit the resultant commercial production of which after expansion/modernization or diversification commences after introduction of VAT have also been allowed exemption under the Assam Industries (Tax Exemption for Pipeline Units) Order, 2005.

The suggested checks are:

Check whether any 'manufacturing activity' is really carried by the unit as per the new definition of "manufacture" given in section 2 (30) of the AVAT Act. As per the new definition, the manufacturing activity must result into transformation of a new article having distinct name, character and use. It may be noted the definition contained in the erstwhile AGST Act was considered as wider defmition in some judicial pronouncement;

Check whether the unit's activity falls under the c~tegory of negative or ineligible list;

Check the monetary limit of tax incentive/remission. Is it commensurate to fixed capital investment?

Check the fixed capital investment. Verify the cost of fixed assets acquired with reference to quotation; invoice, purchase agreement and the receipt of the seller in respect of price paid, use of Road Permit for transportation of the assets in case of inter state acquisition and vehicle registration number. Corroborate the particulars with the check post authorities ,to see whether there is actual import of the assets or not;

Check expenses incurred for development of property with reference to budgets, sanction and technical report and the bills for actual expenditure incurred and the receipt for payment made;

Make a physical inspection to check the existence of fixed capital investment, such as plant & machinery, where practicable, and compare the particulars of assets as are entered in the Schedule attached to the Balance Sheet with the plant or property register and reconciling their total value with general ledger balances;

Check whether the dealer has claimed input tax credit in respect of non-eligible items used as fuel, lubricant, stores etc which have been excluded from the definition of "raw materials" as given in section 2(38) of the AVAT Act;

Check whether the unit possesses Eligibility Certificate from Industry Department under the Assam Industries (Tax Exemption for Pipeline Units) Order, 2005;

Check whether the unit possesses Certificate of Entitlement from Tax Authority;

Check whether any input tax credit has been claimed in respect of manufacture of goods taxable at the first point of sale under the Fourth Schedule (which is otherwise ineligible);

Check the manufacturing account in details. Obtain the figures of quantity and value for each kind of sales/despatch i.e (a) local sales- to registered dealers and unregistered dealers, (b) inter-state sales- to registered dealers and unregistered dealers,(c) Export - direct export and penultimate export (d) inter-state stock transfer;

Check whether the quantity of annual production shown by the unit is commensurate with its annual installed capacity;

Check whether the industrial unit is claiming transport subsidy on purchase of raw materials and sale of finished goods under the North East Industrial Policy, 1997 or under the North East Industrial & Investment Policy, 2007. The transport subsidy is available under the "Transport Subsidy Scheme, 1971". Various documents are ftled claiming subsidy, such as Statement of raw materials purchased, Statement of raw materials utilised and production, Statement of finished goods despatched, capacity assessment certificate, bills and challans of raw materials purchased, receipt from carriers, bills and challans of finished goods, affidavit to the effect of having complied with all the requirements. Check can be made whether the unit is showing any EO.R. destination sales.

A cross check at regular interval with the industry of the above information and cross verification of particulars furnished to other departments like Pollution Control Board, State Electricity Board, Inspector of Factories, Labour department and financial institution may lead to detection of vital clues.

6. Import of taxable goods for re-sale

‘Import' is to be understood as bringing of goods in Mizoram from other state or country, as a result of purchase or otherwise.

The receipt of goods by a commission agent in Mizoram from an outside Principal or receipt of goods by a branch from its head office in other state falls under the definition of import. An importer is a dealer who makes first sale of such goods after import into Mizoram.

According to section 7(6), the taxable quantum /threshold limit in respect of an importer is nil meaning thereby that an importer is liable to pay tax even in respect of first transaction of sale of such imported goods and therefore the dealer is liable to be registered under the MVAT Act.

In respect of a dealer, who claims to have made inter-state import of taxable goods, the following checks can be considered:

(i) Check whether the "Registration Certificate" duly covers the goods so imported;

(n) Check whether the goods so imported are either sold or used in accordance with the purpose mentioned in the Registration Certificate;

(ill) Check whether the goods have been imported on the strength of "Delivery Note" (Form 61) duly obtained by the importer from his jurisdictional tax authority;

(iv) Check whether there is any discrepancy between the particulars received from checkpost and those furnished by the dealer;

(v) Check whether the importer obtained any "Delivery Permit" (Form 66) from his jurisdictional tax authority in respect of import of gods by rail/air etc before taking delivery of goods from the transporter;

(vi) Check with reference to invoices/ pro-forma invoice/stock transfer note whether the imported goods taxable at different rates are duly accounted for in different heads of Purchases/goods Alc;

(vii) Check whether the dealer has duly accounted for "freight inward" in his accounts and whether the net sale price of goods is higher compared to landing cost of goods;

(viiI) Apart from the above checks, in respect of inter-state purchase the following checks should also be exercised :

(a) Verify whether the dealer has claimed any input tax credit on purchases made using the C Forms. If any input tax credit is claimed, initiate immediate action to raise assessment by treating the amount as under- declaration;

(b) Check whether the importer has issued any "C" Form to avail the concessional rate on inter-state purchase;

(c) Check whether the dealer is registered U/S 7(2) of the CST Act;

(d) Check whether the item imported is covered by the Registration Certificate under the CST Act;

(e) Check the counter-foil of the "c" Form issued to various suppliers. When one "C" form is issued covering multiple transaction, a possibility always exists that dealer may show lesser transactions in counterfoil of "C" forms retained by him and showing the entire transactions in the "C" Forms issued to the selling dealer and to uncover such practice, inter-state cross verification may be required;

(f) Check whether the Register of declaration Form in Form II as required under rule 8(5) of the CST (Assam) Rules, is maintained by the dealer;

(g) Check the evidence of payment made to the selling dealer;

(11) Verify whether the dealer had used the C Forms for the correct purpose as per the provisions of Section 8 (3)(b) of CST Act r/w rule 13 of the CST(R&T) Rules. As per the provisions of CST Act, a dealer can use C Forms for the

purchase of goods meant for re-sale, or for use by him in the manufacture or processing of goods for sale or in mining or in the generation or distribution of electricity or any other form of power or for use in the telecommunication network or packing material;

(i) . If the dealer had misused the C Forms for purchasing goods other than those mentioned in the above clause, e.g. for consumption; the officer should initiate action to levy penalty under Section 10 of CST Act.

(ix) Apart from the checks, mentioned up to clause (g), .following checks should be undertaken in respect of inter-state receipt of goods on stock transfer basis:

(a) Check whether the importer has issued any "F" Form on inter-state receipt of goods;

(b) While Form "C" can cover only such goods are specified in the certificate of registration, Form "F" is completely free from any such shackle.

(c) Check the counter-foil of the "F" Form issued to various suppliers. When one "F" form is issued covering multiple transaction during a calendar month, a possibility always exists that dealer may show lesser transactions in counterfoil of "F" forms retained by him and showing the entire transactions in the "F" Forms issued to the Transferor/Principal Head Office and to uncover such practice, inter-state cross verification may be required;

(d) Check whether the Register of "F" Form in Form IIA as required under Rule 8E of the CST (Assam) Rules, is maintained by the dealer;

(e) in case the recipient of goods is a commission agent, check whether has he rendered any account sale to the ex-state principal and whether has he earned any commission on such sale. Check how the payment has been remitted to the principal. Any unsold stock lying with a commission agent at the end of the year should not be included in the closing stock belonging to the commission agent.

Note 1: Sale made by a commission agent in Assam on behalf of an out-state principal is to be included in the Gross Turnover shown in the tax return/annual return filed by the commission agent though such sales is not made in his own account. The agent is a deemed dealer for such sale and is liable to pay tax on such sales under the AVAT Act. The situation is treated differently under the Income Tax Act.

Note 2 : If necessary, a statement showing inter-state purchase/ receipt of goods in FORMAT VIII, with suitable modifications, may be obtained.

7. Checking the first point tax on foreign liquor

Foreign liquor including Indian made foreign liquor (IMFL) is taxable at the first point of sale under the Fourth Schedule vide section 10(1)(b) of the MVAT Act According to the first point sales tax system, the tax is either payable by a manufacturer who makes the first sale inside the State or by an importer who makes the first sale in the State.

But, in case of sale of such liquor, the sale made by a bonded warehouse to a wholesale licence holder or a retail licence holder shall be deemed to be the first point of sale. Therefore, when an IMFL manufacturer in the State sells liquor to another bonded warehouse or when an bonded warehouse, which imports and sells liquor to another bonded warehouse, though such sales are the first sales within the State, by virtue of legal fiction such sales are not deemed to be the first sales [see explanation 2(i) to section 1 0(1)(b)]. To put it in simple words, inter bond sales are not to be considered as the lust sales for the purpose of levy of tax. The purpose is obvious. When one bonded warehouse sells such liquor to another bonded warehouse there is no application of state excise duty. Therefore, the point of collection of tax on sales has been sought to be synchronized with the collection of state excise duty. Now the retail licence holder before lifting the liquor from a bonded warehouse is not only required to deposit the state excise duty but also the tax on sales.

The factors which affect the pricing of liquor are basic price, excise duty, availability fees, gallonage fees, import fees or transport fees etc.

Since such liquor is also governed by the State Excise Act, it is also useful to know the excise procedure applicable to such liquor, as below:-

Procedure applicable under the State Excise law to the selling of Indian Made Foreign Liquor (IMFL):

In the case of foreign liquor, the licensee has to supply for issue of permit after payment of duty into the treasury by challan at the rates prescribed by the Government and produce the same to the Superintendent of Excise. Thereafter, the permit for import of foreign liquor from outside the State is issued. The gallonage fee on foreign liquor is payable on the basis of the sale during the previous month at the prescribed rate.

There are bonded warehouses in the state for storage and issue of foreign liquor. The licensees of these bonded warehouses import their requirements from outside the S tate on the basis of the import permits issued by the Commissioner of Excise. They import the liquor under bond without payment of duty and deposit the same in the warehouse. There is one Excise Officer in charge of each bonded warehouse. The retail and wholesale licensees get issue of their requirements from these bonded warehouses. They have to first apply for permit to the District Authorities after payment of the duty into the treasury by challans. Then, they produce the same with a copy of the challan to the Officer-in-charge, who then issues the liquor on the basis of the permits and the challans. In these case also, gallonage fee is payable in the month following the month of the sale.

The following checks are suggested:

(i) Obtain a monthly statement of inter-state purchase/receipt from the bonded warehouse. Such statement should, inter alia, contain name of the suppliers, invoice no., date, and amount, name of brand, quantity size-wise, vehicle no. and Excise Permit No. and Delivery Note No. under the AVAT Act & "C" Form No. etc., Alternatively, in Format VI given in this manual additional column of Excise Permit No. can be added.

(ii) Obtain a monthly statement of intra-state (local) purchase from another bonded warehouse. Such statement should again be for purchases made from each bond within the State so as facilitate cross checking of transactions. Such statement should, inter-alia, contain the name of the suppliers, invoice no., date, amount, name of brand, quantity size-wise and Excise Permit No. etc.

As there is no prescription of any declaration fonn for inter-bond sales transactions, which do not attract any tax on such sales, such transactions should be considered as prone to evasion of tax and should be checked cm.:efully.

It may be noted that the liability to pay tax is shifted to the purchasing bonded warehouse, which is liable to pay tax on sale of such liquor made to retail licence holder out of locally procured liquor from another bonded warehouse.·

(iii) Check the purchases with reference to source document i.e. invoice. Check whether they have been duly accounted for;

(iv) As the entire sales to retail licence holder are made against excise permit, sales invoice on sample basis should be checked with reference to excise permit;

(v) Check the sales account/sales book with reference to sales invoice;

(vi) Check whether the tax on sales is calculated on the final sale price including excise duty or any other fees payable as per the definition of 'sale price' as contained in section 2(44) of the MVAT Act;

(vii) The tax, which is pre-paid by the retail licence holder before lifting the liquor from the bond, should be considered as tax paid by the retailer on behalf of the bonded warehouse [see explanation to rule 17(3)].

(viii) Check the quantitative details of purchase and sales with excise records maintained in the bond;

(ix) When a bonded warehouse claims exemption from payment of tax on its sales on the ground that such sales are merely inter-bond sales, the particulars of such sales should be sent for cross verifIcation to the tax officer having jurisdiction over the purchasing bonded warehouse;

(x) Check whether any input tax credit has been claimed by a manufacturer or importer on purchase of inputs. It may be noted that the input tax credit in respect of Fourth Scheduled goods is not admissible;

(xi) Check whether the dealer has been issuing "Retail Invoice" in respect of all its sales. It may be noted that since liquor is included in the Fourth Schedule, "Tax Invoice" cannot be issued in respect of sale of liquor.

(xii) The retail licence holder is not liable to pay tax on sale of liquor since liquor suffers tax on the first sales. All the subsequent! second sales are treated as tax paid sales only. However, when a dealer claims to have purchased goods taxable at the first point of sale from a registered dealer and claims that he is not liable to pay tax on second/subsequent sale of such goods being the tax paid goods, the dealer must attach Statement of Tax-paid Purchases, in duplicate, as per CT's circular no. CV 2/86/69 dated 26.11.1987. Such statement shall be according to the FORMAT IX.

3.10 Study of Debit Notes & Credit Notes

When goods are bought or sold on credit and the goods are returned or some changes in the price are to be made on account of discounts etc which requires adjustment in the amount payable or receivable, then such adjustment is done on the basis of some documents called Debit Notes and Credit Notes.

What is Debit Note?

Debit Note is a note or a statement prepared by business organization intimating another person or recipient of the note that his account has been debited with the amount stated in the note for the reasons given in the debit note.

It is prepared in duplicate, the original sent to the person whose account has been debited and the duplicate is used for passing an accounting entry.

Generally it is issued by a debtor (purchaser) to a creditor (seller). The seller after receiving the Debit Note sends a credit note to the purchaser.

But sometimes a seller al~o issues a Debit Note if, for any reason, the amount stated in invoice is less than what should have been stated.

If one party sends Debit Note, other party sends Credit Note and vice versa.

Reasons for issue of Debit Note:

In case of purchase of goods

i) Return of goods to supplier
ii) Short receipt of goods
iii) Price reduction claimed by buyer for defective goods or higher price charged by a supplier.
iv) To claim deduction for discount

In case of sale of goods

v) Increase in rate/quantity
vi) Increase in excise duty, sales tax

vii) Recovery of packing charges, transaction charges, handling charges, warranty charges or after sales service charges from a customer in relation to the sale of good

Other reasons

viii) Extra charges billed by service provider, say a transporter charged Rs, 7000 per lorry instead of Rs. 6000

ix) Debiting insurance company while lodging insurance claim

x) Recovery of charges like advertisement expenses, sales promotion activity charges from customers.

What is Credit Note

A Credit Note is nothing but intimation for having credited the account with a certain amount of the person to whom the Note is sent

The seller issues a Credit Note to the buyer for the value of the goods returned or when the price is overcharged due to some clerical or other error or for the quantity/off-take discount is given.

A Credit Note is issued in the following cases:

i) When buyer returns goods,

ii) When an allowance for damage, defective or short quantity is given,

iii) When buyer returns an empty container,

iv) Issue of debit notes by another person, say a customer or a supplier or job worker

Implication of Debit/Credit Note:

All the credit and debit notes will result in (a) reduction of output tax in the hands of the seller issuing credit notes and (b) reduction of input tax in the hands of buying dealer and it should be done in the return for the tax period in which such credit notes are issued and received.

Section 10 of the MVAT Act which provides for adjustment in output tax clearly lays down that output tax will have to be reduced in the books of seller, when the output tax charged exceeds the output tax actually/properly chargeable either when goods sold are returned within SL'C months from the date of sale or when there is change in the price consideration already charged for the reasons of discount etc.

Particular attention should be given to Credit Notes. When a supplier grants a Credit Note to a registered customer, it affects in two direction: firstly, it reduces the output tax liability of the seller and secondly it reduces the customer's entitlement to input tax deduction for the period in which the Credit Note is issued.

Similarly, when a seller issues a Debit Note, it directly increases output tax liability of the seller and increases the input tax credit entitlement of the purchaser:

As per Section 14(9)(e), the input tax credit already availed of, shall be reversed in the books of the purchasing dealer, if the purchased goods are returned to the selling dealer.

Again as per Section 14(9)(g), the input tax credit already availed of, shall have to be reversed in the books of the purchasing dealer, if such purchasing dealer receives a Credit Note from the selling dealer.

The following checks should be undertaken :

o Whilst verifying the books of purchaser, to confirm whether the input tax figure has been properly adjusted either in "Input Tax account" in the "VAT account" on account of Credit Notes;

o Compare Credit Notes with Purchase Return books or any other similar records;

o Whilst verifying the claim for reduction in output tax of a selling dealer, .check (i) whether the goods claimed to have been returned have actually been returned within six months of sale, (ii) whether such return has been shown in the tax return of the period in which such goods have been returned, (iii) whether such sales return is supported by a Debit Note issued by the purchasing dealer and (iv) the same has returned to stock and the stock balance has been adjusted [Rule 9(4)];

o To check, inter alia, whether the Debit Note or Credit Note contains the number of relevant tax invoice;

o To check whether the amount of tax credited or debited is shown in the Debit Note or Credit Note;

o When extensive credits of output tax are granted to dealer's records should be examined. The officer should normally compare the record from which posting to the VAT account are made with a sequence of outward credits notes, with sales ledger accounts, and with sales return books;

o Particular attention should be given to examining credits between related businesses;

o Officers must bear in mind the possibility of fraud involving completely false credit notes;

o If credit not are issued without VAT adjustment, they should state "This is not a credit note for VAT" Even if the dealer and his customer decide not to adjust the VAT on credit notes which pass between them, the dealer will still need to adjust his records of outputs and inputs in order to complete his VAT return;

o Rule 34 of the A V AT Rules lays down that a credit or debit note shall contain the following details.-

(i) the nature of the document issued, whether credit note or debit note;

(ii) a consecutive serial number;

(iii) the date of the issue of the document;

(iv) the name, address and registration number of the selling dealer;

(v) the name and address of the buyer, together with buyer's registration number, if registered;

(vi) description, quantity and value of the goods (excluding tax) returned;

(vii) the amount of the tax credited or debited;
(viii) the number and date of the relevant tax invoice;
(ix) a brief explanation of the circumstances giving rise to the issuing of the debit note or credit note; and

(x) signature of the selling dealer.

3.11 Physical Verification

Although the audit is through documents it may sometimes be necessary to resort to physical verification of goods. Documents can be falsified but physical absence of goods cannot be rectified. However, the physical verification should not be resorted to too often.

Inventories normally comprise raw materials, work in progress, finished goods, including by products. The audit officer may take physical count of inventories and compare the final inventories with stock records and other corroborative evidence e.g. stock statement submitted to banks for cash credit! overdraft taken from bank against hypothecation of stock.

Any discrepancy noticed in the physical verification should be investigated.

a) Excess stock of inputs would indicate purchases made without proper bills whereas excess output would indicate under-declaration of related inputs. In both the cases, the dealer would not be eligible for any input tax credit as these are not VAT purchases covered by tax invoices.

b) The audit officer shall proceed against input or excess output treating them as goods unaccounted for and go ahead with procedures of seizure and confiscation as outlined in the A V AT Act.
The audit officer may collect security deposit of an amount, which is equal to two times the tax due on the goods, and release them.

In case of an industrial unit enjoying tax incentives, the amount of incentive is linked to fixed capital investment. The existence of fixed capital investment, such as, plant & machinery, where practicable, should be verified by a physical inspection and by comparing the particulars of assets as are entered in the Schedule attached to the Balance Sheet with the plant or property register and reconciling their total value with general ledger balances.

This method can be used only if there is positive suspicion after examining the documents. It is useful to have the threat of physical verification though it may not be used.

Truck drivers can be required to carry consecutively numbered manifests corresponding to an invoice giving particulars of what is carried and the names and addresses, with registered number, of the buyer and seller. In Europe, some of the more blatant (and successful) schemes for VAT evasion have involved illegal movement of goods across international boundaries, and physical checks are useful in this context. These physical checks on merchandise and of the movement of goods ought to be considered as additional tools of enforcement.

3.12 Discussion with assessee

Before finalizing the objections, the audit party should meet the person in authority and thank him for the cooperation.

(a) As the audit progresses, the officer should list all discrepancies as they are discovered for discussion with the VAT dealer at the end of the audit If there appear to be major problems with the accounts, the issues may have to be discussed with the VAT dealer during the audit Otherwise, at the end of the audit visit the discrepancies identified should be resolved with the dealer;

(b) The initial calculation of any under-declaration and/or over-declaration of VAT should be completed at the VAT dealers' premises;

(c) At the end of the visit and before leaving the VAT dealer premises the audit officer should review the work done against the original audit strategy,

(d) The objective should be to ensure that all points originally intended to be covered have been completed, to see if anything remains to be clarified and to identify whether anything new has emerged which has not been followed up;

(e) The officer should attempt to close the visit in a constructive and positive manner The officer should leave the VAT dealer with a list of all discrepancies identified, and detailed explanations of the errors, which have been found;

(f) Indications about malpractices, forgery etc noticed should not, however be given, since further verification or investigation may be adversely affected.

CHAPTER - 4

AUDIT REPORT & RESULT OF AUDIT

4.01 Audit report

On completion of the audit, the officers should proceed to finalise the audit report. The essential elements of post audit action should be to:

(a) Update the summary of dealer's activities in FORMAT I;

(b) Summarise all the irregularities found;

(c) Inform senior officers of the business of the findings;

(d) Factor to be considered in closing the audit visit are'::

· Suspicion of fraud, but no suspicion of fraud,

· Tax under-declared,

· No discrepancies.

(e) In case of under declaration, issue a proposition notice to the dealer. On the basis of the reply furnished by the dealer or if he does not response, further action shall be taken;

(f) Submit the audit report, which, inter alia, may contain the following:

(i) the period(s) audited,

(ii) taxable turnover,

(iii) tax liability,

(iv) export,

(v) exempted sales,

(vi) taxable purchases/ import,

(vii) tax exempt purchases,

(viii) Cross checking of inter-state sale/stock transfer with other sales, cross-checking of export-documents used to prove export,

(ix) Suggestion if the firm needs to be audited more frequently in future than the normal requirement,

(x) Finally, the audit team should enter the summary of audit objections in the computer in the Assessee Profile File as per the following proforma-

I. Dealer's name,

II. R.C. No.,

III. Period(s) of Audit,

IV Previous objections not settled so far,

V. Present objections raised (important ones),

VI Date on which it has been forwarded to Charge/Zonal Division.

The report to be submitted can be in FORMAT XIII, with suitable adjustment of particulars.

The officer should review the work complete on the visit and ensure that all the appropriate action has been completed

4.02 How to measure the result of Audit

To secure an effective operation of the audit programme to the greatest possible extent, it is necessary to monitor the results. The measurement of the result should consist of the following elements:

(a) Number of completed audits;

(b) Number of case where discrepancies have been deleted in audit

(c) Number of cases and the amount of tax payable, where the audit has deleted that such amount payable by the dealer on account of VAT, has not been paid by him.

(d) Amount of tax payable as an outcome of the Audit

These measurements should be made for each and every group of auditor. However the indicators should be interpreted with caution

4.03 Monitoring of Audit

Every month on a particular date the Officer-in-charge of audit should hold a meeting of all the audit teams so as to assess the nature of objections being raised and the progress of the work

CHAPTER - 5

INVESTIGATION

5.01 General

The experience is that tax evaders develop various sophisticated methods for evasion of sales tax. The books of accounts are generally so prepared that it becomes very difficult to detect evasion from those. Generally tax is evaded either by under-stating sales or by inflating closing stock Another common method is of inflating claims of various types.

Evasion leads to accumulation of black money, which manifests itself in forms like investments in real estate, un-accounted stock, un-disclosed bank accounts, lavish life-style, etc.

Investigation can be made either directly or indirectly. Investigation is direct when the auditor collects incriminating evidence against the dealer and establishes the mode of evasion. Where certain receipts due to sale have been suppressed the auditor will have to collect evidence from the parties who have purchased the goods from the dealer against payments, which have not been eventually recorded in the books of accounts of the dealer under audit For this, books of original entry will have to be examined and records of production, sale, stock, etc. should be subjected to an intelligent scrutiny. The records of major debtors and creditors require verification of the evasion of the dealer under audit. The indirect method involves the process whereby concealed or un-recorded sales or purchases are traced out by a close scrutiny of the books of accounts of the dealer under investigation.

When a decision for detailed investigation is taken the audit officers will start preliminary enquiries on the following lines:

(i) Names of business units: On many occasions it is found that the dealers have expanded their business on the strength of evaded amount of tax. Such expansion may be either by one or by different business units. Names of such units are required to be ascertained. Personal visit may be enough to collect the names of different units, if they are situated in the same building. The names may also be collected from telephone directory.

(ii) Assessment records - Once the audit officers know the names of the business units they should study assessment records of those units and note down important points. The study may disclose various contradictions and may lead to important clues.

(ill) List of banks- names of banks with which the dealer under investigation and his associates have accounts is to be prepared. Large transactions are to be noted and verified.

(iv) List of major debtors and creditors- The names of major debtors and creditors along with their complete address are to be noted.

Verification of allegations in tax evasion petitions - Information contained in anonymous and other petitions may be utilized properly if the following procedure is followed:

(a) The petition should be kept in safe custody and a summary of all the allegations should be kept in a confidential folder

(b) The allegation should not be disclosed to the dealer under investigation. Experience shows that it is easier to get an admission to a dealer if he is kept in darkness about the allegation. While the assessment should not be completed without giving the dealer an opportunity to rebut, all necessary information regarding the allegation should be collected and verified from independent source before confronting the dealer with the name.

(c) If the allegations appear to be vague an effort may be made to contact the informer and to collect specific information.

5.02 Duplicate set of accounts

Before commencement of the examination of books of accounts, external characteristics of the books of accounts should be observed. The audit officers should be alert if he finds that-

(i) The books of accounts are spotless-Generally it is very difficult to keep the books of accounts spotless, if the accounts are written regularly.

(ii) The entire are written in one hand- if the entries are found to be written throughout by one hand, it should be checked whether the concerned person was the dealer's employee throughout the year. The names of the persons who have written the books of accounts should be ascertained and the dealer should be asked to show that the salaries of those persons have been duly shown in the books of accounts.

It may also be useful to compare hand-writing of the entries made in different books of accounts for different parts of year.

Scrutiny of trading account, manufacturing account, profit and loss account and balance sheet should form the starting point of the enquiry. However, in order to locate the clue to the tax evaders' system, coordinated examination of various books, bank passbook and other records should be undertaken. Sometimes it may be necessary to apply all the checks while at times a single check may be sufficient.

Development of capacities for detecting goods- If for goods reasons it is suspected that a particular entry in the books of accounts is false; the audit officer must check it from every angle possible. If he addresses problem too exhaustibly, lot of time may be wasted. The art of selecting entries for verification is the most important skill for any audit officer and audit officer has to restrict his enquiries to a few selected entries and it is the selection of these entries that speaks of the skill of the audit officer.

5.03 Clues and their follow-up

Clues: Unearthing vital clues is the most important work of an audit officer. An audit officer has to develop himself so that he is properly equipped to pick up clues, which may even be lying on the surface.

i) Observations and deductions - An audit officer should be on the alert for finding out fraud and also the methods of proving fraud. For example, a printer's bill may be an innocuous document but it may give information regarding an invoice book which has not been produced before the audit officer.

ii) Imagination- the audit officer should be able to visualize the nature of primary records a dealer should maintain The officer should also think of the methods of frauds that may be adopted. For instance, a rent receipt of some obscure premises may be of no interest in itself but it may give some food for thought and the audit officer may find out a place where goods are stored and have been kept out of the stock sheets.

iii) Tenacity- an audit officer should have the tenacity in the face of reverse and disappointment This will help him to get clues in his work

iv) Intuition - An audit officer should cultivate this virtue. In investigation, the danger of seeing the wood for the trees cannot be ruled out It is not possible to exhaust every possibility because in that event investigation will continue for an indefinite period It is intuition which helps an investigation officer or an audit officer to lay hands on the clues that work. Clues can be in the books of accounts as well as outside the books of accounts. The type of clues that an audit officer may ordinarily come across may be classified in the following way-

a) **Credit**

i) Where cash actually comes in and is accounted for in the books of accounts:

ii) Where cash does not come in but credits in personal accounts balance the bogus debits in the various accounts such as purchase, wages etc.

b) **Purchases:**

i) Purchases may be bogus.

iI) Purchase may be genuine but the price may be inflated.

c) **Sales:**

There may be suppression and/ or under-statement of sales

d) **Stocks:**

Stocks may be under valued or suppressed.

The clues may appear in the form of erasure or over-writing. Generally when accounts are manipulated subsequent entries are erased and replaced by convenient entries..

There are instances where dealers were found issuing bogus sale voucher for nominal commission to the intending purchasers. As a result of issue of sale vouchers the purchasers become the owner of the goods at a depressed price and as a consequence the subsequent sale of the purchaser is noted at a inflated price leading to evasion of tax. So it is necessary to check the vouchers of both sales and purchases as far as possible.

5.04 Follow-up

The study of the dealer's organizational set-up is necessary before an audit officer starts his work It is necessary to ascertain what type of work is done and what type of records are being maintained

In case of a manufacturing unit an audit officer should proceed in a logical manner from the point of in-ward entry of raw material to the outward despatch of goods. Study of organizational set-up may enable the audit officer to determine the line of investigation and identification of the weaknesses of the dealer. The study of organizational set-up includes the study of the office routine, the maintenance of in-ward and out-ward register, the manner in which correspondence is filed and the manner of indexing the files etc.

In order to determine the line of investigation it is also useful to understand the dealer's mental make-up, his social stand and his approach to life. Some dealers not only conceal sales but are bold enough to utilise the amount of tax so evaded for investment. Such persons generally take a chance to get away with it and if caught, may not resist for a long time. There are some dealers who do not mind assessment but resist actual payment of tax. There are some dealers with high sense of reputation and dignity who will resist the assessment because the recovery proceedings that may follow the assessment may endanger their reputation and social standing. Dealers with different mental make-ups should be approached in different ways and it is the acumen of the audit officer that will help him to point out the best possible way.

5.05 Accounting Principle

FAP operate on exactly the same principle on accountancy as the manual set of accounts. The FAP, however, do most of the accounting task automatically. For example, whenever an entry transaction is made effecting one account, say by issue of a sale bill, its effect on all the corresponding accounts is automatically implemented by the software and final accounts can be drawn after, each financial transaction. One of the biggest advantages of F AP is such continuous updating of all corresponding accounts. The computerized accounts, however, differs, from manual accounts on a basic point. In FAP unlike manual accounts,

accounts are maintained according to the nature of the transaction. For example, in a manual accounting system all types of accounts such as purchase account, sale account etc. may be maintained in a single ledger. In an FAP there will be separate computer files for purchase register and sale register.

5.06 Financial Accounting Packages

All Financial Accounting Packages can be divided into two parts- one is 'Information Inputs' and the other is ‘Information Retriever’.

Information Retriever differs widely depending upon the features provided in the accounting packages for generating 'Outputs' generally called 'Reports'. These reports vary from package to package and these generally include purchase and sale vouchers, dealer-wise accounts, ledgers, cash book, inventory report, trial balance, P/L Accounts, Balance Sheets etc.

FAP provides accounting bifurcation upto the route level. An user can create accounting bifurcation as per his requirement. It is possible to bifurcate the purchase register, State and Central tax, local tax, freight and so on. In the same way the sale vouchers can be designed in such a way so that an user can bifurcate sales upto as many categories as required by him.

5.07 Security Regulations

Most of the software carries passwords, which means that a password has to be entered before the computer permits access to a user to the accounts. The password protection may be at a single level. In that case all points may become accessible. Once the main software is opened after entry into the password there may be two or multi level passwords also. In such case, separate set of password will be used for opening the accounting package and then for opening an account of a particular dealer and thereafter for accessing specific records within the accounts of the dealer in question.

5.08 Generating Reports

'Reports' in computer parlance refer to output or data. FAP can easily generate information retriever as per requirement of the user. In addition to common statements such as trial balance, ledger accounts, balance sheet, etc. it can also generate reports of the following types:-

(i) Period-wise i.e. month-wise, fortnightly or weekly. Final accounts including trading account, profit & loss account and balance sheet.

(ii) Classification of purchase and sale: item-wise, dealer-wise, value-wise and so on.

(iii) Inventory reports in respect of specific goods, specific period and in adjustments.

(iv) Trend analysis of purchase and sale in terms of products, price and so on. Transaction analysis in terms of cash transaction or bank transaction.

(v) Ratio analysis, bank reconciliation statement, cash flow statement for different periods.

5.09 Use of Computer for investigation

Where accounts are maintained on computer it will be possible for the audit officer to analyse sales and purchase and also to draw trial balance and trading account for a given period. It should also be possible for the audit officer to analyse the ratio to know the health of the business.

Computers can also be useful for analyzing data available on seized manual accounts.

5.10 Reason for ineffectiveness of VAT audit.

Audit needs higher skill than mere administrative ability. Such skilled person may not be available in an organization. Lack of training in technical maters, in reading books of accounts, etc. is mainly responsible for this. At the same time it is to be understood that audit is to be conducted without damaging the business on a day-to-day basis. Audit finding also should be accurate because any mistake will lead to raising of demand to pay huge amounts, which ultimately may be dropped. Cooperation from trade and industry would be available if the approach of the audit team is proper. Without that audit can be ineffective. In developing countries where officers are enamoured by administrative power, most people try to avoid a posting in audit. So long as this attitude does not change, effectiveness of audit will remain a far cry.

5.12 How should audit performance be judged?

The effectiveness of audit function should not be measured in terms of straight receipt derived from additional assessment Measuring effectiveness of the tax audit by the amount of taxes collected through audit is like evaluating, the authorities responsible for enforcing traffic laws on the basis of how much money they collect in fines from drivers. A proper evaluation is in terms of the quantity and quality of the audit carried out and the revenues voluntarily paid. In a limiting case, if no mistakes are found and no extra tax is collected that would be the best situation. The proper evaluation, therefore, should be the extent the audit function contributes to improving tax compliance.

The capacity building of the audit wing can be achieved only through continuous evaluation of the results achieved and exchange of information amongst the officers of the Audit Wing. Each officer in charge of Zonal offices shall arrange a group discussion by audit officers working under his jurisdiction every month. Various methods of evasions detected and the kinds of defects noticed shall be discussed.

The functioning of each wing of the department is complementary to each other. Increase in the overall efficiency of the department can therefore be achieved only through regular interaction among officers of the different wings of the department The officers of the VAT Circles, audit and intelligence wings and other wings in each district will meet once in a month and discuss issues which affect the effective functioning of the respective wing.

Conclusion

In conclusion we may say that audit should not be too elaborate to stifle the trade, too intrusive to alienate the assessee and not too widespread to render itself unworkable. Thus 100 percent pre-refund audit or massive invoice cross-checking should be shunned in preference to a selective approach.

AVAT AUDIT MANUAL

FORMAT-I

SUMMARY OF DEALER'S ACTIVITIES

I Name o[VAT dealer............. ....TIN :....... ....

cs T No.: ....

1. Authorised Person to contact (and status) ____________________

2. Telephone number(s) __.__________________________
Location of premises ____________________________

3. Effective date of registration ____________-----"--'-_____________

4. Accountant (if any) ___________________________
Address________________________________
Telephone number _____________________________

5. Financial year ends _____________________________

6. Address of principal place ofbusiness ______________________

7. other business address ____________________________

8. Main business activity ____________________________

9. Subsidiary business activities __________________________
(provide approximate % of turnover of each activity) _________________

10. Manufacturer YESINO______Enjoying exemption/remission YESINO______ Eligibility Certificate from Industry Deptt. obtained YESINO______________ Authorization Certificate or Certificate of Entitlement obtained YES /NO --------

Entitlement of (a) Period of Exemption _____Cb)Monetary Ceiling ________ Exemption availed (a) Period ________Cb) Amount _____________ Time left of availment________ Unexpired amount of exemption_________ Input/output ratio_______________________________ Licenced capacity____Installed capacity______Actual Production______ Brief description of manufacturing process :____________________

- - < - ,... ~ <I = _ ' -
, tt.

11. Importer (International) YES/NO_______ % OF INTPUTS________
Brief description of imports ________________________

12. Purchases from other states YES/NO_______ % OF INTPUTS________ Brief description of purchases:_______________________ 13. Receipt from other states on stock transfer basis YES/NO_____ % OF INTPUTS____ Brief description of receipt __________________________

14. Purchased within the state YES/NO___% OF INTPUTS___________
Brief description of purchase ________________________

15. Exporter YES/NO __________% OF OUTPUT __________
Brief description of export _________________________

16. Sales to other State YES/NO_______% OF OUTPUT__________ Brief description of inter-state sales ______________________

17. Branch transfer/consignment sales to other states YES/NO ____% OF OUTPUT ____ Brief description of branch transfer/consignment sales _______________

18. Sales within the state YES/NO % OF OUTPUT Brief description of intra-state sale 19. Description of principal outputs 1 % Rate 4% Rate 12.5% Rate Zero-Rated - International Exports Zero Rated - Inter S tate Sale Exempted goods/transactions Fourth Scheduled goods 20. Principal inputs 1 % Rate 4% Rate 12.5% Rate Exempt goods

Fourth Scheduled goods

21. Accounting Method CASH/ MERCANTILE If there is any change in the method of Accounting from previous year.

22. Method of Valuation of Opening stock and Closing stock FIFO/ LIFO If there is any change in the method of Valuation from previous year Yes/No

23. Current Accounting Records - Describe overleaf the books and records used by business. Highlight those used for accounting for VAT. Identify records where the VAT account or VAT calculations are maintained.

24. Audit Report from a Chartered Accountant! Cost Accountar:~ if any, filed by the dealer YES/ NO

25. Information from third parties, if any ______________________

26. Cross reference requests, if any_________________________

27. Matters outstanding from a previous audit, if any __________________

28. Adverse report, ifany____________________________

Date....... .... Recorded by Officer Name.............. ... .

Signature. . . . .

Checked by: Offiaer Name.......................... .... Signature............. ....

Updated.... .... Officer Name. ....

Signature................. ....

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AVAT AUDIT MANUAL FORMAT-II

STATEMENT SHOWING THE BREAK-UP OF PURCHASES & SALES

Name of the dealer under audit.........:........................

TIN ... .

Period of audit...........,...................

Commodi Name & Schedule *4% (imported) *4% (local) goods alc goods alc

1. Opening Stock 2. Add: Purchases from other states 3. Add: Receipt from outside State 4. Add: Purchases within the state:
(i) from registered dealers (ii) Less: Return, discounts etc.
(iii) Net Purchases from regd. dealers (iv) from un-registered dealers Total local Purchases [(iii) +(iv)] 6. Direct Expenses 7. Total 8. Less: Closing Stock 9. Cost of goods sold 10. Sales, stock transfer etc.
(A) Local sales under the AVAT Act (i) to Registered dealers (ii) Less: Return/discounts etc.
(iii) Net sales to regd. dealers (iv) to Un-registered dealers (v) Total Sales taxable under AVAT Act [(iii)+(iv)] (vi) penultimate sales in course of export (B) Inter-state Sales under the CST Act (i) to Registered dealers (ii) to Un-registered dealers (iii) Total Sales taxable under CST Act [(i)+(ii)]
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(C) Secondffransit Sales under the CST Act (D) Inter-state stock transfer under the CST (i) to depots (ii) to agents (iii) Total Stock transfer under CST Act [(i)+(ii)] (E) Export Sales under the CST Act (i) Direct (ii) Penultimate Sale (iii) Total export sales under CST Act [(i)+(ii)] 11. Input tax [on purchases shown at 4(iii)] 12. Output tax [on sales shown at 10(A)(v)] 13. Purchase Tax, if any

Note: This statement is merely illustrative and should be obtained for goods taxable at every rate of tax with break-up ofimportedllocal goods.

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AVAT AUDIT MANUAL FORMAT-III ANNUAL ACCOUNT ANALYSIS TABLE

Name of the dealer:

TIN Number

A. Extraction and analysis from Trading Account

Year ended I I I I I I I I I
Sales at tax rate -- % 1
Opening stock (OS)"".'"'. ".......".....". ...."..2
Add, Purchases (incl. direct expenses).........................3 Less: Closing stock (CS) ...."......... ....4 Less: stock transfer"""".................. ....5 (=) Cost of goods sold (CGS)__"""..".._____._._........"",,6 Gross Profit (Sales at 1-CGS at 6)............"..............7
(GP at 7 x 100) 8
Mark up% = CGS at 6
-
Gross profit % = (GPS~le7a~ ~OO) """...................."".9 Stock turnover ratio: CGS .. "... "..". ....10 (OS +CS)

I

Note: Separate sheet shall be prepared for every commodity taxable at different rates and also on the basis of imported/local purchase. I
,

j 1 I

B. Other figures extracted

Year ended I I I I I I I I
Net Profit....... 11
Drawing/Director's
Remuneration........ 12
Fixed assets 1 3
Current assets 14
Current Liabilities ....15 Long term liabilities ....16 Acid ratio: (current assets - inventory) ....17 Current liabilities Days sales in debtors:
Trade debtors x 365... 18 Sales Days purchases in creditors Trade creditors x 365 .. ..1 9 Purchases

Reconcile value of sales and output tax declared with the arumal accounts figure

Note on difference found:

AVAT AUDIT MANUAL FORMAT-IV STATEMENT OF CREDITORS

Name of the dealer under audit.................................

TIN ....

Period of audit................................

S1. Party's Name, L.F. No. Opening Purchases Payments Closing Remarks No. Address & Balance made during made Balance TIN No. the year during the year/Any adjustment

AVAT AUDIT MANUAL FORMAT-V STATEMENT OF DEBTORS

Name of the dealer under audit.................................

TIN ... .

Period of audit................................

S1. Party's Name; L.F. No. :Opening Sales made Receipts Closing Remarks No. Address & Balance during the during the Balance TIN No. year year/Any adjustment

AVAT AUDIT MANUAL FORMAT- VI STATEMENT OF INTER-STATE SALES

Name of dealer ....

TINICST Regn. No.............................

for the period ....

Sl. Purchaser's Purchase Seller's Items Qnty. Value Carrier Booking Delivef) 'c' Differenc(Input Remark No. Name, order Inv. name, station station Form between tax address No. & No. & RJR No. Bill credit CST date, if date No. & Date, amount & claimed Regn. No. any date Amount 'c' Form if any Qnty.

,
"

AVAT AUDIT MANUAL FORMAT- VII STATEMENT OF INTER-STATE STOCK TRANSFER

Name of dealer (Consignor) ....
TINICST Regn. No.............................

for the period ....

1 2 3 4 5 6 7 SL Name and Regn. No. of Description Invoice No. Qnty. Value of No. Address of Consignee of goods & Date goods Consignee under CST Act.

8 9 10 11 12 13 14 15 Carrier name, "F" Amount Qnty Alc Sale Gross sale Commission Incidental CNNo.& Form covered covered by No. & proceeds charges Date No. by"F" "F" Form date Form

16 17 18 19 Net sale Date of Date & mode of Remarks proceeds arrival remittance of (including DID goods. No.

(In case of stock transfer to Head Office column 1 to 11 will be sufficient, other columns may be dispensed with)

I I

AVAT AUDIT MANUAL FORMAT - VIII

STATEMENT OF INTER-STATE PURCHASE

Name of dealer...

TIN/CST Regn. No............................. for the period ....

Sl. Seller's Purchase Seller's Items Qnty. Value C/N Name Delivery Delivery 'C'Form Remark No. Name, order No. Inv. No. & No. & of the NQte No. Permit No.
address & & date, if & date freight date transpor No. & Date, CST Regn. any Qnty. ter Date Amount No. .

AVAT AUDIT MANUAL FORMAT-IX STATEMENT OF T AX-PAID PURCHASES

Name of dealer..

TIN.................................... for the period ....

Sl. Name & Address of the TIN Invoice No. Date Amount Item Remarks No. dealer 0'
,

AVAT AUDIT MANUAL FORMAT-X

STATEMENT OF GREEN TEA LEAF PURCHASE

1. Name of the Factory owner buying green tea leaf:
2. Address:
3. Factory Registration No. :
4. TIN/CST Regn. No.............................

Name of the owner of Full address of the Estimated crop. to be Amount of advance Rate at which green the green tea leaf seller seller including village, purchased as stipulated giy~ to theseller, if leaf is purchased Mouza, P.S., Sub-Div., in the agreement with any District and Telephone the seller No., ifany 1 2 3 4 5

Area under cultivation If plantation is on Whether registered Whether registered Total Green tea leaf of growers in bighas Government land, under the Assam under the Assam purchased upto the with Dag No. Patta No details should be given Agricultural Income Taxation (On previous month and amount of land by the seller Tax Act Specified Lands) Act revenue per year 6 7 8 9 10

Total green tea leaf Total green tealeaf Total tea made Total tea made Total tea made upto Remarks, If any purchased during purchased from the from the green during the month the month the month parties leaf purchased (Co!. 13 + Col. 14) (Co!. 10 + Co!. 11) upto the previous month 11 12 13 14 15 16

AVAT' AUDIT MANUAL FORMAT-XI

STATEMENT OF QUANTITATIVE DETAILS OF MADE TEA

1. Name of the Tea Garden 2. Address:

3. TIN:

4. CST Registration No. :

Period ending: ....

At Garden At Guwahati Tea With commission Total Auction agent
.
(i) Opening Stock (ii) Production (iii) Receipt (a) from garden (b) from GTAC (iv) Total (v) Despatch (vi) Sale (vii) Withdrawal (viii) Sample (ix) Labour Tea (x) Total .. (xi) Closing Stock '''
..

AVAT AUDIT MANUAL FORMAT - XII STATEMENT OF TEA SOLD THROUGH GAUHATI TEA AUCTION CENTRE

1. Name of the Tea Garden/Bought leaf factory :
2. Address:
3. TIN:
4. CST Registration No. :

I I I
,
! 't

Period ending: ....

SL Name of Broker & his Broker's Alc Quantity Price Auction Sale Date of Remarks No. Registration No. sale No. & Sold realised No & Date of accounting date sale by Tea . . Estate
..

I I I

Authorised Signatory

AVAT AUDIT MANUAL

FORMAT - XIII

REPORT ON AUDIT VISIT TO DEALER

1. Name of VAT Dealer 2. TIN 3. Period of audit 4. Address (es) visited 5. Person (s) interviewed 6. Date and time of visit: Date from to Date from to Date from to

7. Summary of dealer's trading activities and Record - Updated and signed _________

8. BASIC CHECKS, whether completed, Yes/No___________________ 9. GENERAL REVIEW, whether completed, Yes/No_________________ 10. CREDIBILITY__________________________

11. IN-DEPTH CHECKS, whether completed, Yes/No_________________ 12. AUDITING OF SPECIAL FOCUS AREAS Yes/No________________

13. PHYSICAL VERIFICATION Yes/No
----

14. Conclusions and credibility of returns. ________________________

15. Previous objections not settled so far, ______________________

16. Matters for consideration on next visit.

17. Irregularities found, particulars of assessment ____________________

18. Turnover of sales, stock transfer, turnover of purchases and other details [As per separate annexure (i)]

19. Liability of tax, interest etc. for the period under audit, [As per separate annexure (ii)]

Annexure (i)

Turnover and other details for the period under audit:

Particulars As disclosed by dealer As found upon audit (Rs.) (Rs.) A. Sales, stock transfer etc.
1. Local sales under the A V AT Act (i) Exempted goods (First Sch.) (ii) @ 4% goods (Second Sch.) (iii) @ 2% goods (Third Sch.) (iv) @ 1 % goods (Third Sch.)· (v) @12.5% goods (Fifth Sch.) "'-"!
...
(vi)@_%goods(FourthSch.) (vii)@ _% goods (Fourth Sch.) (viii)@_%taxpaidgoods(FourthSch.) (ix) @_% tax paid goods (Fourth Sch.) (x)@_%(other,ifany) 2. Inter-state Sales under the CST Act (i) to Registered dealers (ii) to Un-registered dealers 3. Second/Transit Sales under the CST Act 4. Sales in the course of Export out of India 5. Sales in the course of Import into India 6. Inter-state stock transfer under the CST B. Purchases/Receipts etc.
1. Purchases from other states 2. Receipt from outside State 3. Purchases within the state:
;
[(i) from registered .dealers (ii) from un-registered dealers

Annexure (il)

Liability of tax, interest etc. for the period under audit-

particulars· . As disclosed by the dealer As per Audit (Rs.) in tax returns (Rs.) (i) Output tax (ii) Input tax credit (iii) Net tax credit (iv) ITC adjusted with CST (v) Output tax remitted/exempted (vi) Net tax payable (vii) Net tax paid (viii) Interest payable (ix) Interest paid -

Observation of audit (a) Short payment by the dealer(i) Tax (ii) Interest (iii) Total (b) Other Observations - ,.
Reasons for the Observations;

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ANNEXURE - 1

Cross Reference

Introduction

This annexure to the audit manual provides a basis for the procedures that should be followed when issuing cross-references to verify dealer's declared tax details as per their VAT returns.

The checking of one VAT dealers input tax claim to the selling VAT dealer's output tax is a vital control in VAT audit. Manipulation of tax invoices and false tax invoices are a major source of fraud and evasion.

A checking system should be used to counter this practice. This system provides that audit officers can refer iilformation from original input tax invoices for checking at the VAT dealer issuing the invoice.

This will ensure that the tax being ciaimed as an input credit has been accounted for and paid by the seller.

The information required ,should be recorded, without the knowledge of the VAT dealer being audited, in case the VAT dealers are in collusion to defraud the tax department.

The Apex Office is responsible all cross-referencing policy issues/considerations. The content of this manual are not an interpretation of the law. Rather, they'are administrative operating procedures following international best practice.

Section 73 of the AVAT Act empowers the Commissioner of ,Taxes to undertake cross checking of transactions of sale and purchase. However, the class of dealers which is required to furnish the information shall.have to be notified in the Official Gazette.

Background

It is recognised in many countries that the use of invoice cross-referencing is a powerful tool in the detection and prevention of fraud. Many supporters of VAT highlight the 'self-policing' aspects of the tax. Put simply this means that the output tax of one dealer is the input tax of another. The dealer claiming input tax will maintain his purchase invoices in order to avail of the rebate of tax allowable. This allows the tax officer to take details of purchases made by the dealer and by the use of cross-references ensure that output tax has been accounted for in the records of the selling dealer.

Similarly by eliciting details from check-post the VAT officer may ensure accurate recording of inter-states sales and purchases in the dealer's accounting records. There is nothing complicated about this, the procedures are simple and require no specialized skills other the ability to compare an invoices or invoices with entries made in the dealers books of account and secondary records.

Invoices, which are not genuine, are to be found out by cross verification of documents, such as invoice. In some countries, like France, there is Directorate of Verification for verifying invoices of very high value. But such systems underline the importance of cross' verification. In South Africa, South America and even in Europe, there has been a menace of false invoice. So the thrust of audit should be to prevent such misuse be cross verification. However, cross-verification should not be done of all invoices but selectively.

Some countries have been attracted by the theoretical possibility of cross-checking all purchases and sales invoices to promote compliance. Cases include South Korea, China, Cote d'Ivoire, Indonesia, and Bulgaria where taxpayers are requested to attach a copy (or a list) of their purchase invoices to their monthly returns. This approach has often reflected a concern that the input credit system is being abused. In several countries, requirements to audit 100 percent of the claims prior to refunding VAT excess credits complicate matters; not only does this policy delay the processing of refunds, it also implies that most audit resources are assigned to the verification of refund cases. Since not all refunds can be audited in a timely fashion, a database of all purchase and sales invoices is seen as facilitating the verification of refund claims. The South Korean experience indicates that massive cross-checking of invoices is costly to administer, burdensome for taxpayers, and ultimately not effective in controlling evasion. While information technology has improved spectacularly since then, the sheer volume of transactions continues to make massive crosschecking a daunting task Moreover, it :runs the risk of alienating taxpayers. The practical approach, therefore, is to resort to cross checking only when some specific irregularities have been detected in the handling of invoices in the company's books of account The approach should be selective and not comprehensive.

Haryana VAT Act provides for enclosing a list of goods purchased from VAT dealers on Tax Invoice (LP-7) along with return.

List showing purchase of goods from VAT dealers on Tax Invoice

I 1

SI No. Name with TIN of VAT dealer from Turnover charged to tax whom goods so purchased at different rates Name TIN @ % @ % 1 2 .~
, .
Total

Note: There will be a single entry in respect of each dealer from whom goods were purchased during the year.

Haryana VAT Act also provides for enclosing a list of goods sold to registered VAT dealers on Tax Invoice (LS-9) along with return.

Since the purchase in the hand of one dealer is the sale in the hand of other and the furnishing of dealer-wise summary along with return is useful for easy cross checking.

For ensuring proper enforcement mechanism, each tax payer should furnish dealer-wise details of purchases along with the return to claim input tax credit

The Purpose of Cross-Referencing

The primary ebjective 9f the use ef cross-referencing is to. ensure that registered dealers are acceunting fer, and paying, the cerrect ameunt ef tax at the right time in accerdance with the law.

Additienally the cress-referencing ef sales and purchases inveices and check-pest data allews the auditer to. assess the credibility, er etherwise, ef the business activities ef the dealer.

Degree of checking

It weuld be impossible fer every transactien between every registered dealer to. be physically verified. The sheer velume ef decuments invelved makes this impessible. Therefere it is impertant to. be selective in the cross-referencing ef infermatien Essentially there are feur types ef infermatien that the tax efficial sheuld be trying to. verify as fellews:· Check-post data en the inter-state mevement ef geDd$.
· Sales inveices · Purchases inveices · VAT return details

Check pest data may be required to. be verified to. ensure that geeds identified as being experted from the State actually leave the State which because ef zero rating Df such transactien result" into. refund ef input tax credit AdditiDnally geeds that the imperted into. the State need to.
be seen to. be entered in the dealer's recerds, eventually finding themselves en to. the VAT return as sales.

Sales inveices need to. be verified to. cenfirm that eutput tax charged en'the inveice is recerded in the selling dealer's beeks ef acceunt and transferred to. the cerrect VAT return

During an audit an efficer may netice a large number ef sales, cerrectly reported and tax o.n the sales aCcoul1ted fo.r, between his dealer and another dealer. It might be beneficial to. extract a velume ef transactiens cevering a defined peried [i.e. ene month] and then using this infermatien check whether the recipient of the go.o.ds has made sales censistent with the purchases by applying a mark-up. Fer instance a whelesaler might be seen to. be making a large number ef lew value sales to. a Composition ef Tax dealer that might suggest that the dealer should be registered under the full VAT scheme and therefere werthy ef attentien

Purchase invo.ices need to be verified to. ensure that the purchasing dealer has not falsified inveices er claimed an incerrect ameunt as rebate and that the selling dealer has recerded the sale and acceunted fer the VAT.

VAT return details need to. be verified against informatien relating to inter State sales and purchases and in relation to. large invo.ices either issued er received. In the case ef repayment returns selected large invoices may need to. be verified befere the repayment can tale place.

Cross-reference requests

A cross-reference request form is a manually cempleted decUll1ent that alerts a Tax efficer that a verificatien check needs to. be completed en an inveice, er inveices, relating to. a transaction, or transactions between two. registered dealers.

An example of this fonn is included at Appendix A.

The form should be completed with as much detail as possible to allow the officer undertaking the cross-reference check to be able to accurately identify the transaction to which the CroSSreference refers.

In particular, the issuing office should complete the following;-

· The details of the office to which the query is addressed.

· Whether or not the reference is urgent or routine.

· The name, address and VAT registration number of the dealer to whom the verification is aimed should be entered [i.e. a dealer purchasing a large value of goods from another dealer].

· The issuing officer should then indicate what verification check he requires from the office to which the reference is being sent. Option 'A' is usually used to ensure that all output tax is being declared by a dealer who has sold goods and option 'B' is usually used where there may be some doubt regarding the volume of trade being undertaken.

· Finally the issuing office should note the details of the name, address and VAT number of the dealer where the cross-reference originated.

The receiving office should allocate the cross-verification reference to the appropriate officer who will undertake the verification at the dealers premises immediately, if the reference is urgent, or as part of a normal VAT audit if the reference is routine.

Following the verification the officer then attach a report of his findings and return the crossreference form, via the head of office, to the originating officer.

The originating officer will then decide what action is appropriate in the circumstances. This may involve another visit to the dealer's premises or the issue of an assessment for additional tax without further visit.

Cross-reference invoices details.' .

Whilst undertaking visits to dealer's premises the tax auditor, from time to time, will come across invoices that do not appear genuine.

Whilst the purpose of cross-referencing invoice details has already been noted above it does no harm to repeat them here.

Sales invoices need to be verified to confirm that output tax charged on the invoice is recorded in the selling dealer's books of account and transferred to the correct VAT return.

Purchase invoices need to be verified to ensure that the purchasing dealer has not falsified invoices and that the selling dealer has recorded the sale and accounted for the VAT.

Using their experience of the type of trade being undertaken by the dealer the auditor will keep an eye open for factors that do not appear normal, for instance a handwritten purchase invoice, a purchase inconsistent with the type of trade being practiced, a capital purchase that is not evident, etc. \

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Without alerting the dealer to their concerns the auditor should take up details of the invoiCe and upon return to the officer complete a cross-reference verification form as mentioned above.

Auditors will also be given cross-reference forms relating to sales invoices to verify at a dealer's premises to ensure that output tax has been accounted for in the books of account and on the monthly VAT. Auditors should not alert the dealer at the outset of the visit that these details are to be verified for two reasons:-

. If the dealer has been dishonest he may attempt to destroy or withhold evidence
. If the dealer has entered the invoices in his books of account and paid over the VAT due on the sales raising the matter prior to checking in the books of account will " make the auditor look unprofessional and cast doubt in the mind of the dealer that the tax auditor views him as potentially dishonest

It is much better to quietly verify the details and confront any problem with the dealer once the facts have been clearly established and evidence secured. '

Cross-referencing check post data

Check posts at inter-state borders are erected to keep a track on the movement of goods.

For making import of taxable goods from other states either on account of inter-state purchase or on account of inter-state receipt of goods on consignment basis/depot transfer for re-sale, Form61 known as "Delivery Note" prescribed in the AVAT Rules has to be obt:lined by the importing dealer from his jurisdictional authority and such Delivery Note must be produced before the check post authority.

Similarly, for importing plant & machinery, raw materials etc for consumption, a manufacturing unit has to obtain Form 62 i.e. "Road Permit" from his jurisdictional authority and such Road Permit must be produced before the check post authority.

For making import of taxable goods from other states by railways/airways etc, "Delivery Permit" in Form 66, as prescribed in the AVAT Rules, has to be filed by the importing dealer with his jurisdictional authority and has to obtain the endorsement of such authority on such delivery permit before taking delivery of goods from the transporter/carrier.

A dealer may import goods at 12.5% but may account for the transaction as some other goods taxable at 4%. Again the value shown at check post may be different from that shown and recorded in accounts. Therefore the jurisdictional authority can check such import particulars with the check post authorities.

This apart, the exemption! remission given to an industrial unit is linked to fixed capital investment For claiming tax benefit on the basis of investment, plant & machinery and other fixed assets may be shown to have been purchased merely on the basis of paper transaction without being 2.ny real/actual transaction If such purchase are shown to have been made from other states, the transaction can be verified with the check post particulars.

For exporting taxable goods to other states, a registered dealer has to (a) ol'tain "Tax Clearance Certificate" from his jurisdictional authority and such certificate is required to be produced before the check post authority (b) furnish the details of consignment according to invoiGe/ Consignment Note to his jurisdictional authority.

The check post authority transmits original copies of such Delivery Note/ Road Permit and copy the "Tax Clearance Certificate" in Form 63 to the respective Authority having jurisdiction over the dealer.

But it may also happen that a dealer may also try to show a transaction as inter-state transaction/export transaction and claim the refund of input tax credit. It may be noted that mere furnishing of "c" form cannot determine the nature of a transaction.

In such cases, an audit officer may verify the claim .of inter state sales/export sales to verify whether the movement of goods actually took place or not.

Essentially the auditor will be required to verify whether or not the details of consignments, as reported at check-posts, have been recorded in the dealer's book of account.

For instance a consignment of goods received by way of consignment sale from a neighbouring State should find themselves recorded potentially in the purchase daybook, the stock register and ultimately in the sales register of a business. By using the dealers audit trail an auditor may be asked to verify that goods moved across the State border have been accounted for correctly and any tax due paid accordingly.

In addition to the detail contained on the cross-reference form, the form used for the crossreference of check post data will contain fields for the entry of the vehicle number, the data of arrival at the check post and the declared invoice value of the consignment.

Cross-referencing VAT return data

That VAT return of a registered dealer contains a large amount of information, in cases where a reference has been sent from the jurisdictional tax officer, to another regarding the sales of one dealer it may be possible, simply by looking at the VAT return, to see whether or not there may be grounds for suspicion.

For instance if dealer A claims a large amount of input tax relating to a sale made by dealer B and that transaction is selected for cross-referencing, if the VAT return submitted by dealer B does not allow at least the corresponding amount of output tax there would be grounds for considering that something was wrong.

The VAT return WIll also contain data pertaining to (amongst others) purchases of capital goods, interstate sales, stock transfer and consignment sales, and exempt sales. All of these figures can be used to provide a first level face vet of any cross-references that ay be submitted by other offices.

Cross-referencing inter-state data

In case of any doubt as to genuineness of inter-state transactions like out of state purchases, inter-state sales, branch transfers and consignment sales etc. and such transactions need to be verified/corroborated with the particulars held by the counterparts in other states, shall be noted down and should be referred to the head office for undertaking inter-state cross verification. '

Action at the dealer's premises

(a) The role of the audit officer in cross-referencing

In undertaking his duties the visiting audit officer will be required to verify transactions reported on cross-reference forms, either those sent by other offices or from border check-posts.

It is therefore important that the officer understand the dealer's business activity, his accounting records and the audit trail of the business in order to be able to trace a cross-referenced transaction to the books of account.

Auditors may be asked to make a one off visit to a dealer's to verify the details of a transaction where the reference is urgent. In the normal course of business however auditors will verify a number of cross-reference forms when they undertake routine inspections by comparing the reference with the books of account of the dealer. It is therefore important that officers have grasped the rudiments of book keeping so that cross-references can be verified without consuming too much time.

It must be remembered that the existence of a cross-reference does not imply guilt ona dealer but is merely a method of ensuring that the dealer is declaring the correct amount of tax.

At the dealer's premises the officer should not alert the dealer to the fact that he has some verifications to undertake. The officer should complete his initial interview and then whilst checking the books and records of the company compare the reference details with entries in the books of account. Irregularities will be dealt with separately.

Additionally, whilst conducting routine audits as a dealer's premises the auditor may note transactions that would justify the issuing of a cross-reference form. Individual officer will establish their own criteria for the issuing of cross-reference forms but in general the following three guidelines -might be considered as a starting point:-

· Purchase transactions involving huge input tax credit;

· Where the input tax rebate claimed exceeds a certain monetary value;

· Where the purchase is not consistent with the nature of the business being undertaken;

· Where the invoice to support the input tax claim appears doubtful (i.e. a hand written or non-legible invoice).

(b) Action to be taken where fraud is suspected

Specific action to be taken where a dealer is suspected of having committed a fraudulent act will be dealt with in the Fraud and investigation. However, there are a number of prudent measured that need to be taken by the auditing officer in any event.

These may include:-

· Safeguarding personal safety Under no circumstances should a VAT auditing officer put his or her personal safety at risk in obtaining evidence to support a potential fraud. If the officer suspected that a violent situation could arise then they should leave the dealer's premises immediately and seek guidance and assistance from senior management.

· Safeguarding information Under no circumstances should the visiting officer present the cross-reference information, being checked or taken, to the dealeI: Copies of invoices and crossreference forms that have been completed for subsequent verification should be kept securely about the officer's person or in a briefcase.
· Safeguarding evidence Where an officer believes that fraud may have been committed he may wish to exercise his powers under Section 74 of the Assam Value Added Tax Act, 2003.
However, this should be done bearing in mind the risks to personal safety above.
· Not altering suspicion The audit officer, [by following the three points above as a guideline] should not alert the dealer to the fact that he, or another dealer, are under suspicion To do so might result in the destruction of crucial evidence or the fabrication of records to further conceal the fraud.

Management controls

The system of cross verification of transactions requires the creation of separate records in the YAT office to record the issue of references and the receipt of references.

The records should be monitored on a weekly basis by the Zonal nCT/ACT to ensure that the system is functioning effectively.

The records should be used to ensure responses are received and that the time limits are met

· Recording issue of cross-reference: The Audit Officer issuing cross reference should record the details of all cross-references issued, both urgent and routine, in a register maintained for that purpose. An example of the format that the register should take is shown at Appendix B.

'. Recording receipt of cross-reference: When a cross-reference is received from another office, the Audit officer receiving the cross reference should record the details of the cross-reference in a register maintained for that purpose and allot it a sequential reference number. An example of the format that the register should follow is shown at Appendix C.

· Recording cross-reference forms (check-posts) : When a cross-reference form is sent to a check-post officer, it to be recorded in a recorded in a register for that purpose. An example of the format that the register should follow is shown at Appendix D.

· That cross-reference forms with an "urgent" priority are routed quickly to an officer for action

· That cross-reference marked "urgent" are genuinely urgent and where considered not to be so a report should be submitted to the head of the Fraud and Investigation policy unit

· That routine cross-reference are placed in the dealer's folder to await action at the time of the next control visit

. That responses to cross-reference forms are also noted in the cross-reference register prior to filing in the dealer's folder.

· That follow up action (such as the issue of an assessment for additional tax) is dealt with expeditiously following the return of the cross-reference.

A report should be made on a monthly basis by each Zonal DCT to the JCT, Fraud and investigation detailing the number of references issued in each category (urgent and routine) and the amount of additional revenue raised as a result of the cross-references.

JCT, Fraud and Investigation should report these figures to the Commissioner, with details of prosecutions undertaken and the resultant outcomes.

AVAT AUDIT MANUAL

CROSS REFERENCE ANNEXURE

"Appendix A"

CROSS REFERENCE FORM

Date

Month

Year

Issuing officer________________________________ Receiving office ________________________________ Status of reference (Delete as appropriate) Name of VAT dealer audited:

* Urgent

* Routine

TIN NO: Address:

Name of the dealer referred:

TIN I GRN:

Details of invoice(s) to be audited are listed below:
These invoices are inputs I outputs to my dealer (delete as appropriate)

Date Invoice No Description Net value VAT Receiving officers of goods remarks
-
, .
.

Issuing officer Reply from receiving officer
,
Issuing officer name Receiving officer name Signature Signature Date Date

Compared Satisfactory* Compared Unsatisfactory. Report/copy invoices attached*

Comments:

AVAT AUDIT MANUAL CROSS REFERENCE ANNEXURE

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f\,)

"Appendix B"

Issuing office Cross-Reference Record

Reference U R Dealer's name & VAT Registration Sent to Date Reminder Date date Reply Outcome Number Number (Urgent refs only) received
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"Appendix C"

Receiving Office Cross Reference Record

SI Issuing Office U R Dealer's name & VAT If urgent, any reminder Date reply sent Outcome No. Reference Number Registration Number received

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AVAT AUDIT MANUAL CROSS REFERENCE ANNEXURE

"Appendix 0"

Check post Cross Reference Record

Reference U R Dealer's name & VAT Transport details (Hauler, vehicle Sent to Date Reminder Date Reply Outcome Number Registration Number registration number etc) date

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ANNEXURE - 2

ACCOUNTING RATIOS

Financial statements as used in accounting refers to at least two statements (i) Trading & Profit & loss account & (ii) balance sheet.

Such statements must be made simpler for any reader to understand the operating results and financial health of the business. This is done with the help of various tools of financial analysis such as comparative statement, common size percentage, trend analysis and ratio analysis. It is only with the aid of the above tools that helps the interested reader in giving tongue to the dump heaps of figures which in turn help in achieving the ultimate aim of interpreting the financial statements.

The relationship between two figures expressed arithmetically is called a ratio. The ratios should be worked out on the basis of figures which are significantly related to each other. Ratio analysis means the process of computing, determining and presenting the relationship of items and groups of items of the financial statements.

An auditor employs a number of techniques to assess the reliability and validity of data under examination. And, one of the important techniques is using business ratios as audit tools to check the internal consistency of the firm/company and overall reasonableness of the data. Ratios may be based on figures in the Profit and Loss Account, in the Balance Sheet or in both.

Business ratios can at best be used like a doctor uses symptoms- indications that something is wrong somewhere. Just as the doctor will try to get to the real reason, the auditor to study these symptoms and should try to locate the real factors lading to the present state of affairs, correlate them, and reach definite conclusion or identify areas for further enquiries.

A large number of ratios can be worked out while reviewing the financial statements of an enterprise. However, for the purpose of VAT we shall restrict ourselves to the following business ratios:-

(1) Profitability ratios (2) Turnover ratios (3) Financial ratios

These are discussed one by one as follows:-

(1) PROFITABILITY RATIOS:

Profitability ratios are of utmost importance for a concern. These ratios are calculated to reveal the end results of business activities, which is the sole criterion of overall efficiency a business concern.

(a) Gross Profit Ratio:

This ratio is of vital importance for gauging business results. Gross profit is the difference between the sales and cost of sales. This ratio tells gross margin on trading and is calculated as under:

Gross Profit x 100 Net Sales

Net Sales = Total sales - Sales Return - cash Discount Gross Profit = Net Sales - Cost of goods sold Cost of goods sold = Operating Stock + Purchase + Direct expenses relating to purchases + manufacturing expenses --' Closing Stock Alternatively, the gross profit may also be calculated by preparing a Trading Account.
For example, if gross profit is Rs. 15,000 and net sales Rs;.100,000, the Gross profit Ratio

Here,

15%.

Where a number of different products are sold, this ratio has to be calculated for each of the products separately. There may be gross profit for the dealer's business as a whole, but one or two prqducts may be showing gross loss. This will come to light only when this ratio is calculated for each of the products.

Any big change in the ratio over a period of years should be investigated. An increase or decrease in the gross profit ratio in comparison with previous years, may suggest a higher or lower cost of production and! or cost of sales with a fixed selling price.

If a comparison is made between dealer's gross profit percentage trend over the years against gross profit percentage of other similar business houses, a standard can be arrived at as to the percentage of gross profit a business should earn.

The higher the ratio, the better it is. A low ratio indicates unfavourable trends in the fonn of reduction in selling price not accompanied by proportionate decreas~ in cost of goods or increase in cost of production. It may also suggest over valuation of operating stock or under valuation of closing stock or of misappropriation of goods.

If purchases are recorded in full and a percentage of sales are suppressed, the effect will be to reduce the gross profit to sales ratio.

A decrease in the ratio may be for the following factors :

(a) increased costs without corresponding increase in selling price,

(b) reduction in selling price without any corresponding decreased costs,

(c) items of stocks omitted from inventory,

(d) valuation of opening stock at a lower figure,

(e) misappropriation of pilferage of stock,

(f) goods purchased other than for business purposes but accounted for in purchases,

(g) omission of sales.

An increase in the ratio may be for the following factors :

(a) decreased costs not reflected in selling price)

(b) increased selling price without any corresponding decreased costs)

(C) purchases omitted in inventory)

(d) inflation of sales figure,

(e) valuation of closing stock at a higher figure,

Cf) valuation of opening stock at a lower figure.

The gross profit should be adequate to over fixed expenses. An important factor which will affect this ratio is the practice of increasing or reducing sale price of goods sold by "mark ups" and "mark downs". Change in method of valuation of stock will also affect this ratio.

"Mark-up"

"Mark-up" is the percentage which the owner of the business add to his purchase prices to produce the gross profit Put another way the "mark-up" relates to purchase price, the "gross profit" relates to sales price.

There is a constant relationship between the "mark-up" and gross profit and theyare derived as follows:

The technique:

In a given period the following figures are available:

· The total amount realized from sales is Rs. 1,250)000/-

· The total price paid for the goods sold was Rs. 1,000,000/-

· Therefore, the gross profit (to cover the expenses of running the business and leave a net profit for the owner) is Rs. 250,000/-

The owner of the business will call this his "mark-up": that is, the percentage he has to add to his purchase prices to produce the gross profit

The "mark-up" percentage is calculated by taking the amount of the gross profit i.e.

Rs. 250,000/- dividing it by the total price paid for the goods resold and multiplying the result by 1 00 to produce a percentage:

Gross Profit x 1 00 % Mark-up = Cost of goods sold

following is a very simple example to

0/ M . - Gross profit x 1 00 o argm . Sales

demonstrate the operation of the mark-up

Gross Profit x 100 Cost of goods sold

250,000 x 100 1)000,000

=

25% Mark-up

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To calculate the profit margin i.e. the percentage by which the total sales amount is greater than the total purchase amount, using the same figures the calculation is as follows.

G P Ratio = Gross profit x lOO Sales

250,000 x lOO 1,250,000

20% Profit margin

These percentages are used as follows:

(i) Either the mark-up or the profit margin on representative transactions of a business are calculated. The percentage mark-up is then applied tQ:the total purchases in a period and should result in a figure close to the declared sales figure.

(ii) Alternatively, if the amount of gross profit is deducted from the total sales, the remaining figure should be similar to the declared purchases. Account has got to be taken of levels of stock because for the discrepancy or the extent of the apparent under-declaration.

(iii) Unsatisfactory results indicate that sales may not have been correctly accounted for.
However, as with any credibility check, detailed examination would have to follow to find either the reason for the discrepancy or the extent of the apparent under-declaration.

It makes no difference whether a mark-up or net-profit calculation is used for a credibility check provided they are used consistently e.g. either use the mark-up or the gross profit calculation but not a mixture of both.

(b) Operating ratio:

This ratio indicates the proportion that cost of sales bears to sales. Cost of sales includes direct cost of goods sold as well as other operating expenses, administrative, selling and distribution expenses which have matching relationship with sales.

It excludes income and expenses which have no bearing on production and sales i.e. nonoperating income and expenses like interest, dividend received on investment, interest paid on loans, profit or loss on sale of fixed assets/investments.

It is calculated as follows:-

(Cost of goods sold + Operating expenses) x 100 Net Sales

Here,

(i) Cost of goods sold = Operating Stock + Purchase + Direct expenses relating to purchases + manufacturing expenses - Closing Stock

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Or

Cost of goods sold = Net Sales' - Gross profit

(ii) Operating expenses =Administra~ive expenses (i.e. office expenses) + Selling & Distribution expenses.

For example, if cost of goods sold = Rs. 1,50,000 and operating expenses = Rs. 2,00,000 and net sales = Rs. 7,00,000 then, this ratio will be 50%.

The lower the ratio, the better it is. The higher the ratio, the less favourable it is because it would have smaller margin of operating profit for distribution as income amongst the owners and creation of reserves. For us too it is cause of concerns it indicate that the company may default in payment of tax dues if the trend persists.

(c) Expenses ratio:

These are calculated to ascertain in relationship that exists between operating expenses and volume of sales.

);> Material consumed ratio = Materials consumed x 1 00 Net sales

Materials consumed = (opening stock + purchase - closing stock)

);> Conversion cost ratio = (Labour expenses + manufacturing expenses) x 100 Net sales

);> Administrative expenses ratio = Administrative expenses x 100 Net sales

);> Selling & Distribution expenses ratio = Selling & distribution expenses x 100 Net sales

The aggregate of the four expenses ratio will be equal to the operating ratio.

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(2) TURNOVER RATIOS:

These ratios are very important for a concern to know how the facilities at its disposal are being utilised or to measure the effectiveness with which a concern uses its resources at its disposal.

The higher the turnover ratio, the better the profitability and use of capital or resources will

be.

The important turnover ratios are:(a) Stock turnover ratio (b) Debtors turnover Ratio (c) Creditors Turnover ratio

(a) Stock Turnover Ratio

This ratio, also known as inventory turnover ratio, establishes relationship between cost of goods sold during a given period and average amount of inventory held during the period. This ratio reveals the number oftimes finished stock is turned over (i.e. into sales) during a given accounting period.

Higher the ratio, the better it is because it shows that finished stock is rapidly turned over.
A low ratio may be on account of various reasons like poor quality of finished goods, overvaluation of closing stock of finished goods, accumulation of obsolete and slow moving finished goods, expensive buying etc. it is calculated as follows:-

Cost of goods sold

Stock Turnover ratio =

Average stock

Where, cost of goods sold (for a retailer) = Opening stoc.k + purchase + purchase related expenses - closing stock

Cost of goods sold (for a manufacture) = Opening stock + Purchase (including direct expenses relating to purchase) + manufacturing expenses - closing stock

Alternatively, it can be fo nd as, Sales - Gross profit

Average stock =

Opening stock + Closing stock

2

A fall in the rate of turnover should be indicative of overvaluation, overstocking or of falling sales. A significant increase could indicate misappropriations of stock

From a practical audit viewpoint, it is often difficult (e.g. due to seasonal factors) to obtain a realistic average stock figure.

Average Age of Inventory:

Average age inventory represents how many days or months, on an average, an item of inventory remains in firm's inventory. It is calculated as follows:

365 days / 12 months

Average age of inventory =

Stock turnover ratio

The average age can be calculated for each item of inventory. The shorter the average age of the firm's inventory, the more liquid it may be considered.

(b) Debtors' Turnover ratio:

This ratio measures the relationship between net credit sales effected during a particular period and the average receivables outstanding during the said period.

Average receivable may be arrived at by adding the opening and closing balances of debtors and bills receivable and then dividing by two.

This ratio is expressed in two different forms as follows:

~ debtors Turnover ratio = Net Credit Sales / Average Receivables ~ Average Collection period = 365 days/ Debtors Turnover ratio

This ratio is a measure of collectivity of accounts receivables and tells about how the credit policy of the firm/company is being enforced. Suppose, a company allows 30 days credit to its customers and the ratio is 45; it is a cause of anxiety because debits are outstanding for a period of 45 days. Higher the ratio more chances of bad-debts and lower the ratio, less the chances of baddebts. Suppose in 2000-2001, debtors in the beginning & end stood at RsAO,OOO/- and Rs. 60,000/-; credit sales at Rs. 250,000/-. The debtors' turnover ratio and collection period shall be calculated as under:-

Debtors' turnover ratio =

Credit Sales Average debtors

250,000 50,000

5 times

Collection period =

Days in a year Debtors turnover ratio

365 5

= 73 Days

A low debtor ratio could indicate that pressure is being applied to customers to ensure early payment. This is window-dressing and may distort the analysis of the final accounts.

(c) Creditors' Turnover Rat 0:

This ratio gives the average credit period enjoyed from creditors and is calculated as under:-

Net credit Purchases

Average Accounts ~payable

Average accounts payable may be arrived at by adding the opening and closing balance of Sundry Creditors and Bills payable and then dividing the total by two.'

A high ratio indicates that creditors are not paid in time and therefore it indicates a shortage of cash. A high ratio could also mean that the company is strong enough in the market to dictate terms to its suppliers. On the other hand, a low ratio gives an idea that the business is not taking full advantages of credit period allowed by creditors.

Sometimes we have to find the average payment period (or debt period enjoyed) to know the speed with which payments are made to creditors. It is calculated as under:

Days (or Months) in a year Creditors' Turnover ratio

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FINANCIAL RATIOS:

These ratios are calculated to judge the financial health of a firm from long-term as well as short-term solvency point of view. The following are the ratios, which are calculated in this respect

(a) Current ratio or Working Capital ratio:

This is the most widely used ratio. It is ratio of current assets to current liabilities. Its expressed as follows:

Current assets

Current ratio =

Current liabilities

Generally, 2: 1 is considered ideal for a concern i.e. current assets should be twice the current liabilities. If the current assets are two times the current liabilities, there will be no adverse effect on business operations when the payment of current liabili~i~s is made. If the ratio is less than 2, difficulty may be experienced in the payment of current liabilities and day to day operations of the business may suffer. A very low current ratio is indicative of over trading, lack of liquidity and suggests a shortage of working capital. If the ratio is higher than 2, it is very comfortable for the creditors but, for the concern, it is an indicator of idle funds or inefficient use of fund and a lack of enthusiasm for work

For the calculation of this ratio current assets will include cash, bank balance, short term investment, bill receivable, trade debtors, short-term loan and advances, inventories and pre-paid payments. It should be noted that advances made to employees recoverable over a long period, advance to suppliers for supply of machinery etc, slow moving or obsolete stock and doubtful debt should be excluded from current assets. Similarly, the securities which cannot be sold readily should also be excluded.

Current liabilities will include bank overdraft, bill payable, trade creditors, provision for taxation, accrued, proposed dividends, unclaimed dividends, advance payment and unexpired discounts, accrued interest on loans, outstanding expenses and the portion of long-term debt to mature within one year. In calculating this ratio any liability which falls due for payment within one year is treated as current liability.

With the help of this ratio, the amount of current assets and current liabilities can also be calculated provided the amount of working capital is given For example, if current ratio is 2.5 and working capital is Rs. 60,000 the amount of current assets and current liabilities will be calculated as under,

Current ratio =

Current Assets Current Liabilities

Working capital = Current assets - Current Liabilities Supposing Current Liabilities = Rs. i 00 Then Current assets = Rs. 250

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Working capital = 250 - 100 = Rs. 150

If the working capital is Rs. 150, the current assets are Rs. 250

If the working capital is Rs. 1, the current assets are Rs. 250/150

If the working capital is Rs. 60,000 the current assets are Rs. (250/150) X 60,000

= Rs. 1,00,000

And, Current Liabilities = Current assets - Working capital

= 1,00,000 - 60,000 = Rs. 40,000

An equal increase in both current assets and current liabilities would decrease current ratio and similarly equal decrease in current assets and current liabilities would increase current ratio.

It is possible for a firm to have high current ratio and still find difficulties in paying its current liabilities? High current ratio, i.e., the ratio of current assets to current liabilities may not necessarily indicate liquidity and be an encouraging signal from the viewpoint of short- term creditors. All current assets cannot be treated as investments which are easily marketable and sold in case cash is require. For this purpose, the liquid ratio is worked out.

(b) Liquid (or Acid test or Quick) Ratio:

This is the ratio of liquid assets to current liabilities. It is calculated as follows :

Quick ratio

Liquid Assets Current Liabilities

=

Cash + Bill receivables + Sundry debtors (Net)+ Temp. investment Current Liabilities

Usually 1: 1 ratio is considered ideal ratio for a concern because it is wise to keep the liquid assets at least equal to the current liabilities at all times.

Liquid assets are those assets which are readily converted into cash and will include cash and balances, bills receivable, sundry debtors (after providing for doubtful debt) and short term investments. Inventories and prepaid expenses are not included in liquid assets because the emphasis is on the ready availability of cash in case of liquid as~ets. ,

Current liabilities include all items of current liabilities. This ratio is the 'acid test' of the concern's financial soundness. Some accountants do not prefer to include bank overdraft in current liabilities but on the basis of conservatism it is always good to include bank overdraft in current liabilities.

Suppose current liabilities are Rs. 30,000; current ratio 2 ; Liquid ratio I :5. Quick Assets and Stock in trade are calculated as under:

Current Assets

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Current ratio

Current Liabilities

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Or Current Assets

= Current Ratio x Current Liabilities

= 2 x 30,000 = Rs. 60,000

Quick ratio

Quick Assets Current Liabilities

(Where Quick Assets = Current Assets - Stock)

Or Quick Assets

= Quick Ratio x Current liabilities 1.5 x 30,000 = Rs. 45,000

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Therefore, Stock in Trade = Current assets - Quick Assets = 60,000 - 45,000 = Rs. 15,000

Alternatively, quick ratio can also be calculated as below :

Quick ratio =

Quick Assets Quick Liabilities

Where,

Quick Liabilities = current liabilities - bank overdraft.

The above list of ratios is not exhaustive not is it necessary to work out all the ratios in each case. Some of them may be worked out to begin with. If they indicate an untoward trend, then the others may be worked out. The discretion is left to the audit team.

Apart from above ratios, the following ratios can also be calculated :

(a) Input/output ratio (b) Power and fuel/production ratio (c) Wages/production ratio

An examination of these ratios can give useful hints for scrutiny. It may however be noted that a deviation in these ratios by itself is not sufficient to reject the account books but has importance as corroborating evidence and is to be used alongwith other evidence for the purpose of making best judgment assessment.

Causes of Variations in Accounting Ratios:

Any significant variation in the ratio should be investigated_ Some of the possible causes of variations are indicated below, in discussing the ratios themselves. In investigating these variations the following points should be kept in mind:

(a) variations in any structural relationship may be due to legitimate causes. It does not necessarily follow, nor indeed is it the most usual experience, that, because a given relationship has varied, the cause is error or evasion;

(b) variations in relationships are most significant when it is found that 2 or more relationships have varied concurrently in such a way as to be explainable by reference to a single cause - especially if that possible single cause is error or evasion of a particular kind, e.g. a reduction in current ratios, an increased time taken to pay creditors (creditor ratio) and a reduced period of credit given (debtor ratio) suggests a deterioration in the liquidity position;

(c) variations in relationships from one year to another are generally not especially significant Trends in relationships are far more important, and attention should be directed particularly to abnormal departures in any year, or years, from general trends.

Illustration: The condensed financial statements of Aisan Ltd. for last three years are summarized below:

PROFIT & LOSS ACCOUNT For the year ended 3151 March

Debit

Credit

Particulars 2005 2006 2007 Particulars 2005 2006 2007 Rs. Rs. Rs. Rs. Rs. Rs. To Opening Balance 40,000 50,000 100,000 By Sales 800,000 1.260.000 1,740,000 To Purchases 650,000 1.100,000 1,580,000 By Closing Stock 50,000 100,000 200,000 To Gross Profit c/d 160,000 210,000 260,000 850,000 1,360,000 1,940,000 850,000 1,360,000 1,940,000 To Expenses 80,000 100,000 120,000 By Gross Profit bid 160,000 210,000 260,000 To Debenture Interest . 20,000 To Net Profit c/d 80,000 110,000 120,000 160,000 210,000 260,000 160,000 210,000 260,000 To Income Tax 440,000 64,000 72,000 By Net Profit bId 80,000 110,000 120,000 To Balance cld 36,000 46,000 48,000 476,000 110,000 120,000 80,000 110,000 120,000

BALANCE SHEET As on 31 51 March

Liabilities 2005 2006 2007 Assets 2005 2006 2007 Rs. Rs. Rs. Rs. Rs. Rs. Equity Share Capital 200,000 200,000 200,000 Fixed Assets 178,000 186,000 202,000 Profit & loss Nc 36.000 82,000 130,000 Stock 50,000 100,000 200,000 Debentures 200,000 Debtors 100,000 210,000 480,000 Creditors 112,000 224,000 332,000 Bank 20,000 10,000 Bank Overdraft 20,000 348,000 506,000 882,000 348,000 506,000 882,000

You are requested to:

(a) Compute the following ratios for 2005, 2006, 2007:
(i) Gross Profit Ratio; (ii) Net Profit Ratio; (iii) Stock Turnover Ratio; (iv) Current Ratio;
(v) Liquid Ratio; and (vi) Debt Collection Period.

(b) Comment briefly on the results of the business over the last three years using the above ratios.

STATEMENT SHOWING THE DIFFERENT RATIOS

Accounting Ratio 2005 2006 2007 160,000 210;000 260,000 1. Gross Profit Ratio = X 100 = X 100 = X 100 800,000 1,260,000 1,740,000 Gross Profit = X 100 = 20% = 16.67% = 14.94% Sales
. '
80,000 110,000 .. 120,000 2. Net Profit Ratio = X 100 = X 100 = X 100 800,000 1,260,000 1,740,000 Net Profit = X 100 = 10% = 8.73% = 6.89% Sales 640,000 1,050,000 1,480,000 3. Stock Thrnover Ratio = = = (40,000+50,000)/2 (50,000 + I 00,000)/2 (100,000+200,000)/2 Cost of goods sold = = 14.22 times = 14 times = 9.87 times Average Stock 170,000 .320,000 680,000 4. Current Ratio = = = 112,000 224,000 352,000 Current Assets = = 1.52 = 1.43 = 1.93 Current Liabilities (170,000- 50,000) (320,OaO -100,000) (680,000 - 200,000) 5. Liquid Ratio = ~ = 112,000 224,000 352,000 Current Assets - Stock = = 1.07 = 0.98 = 1.36 Current Liabilities 100,000 210,000 480,000 6. Debt Collection Period = X 365 = X 365 = X 365 800,000 1,260,000 1,740,000 Closing Debtors = X 365 = 46 days = 61 days = 101 days Credit Sales

* Average Stock = (Opening Stock +Closing Stock)/2

**Cost of goods sold = (Opening Stock + Purchases - Closing Stock)

The Project is to express comments on the results of the business of Asia Ltd. for the last three years on the basis of the following accounting ratios:

(i) Gross profit ratio;
(iii) Stock Turnover Ratios;
(v) Liquid Ratio; and

(ii) Net Profit ratio;
(iv) Current Ratio;
(vi) Debt Collection Period.

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The Profit and Loss Account for the year ended on March 31, 2005, March 31, 2006 and March 31, 2007 and also the Balance Sheet as on dates has been provided. The data so provided has been utilised for computing the ratios. The computation of the ratios is given at th,e end of the conclusion as working note. On the basis of the computed ratios, views have been formed and expressed.

Conclusion and Comments:

1. Sales and net profits have increased in absolute terms over three years, but, its gross profit ratio has fallen sharply over these years-from 20 per cent in 2005 to 14.94 in 2007, Possible reason for the fall in Gross profit ratio can be that the company has reduced the profit margin to increase its sales or cost of sales has increased without corresponding increase in sales price. It is also indicated by the decreasing Net profit Ratio from 1 0 per cent in the year 2005 to 8.773 per cent in the year 2007 and 6.89 per cent in the year 2007.

2. It is apparent that the company's rapid growth in sales in 2006 has been at the expenses of efficient use of available resources, e.g., stock tUrnover ratio has fallen from 14.22 times in 2005 to 9.87.

3. The current ratio has improved (up from 1.52 in 2005 to 1.93 in 2007).

4. Liquid ratio has also improved from 1.07 in 2005 to 1.36 in 2007.

5. The debt collection period has adverse growth and has increased from 46 days in 2005 to 101 days in 2007. It shows that the company is selling its stock by offering higher credit period which may result in higher bad debts. Therefore, company may face problem in realisation from debtors.

ANNEXURE - 3 EVALUATION OF INTERNAL CONTROL

The auditor should acquire an understanding of the accounting system and related internal ontrol and should study and evaluate the operation of those internal controls upon which he wishes ~o rely in determining the nature, timing and extent of other audit procedures.

Different techniques are used to record information relating to internal control system One such technique is questionnaires.

(A) Questionnaire for evaluating Internal Control regarding Sales:

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I) Order booking:

1. What record is kept of sales orders received by post or otherwise?
2. In deciding upon the acceptance of orders, are the stock position and production programme considered?
If yes, how the same are evidenced?
3. How the credit limit of a customer fixed before credit is is granted?
4. Who authorizes discount and on what basis?
5. Is there any procedure for accepting an order on unusual terms?
If yes, state the procedure.

II) Despatch and billing:

6. What records are kept for goods dispatched to customers?
7. Are acknowledgements of the receipt of goods obtained from customers? If yes, where and how these records are kept?
8. Are sales invoices compared with:
(a) Orders as received?
(b) Goods despatch records?
(c) Acknowledgements as received?
(d) Specification of goods mentioned in the order?
9. (a) How many copies of invoices are prepared?
(b) How are they distributed?
© Are they pre-numbered?
(d) Are the copies of invoices of different colours?
10. Who signs the invoices? Gives their status?

III) Return of goods and credit notes :
} 1. What f7cords are kept when goods are retunled by customers ?
12. 'From what sources of information 'ereditliotes prepared?
13. Are all credit notes authorised by a responsible person? if yes, give his status.

IV) Debtors ledger :
14. How many independent accounts does it contain ?
15. Are year-end confirmati s of balances obtained from the customers?
16. Are receipts issued where payments are received in cash or bearer cheques ? How are the receipts kept?
17. What is the procedure for following up outstanding debts ?
18. Are special discount or allowances given to customers ? If yes, what is the basis?

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(B) Questionnaire for evaluating Internal Control regarding Purchases :

1) How purchases orders are placed upon suppliers?
2) What records are kept for this purpose?
3) How is it ensured that all purchases have been made as per order?
4) Who acknowledges the receipt of goods at the time of delivery?
5) Where and how such acknowledgements are kept?
6) Are Goods Inward Book maintained at the place where goods are kept?
7) Are purchase bills checked with acknowledgements & Goods Inward Book?
8) How Input Tax paid is recorded in books?
9) Have Input Tax credit been claimed on original tax invoices only? If no, give reasons 10) How goods returned are recorded and verified?
11) When goods are returned Input Tax Credit is reversed or not?
12) If Yes, when?
13) Whether credit notes are obtained from suppliers or not?
14) How many suppliers are there in the Creditors ledger?
15) What is the percentage of outside purchase to total purchase?
16) Where payments are made in cash acknowledgements are obtained from suppliers or not?

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(C) Questionnaire for evaluating Internal Control regarding Wages :

There are various way to obtain information about production of a unit e.g. analysis of ratio of various manufacturing expenses. One such means is evaluation of internal control relating to wages.

(1) Is the industry covered by any Wage Board or is it subject to any provision of any law as regards any aspect of wages?
(2) Is there any wage agreement with the workers in force?
(3) How many workers are employed in the factory?
(4) Are records maintained to show:
(i) Terms of engagement?
(ii) Basis of wage payment?
(iii) Identification mark?
(iv) Specimen signature (v) Photograph?
(5) What are the normal working hours?
(6) On what basis is overtime paid?
(7) Are time clocks used ? If not, how is attendance recorded?
(8) (i) In respect of employees paid on HOURLY BASIS, are job cards maintained in addition to clock cards?
(ii) If Yes, are the two records tallied?
(9) (i) In respect of employees paid on PRICE BASIS, state the method of recording work done?

(ii) How are Piece Work qualities and quantities checked?
(iii) Are records maintained for rejections?
(10) Describe the way in which pay-roll is prepared from clock cards, job cards and piece work cards?
(11) Is any incentive payment in force? If so, briefly explain the scheme.
(12) (i) Are the wages paid weekly or monthly?
(ii) To which day of the week are wages made up, if wages are paid weekly (iii) On which day are the wages paid?
(13) What is the procedure laid down for building up the composition of wages?
(14) Do employees signify receipt of pay packets?
(15) (i) How are the deduction from gross wages accounted for?

(i) What is the system of payments to outside authorities to whom deductions along with employer's contribution, if any, are payable? (example - E:S.I., Profession tax etc.

(ii) Are these paid in time?

(16) Are there any special features of the wages sheet? Please enclose a specimen of wages sheet.

(D) Questionnaire for evaluating Internal Control regarding Stock & Stores :

(Store here means -Raw materials, Consumable stores, Spares & Finished Products.)

(1) Whether any stock register is maintained?

(2) If yes, who maintains it and where?

(3) Is the principle of valuation at cost or net realizable value, which ever is lower, has been applied on a consistent basis?

(4) Has there been any change in the basis of ascertainment of the cost of stocks, for example, LIFO basis to FIFO basis or vice versa?

(5) Have physical stocks been properly adjusted for items like goods sold but not yet dispatched, goods sent to customers on approval basis, goods sent on consignment and sold out, goods received on consignment etc.

(6) Are stocks physically verified? If yes, when & how?

(7) Give the code no. of each item of stores.

(8) Are Bin Card and Store Ledger maintained?

A Bin Card is lJsed to keep physical record of each item of stores, it generally contains three colunhis viz. receipt, issue and balance. It is kept at a place where the items are stored. The Store keeper maintains the "Bin Card.

The Store ledger is maintained by the office. Here values are also recorded in addition to quantities.

(9) Are issues made only ion receipt of requisitions by the Using Departments?

(10) How is shortage accounted for?

(E) Questionnaire regarding power consumption.

1. What are the sources of power in the factory?
2. How many electric meters does the firm own?
3. Are there separate meters for the factory where machines are installed ? If yes, given details.

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4. How many machines are used in the manufacturing process? Given details as per the following format.

Sl. Type of No of Items Unit Source of Power No. of hrs in No. machine machine manufactured capacity power consumption use during the per hour period

5. If coal, diesel, petrol, any other natural gas, etc are used as source of power give details as per format below

Sl. Item Opening Stock Purchase during Closing Stock Quantity consumed No. the period
(1) (2) (3) (4) (5) (6) = (3) + (4) - (5)

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ANNEXURE -4

FRAUD INVESTIGATION

Introduction:

Like other taxes VAT can be evaded. Any tax system which basically relies on selfassessment systems requires a firm enforcement system

The investigation of fraud is a vital element in the administration of VAT. The purpose behind a VAT fraud investigation is to deter VAT dealers from knowingly making fraudulent VAT returns.

A distinction is to be drawn between innocent errors made on VAT returns and false declarations made with the intent to defraud.

Detection of frauds and errors

Audit has a deterrent effect on fraud and errors. The term 'fraud' refers to an intentional act by one or more individuals among management, employees or third parties, involving the use of deception to obtain an unjust or illegal advantage. On the other hand, the term 'error' refers to an unintentional mis-statement in the financial statements. Unlike error, fraud is intentional and usually involves deliberate concealment of facts.

Forms of evasion

There are numerous ways to categorize evasion. The following list gives flavor of various types of VAT evasion.

Inflation of Input Tax Credit with the help of false invoice

This is the device by which the dealer inflates the input tax credit through the use of counterfeit invoice to show non-existent or overvalued purchases. Since input tax credit can be taken by themselves and it is not likely to be audited every year and also because the number of I tax invoice is very large, there is a tendency on the part of the manufacturer and dealers to account for a few fictitiouslbogus invoices for the purpose of inflating the claim of input tax credit This can be checked only if the invoices are matched.

VAT is regarded is th~oretically self-policing if the VAT trail can be pursued. The so-called VAT-trail is supposed to give the clue to verification of such false invoices to find out the false credit However, the role of VAT trail is theoretically effective but in practice it is well neigh impossible to verify such a large number of invoices by cross verification which needs enormous efforts and time. Realising the difficulty of cross checking, the buyer and seller may get into collusion so that for one transaction there can be two false invoices. Such deception could be uncovered by comparing for every transaction which is an enormous task even with the aid of computer. .!

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False Export Claims

In case of export since there is no VAT payable on the goods exported, the whole of input tax credit becomes liable to be given back to the exporters as refunds.

Companies that export much of their output are often in continuous credit to the government.
Completely false export sales can be invoiced and the claim for VAT refund made- very like printing money.

The large potentiality of fraud in respect of export has made it clear that VAT is "uniquely susceptible to fraud to the extent that a supplier's invoice, or export's certificate, is in effect a cheque, drawn on Government and so inherently constitute a tempting target for those who would loot the treasury".

There should be pre-audit of all amounts above a certain limit before refund.

The AVAT Act provides for provisional refund against furnishing of bank guarantee and final refund against tax audit.

Under-reported Sales

Underreporting of sales is the most usual way to evade VAT. The lower the value of sales, the less the VAT owed. The only danger is that if an invoice is issued, the purchaser will claim his input tax credit and this would not match in an audit against the VAT paid. But this danger depends on the likelihood of audit being able to detect it. Of course, the question of non-matching invoices does not arise if the sale is retail. Retail services are particularly prone to evasion through underreporting of sales.

Taxpayers may be picked for audit if their reported sales as a ratio to purchased inputs is lower than average over a period of years. The authorities can also check inventories and warehouse stocks to catch these evasions. However, such searches are time consuming, expensive, and sometimes annoying to the honest trader who is attempting to comply with all the regulations.

In Italy, customers of restaurants and hotels can be stopped by the police on leaving the premises and asked for the receipts showing the VAT paid; this is supposed to encourage the customer to ask for the receipt and may discourage him from being a willing partner with the retailer to evade VATS

.It must be appreciated that the VAT at risk is only for the particular stage of production or distribution. Earlier processes will have declared their sales and purchases and paid the VAT appropriate to their value added. Indeed, if the invoice for the non-reported sales is suppresseQ (other than at the retail stage), the VAT liability will catch up at the next stage as the purchaser will be unable to claim his VAT deduction. Of course, VAT may be fully at risk if the seller does nOt report the sale, but the buyer takes the VAT credit on his purchase and this tax credit w~ cover all value added in previous stages of production.

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Bogus Traders

Also difficult to check is the creation of short-lived bogus companies. These can fabricate fake export invoices and claim VAT rebates on goods that have never been handled. Alternatively, they may actually sell the goods on the domestic market but claim a VAT rebate on a bogus export invoice. In one example, a trader set up 48 fake companies to "work the export racket"; the rebates claimed in each case were relatively modest but in total were substantial.

Unrecorded Cash Purchases

S mall traders (and sometimes large ones) will buy goods from a primary (unregistered) supplier, such as a farmer, and because the transaction is not recorded, the purchaser will be able to sell the goods without charging VAT and no record will exist In general, this is not a serious problem because most purchasers will want to record the sale to claim the VAT as credit But if the production chain is short, which it frequently is· in developing countries, and then this can become a major form of evasion.

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Non Registration

Traders have an obligation to assess their trading turnover and as soon as their turnover crosses the threshold, they must register for VAT. If traders initially are not within the VAT limits, most legislation requires traders to notify the authorities either ex post when sales exceed the limit, and even, in some cases, when there are reasonable grounds to believe that sales in the coming 12 months will exceed the annual threshold. The problem of evasion is created when traders who should register do not do it as long as they are not detected by the tax department

This means that although they pay VAT on their purchases, their sales are not liable. Their value added, therefore, escapes VAT and they are in a better competitive position than those who pay tax. The government loses revenue.

VAT collected but not remitted to the Authorities

This is a straightforward example of evasion that is particularly pernicious in the construction industry where small traders may collect VAT and then disappear.

Extra alertness is necessary on the part of tax authorities to track such cases. In Belgium, to meet this evasion, VAT was able to take advantage of an anti-income tax avoidance device; the client is made liable for the VAT if the building firm he employs is not registered (and the registration system is specifically designed to keep track of the small builders-not only for the VAT but also for social security).

Imported goods and collected tax but unreported sales

There have been cases where goods have been imported illegally and the same are sold with the full VAT added, but the sales are not reported and VAT collected are not deposited to the authorities. Gold, spices are the examples, but for any commodity to be used in this way there has to be a sizable legitimate trade in the goods.

Credit claimed for purchases that are not creditable

A dealer may not be entitled to input tax -credit in respect of various types of purchases. But nevertheless the dealer can claim input tax credit in respect of such non-eligible purchaSes.

For example, input tax credit is not available on purchase of capital goods, raw materials, packing materials which are meant for use in manufacture or packing of goods specified in the Fourth Schedule. The input tax credit is also not available on purchase of any goods specified in the Fourth Schedule if such goods are for the purpose of re-sale or use at rwise. Again input tax credit is not available in respect of purchase of capital goods specified in the negative list given in the Seventh Schedule e.g. vehicles of all types, office equipment, furniture etc.

While checking dealer's claim of input tax credit, it should be checked whether the dealer has taken the benefit of tax credit in respect of such non-eligible items.

Credit Claimed for taxable Supplies Used in Exempt Activities

If a business is wholly exempt, no credit can be claimed. The problem arises when a trader is selling both taxable and exempt goods and services. It can easily divert purchased inputs on which VAT credit is claimed against taxed sales to help produce and sell exempt items. It is much more difficult when the same raw materials may be inputs to exempt and taxable outputs and some traders may deliberately offset more credit against VAT than was actually involved.

Proviso to section 14(3) and Rule 11 (2)(c) of the A V AT Rules, 2005 provides for allowance of input tax credit on proportionate basis.

When the sales turnover of a dealer consists of sales both taxable goods and exempted goods and input tax relating to taxable goods is not identifiable, the amount which can be claimed as input tax credit has to be calculated as follows :

Input tax X Taxable tur over Gross Turnover

Carrousel fraud (fraud on inter state sales)

Fictitious transactions of goods are made in order to get refunds on allegedly pre-paid VAT.
However, the goods are only purchased and resold fictitiously to a dealer in another state. As a consequence, the operator claims refund without having paid VAT.

These fictitious supplies may be advanced through the use of numerous shell companies creating the illusion that goods are being supplied to another state and back So called fraud carrousels are based on a series of fictitiOUS supplies from one member state to another and vice versa that enable companies to claim VAT refunds through utilisation of various shell companies without paying VAT at all. The shell companies can be sacrificed because they have a limited liability. The construction involves at least four companies. The fraudulent trader pretends to purchase domestically from a shell company, which does not pay VAT. This trader, however, claims a refund and supplies a foreign trader with a zero rated intra community transaction The foreign trader is a shell company that does not pay VAT on the intra community acquisition It can again sell the goods to another company, which could be second fraudulent tr?der. He would then . sell zero rated once more across the border to the very first shell company and claim another refund. Thus, in fact, the good neither need to be moved, nor do they necessarily need to exist. Even if no VAT has been paid, refunds have been claimed twice. The shell companies will eventually be identified. However, the fraudulent trader can only be traced after the shell companies have been traced and dismantled.

Cloning Fraud

This is a fraud perpetuated by using the VAT Registration numbers of reputed companies.
The modus operandi is that a person carries on business without registering himself but by using the VAT registration number of someone else. The dealer disappears without filing VAT returns as he obviously cannot file using the hijacked VAT registration number. The innocent buyer of goods from this dealer who claims Input Tax Credit on the purchases effected faces the prospect of his claim being disallowed at a later date when the officials discover that the invoice is bogus. The dealer whose number has been hijacked also has to face the demand for payment of the VAT on the bogus invoices raised in his name and has to convince the officials that he had not issued those invoices. In the Indian context this fraud is likely to happen more often. The important check that the tax officials must exercise is to verify registrants properly and also watch out for the unnatural sales lower than market price since the fraudsters are in a hurry to sell and vanish.

Artificial disintegration of firms

To remain below the threshold limit some firms break themselves into two or more while the main firms controls financially the other firms. The other firms in effect becomes the dummies of the main firm.

Credit claimed for invoices from unregistered suppliers

Credit for VAT paid on inputs can only be claimed when the purchase is made from a registered supplier. An unregiste~ed supplier could be an exempt or a small trader, perhaps already enjoying a special treatment for VAT, or it could simply be a private person. If the trader, who has purchased from the unregistered supplier, pretends that the purchase invoice has a VAT number, or creates an imaginary VAT number, the authorities are defrauded.

Credit Notes on purchases including VAT not shown in returns

A seller may issue a credit note in respect of discount allowed or some other reason subsequent to a sale transaction. On receipt of such credit note, the buyer is supposed to reduce the input tax credit. But if the purchaser takes full credit for VAT on the full invoice and does not reduce the input tax on account of the credit note, the authorities will allow more VAT credit than they ought.
The trader's books may all be in order and all the purchase invoices may be properly kept and available for inspection. The cheating may show up only through a financial match on checks issued against (sometimes numerous aggregated) invoices from the same supplier. Sometimes the cross-check can be initiated from the credit invoices of the supplier.

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Multiple Rates and Incorrect Descriptions

Multiple rates of VAT are the bane of VAT administration. Tax forms become more complicated as VAT at the appropriate rate has to be applied to both inputs and outputs; the chances for genuine error are enhanced and the opportunity for deliberate misclassification is widened. Where traders are buying and selling goods and services that may be liable to three or more rate of VAT, clearly the compliance costs rise and the reduction in tax liability by shifting goods from "luxury" to standard rates can be tempting; equally, the refunds can be inflated by allocating an undue proportion of sales to exempt or low rate categories.

The classic opportunity to combine underreporting sales and misclassification of goods occurs in retailing. In a small shop, the owner can persistently misallocate goods for a lower VAT in ringing up the sale on the cash register. In larger stores, an· assistant can favor friends, defrauding the revenue, in exactly the same way. An even more direct way to falsify till roll records is to start a new roll halfway through the day and submit the half roll as the record of the day's sales.

Checking such evasion is difficult without effective audits and even then a pattern of deliberate misclassification has to be established to identify evasion rather than error. This consideration emphasizes the need to limit the number of tax rates and exemptions to as few as possible.

Barter Arrangement

If there is collusion between seller and purchaser to exchange goods and services with no payment and no invoice record, then there is no documentary liability to VAT. There may be, of course, depending on the VAT law, an implicit liability to VAT that ought to be reported. Again, collusion can involve a sale for cash of, say, color television sets and issuing false invoices for an equivalent value for the sale of some other items that the same purchaser would b~ able to represent as an input to his business.

Bill Trading

One undesirable offshoot of the single point tax system is an evil called "bill-trading". Bill traders are those who do not deal in goods but sell bogus bills. Some unscrupulous traders claim second sale exemptions on the strength (}f bogus bills obtained from bill traders. There is a fear that this evil of bill trading may reach on unmanageable level under VAT regime. Under that system, sale bills are equivalent to bank cheques since tax rebates and even cash refunds can be claimed by producing them It will definitely be a herculean task for the tax administrators under the VAT system to tackle the menace of bill trading. Only a system of proper cross verification can check the menace of such bill trading.

Identification of fraud by audit officers:

a) The purpose of VAT audit should be to identify discrepancies and geficiencies in the VAT dealer's records and ensure that the full amount of VAT due has been recorded and paid on each return.

b) Having identified an error, the officer should attempt to establish whether it was innocently made, or made deliberately with the intention of reducing the tax to be paid.

c)

If the VAT dealer is unable to offer a reasonable explanation for any error, th~ offict:r should attempt to gather any evidence to suggest an intention on behalf of the VAT dealer to defraud the Tax Department of the VAT due.

The officer should approach this task by seeking to establish the VAT dealer's normal operational and accounting methods and then seek an explanation for any various from normal business procedures.

Where the explanations offered are unconvincing, there must be a suspicion that a fraud could have been committed.

In all other cases where there are grounds for suspecting fraud,. the officer should take possession of the relevant documents and any evidence under cover of a panchanama attested by two independent witnesses. If this is not practical and withdraw from the audit advising the VAT dealer that there is a need to look further at his records and check them back at the office.

No indication should be given that fraud is suspected, or that anything serious is wrong, so that the VAT dealer does not seek to destroy evidence while the case is being reviewed.

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The types of VAT fraud are too varied for a definitive list to be provided, but table details the more common types of fraud which have been detected in VAT systems.

The table also specifies the counter measures that could be employed by administrators. The list is not exhaustive, and is for guidance only to create awareness of possible VAT frauds.

There should be a list of VAT frauds (where an intention to defraud exists) evasions (were· an error is considered to be mistake) completed & regularly updated by each office. This information should be centrally located in the Central Investigation Unit (cru) and made available to all offices on a quarterly basis.

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ASSAM VALUE ADDED TAX AUDIT MANUAL ILLUSTRATIONS OF VAT EVASIONS AND FRAUD

The list is merely illustrative and not exhaustive

TYPE OF EVASION OR FRAUD ADMINISTRATIVE MEASURES 1. Failure to register Survey and surprise visit and cross reference 2. Bogus registration to obtain refunds Audit visit prior to payment of refund 3. False export of goods Check customs clearance certificate and Commercial documentary evidence of export 4. False tax invoices and alterations to tax Audit officer can refer information from invoices original tax invoice for checking at the VAT dealer issuing the invoice.
5. Suppressed sales for calculation of output Use 'mark-up' techniques based on purchase tax (Retailers off - record sales, (sales records combined with an inventory check.
invoices not issued) Cash reconciliation can be made. Possible indicators are : the missing sale invoice and inconsistent banking etc.
6. False input tax claims Check tax invoice. Audit officer can refer information from original tax invoice for checking at the VAT dealer issuing the invoice.
Possible indicators are : alteration to tax invoice, photocopies of invoice for taking credit, lack of records of vendor, capital goods purchased not available for inspection, mismatch between sale value and credit claimed etc.
7. Mis-declaration of purchases - incurred for ~ Confirm purchases, where input tax has been private! non-business or exempt activities. claimed, are used for taxable business activities.
- Check stock for re-sale, or identify goods and capital assets.
8. Incorrect tax rate applied Confirm eligibility of all zero rated, exempt, 1 %, 4% sales.
9. Unrecorded purchases, to suppress sales - Check stock and sales records to purchase records - Check banking records.
10. Incorrect deduction of input tax for non- - Identify exempt activities.
business! exempt activities. - Check creditable input tax calculation

11. Input tax credit claimed for purchases from Check tax' invoices and confirm particulars unregistered suppliers. against VAT register:
12. Input tax credit claimed for negative list Check invoice for input tax claims in purchase goods (automobiles) petroleum etc.) record.
13. Credit notes· on purchases - VAT not Check accounting records to source documents.
adjusted.
14. Use of false export documents to substantiate Check documentation against requirements.
claims for zero rating of exports.
15. VAT collected from customers - not declared - Use of cross reference system to check and remitted to the Tax Department purchase records of customers. (sales to VAT dealers) Application of mark-up to purchases to non-VAT registered dealers.
- Check with banking records.
16. Part of business activities suppressed from Physical inspection of all business premises, VAT account coupled with overview of all business accounts/ annual accounts, if available.
17. Cancellation of VAT registration and Use cross reference system.
continuing to trade and charges VAT.
18. Charging tax on sale of a business (properly - Check all sales of business for correct VAT .
exempt) with credit claim by purchaser and treatment no tax paid by seller. - Use cross reference system for any large input tax claim.