

## CAG's Audit of Indirect Taxes

SS	Tax	
50,245.00	7,512	142,733.00
25,466.00	-	25,466.00
165,412.00	8,271	157,140.00
45.00	12,532	238.00
		33,797

*The objective of this article is to familiarise the CAG's Audit of Indirect taxes to the Chartered Accountants professionals for better tax audit, compliance of tax laws and thereby building a synergy. In an earlier article on CAG's Audit of Direct Taxes published in this journal, CAG's mandate was discussed with reference to the decision of the Delhi HC in the case of Association of Unified Telecom Service Providers of India & Others. The Supreme Court upheld the decision of the Delhi HC on 17<sup>th</sup> April, adding further that the duties and powers conferred under Article 149 form the basic structure of the Constitution like parliamentary democracy and independence of judiciary and cannot be taken away by the Parliament by bringing any legislation to that effect. Read on...*

To understand the mandate of CAG clearly, it is important to cite a relevant part from the "Regulation on Audit and Accounts, 2007", issued under section 23 of the DPC Act, 1971.

### A. GENERAL REGULATIONS

- As per Regulation 1(2) *ibid*, applicability of these regulations is as under:

*"These Regulations shall apply to the officers and staff of the Indian Audit and Accounts Department and all ministries and departments of the Union Government, State Governments*

*and Union Territory Governments as well as bodies, authorities and enterprises, to which the audit or accounts jurisdictions of the Comptroller and Auditor General of India extend."*

- There is no power of direction by the executive in relation to the performance of the audit mandate. {Regulation 9}.
- The scope of audit of receipts includes examination of integrity of data, information and documents which form the basis of a policy {Regulation 55}.
- Regulation 6 reiterates the provisions under section 18 of the DPC Act, 1971 which has the following main aspects: The Comptroller and Auditor General has the authority:
  - (a) to inspect any office of accounts under the control of the Union or of a State or of a Union Territory having a legislative assembly;
  - (b) to require that any accounts, books, papers



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and other documents relevant to audit shall be sent to such place as he may appoint for his inspection;

(c) The person in charge of the audited office or department shall afford all facilities for such inspection and comply with requests for information in as complete a form as possible and with all reasonable expedition.

- The head of the office of the auditable entity has to provide appropriate and reasonable office accommodation and other office amenities to the audit team for official use and at par with facilities available in the auditable entity. (Regulation 175)
- The form, type and extent of data, information and documents, including those from the third party, required for audit tests and evidence shall be determined by the audit officer and shall have access thereto. (Regulation 169).
- The evidence used by the audit officer shall normally and as far as possible be documentary including electronic records, photographs, results of any study or survey, *etc.* The audit officers may rely upon evidence from internal sources of the auditable entity as well as from external sources. (Regulation 170)
- Where required by the audit officer, the auditable entity shall attest the data, information and documents forming the evidence. (Regulation 171)

### About Indirect Tax Administration Set Up and their Functions

There are two types of indirect taxes:

- A. **The taxes which form part of central receipts**-Central Excise, Service Tax, Customs Duty, Central Sales Tax.
- B. **The taxes which form part of State receipts**-Sales Tax, VAT, Stamp Duty and Registration fees, Land revenue, State Excise, Taxes on Motor Vehicle, *etc.* which may vary from state to state. In this article, CAG's audit of State Receipts is not dealt with.

In case of Indirect Taxes (Central), the Central Board of Excise and Customs (CBEC) is the apex body under the Department of Revenue of Ministry of Finance, Govt. of India, entrusted with the administrative authority for its subordinate organisations like Custom Houses, Central Excise and Service Tax Commissionerates. CBEC formulates the policy concerning levy and collection

of indirect tax revenue, prevention of smuggling and administration relating to Customs, Excise, Service Tax and Narcotics to the extent under its purview which is executed by its lower field formations.

In case of State Indirect Taxes Receipts, it is governed by Acts and Rules of respective States.

The assessment function in the Indirect Tax wing (Central) distinctly differs from that followed in the Direct Tax wing. It underwent a complete change when in October 1996, invoice-based self-assessment by assesseees was implemented based on the Chelliah Committee recommendations. With the introduction of self-assessment, the role of the Central Excise Department has undergone a transformation from the role of pre-clearance-assessment to post-clearance scrutiny of assessment. The same self-assessment system has been prescribed for service tax as well.

Under this self-assessment regime, the department (Central Excise and Service Tax) has a three pronged compliance verification system *viz.* (a) scrutiny of returns; (b) audit; and (c) anti-evasion. These layers prescribe gradually increasing intensity of scrutiny by the department to which assesseees' self assessment is subjected to.

Customs Receipts Audit wing audits the Bills of entries, Drawback claims, refund claims passed by the Customs Commissionerates, licenses issued under various Export Promotion Schemes issued by the DGFT, local audit of Export Oriented Units/ Software Technology Parks/Special Economic Zone units are conducted. At the same time, expenditure audit of SEEPZ/SEZ Authorities are conducted and a Separate Audit Report (SAR) is issued.

### About Indirect Tax Audit Wing of the CAG

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**At the CAG headquarters in New Delhi, Dy. Comptroller and Auditor General (Central Revenue Audit) heads and controls the Direct Tax and Indirect tax audit except State Revenue with the help of Director General (Direct /Indirect Taxes) and other officers. At the field level, there are four Central Revenue Audit offices at the four metro cities headed by Director General of Audit and Principal Director of Audit in some major cities.**

**An audit plan for the forthcoming financial year is prepared considering the constraints of available workforce and working days in a financial year. Adopting Risk Based Auditing based on Risk analysis and sampling technique, units to be audited are selected and distributed among the Local Audit Parties.**

help of Director General (Direct/Indirect Taxes) and other officers. At the field level, there are four Central Revenue Audit offices at the four metro cities headed by Director General of Audit and Principal Director of Audit in some major cities. In certain states where there are no separate central audit offices, the Indirect Tax wing functions under Pr. Accountant General/Accountant General. In either of the cases, the audit of the State Revenue Receipts are conducted and reported by Pr. Accountant General/Accountant General. Actual audit at field is conducted by the Local Audit Parties (LAPs) of groups named as CERA (Central Excise Receipts Audit-for Central Excise and Service Tax), CRA (Customs Receipts Audit), Sales Tax Receipt Audit (STRA) and other State Revenue audit wings with the LAPs headed by Senior Audit Officers/Audit Officers under the control and supervision of Group officers *viz.* Directors/Deputy Directors/Deputy AG who in turn report to their respective Director General/Principal Director/Pr. AG/AG.

### Necessity of CAG Audit

India's fiscal system Indirect Tax receipts contribute to 44.16<sup>1</sup> % Gross Tax receipts of the country in 2011-12). India, being a global economic destination, Indirect Tax administration is one of the critical factors for accelerated economic growth of the nation. The statistics in the table shows the importance of Indirect Taxes *vis-à-vis* GDP of the country.

As a part of the checks and balances of the parliamentary democracy, CAG reports help the people's representatives to ensure proper accountability of the executive through effective review, monitoring and control of government receipts going into the Consolidated Fund of India and accounting expenditure therefrom. It's an inalienable responsibility of CAG to submit the reports on revenue and expenditure to the President and the Governor to place before the legislature. CAG's revenue reports ensure that a proper system of tax collection and administration with internal controls are in place, tax revenue is correctly assessed and collected in compliance with tax laws and there is no under assessment or over assessment.

### Audits Conducted by Indirect Tax Audit Wing of CAG

The audit planning with selection of charges to be audited is done on the basis of application of specified inherent risk parameters and systematic sampling methodology. The units to be audited are categorised into high, medium and low risk units based on selected parameters and are audited annually, biennially or pent annually.

Traditionally, we have been conducting assessee centric audit involving scrutiny of verification by the department of compliance of various tax laws by the assessee (Central Excise and Service Tax). Findings of these audits are compiled in our Compliance Audit Reports. System issues were taken up by way of annual performance audits of any selected aspect. From the financial year (FY) 2011-12, Indirect Tax audit by CAG has switched more towards department centric approach where higher stress is on regular audit of all the important systemic aspects in the department than on the compliance by the assessee.

Similarly, audit of Customs involves auditing of Shipping bills and Bills of entries for export/import

(Figures in ₹ Crore)

Financial year	GDP	Gross Tax Revenue (GTR)	Indirect Tax Revenue	Indirect Tax revenue as percentage of GDP	Indirect Tax revenue as percentage of GTR
2007-08	4987090	593147	279497	5.60	47.12
2008-09	5630063	605298	269988	4.80	44.60
2009-10	6477827	624527	245373	3.79	39.29
2010-11	7795314	793307	345371	4.43	43.54
2011-12	8974947	889118	392674	4.38	44.16

(Source- Website of Department of Revenue & CAG Audit Report No. 17 of 2013)

<sup>1</sup> Source Report 17 of 2013 of C&AG of India.

**Common mistakes observed during the audit involve 'arithmetical mistakes in original/ revised returns filed,' 'taking ineligible Cenvat credit on input services having no nexus with the activity of manufacture,' 'non reversal of Cenvat credit in respect of exempted clearances/trading activity,' and 'taking Cenvat credit on such items as capital goods which are not covered under its definition.'**

and involves auditing of Custom warehouses, import through post offices, import/export general manifest and drawback claims and concession given by DGFT (Director General of Foreign Trade under commerce Ministry) in the form of Custom duty forgone to export oriented units, units under special Economic zones and individual exporters/importers under various schemes announced to promote export under Foreign trade Policy. Presently, the customs department is highly computerised. The importer/exporter has to first apply to DGFT to obtain license for import/export. Against this license, not all the bill of entries and shipping bills are entered in the system. The system itself, through its in-built risk analysis, processes it online and the duty is assessed and collected.

The audit of EOU units is classified on the risk factors such as heavy import, more percentage of DTA sales, opting out of EOU status. A certain percentage of units out of said risk are selected for audit. Bills of Entries and dutiable shipping bills are selected for audit as per random sampling method.

### Conducting Audit and Processing of Audit Output

An audit plan for the forthcoming financial year is prepared, considering the constraints of available workforce and working days in a financial year. Adopting Risk Based Auditing based on Risk analysis and sampling technique, units to be audited are selected and distributed among the Local Audit Parties. The allocation of time schedule for audit is done on the basis of the workload available for each unit. Prior intimation of the audit schedule is forwarded to the department to make the records ready for audit.

Objections are raised in the form of Audit Memo or Half Margin memo (AM/HM) seeking response of the audited entity. The Draft Inspection Report consisting of objections raised along with replies

and rebuttals to reply *etc.*, are submitted by the inspecting officer in audit office, which is vetted there for its correctness. The vetted report after it is approved by the Director, CERA/CRA becomes Inspection Report (IR) or Local Audit Report (LAR) and is issued to the concerned authorities dealing with and supervising the issues raised in the report. At this stage, some of the Draft IR paras may not get included in IR. Similarly some of the important paras in the IR/LAR gets registered as Potential Draft Paragraph (PDP) in the audit office, with a view to subsequently sending it for inclusion into the C&AG Audit Report. For this purpose, distinct response from higher authority of the department is required and hence from the list of PDP cases already registered, Statement of Facts (SOFs) are issued in Demi-Official letter format to the jurisdictional Commissioner. On receipt of his reply or otherwise if the audit office is convinced of the validity of the para, the same SOF is converted into Draft Paragraph (DP) and sent to the C&AG office for further inclusion into the audit report. At the C&AG office level, as a result of their scrutiny, DPs are converted into Draft Audit Paragraph (DAP) and issued to the Ministry of Finance for their response. One copy of the same is sent to the audit office, for confirmation of facts and figures, from where these DAPs originate. Similarly, the Ministry also forwards these DAPs to the relevant field formation downwards for confirmation and also for updated status of action taken thereon. At the C&AG office, response from both the audit office and the Ministry is studied and final decision is taken for inclusion of these DAPs as Audit Paras (APs) in the C&AG Audit Report (AR). The AR after being led, through the President, in the Parliament is handed over to Public Accounts Committee (PAC). In the PAC meeting, in a quasi-judicial set up, the audited Ministry/ Department's Secretary has to reply to the queries of the PAC chairmen and its members in the presence of higher officials of the audit office. Subsequently, the Department has to submit Action Taken Note (ATN) against each of the APs to the C&AG, which after verifying its correctness returns to the department for onward submission to the PAC again, as a proof that ATN has been duly vetted by the C&AG with/ without comment as required.

### Highlights of Recent Audit Reports (2013)

In 2013, CAG submitted one Compliance Audit report and one Performance Audit report.

The contents of these reports add value to the perception of the tax practitioners.

## A. Compliance Audit Report (Central Excise and ST) (17 of 2013)

- Nearly fifty % of the assesseees in service tax, paying duty of one crore or more, due for annual audit was not audited by the department.
- Instances of incorrect availment/utilisation of Cenvat credit, short/non payment of duty or interest having revenue implications of ₹61.44 crore and ₹478.04 crore in Central Excise and Service Tax respectively were reported in this report.
- Instances of deficiencies in scrutiny of returns, internal audit, ineffective call-book review, non-recovery of Government dues *etc.* of ₹30.07 crore were noticed which can be attributed to internal control deficiencies of the department.

## B. Performance Audit Report (9 of 2013) on Service Tax on Import of Services

- The department does not have a mechanism to arrive at a reliable estimate of value of taxable services imported.
- It has no specific accounting code or other reliable alternative to ascertain the service tax paid on such services imported.
- The department did not have a system to utilise data available with the Income Tax department relating to remittances to NRIs.
- Non fulfillment of liability by export oriented units and associated enterprises indicated the need for strengthening of monitoring on this front.
- The department did not have in place a system to utilise data on high value transactions of specific nature available with certain Ministries/RBI to check possible cases of evasion of tax.

**The internal auditors (Chartered Accountants), The CBEC (Indirect Tax Department) and Revenue Audit are the three pillars of the Indirect tax collection system. The internal auditor helps in preparation and finalisation of the accounts of an entity, files the returns and thereby facilitates assesseees in the process of self assessment of duty.**

## C. Compliance Audit Report (Customs) (14 of 2013)

- Exporters/Importers had availed the benefits of duty exemption scheme but did not fulfill the prescribed conditions.
- Short levy of duty due to incorrect application of notification.
- Short levy of duty due to misclassification of goods.

## D. Performance Audit Report(8 of 2013) on Deemed Export Duty Drawback Scheme and Reimbursement of Central Sales Tax

- The procedure for claiming deemed export benefit do not impose any restriction on the recipient where the duty has not actually been borne by the recipient.
- DGFT do not impose any time limit for the applicant to comply with the Deficiency Letter with the scheme. Unintended advantage could be taken to avoid imposition of a late cut on claim or its time barring.
- Duty drawbacks were paid to suppliers for supplying imported goods to the project.
- CST was reimbursed without proper certificate from Chartered Accountants.
- Refunds of CST were made from imported goods and on goods procured from EOU/SEZ.
- Refund of CST on goods utilised in production of exportable commodity.

## Lessons That Can Be Learnt From Revenue Audit Reports

Common mistakes observed during the audit are related to:-

- Arithmetical mistakes in original/revised returns filed.
- Taking ineligible CENVAT Credit on input services having no nexus with the activity of manufacture.
- Non reversal of CENVAT Credit in respect of exempted clearances/trading activity.
- Taking CENVAT Credit on such items as capital goods which are not covered under its definition.
- Non-payment of amount in respect of raw materials, on which CENVAT Credit was taken, being written off.
- Simultaneous availment of credit under CENVAT scheme and depreciation under Income-tax Act.
- Undervaluation of goods or services due to non inclusion of additional considerations towards the goods or service.

- h. Non payment of service tax as a recipient of import of service.
- i. Undervaluation of goods under Cost Accounting Standards 4 (CAS-4) when goods are cleared to related parties.
- j. Non-payment of duty on non-receipt of material from job workers.
- k. Application of old rate (*i.e.*, 13 %) of interest instead of the new one (*viz.* 18 %).
- l. Non-levy/non-payment of mandatory penalty where cases have been detected during audit or investigations and the matter was concluded without issue of Show Cause Notice (SCN).
- m. Availment of exemptions without fulfilling the conditions mentioned therein.
- n. The department sanctioning refund to assessees even when recoverable arrears were pending against them.
- o. Non/short payment of service tax especially in those situations where the same has already been collected from its customers.

Though in the case of Customs Duty, Chartered Accounts do not have any direct relation as most of the Customs related responsibilities are performed by Custom House Agents (CHAs) on behalf of the

assessee, but their active role comes at the time of any litigation with the department.

### Conclusion

The internal auditors (Chartered Accountants), the CBEC (Indirect Tax Department) and Revenue Audit are the three pillars of the Indirect tax collection system. The internal auditor helps in preparation and finalisation of the accounts of an entity, files the returns and thereby facilitates assessees in the process of self-assessment of duty. Indirect tax department with its multipronged compliance verification system ensures that the assessees are complying with the tax laws. CAG's revenue audit, by raising timely observations towards any loophole to be plugged, ensures that applicable tax regulations, systems and procedures are complied with. There needs to be better understanding, coordination and synergy among these functionaries. By learning from each other and focusing on respective sphere of responsibilities, these functionaries will be able to provide effective tax administration, compliance, recognising the tax payers' right to enforce tax laws in a fair, equitable and non-arbitrary manner. ■

