

## **Chapter I: Overview of Internal Audit in Income Tax Department**

### **1.1 Introduction**

Internal audit is an independent management function, which involves a continuous and critical appraisal of the functioning of an entity with a view to suggest improvements thereto and add value to strengthen the overall governance mechanism of the entity, including the entity's strategic risk management and internal control system. Internal Audit, being an integral part of the internal control system, has an important role to play in ensuring compliance to prescribed rules, regulations and guidelines.

### **1.2 Internal Audit in Income Tax Department**

Income Tax Department (ITD) is subjected to Internal Audit of assessment and accounting functions. Internal audit of assessment work in ITD is undertaken by the Additional Commissioners of Income Tax (Addl. CstI), Special Audit Parties (SAPs) and Internal Audit Parties (IAPs) of ITD and internal audit of accounting and financial matters is undertaken by Internal Audit wing of Principal Chief Controller of Accounts (Pr. CCA) of Central Board of Direct Taxes (CBDT).

#### *a. Internal Audit of Assessment Function*

Internal audit was introduced in ITD in the year 1954 with the objective of providing a second check over the arithmetical accuracy of assessment made by the Assessing Officers (AOs). With the entrustment of audit of Direct Taxes to the Comptroller and Auditor General of India (C&AG) in 1960, the scope of duties of Internal Audit was made co-extensive with that of statutory audit in pointing out errors, omissions and mistakes, if any, in the assessments and ensuring remedial action in respect of the same.

In the year 2001, Chain Audit System was introduced wherein the task of auditing the work of an Assessing Officer (AO) was allotted to another AO. However the quality of internal audit under this system was affected due to overlapping of assessment and audit functions and owing to low priority accorded to the Internal Audit work. CBDT decided to abolish the Chain Audit System and introduced Quality Audit System in 2005 and substituted it with a new Internal Audit System with effect from 1 June 2007 in order to ensure an effective and objective set up of Internal Audit with no overlapping between assessment and audit functions. In January 2011, a new Audit Manual was brought out providing guidance for Internal Audit in the new set up. Subsequently in October 2013, CBDT issued instructions outlining the roles of Supervisory Authorities in order to further streamline the functioning of

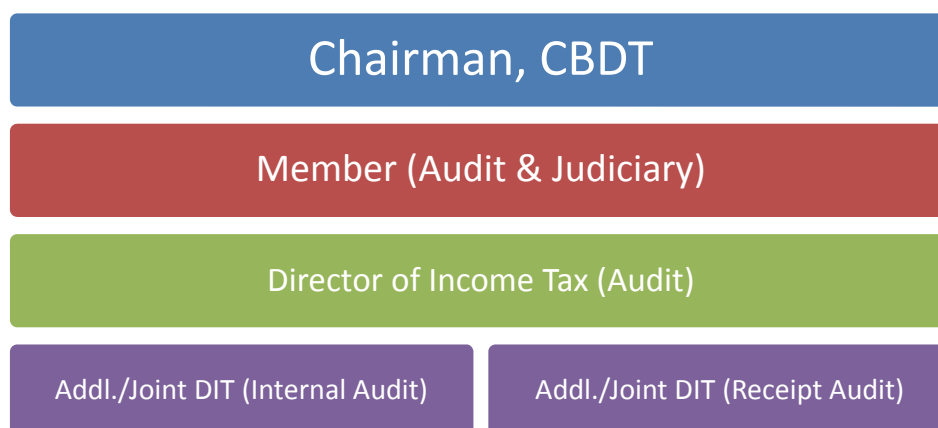
Internal Audit. Internal Audit in ITD has evolved over the years and has assumed significance as an independent function with no overlapping between assessment and audit functions.

*b. Internal Audit of Accounting Function*

The Principal Chief Controller of Accounts (Pr. CCA), CBDT heads the accounting organization of the CBDT with Revenue Secretary as the Chief Accounting Authority. The Internal Audit Unit is working under the control of Pr. CCA, CBDT with the assistance of Chief Controller of Accounts (CCA), Controller of Accounts (CA), Deputy Controller of Accounts (DCA) and Assistant Controller of Accounts (ACA) and is responsible for ensuring correctness of payments, accounts, records and other subsidiary registers. Internal Audit under the Pr. CCA, CBDT also checks initial accounts maintained in the executive offices to ascertain how far the rules and regulations, systems and procedures in accounting and financial matters have been followed.

**1.3 Organizational Set-Up of Internal Audit of ITD**

Central Board of Direct Taxes (CBDT), as a part of Department of Revenue, Ministry of Finance, is the apex body charged with the administration of Direct Taxes. CBDT is headed by the Chairperson and comprises of six Members. In addition to the functions and responsibilities outlined by the CBDT, the Chairperson and Members are responsible for exercising supervisory control over field offices of the CBDT, known as Zones. In scheme of reorganization Principal Chief Commissioner of Income Tax (Pr. CCIT) is the Cadre Controlling Authority of each zone whose jurisdiction is generally co-terminus with state. Member (Audit & Judicial) heads the Audit functions in CBDT and is supported by DIT (Audit). Organogram of CBDT showing the Audit formations is shown in Graph 1.1

**Graph 1.1 Organogram of CBDT**

Internal Audit in ITD at the field level is headed by the CIT (Audit) who functions under the direct administrative control and supervision of cadre-controlling Chief Commissioner of Income Tax (CCIT). The Internal Audit set up consisted of CIT (Audit), Additional CIT (Audit), Special Audit Parties and Internal Audit Parties. In the metro charges of Mumbai, Delhi, Chennai and Kolkata, there are two CsIT (Audit) each whereas in the other charges there is one CIT (Audit) each. There are 22 CsIT (Audit) in the Internal Audit set-up of ITD. CIT (Audit) is responsible for audit work pertaining to all the cases in their jurisdiction.

Each CIT (Audit) is assisted by an Additional CIT who is responsible for audit of bigger cases<sup>1</sup> as per stipulated norms and for supervision of the work of Special Audit Parties (SAPs) and Internal Audit Parties (IAPs). SAPs are headed by Deputy Commissioners of Income Tax (DCsIT) and comprise two Income Tax Inspectors (ITIs) and one Senior Tax Assistant (Sr. TA)/TA. IAPs are headed by Income Tax Officers (ITOs) and comprise two ITIs and one Sr. TA/TA. The Office of CIT (Audit) includes one ITO (HQ) who is responsible for coordinating and monitoring the functioning of Internal Audit. ITO (HQ) is assisted by one ITI and two Sr. TAs/TAs.

#### **1.4 Why we chose the topic**

Internal Audit is an integral function within the ITD which has undergone significant evolution over the years as brought out in para 1.2 of this Chapter. A new Internal Audit System was introduced in ITD in June 2007 with no overlapping of assessment and audit functions besides outlining well defined roles for effective functioning and management of Internal Audit.

<sup>1</sup> Assessed Income above ₹ 25 /10/1 crore for corporate cases and above ₹ 10/ 5/1 crore for non-corporate cases specified for metro/non metro area

We had earlier reviewed the functioning of Internal Audit in ITD in 1991 (Para 2.01 of C&AG Audit Report No. 5 of 1991) and 1998 (Para 3.1 of C&AG Audit Report No. 12 of 1998). We also conducted Review of Chain System of Internal Audit (Para 1.29 of C&AG Audit Report 13 of 2005) which was a part of the Review on “Status of improvement of efficiency through the ‘Restructuring’ of the Income Tax Department”. Besides, the issue of ‘Effectiveness of Internal Audit’ is brought out under Chapter 1 on Tax Administration of C&AG’s Compliance Audit Report placed in Parliament every year. However, we never evaluated functioning of new Internal Audit introduced in 2007.

The issues pertaining to Tax Administration of Ministry of Finance were discussed in the Public Accounts Committee (PAC) meeting held in June 2013, as detailed in 87<sup>th</sup> Report of the PAC (2013-14) of August 2013. The performance of Internal Audit viz. achievement of targets in terms of auditable cases, settlement of audit observations raised by Internal Audit within specified timeframe were discussed in detail by the Committee. The Ministry had stated in its response that time frame of 4 months has been fixed for disposal of internal audit objection to be settled as per the Action Plan for Financial Year 2012-13.

In this backdrop, we undertook this Performance Audit to ascertain the efficiency and effectiveness of functioning of Internal Audit wing in the ITD.

### **1.5 Objectives of the Performance Audit**

The audit objectives of the “Functioning of Internal Audit Wing in Income Tax Department” were to derive an assurance whether:

- a.** Internal audit is effective in providing reasonable assurance to the CBDT and Senior Management regarding achievement of objectives relating to compliance, assessment and other inter-related activities, as determined by CBDT.
- b.** Internal audit is playing an effective role in enhancing the quality of assessments.
- c.** There is an effective and efficient follow-up mechanism of internal audit findings and recommendations.

## **1.6 Legal framework**

The Audit Manual, 2011 of the ITD regulates the functioning of Internal Audit of ITD. The activities of Internal Audit are also governed by CBDT Instruction Number 3 of April 2007 on 'New Internal Audit System' and Instruction Number 15 of October 2013 on 'Strengthening the role of Supervisory Authorities under the New Internal Audit System introduced in 2007'. The Manual of Internal Inspection of CBDT also outlines the practice and procedure for functioning of Internal Audit under Pr. CCA, CBDT.

## **1.7 Audit scope and coverage**

We examined the areas of planning for Internal Audit, targets and achievements of Internal Audit as per Action Plan, reporting of significant audit findings and recommendations to the Senior Management in ITD and follow up mechanism in place to ensure remedial action in case of errors, omissions and mistakes pointed out by Internal Audit. We covered the work done by the Internal Audit by examining the compliance in up to 50 *per cent* of cases identified on the basis of monetary limit of objection raised by Internal Audit Wing of ITD and Internal Audit done by the Internal Audit Wing of the Pr. CCA during the financial years 2010-11 to 2013-14 and up to the date of audit. We requisitioned 31,275 assessment records containing internal audit objections from the Assessments units located all over India. However, ITD provided and we examined 17,656 files from Circles and Wards in different regions.

We also examined the control issues relevant to CIT (Audit) charges and monitoring mechanism at the level of DIT (Audit) as well as Regional Supervisory Authorities administering the CIT (Audit) charges.

## **1.8 Constraints**

The restructuring of ITD in 2013 led to significant changes in jurisdiction of Assessing Officers and their Supervisory Authorities. The jurisdictional overhaul affected the collection of information from field formations of ITD considerably as the records were not readily available for audit. Non production of records pertaining to internal audit was a major constraint while undertaking the review specifically in Chennai charge.

### **1.9 Acknowledgement**

We acknowledge the co-operation of ITD in facilitating the audit by providing records and information in connection with the conduct of this performance audit. An entry conference with CBDT was held on 24 September 2014 wherein audit objectives, scope of audit and main areas of audit examination were explained.

We issued draft Performance Audit report to the Ministry on 1 May 2015 for their comments. Post receipt of the Ministry's response in June 2015, we held Exit Conference with CBDT on 17 June 2015 to discuss audit findings and audit recommendations vis-à-vis their comments. We have duly incorporated the Ministry's comments together with the audit comments in the report.