

**Compendium of
Industry-Specific Audit Guides**
(As on September 1, 2013)



The Institute of Chartered Accountants of India
(Set up by an Act of Parliament)
New Delhi

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Foreword

Members of the Institute of Chartered Accountants of India are engaged in conducting audits in different industries/sectors of the economy. Audits in different industries/sectors involve their individual peculiarities and pose many challenges to the auditors. To resolve these peculiarities and challenges, members sometimes need guidance from the Institute in the form of industry/sector specific Technical Guides.

I am happy that the Auditing and Assurance Standards Board of the Institute has been bringing out various industry/sector specific Audit Guides for the guidance of the members and to assist them in conducting audits in various industries/sectors. Till date, the Board has issued Guides dealing with Audit of Automobile Industry, Audit of Hotel Industry, Audit of Non-Banking Financial Companies, Audit of Shared Service Centre Structure, Audit of Telecom Industry and Audit of E-commerce. I am happy that in an effort to consolidate the important guidance spread out in these different guides, the Board is bringing out a Compendium as a one stop referencer for the benefit of the members.

At this juncture, I wish to place my appreciation for CA. Abhijit Bandyopadhyay, Chairman, Auditing and Assurance Standards Board for his proactive initiatives to bring out various publications for the guidance of the members. I am sure that the members will find the Compendium useful.

September 3, 2013
New Delhi

CA. Subodh K Agrawal
President, ICAI

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Preface

Audit of financial statements is, perhaps, one of the most challenging tasks undertaken by our members in practice. The auditing standards prescribed by the Institute provide the fundamental principles for carrying out an efficient and effective audit of financial statements. However, the peculiar features of the internal and external operating environment of an industry, such as business models, nature and extent of IT proliferation, geographical spread, applicable laws and regulations applicable more often than not give rise to peculiarities in critical aspects such as internal controls and financial reporting, particularly, revenue recognition, capital vs revenue expenditures, etc. It needs no reiteration that these aspects, in turn, have significant bearing on the way in which the audit of their financial statements is carried out.

With a view to provide the members with an understanding of the peculiar features of different industries and how they may impact audit of the financial statements of an entity operating in that entity, the Auditing & Assurance Standards Board has brought out a number of industry specific audit Guides. These Guides not only provide an insight into the salient features of these industries but also guide the members on how to tailor their audits to meet these peculiar features, in terms of audit planning, risk assessments, documentation, reporting, etc.

This Compendium is aimed at bringing such industry specific audit under one roof as a ready reference for the members. It contains audit guides on hotel, telecom, automobile, non banking financial companies, shared service centres and e-commerce industries. I may only add at this juncture, that these Guides are only a helping hand. They do not override the requirements of the Standards on Audit and the members are expected to exercise professional judgment and skepticism in conduct of all audits.

I take this opportunity also to thank CA. Subodh K Agrawal, President, ICAI and CA. K Raghu, Vice President, ICAI for their support to the activities of the Auditing and Assurance Standards Board.

I also wish to place on record my gratitude for my colleagues on the Board viz., CA. Naveen ND Gupta, Vice Chairman, CA. Rajkumar S Adukia, CA. Jay Ajit Chhaira, CA. Shriniwas Y Joshi, CA. Sanjeev Maheshwari, CA. Dhinal A Shah, CA. Shiwaji B Zaware, CA. M. Devaraja Reddy, CA. S. Santhanakrishnan, CA. J. Venkateswarlu, CA. Manoj Fadnis, CA. Sanjiv K Chaudhary, CA. Vijay K Gupta, Shri Gautam Guha, Shri Bhaskar Chatterjee, CA. Niraj Kumar Jhunjhunwala, CA. Sanjay Vasudeva, CA. Ganesh Balakrishnan, CA. Charanjeet Surendra Attra, CA. Harinderjit Singh and CA. Saunak Ray for their support and guidance to the Board. I also wish to place on record my thanks to the special invitees to the Board, viz., Dr. Manoj Anand, CA. Vijay Sachdeva, Shri Sunil Kadam, CA. Nilesh Vikamsey, CA. Anirudh Sankaran, CA. Jitendra Kumar Agarwal and CA. Amit Roy for their support to the various activities of the Board.

I am confident that this Compendium of Industry Specific Audit Guides will prove to be a valuable technical resource for the readers.

September 3, 2013
Kolkata

CA. Abhijit Bandyopadhyay
Chairman,
Auditing and Assurance Standards Board

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<p>Note: Detailed contents of each of these Technical Guides is given at the beginning of the respective Guides</p>
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**Technical Guide on
E-Commerce - Considerations
for Audit of Financial
Statements**

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Foreword

Information technology has grown to be an integral part of our environment, and a common goal of using technology is to simplify the way we do things – achieving a complex task by the simple press of a button. This new environment poses new challenges for the organizations as well as for the auditors thereby requiring auditors to be armed with specialized skills while discharging their professional responsibilities.

I am happy to note that the Auditing and Assurance Standards Board has brought out *Technical Guide on E-Commerce - Considerations for Audit of Financial Statements*. The Technical Guide is an attempt to provide guidance for application of the principles enunciated in the Standards on Auditing while performing audit of entities involved in e-commerce activities. I would also like to appreciate the endeavors of the Board in bringing out technical literature on new areas with the objective of enhancing commitment and competence of our members.

I am confident that the members will find this Technical Guide useful while carrying out their assignments.

June 3, 2008
New Delhi

CA.Ved Jain
President

Preface

In a technology savvy environment, e-commerce has increasingly become an integral component of business strategy and a strong catalyst for economic development. With developments in the Internet and Web-based technologies, distinctions between traditional markets and the global electronic marketplace are gradually being narrowed down. The speed and convenience of the new technologies have not only provided unique new business opportunities, but also certain embedded risks.

This new environment poses fresh challenges for auditors engaged in auditing those clients who are adopting e-commerce strategies. Just as businesses are adapting to advances in technology, the auditing profession also needs to respond to the changing environment. Thus, the Auditing and Assurance Board of the Institute of Chartered Accountants of India has developed this Technical Guide to guide auditors when auditing the financial statements of an entity where considerable information is transmitted, processed, maintained or accessed electronically. This Technical Guide apart from giving a brief on e-commerce also explains the risks that sprout up in an e-commerce environment which an auditor must essentially understand for effectively discharging his professional responsibilities. This Technical Guide identifies specific matters related to e-commerce environment and provides guidance to apply relevant Standards on Auditing (SAs) while performing audit in an e-commerce environment.

I must place on record deep appreciation for the efforts put in by CA. Gunjan Bansal for preparing the basic draft of the Technical Guide. I am also thankful to my colleagues at the

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Auditing and Assurance Standards Board for their considered and uninhibited views so necessary to make the Technical Guide more comprehensive and user friendly. I also need to express my thanks to Shri Vijay Kapur, Director and CA. Jyoti Singh, Assistant Director for their inputs in giving final shape to the publication.

New Delhi
June 3, 2008

CA. Harinderjit Singh
Chairman
Auditing and Assurance Standards Board

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E-commerce-An Introduction

1.1 Electronic commerce (e-commerce) has become a buzzword for businesses over the past few years, with increased awareness about the use of computer and communications technologies to simplify business procedures and increase efficiency. E-commerce is more than a technology, it is a business model built around the application of information and communication technologies to any aspect of the value chain for products and services. Perhaps the clearest indication of the growing importance of e-commerce in the global economy is the rapidity with which internet use has grown and spread during the last decade. The boom in e-commerce also includes increased use of other media for trade, such as the telephone, television, fax, and electronic payment. E-commerce has been the catalyst for the enhancements and greater efficiency in areas that include:

- Selling products and processing orders;
- Tracking customers' buying habits;
- Presenting customers and prospects with product catalogs;
- Presenting financial statements to investors;
- Providing customers with inventory availability information;
- Providing message databases for off-site sales people and staff; and
- Processing purchase orders and invoice from suppliers.

Historical Perspective

1.2 The origin of commerce by exchanging goods occurred before recorded history. Now commerce is a basic activity of goods trading and buying in everyday life. Entering into the electronic era, the way individuals and organizations do business and undertake commercial transactions have been changed. The emergence of large business organizations in the late 1800s and early 1900s triggered the need to create and maintain formal records of business transactions. The process of using a person or a computer to generate a paper form, mailing that form, and

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then having another person enter the data into the trading partner's computer was slow, inefficient, expensive, redundant and unreliable.

1.3 The history of e-commerce is how information technology has transformed business processes. The meaning of electronic commerce has changed over the last 30 years. Originally, electronic commerce meant the facilitation of commercial transactions electronically, using technology such as Electronic Data Interchange (EDI) and Electronic Funds Transfer (EFT). These were both introduced in the late 1970s, allowing businesses to send commercial documents like, purchase orders or invoices electronically. The growth and acceptance of credit cards, automated teller machines (ATMs) and telephone banking in the 1980s were also forms of electronic commerce. From the 1990s onwards, electronic commerce would additionally include enterprise resource planning systems (ERP), data mining and data warehousing.

Traditional Commerce and E-Commerce

1.4 E-commerce has changed the way the organizations operated in their traditional business environments. E-commerce implementations are often coupled with re-engineering of traditional business processes by examining how business should be conducted by taking the advantage of the technology. Specifically, e-commerce replaces the traditional manual business processes with their automated electronic equivalents to accelerate ordering, delivery and payment procedures e.g., on-line booking of train tickets and air tickets, trading in stock market, on-line purchase of movie tickets, on-line auction and shopping, on-line supply chain management, on-line banking, etc. If we look at these changes closely, we will find that e-commerce is an enabler and has not changed the basics of the traditional business.

1.5 To understand e-commerce in the context of the traditional business, we may take an example of a bank, which has enabled on-line banking:

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S. No.	Traditional banking environment	On-line banking environment
a)	Customer visits home branch to deposit cash.	Customer may visit any branch/ATM of the bank to deposit cash.
b)	Customer visits home branch to deposit cheque/transfer funds.	Customer may deposit cheque at any branch/ATM of the bank and may use internet banking to transfer funds.
c)	Customer makes a telephone call to branch/visits branch for balance enquiry. Customer used to receive periodic statements from bank for transactions done.	All this information is available any time by using internet banking to the customer.
d)	For utility bill payment manual process is followed.	Using internet, utility bill payments can be made.
e)	To place fixed deposit or withdraw a fixed deposit customer visits the home branch.	Internet banking can be used to place fixed deposit or withdraw from fixed deposit.

It is clear from the above that e-commerce has brought business and customer closer by directly connecting them and by accelerating ordering, delivery of product and information and payment processes. However, it may be noted that e-commerce can not replace all the functions in the traditional business. For example, take the case of an automobile purchase. Before a buyer actually buys an automobile, he or she needs to test drive it. Such functions, obviously, cannot be performed on-line.

Objectives of the Technical Guide

1.6 The objectives of this Technical Guide is to assist the auditors of financial statements where an entity engages in commercial activities that takes place by means of connected computers over a public network, such as the internet (e-commerce). The guidance in this Technical Guide is particularly relevant to the application of:

- SA 230, Audit Documentation.
- SA 250, Considerations of Law and Regulations in an Audit of Financial Statements.
- SA 300, Planning an Audit of Financial Statements.
- SA 315, Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and its Environment.
- SA 330, The Auditor's Responses to Assessed Risks.
- SA 500, Audit Evidence.

This Technical Guide identifies specific matters to assist the auditor when considering the significance of e-commerce to the entity's business activities, and the effect of e-commerce on the auditor's assessment of the risk for the purpose of forming an opinion on the financial statements.

Definition of E-commerce

2.1 In common parlance, e-commerce is the buying and selling of goods and services on the Internet, especially the World Wide Web. Generally, e-commerce may be comprised of:

- E-tailing or "virtual storefronts" on web sites with on-line catalogs, sometimes gathered into a "virtual mall";
- Gathering and use of demographic data through Web contacts;
- Electronic Data Interchange (EDI), the business-to-business exchange of data;

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- E-mail and e-fax and their use as media for reaching prospective and established customers (for example, with newsletters) including internet telephony;
- Business-to-business buying and selling;
- The security of business transactions services;
- Any other activity of similar nature.

2.2 E-commerce has been defined by different organizations in the following manner:

Information Systems Audit and Control Association (ISACA) defines e-commerce as the process by which organizations conduct business electronically with their customers, suppliers and other external business partners, using the internet as an enabling technology. Therefore, it encompasses both business-to-business (B2B) and business-to-consumer (B2C) e-commerce models, but does not include existing non-internet e-commerce methods based on private networks, such as EDI and SWIFT.

Organization for Economic Co-operation and Development (OECD) defines e-commerce as commercial transactions, involving both organizations and individuals, that are based upon the processing and transmission of digitized data, including text, sound and visual images and that are carried out over open networks (like, the internet) or closed networks (like, AOL or Minitel) that have a gateway onto an open network.

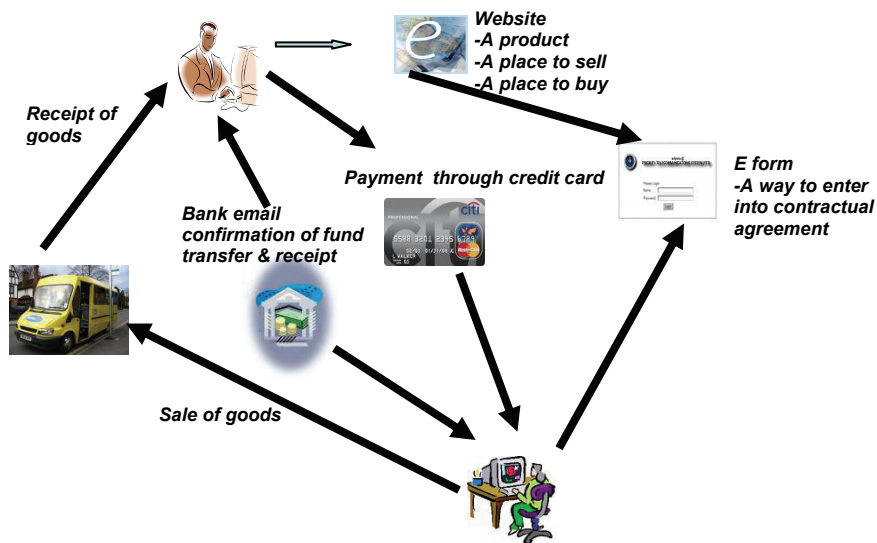
The International Fiscal Association (IFA) has, for the purpose of the National and General Reports released at the 55th Congress held in October, 2001, defined e-commerce to be 'commercial transactions in which the order is placed electronically and goods or services are delivered in tangible or electronic form and there is an ongoing commercial relationship'.

2.3 In view of the above, elements of e-commerce may include:

- a) A product or service.

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- b) A place to sell the product or service - in e-commerce, a Website displays the products in some way and acts as the place.
- c) A way to get people to come to your Website (the place).
- d) A way to accept orders - normally an on-line form of some sort, e.g., on-line order for purchase of books.
- e) A way to accept money - normally a merchant account handling credit card payments. This piece requires a secure ordering page and a connection to a bank. One may also use more traditional billing techniques either on-line (e.g., Real Time Gross Transfer) or through the mail.
- f) A fulfillment facility to ship products to customers. In the case of software and information, however, fulfillment can also occur over the Web through a file download mechanism.



- g) A way to accept rejected/returned goods and services.
- h) A way to handle warranty claims if necessary.

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- i) A way to provide customer service (often through e-mail, on-line forms, on-line knowledge bases, etc.).

These elements are not exhaustive considering the continuous changes in the domain of e-commerce.

Internet vis-à-vis World Wide Web- The Common Misconception

2.4 The terms “internet”, “world wide web”, “net”, and the “web” are often used interchangeably. However, from a technical perspective, the internet and world wide web are two separate entities. The internet is a collection of wires, protocols, and hardware that allows the electronic transaction of data over Transmission Control Protocol (TCP)/Internet Protocol (IP). Any data can be transferred over this collection of hardware and software components. Examples include e-mail, faxes, video, voice, and web pages. The internet is the hardware and software infrastructure that allows for this data transfer and global networking

2.5 The world wide web (www) exists on the internet. The web is composed of hypertext pages viewed by a browser, which is served from a web server over TCP/IP. Web pages always begin with http:// or https://, signifying that the content being viewed is in hypertext and transferred using the Hypertext Transfer Protocol. So while the internet is the infrastructure, the web can be thought of as an application for the internet. For example, e-mail, file transfer protocol (FTP), and peer-to-peer applications.

Business Models for E-commerce

2.6 In the most basic sense, a business model is the method of doing business by which an organization can sustain itself- that is, generate revenue. The business model spells out how an organization makes money by specifying where it is positioned in the value chain. Internet commerce will give rise to new kinds of business models. That much is certain. However, the web is also likely to reinvent tried and tested models. Auctions are a perfect example. One of the oldest forms of brokering, auctions have

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been widely used throughout the world to set prices for such items as agricultural commodities, financial instruments, and unique items like, fine art and antiques. The web has popularized the auction model and broadened its applicability to a wide array of goods and services.

2.7 Business models have been defined and categorized in many different ways. The basic four categories of business models are discussed in the following table:

	Business originating from....	
	Business	Consumer
Demand initializing from.... Consumer Business	B2B	C2B
	B2C	P2P/C2C

Business-to-Business (B2B)

It refers to the full spectrum of e-commerce that can occur between two organizations. Among other activities, this includes purchasing and procurement, supplier management, inventory, etc.

Business- to- Consumer (B2C)

It refers to exchange between business and consumers, such as those managed by on-line bookshops, e-mail and information websites.

Peer- to-Peer (P2P)

Exchanges involve transactions between and among consumers. These exchanges can include third-party involvement, as in the case of the auction websites. Other operations that support peer-to-peer activity include job search websites.

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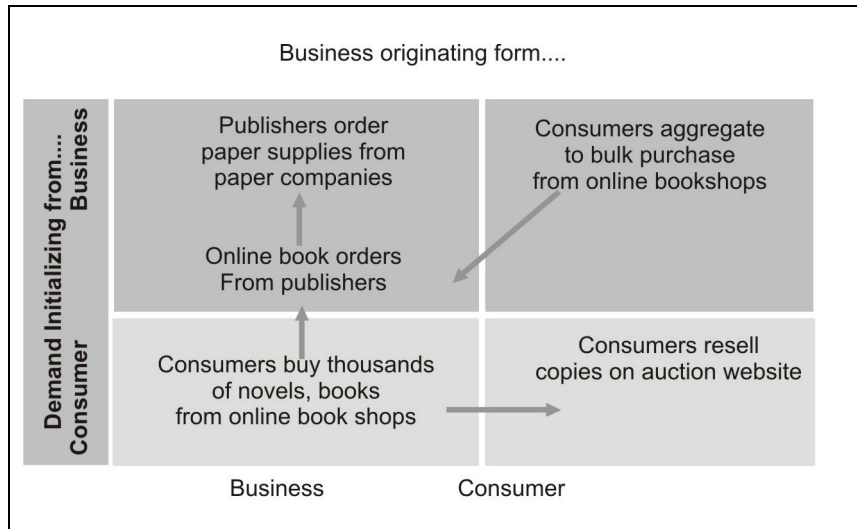
Consumer- to- Business (C2B)

Consumers can band together to present themselves as a buyer group in a consumer-to-business (C2B) relationship. These groups may be economically motivated, as with demand aggregators, or socially oriented, as with cause related advocacy groups.

Apart from the abovementioned four key models, following two new models have also emerged:

- (i) Business to Government e.g., electronic submission of corporate tax returns.
- (ii) Consumer to Government e.g., electronic submission of individual income tax returns.

2.8 Example illustrating convergence of above stated four key e-commerce models is as follows:



Risks associated with E-commerce

3.1 The risks associated with e-commerce systems are no different than those associated with traditional information systems. These risks include unauthorized access, unauthorized changes to programs or data files, misstatements caused by

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processing or logic errors, and lack of physical security. Other risks may, however, be unique to e-commerce systems. Following are some potentially unique risks in an e-commerce environment:

- *Security of system and protection against malicious intrusion or penetration by outsiders* – The intrusion may be to disrupt the system or to steal, modify, or otherwise put the organization at a competitive disadvantage.
- *Integrity and completeness of processing* – The risks differs from similar risks only in that different paths can be taken that might threaten processing integrity. The internet opens the systems to penetration from many different sources.
- *Integrity of data communications* – Computer viruses are a large and costly problem. An organization faces additional risks if communications are intercepted, modified, sent to the wrong party, replicated and delivered to many customers, or lost in process. A company dependent on electronic communications is essentially “betting the company” if it does not control the risks associated with data communications.
- *Trading partner agreements* – Many systems are designed with a group of trading partners in mind. Trading partners usually make contracts that all parties must agree to. Penalties are often severe if the contracts, including the protection of data, are not met.
- *Systems interdependencies* – The economic advantages associated with these systems creates interdependencies that did not exist in any previous business arrangement. Compromises anywhere along these interdependencies could seriously jeopardize either trading partners.
- *Paperless systems coupled with “soft controls”* – The movement to e-commerce is just one part of re-engineering a system. These changes are often coupled with just-in-time inventory systems in which the purchasing company specifies (a) quality criteria that must be met, (b)

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availability requirements, and (c) shipping requirements. The shipping requirements are loaded directly into production with no inspection or counting. The trading partner agreements specify payment terms, penalties, and so forth. The organization must adapt not only to paperless system, but also to a system in which a record of incoming items is not established at its source.

All these unique risks should form a basis for assessing the controls needed and the effectiveness of these controls to mitigate these risks on implementation.

Components of Control System

3.2 There are four major components of control system in an e-commerce environment:

- a) **Security** - Controls with respect to confidentiality, integrity, availability, accountability and non-repudiation of information.
- b) **Application integrity** - Controls to ensure integrity of transaction processing at application level like, implementation of firewall, validation of critical data at application level, existence of audit trails, exception monitoring and reporting, customer confirmation, controls on data transmission and reception and backup and recovery controls.
- c) **Development Process** - Controls on development process of e-commerce application including policies and procedures, application design, testing, change management, data conversion and implementation/roll outs.
- d) **Process Control** - Controls on for controlling the output whether the input data are being correctly routed through the architectural framework of e-commerce.

3.3 The control system would help in yielding reliable information when they meet the following security requirements:

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- a) ***Integrity*** - This requirement is fulfilled for an IT system when data and information are complete and accurate, systems are complete and appropriate and all of these are protected against unauthorized modification and manipulation. Appropriate testing and release procedures are typical means by which the integrity of data, information and systems can be ensured. Technical measures to achieve this include firewalls and virus scanners. The reliability increases when the IT infrastructure and the data, information and IT applications are used in a specified configuration and only authorized modifications are permitted.
- b) ***Availability*** - Under this requirement, the enterprise ensures the constant availability of the hardware, software, data and information to maintain business operations and that the hardware, software, data, information and the requisite IT organization can be made operable within a reasonable period of time (e.g., after an emergency interruption). It is important, therefore, to establish appropriate back-up procedures for emergencies. In addition, the ability to convert digitally maintained books and records into human-readable format within a reasonable period of time is essential.
- c) ***Confidentiality*** - This requirement means that data obtained from third parties should not be transmitted or disclosed without authorization. Organizational and technical measures, such as encryption technologies, instructions to restrict the transmission of personal data to third parties, transmit encrypted data to authorized third parties, identify and verify the recipient of data and to delete stored personal data after a certain length of time.
- d) ***Authenticity*** - This requirement relates to the traceability of a business transaction to the individual who initiated it. This can be done by, for example, using an authorization procedure. When data or information are exchanged electronically, it is important that the other party be

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identified or is identifiable e.g., by using digital signature procedures. It may be convenient to use shared external or independent facilities (e.g., trust centers) for this purpose.

- e) **Authorization** - This requirement means that only certain persons, appointed in advance (so called authorized persons), may access certain data, information and systems (e.g., password protection) and that only authorized persons can use the rights defined for this system. This includes reading, creating, modifying and deleting data or information or the administration of an IT system. Useful methods to achieve this are physical and logical security procedures.
- f) **Non-repudiation** - This requirement is defined as the ability of IT-aided procedures to bring about desired legal consequences with binding effect. It should be difficult for the person initiating the transaction to deny its validity on the grounds that the transaction was unintended or unauthorized. The use of public key systems can help prevent repudiation.¹

E-security

3.4 E-security refers to the process of ensuring the confidentiality, integrity, and availability of electronic information and protecting it against malicious attackers who could use or alter the information to disrupt critical national infrastructure and industry.

3.5 The thirteen layers of e-security² covers both the hardware and software pertaining to network infrastructures. These thirteen layers comprise a matrix, which manages the externalities associated with open architecture environments:

¹ The primary advantage of public key cryptography is that private keys never need to be transmitted. A sender cannot repudiate a message by claiming the key was compromised during transmission by the other party. Users have sole responsibility for protecting their private keys.

² World Bank publication – “Electronic Security: Risk Mitigation in the Financial Transactions”.

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- a) ***Risk Management*** - A broad based framework for managing assets and relevant risks to those assets.
- b) ***Policy Management*** - A program should control entity policy and procedural guidelines vis-à-vis employee computer usage.
- c) ***Cyber-Intelligence*** - Experienced threat and technical intelligence analysis regarding threats, vulnerabilities, incidents, and countermeasure should provide timely and customized reporting to prevent a security incident before it occurs.
- d) ***Access Controls/Authentication*** - Establish the legitimacy of a node or user before allowing access to requested information. The first line of defense is access controls; these can be divided into passwords, tokens, biometrics, and public key infrastructure (PKI).
- e) ***Firewalls*** - Create a system or combination of systems that enforces a boundary between two or more networks.
- f) ***Active content filtering*** - At the browser level, it is prudent to filter all material that is not appropriate for the workplace or that is contrary to established workplace policies.
- g) ***Intrusion detection system (IDS)*** - This is a system dedicated to the detection of break-ins or break-in attempts, either manually or via software expert systems that operate on logs or other information available on the network. Approaches to monitoring vary widely, depending on the types of attacks that the system is expected to defend against, the origins of the attacks, the types of assets, and the level of concern for various types of threats.
- h) ***Virus scanners*** - Worms, Trojans, and viruses are methods for deploying an attack. Virus scanners hunt

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malicious codes, but require frequent updating and monitoring.

- i) ***Encryption*** - Encryption algorithms are used to protect information while it is in transit or whenever it is exposed to theft of the storage device (e.g., removable backup media or notebook computer).
- j) ***Vulnerability testing*** - Vulnerability testing entails obtaining knowledge of vulnerabilities that exist on a computer system or network and using that knowledge to gain access to resources on the computer or network while bypassing normal authentication barriers.
- k) ***Systems administration*** - This should be complete with a list of administrative failures that typically exist within financial institutions and corporations and a list of best practices.
- l) ***Incident response plan (IRP)*** - This is the primary document used by a corporation to define how it will identify, respond to, correct, and recover from a computer security incident. The main necessity is to have an IRP and to test it periodically.
- m) ***Wireless Security*** - This section covers the risks associated with GSM, GPS and the 802.11 standards.

Technology Considerations

4.1 Various types of e-commerce applications and technologies are being used by the organizations to increase scope of business. As a result, business processes have become more complex than ever. In such a scenario auditor may also consider factors enumerated in the following paragraphs during its risk assessment process. It may be noted that the points discussed below are not exhaustive. New methods for building and running websites are constantly evolving, and the specific technology used may differ greatly from one organization to the next. For these reasons, if required, the auditor may involve an expert or specialist as an effort to consider key control issues.

Identification, Authentication and Authorization

4.2 *Identification* is the process of providing unique credentials to an individual for usage of the respective system e.g., user name or user ID provided to a user of the system. *Authentication* is the process of identifying an individual, usually based on a username and password. Authentication is distinct from *authorization*, which is the process of giving individuals access to system objects based on their identity. Authentication merely ensures that the individual is who he or she claims to be, but says nothing about the access rights of the individual. The use of passwords, tokens (such as smart cards), digital certificates or biometrics (more commonly fingerprint, hand geometry and voice biometrics) are used to verify the identity of a user. Most computer security systems are based on a two-step process. The first stage is authentication, which ensures that a user is who he or she claims to be. The second stage is authorization, which allows the user access to various resources based on the user's identity.

4.3 Strong customer identification and authentication processes are also important in the cross-border context given the difficulties that may arise from doing business electronically with customers across national and international borders, including the risk of identity impersonation and the difficulty in conducting effective credit checks on potential customers. Auditor should ensure that all the users have been uniquely identified in the system and suitable and adequate procedures to authenticate the users of the system have been implemented. Auditor should also ensure that all the users have been granted access (authorization) to various resources on a 'need to know' and 'need to do' basis. Auditor should also ensure that sufficient controls exist in the organization for potential areas of vulnerability and periodic reviews of all users and authorizations granted to them is carried out by the management.

Alignment of Business Processes

4.4 An e-commerce transaction may travel through a series of applications and systems from the stage of initiation to its

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completion. For example, a customer may enter a transaction using organization's website. The transaction may then be passed to application system by the web server. Finally, the application system may pass the transaction to the accounting system. In an e-commerce environment, it is important that the transactions generated from the website are processed properly by the internal systems (such as accounting system, inventory management system, etc.). In case the transactions are not properly captured and transferred to other interconnected systems, it may affect:

- a) The completeness and accuracy of transaction processing and information storage;
- b) The timing of recognition of sales revenue, purchases and other transaction; and
- c) Identification and recording of disputed transactions.

Therefore, the auditor may consider controls over integration of various internal systems and applications involved in the processing of transactions. Further, the auditor should also consider controls over systems changes and data conversion to automate process alignment.

Internet Technology

4.5 Keeping in view the exposure created by internet in e-commerce transactions, auditor may examine following internet specific considerations having impact on risk assessment:

- a) ***Plug-ins, Programs, and Components*** - Organization should utilize the most commonly used plug-ins for their site's supported browsers. Use of internally developed or custom plug-ins may not be practical when a commercially available plug-in exists.
- b) ***Browsers*** - Organization should consider the importance of building applications that can run on current and past versions of the most popularly used browsers like, Netscape Navigator, Microsoft Internet Explorer, etc.
- c) ***Internet Service Providers (ISPs)*** - If the organization

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internally develops portal and supporting infrastructure, it is advised to consider making it the standard for hosting all applications. If business requires the use of an external Internal Service Provider (ISP), it should consult the information security team early in the project development process to ensure that the ISP does not breach the company's firewall security.

- d) ***Cookies and Push Technology*** - Organization should have a company policy regarding the use of cookies and push technology. The auditor may also discuss the policy regarding information gathered via cookies, as well as the use of push technology, with the organization's legal department to prevent violations of local legislations.

Application Development and Change Management Process

4.6 In an e-commerce environment, practices for developing e-commerce applications and change management thereof do not differ greatly from those associated with other types of systems, except that "time to development/changes" is generally much shorter. The need to enter the market quickly shortens e-commerce development life cycles. In this regard, the auditor should consider following:

- a) ***Policies and Standards*** - Organization should have internal policies and standards regarding information security and application development.
- b) ***Application Design*** - Auditor should verify controls in place to ensure application design is reviewed before coding begins.
- c) ***Testing*** - Adequate controls should be in place to ensure web applications testing, which covers unit, system, integration, and user acceptance testing.
- d) ***System Performance*** - Adequate controls should be in place to ensure developers test and monitor system

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performance, resolving any problems with network engineering promptly.

- e) ***Change Management*** - Change Management Process of adherence to program change management procedures should be in place.
- f) ***Capacity Planning and Management*** - Auditor should ensure that planning for future capacity growth has been carried out during the systems planning phase.
- g) ***Data Conversion*** - Auditor should ensure that a data conversion plan that is tested and approved by users has been developed by the organization.
- h) ***Implementation/Rollout*** - Auditor should ensure that there is a detailed rollout plan subject to review and approval by users before rollout is generated.

Storage of Information

4.7 Information takes many "states" within an e-commerce environment. Data "at rest" can be found stored on mainframes, web servers or even proliferated to an infinite number of desktops. The same information can be stored to back-up tapes at off-site storage facilities or even on CDs and USB drives. In an e-commerce environment, as information moves through operational processes both within and outside the enterprise, it becomes data "in transit." Data moves throughout the enterprise from one computing platform to another. Data on the mainframe can be sent to servers or desktops and vice versa.

4.8 Auditor should consider if a suitable and secure encryption mechanism has been implemented by the organization to ensure 'integrity' of the data during its all states. It will ensure that only authorized information is stored in the systems and the stored information is protected from unauthorized changes. The common thread in most legislation today is that customer data must be vigilantly protected. Therefore, the auditor should also consider confidentiality aspect of information by considering access control mechanism implemented in the organization.

Non-Repudiation

4.9 In an e-commerce environment non-repudiation means to ensure that a transferred electronic message has been sent and received by the parties claiming to have sent and received the message. Non-repudiation is a way to guarantee that the sender of a message cannot later deny having sent the message and that the recipient cannot deny having received the message. Non-repudiation can be obtained through the use of:

- a) **Digital signatures** - function as a unique identifier for an individual, much like a written signature.
- b) **Confirmation services** - the message transfer agent can create digital receipts to indicate that messages were sent and/or received.
- c) **Timestamps** - timestamps contain the date and time a document was composed and proves that a document existed at a certain time.

Business Continuity Planning

4.10 E-commerce information is a valuable asset and must be thoroughly protected, along with ensuring the ability to resume business operations should an incident occur. The threats related to Information Technology may be classified as follows:

- (a) **Physical threats** are those that result from physical access or damage to information resources such as servers, network equipment, computer rooms, etc.
- (b) **Logical threats** are those that allow information to be compromised without needing the physical presence of a person, e.g., via the Internet.
- (c) **Technical failure** is a common threat for IT systems. For example, if key data is stored only on the hard disk of one server then the failure of that hard disk would be catastrophic.

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- (d) **Infrastructure failure** can be a subtle form of threat. For example, if business relies on Internet connection to receive orders from customers, it could miss out on new purchase orders if that connection fails.
- (e) **Human error** is major threat. If an honest mistake by a user or system manager could cause an irrevocable loss of data, action needs to be taken to prevent it from happening

4.11 Thus, to manage the associated risks rigorous business continuity planning is essential. Business continuity planning is the process of planning for the unexpected. An effective plan will provide procedures to minimize the effects of the unexpected disruptions. For this purpose, the auditor should ensure that suitable security, availability and recovery procedures have been designed and are operating effectively. Further, the auditor should also ensure that the organization has tested the Business Continuity Plan to ensure that it has covered all the angles and also whether the plan is achievable.

Audit Considerations in an E-commerce Environment

5.1 The advent of web-based ordering and operating systems increases the challenges many auditors face when auditing clients who are adopting e-commerce strategies. E-commerce produces new and more complex value added models and in this process several integrated applications are developed and deployed at a rapid pace. Therefore, it is important for the auditor to understand the extent of dependence of the business on e-commerce and also its impact both on the business model and operations. For example, e-commerce might be used to:

- Provide only information about the entity and its activities, which can be accessed by third parties such as investors, customers, suppliers, finance providers, and employees;
- Facilitate transactions with established customers whereby transactions are entered via the Internet;

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- Gain access to new markets and new customers by providing information and transaction processing via the internet;
- Access Application Service Providers (ASPs); and
- Create an entirely new business model.

At an organizational level the auditor would need to understand what business activities and processes have been replaced by e-commerce and what risks do these changes pose. Further, the new processes/activities and technology that have been introduced bring their own set of issues relating to risks and controls and need to be properly understood and addressed.

Skills and Knowledge

5.2 Auditor should have sufficient knowledge of the business of the organization and the industry in which the organization operates. Relevant industry factors include industry conditions such as the competitive environment, supplier and customer relationships, and technological developments. In addition to business knowledge auditor should have appropriate knowledge of Information Technology. This will help auditor to:

- Determine the extent and complexity of e-commerce activities in the organization;
- Understand e-commerce strategy of the organization,
- Determine nature, timing and extent of audit procedures.

5.3 With the growing complexity of Information and Internet technology, e-commerce to date has created a basis for new markets and products, as well as customer empowerment. Developments in web technology have opened communication among platforms, networks, and end users, representing a major step forward from the more insular systems of the past. However, the same technology that enables this increased interconnectivity has also introduced numerous opportunities for control breaches.

In such a scenario organization's e-commerce activities may be operating in a more complex environment. To address key control issues, auditor may decide to use the work of an expert to obtain

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sufficient and appropriate audit evidence for the purpose of the audit. For example, the work of an expert may be used to understand the risks in e-commerce activities, to test technical controls, analysis of audit trails and key transactions, etc. As mentioned earlier, it would be important to give consideration to use of specialists (e.g., IT auditors) to ensure that risks have been identified and addressed appropriately in the audit. If the use of such a professional is planned, the auditor should, in accordance with SA 620, “Using the Work of an Expert”, obtain sufficient appropriate audit evidence that the work performed by the expert is adequate for the purposes of the audit

Legal Considerations

5.4 Legal frameworks in different jurisdictions vary in their recognition of e-commerce. Nonetheless, management needs to consider legal and regulatory issues related to the entity’s e-commerce activities, for example, whether the entity has adequate mechanisms for recognition of taxation liabilities in various jurisdictions or documentation requirements for order processing and invoices to comply with tax legislation. Factors to be considered include the place where:

- a) The entity is legally registered;
- b) Its physical operations are based;
- c) Its web server is located;
- d) Goods and services are supplied from; and
- e) Its customers are located or goods and services are delivered.

These all may be in different jurisdictions. Without understanding the regulations and the law applied in different jurisdictions, organizations may be subject to fines and adverse judgments and may incur other costs, such as legal fees to defend themselves in case they inadvertently breach such laws. This may also give rise to a risk that taxes due on cross-jurisdictional transactions are not appropriately recognized.

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5.5 Legal or regulatory issues that may be particularly relevant in an e-commerce environment include:

- a) Adherence to national and international privacy requirements;
- b) Adherence to national and international requirements for regulated industries;
- c) The enforceability of contracts;
- d) The legality of particular activities, for example Internet gambling;
- e) The risk of money laundering; and
- f) Violation of intellectual property rights.

5.6 Standard on Auditing (SA) 250 "Consideration of Laws and Regulations in an Audit of Financial Statements" deals with the auditor's responsibilities relating to laws and regulations when performing an audit of financial statements. The auditor should obtain a general understanding of:

- (a) The legal and regulatory framework applicable to the entity and the industry or sector in which the entity operates; and
- (b) How the entity is complying with that framework.

After obtaining the above general understanding, the auditor shall obtain sufficient appropriate audit evidence regarding compliance with those laws and regulations generally recognized by the auditor to have a direct effect on the determination of material amounts and disclosures in the financial statements

5.7 While an audit cannot be expected to detect non-compliance with all laws and regulations, the auditor is specifically required to perform procedures to help identify instances of non-compliance with those laws and regulations where non-compliance should be considered when preparing financial statements. When a legal or regulatory issue arises that, in the auditor's judgment, may result in a material misstatement of the financial statements or have a significant effect on the auditor's procedure or the auditor's report, the auditor considers management's response to the issue. In some cases, the advice

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of a lawyer with particular expertise in e-commerce issues may be necessary when considering legal and regulatory issues arising from an entity's e-commerce activity.

5.8 Auditor may consider provisions of Information Technology Act, 2000 including that related to following:

- a) Legal recognition of electronics records;
- b) Legal recognition of digital signatures;
- c) Use of electronic records and digital signatures in Government and its agencies;
- d) Retention of electronic records;
- e) Attribution, Acknowledgement and Despatch of Electronic records;
- f) Provision for certifying authorities and Subscribers in connection with digital signature; and
- g) Provision for penalties for cyber offences.

The text of The Information Technology Act, 2000 is given in Appendix B of the Technical Guide.

Audit Planning

5.9 Standard on Auditing (SA) 300 "Planning an Audit of Financial Statements" lays down that the auditor should plan the audit so that the audit will be performed in an effective manner. In an e-commerce environment, while establishing the overall audit strategy the auditor should consider the effect of information technology on the audit procedures, including the availability of data and the expected use of computer assisted audit techniques.

5.10 In an e-commerce environment the entries in accounting records are often initiated, recorded, processed and reported in electronic form. Accordingly, the auditor should consider the following points during the planning stage:

- a) Scope in e-commerce environment e.g., understanding of flow of accounting transactions, records and information, location where the related system are hosted, interfacing of

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accounting systems with other systems, reporting requirements, etc.

- b) Identification of key risk areas with respect to e-commerce environment and plan to address these areas to reduce the risk at acceptable low levels.
- c) Request for report of internal audit, if any, covering the e-commerce activities. The considerations in such report may be included in the audit plan by the auditor.
- d) Understanding of internal controls instituted by the management with respect to e-commerce activities.
- e) Develop and document an e-commerce audit plan as a part of overall audit plan.
- f) Keeping in view complexity and specific environment of information technology set up, audit plan should include deployment of appropriate experienced team members.
- g) Timing of audit e.g., interim reviews or final reviews with regard to e-commerce activities.

Risks and Control System

5.11 Standard on Auditing (SA) 315 “Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and its Environment” lays down that the auditor should identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertions levels, through understanding the entity and its environment, including the entity’s internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement. This will help the auditor to reduce the risk of material misstatement to an acceptably low level.

5.12 Wherever e-commerce transactions are used for key business processes, there is significant change in the manner in which some of the activities are performed as compared to traditional transactions. This change can introduce risks by (a) eliminating or reducing efficacy of some traditional controls (b) adding new elements like, technology, new activities, legal

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considerations, etc. which need to be appropriately considered during audit and (c) speeding up transactions which can bring its own issues with cut-offs, period end procedures, etc. In order to identify risks associated with e-commerce transactions, the auditor should analyze the e-commerce application by considering the following factors:

- a) Management
- b) Technology
- c) Human Interface

5.13 Management faces many risks relating to the entity's e-commerce activities, including:

- Loss of transaction integrity;
- Risk of business process failure;
- E-commerce security risks, including virus attacks, unauthorized access;
- Improper accounting policies related to, for example, capitalization of expenditures such as website development costs, misunderstanding of complex contractual arrangements, title transfer risks, translation of foreign currencies, allowances for warranties or returns, and revenue recognition issues such as :
 - Whether the entity is acting as principal or agent and whether gross sales or commission only are to be recognized;
 - If other entities are given advertising space on the entity's web site, how revenues are determined and settled (for example, by the use of barter transactions);
 - The treatment of volume discounts and introductory offers (for example, free goods worth a certain amount); and

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- Cut off (for example, whether sales are only recognized when goods and services have been supplied);
- Non-compliance with taxation and other legal and regulatory requirements, particularly when Internet e-commerce transactions are conducted across international boundaries;
- Failure to ensure that contracts evidenced only by electronic means are binding;
- Over reliance on e-commerce;
- Systems and infrastructure failures or “crashes”; and
- Financial risks e.g., foreign exchange risks, credit risk, etc.

5.14 With regard to “Risks arising from IT”, SA 315 lays down that the use of Information technology affects the way control activities are implemented. From the auditor’s perspective, controls over IT systems are effective when they maintain the integrity of information and the security of the data such systems processes, and includes effective general IT controls and application controls.

General IT controls are policies and procedures that relate to many applications and support the effective functioning of application controls. General IT controls that maintain the integrity of information and security of data commonly include controls over the following:

- Data center and network operations
- System software acquisition, change and maintenance
- Program change
- Access security
- Application system acquisition, development and maintenance

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Application controls are manual or automated procedures that typically operate at a business process level and apply to the processing of individual applications. Application controls can be preventive or detective in nature and are designed to ensure the integrity of the accounting records. Accordingly, application controls relate to procedures used to initiate, record, process and report transactions or other financial data.

5.15 Matters that may be relevant to the auditor when considering the entity's e-commerce strategy in the context of the auditor's understanding of the control environment, include:

- a) Involvement of those charged with governance in considering the alignment of e-commerce activities with the entity's overall business strategy;
- b) Whether e-commerce supports a new activity for the entity, or whether it is intended to make existing activities more efficient to reach new markets for existing activities;
- c) Sources of revenue for the entity and how these are changing (for example, whether the entity will be acting as a principal or agent for goods or services sold);
- d) Management's evaluation of how e-commerce affects the earnings of the entity and its financial requirements;
- e) Management's attitude to risk and how this may affect the risk profile of the entity;
- f) The extent to which management has identified e-commerce opportunities and risks in a documented strategy that is supported by appropriate controls, or whether e-commerce is subject to ad hoc development responding to opportunities and risks as they arise; and
- g) Management's commitment to relevant codes of best practice or web seal programs.

Outsourcing Arrangements

5.16 Sometimes an entity may depend on service organizations such as Internet Service Providers (ISPs), Application Service Providers (ASPs) or data hosting companies to provide many or all of the IT requirements of e-commerce activities. The entity may also use service organizations for various other functions in relation to its e-commerce activities such as order fulfillment, delivery of goods, operation of call centers and certain accounting functions. Standard on Auditing (SA) 402, "Audit Considerations relating to Entities Using Service Organizations" lays down that when an entity uses service organization the auditor may consider how an entity's use of a service organization affects the entity's internal control systems so as to identify and assess the risks of material misstatement and to design and perform further audit procedures.

5.17 In obtaining an understanding of the entity and its environment, the auditor may determine the significance of service organization's activities to the entity and relevance to the audit. Auditor may use the report of the service organization auditor. While doing so, the auditor may consider the professional competence of that auditor in the context of the specific assignment undertaken by the service organization auditor. With respect to involvement of service organizations (third parties), the auditor may also consider the following points:

- a) The responsibility for negotiating should be delegated to levels of management and staff that are experienced in the area. Appropriate service-level agreements should be incorporated in the contract, such as the performance of key control processes, compliance with statutory laws and regulations, non-disclosure agreement or provisions for audit rights.
- b) Third parties should have the necessary types and levels of insurance or provide appropriate levels of indemnification in the event of a problem.

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- c) Involvement of legal department while signing the contracts with the service organizations.
- d) Service Organization should provide evidences of Business Continuity Plan / Disaster Recovery Plan and Risk Mitigation Plan in order to minimize business risk.

Going Concern

5.18 E-commerce activities in an organization may be complementary to its traditional business. For example, a banking company may use e-commerce for some of its activities (e.g., pay order request, opening of fixed deposit accounts and transfer of funds) in addition to serving its customers by conventional methods. In contrast, e-commerce activities may be a new line of business in the organization or the organization may be carrying out all or significant amount of its business activities through e-commerce e.g., an on-line newspaper which is available free through the website and makes its revenue by selling advertising space on the website. In this context, the auditor should consider effect of entity's dependence on e-commerce activities and on its ability to continue as a going concern. Standard on Auditing (SA) 570, "Going Concern" specifies that when a question arises regarding the appropriateness of the going concern assumption, the auditor should gather sufficient appropriate audit evidence to attempt to resolve, to the auditor's satisfaction, the question regarding the entity's ability to continue operation for the foreseeable future.

5.19 Indications of risk that continuance as a going concern may be questionable could come from the financial statements or from other sources. In an e-commerce environment auditor's consideration may also include the following factors:

- a) Robustness of the business model, especially the revenue stream.
- b) Ability to attract continued funding from investors especially in the case of continued losses.
- c) Fundamental changes in market and/or in technology.

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- d) Loss of key customers, increase in competitors, cultural differences, etc.
- e) Outsourcing arrangements for key e-commerce elements.
- f) Allocation of resources and capital.
- g) Changes in legislation or government policy.

Audit Evidence

5.20 Electronic records and digital signatures are major shift in business processes. Today, electronic records and digital signatures have legal and commercial equivalence of paper records and written signatures. The Information Technology Act, 2000 gives recognition to electronic records and digital signatures. Therefore, electronic records can be used as audit evidence for the purpose of audit. However, electronic records may be more easily destroyed or altered than paper records without leaving evidence of such destruction or alteration. Electronic audit evidence may include Screen Print, Electronic reports from the auditee's computer system, Audit trails, Access Control List, etc.

For an auditor of financial statements, the objective of audit evidence in e-commerce environment remains same as in the case of non e-commerce environment. However, in an e-commerce environment the audit evidence are mostly in electronic form and, therefore, the auditor should understand and evaluate the effect of electronic records on audit documentation.

5.21 Audit evidence is cumulative in nature and, therefore, it may be noted that electronic evidence does not eliminate the need of paper evidence. In an e-commerce environment it is not necessary for an auditor to gather the audit evidences in electronic form only. Keeping in view the objectivity and availability of audit evidence, it may be gathered either in electronic form or in paper form. In this respect, an auditor may consider following:

- a) The scope, objectives, planning, methodology followed for audit and assumptions should be completely documented.

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- b) Whether the entity's information security policies and security controls as implemented are adequate to prevent unauthorized changes to the accounting system or records, or to systems that provide data to the accounting system.
- c) Auditor should enquire and understand how management is gaining comfort on internal controls over financial reporting in an e-commerce environment. In case the auditor finds that internal controls identified by the management are sufficient for the purpose of audit and these internal controls are also operating effectively, auditor may decide to rely upon such internal controls and gather related audit evidence, including electronic audit evidence. In case the auditor finds that the internal controls identified by the management are not sufficient or not operating effectively for the purpose of audit of financial statements, he may decide to obtain additional audit evidence in order to form an opinion on the financial statements.
- d) Auditor may consider user of computers to gather, understand, analyse, examine and retain evidences for audit documentation purpose.
- e) Integrity of electronic information and records is must to ensure that audit evidence being documented is complete, accurate, valid, sufficient and reliable. Organizations are using increasingly complex software to process and store accounting and business transactions. Therefore, the auditor should consider, understand and evaluate Risks and Control System. This will help ensure the integrity of electronic evidence being documented by the auditor.
- f) If the evidence being gathered is in electronic form (i.e., reports, print screens, etc.) then the auditor should gather evidence directly after getting appropriate access to the computer system of the auditee. In case help is taken from the auditee personnel (say, IT or finance team) for gathering of electronic evidence such a process needs to

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be supervised by an expert possessing such skills, who may either be the auditor's staff or an outside professional engaged by the auditor in order to ensure completeness and accuracy of the evidence gathered.

- g) The auditor may test automated controls and control over changes to the electronic information, such as record integrity checks, electronic date stamps, digital signatures and version controls when considering the integrity of electronic evidence.
- h) While determining the sufficiency and reliability of electronic information, the auditor may also consider compensatory manual controls in place. For example, depending on the auditor's assessment of automated controls, the auditor may also consider the need to perform additional procedures such as confirming transaction details or account balances with third parties.

Audit Trails

5.22 In an e-commerce environment, employees, customers and providers access services, products and information related to the business. Integrity, confidentiality, efficiency, effectiveness and availability in an e-commerce environment are a prerequisite to ensure that financial records and accounts are sufficiently reliable for reporting. Audit trails are key information to achieve this objective.

5.23 Audit trails may be generated in a variety of systems and equipments. For example, every person who enters the organization's network with a user ID and password is logged and the transactions carried out by the person are recorded for later control. Similarly, an organization may log the customer's transaction from its initiation through collection of the receipt and delivery of the product. Additionally, the organization should keep the security administrator's log because he has the option to assign processing functions, which are assessed as highly confidential to the employees. Furthermore, these tasks should be

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logged beyond the compensating controls implemented (e.g., dual control).

5.24 Auditor may use audit trails to:

- a) Follow the history of a transaction;
- b) Investigate the causes when a record is found to be erroneous;
- c) Analyze data after massive file destruction;
- d) Correctly interpret the file where data damage is program caused;
- e) Investigate false information that has been sent to system users; and
- f) Monitor procedural violations to highlight possible breaches of security, etc.

Auditor may adopt following strategy to understand the extent of availability and use of audit trails:

- a) Interview appropriate management and staff to gain an understanding of the types of audit trails being generated by the applications;
- b) Identify information requirements relevant for the business process;
- c) Identify inherent IT risks and the overall level of control;
- d) Select the audit trails to be reviewed; and
- e) Review of audit trails.

Examples of audit trails include - Failed access attempts, Incorrect value assigned to data, Attempts to change restricted data, Excessive use of certain data and Invalid entries in event logs and Transaction logs.

5.25 Auditor may use Computer Assisted Audit Techniques (CAATs) to assess the integrity, effectiveness and efficiency objectives of audit trails. The use of CAATs allows for the

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complete analysis of audit trails, focusing testing on subsets that appear with errors or irregularities and presenting them in a new format (file or paper). In addition, the following should also be verified by an auditor to ensure integrity, completeness and sufficiency of audit trails:

- a) Analyze the security ACL (access control list) assigned to the resources (operating systems generally) where the logs are stored (on-line, off-line, on-site, off-site).
- b) Check for existence of policies and procedures about audit trails in applications and products.
- c) Review the audit trails towards recreating activity or error analysis as needed.
- d) Review the parameters installed in the equipment/software regarding activation/deactivation or deletion.
- e) Obtain and assess the risk assessment document for each audit trail generated.
- f) Check for the existence of controls over the audit trails considered as highly important with regard to their confidentiality and integrity (e.g., Electronic Fund Transfer systems and their equipment, network, procedures, etc.).
- g) Monitor routines to analyze audit trail availability.
- h) Review the access control audit trails on the security software or key management reports.

Accounting Policies

5.26 Auditor should examine appropriateness of accounting policies adopted by the organization with respect to its e-commerce activities. These accounting policies may be related to conversion of foreign currencies, capitalization of development cost, revenue recognition, recognition and measurement of cost, disclosures in the financial statements, etc. Accounting Standard (AS) 26 “Intangible Assets” prescribes the accounting treatment for intangible assets. AS 26 also contains illustrative application of

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the Accounting Standard to Website costs and to Internal Use Computer Software, which can be internally generated or acquired. "Guidance Note on Accounting by Dot-Com Companies" deals with accounting by dot-com companies and other entities engaged in electronic commerce (e-commerce) in respect of certain issues relating to revenue recognition and expense recognition.

Audit Documentation

5.27 Standard on Auditing (SA 230) "Audit Documentation" refers to documentation as "the working papers prepared or obtained by the auditor and retained by him, in connection with the performance of his audit". For documentation of electronic records and evidence auditor should consider the following points:

- a) The nature and timing of the audit procedures to be used may be affected by the fact that some of the accounting data and other information may be available only in electronic form. For example, purchase, shipping, billing, cash receipt, and cash disbursement transactions are often consummated entirely by the exchange of electronic messages between the parties. Certain electronic information may exist only at a certain point of time. However, such information may not be retrievable after a specified period of time if files are changed and if backup files do not exist. An organization's data retention policies may require the auditor to request retention of some information for the auditor's review or to perform audit procedures at a time when the information is available.
- b) Electronic evidence needs to be preserved electronically by the auditors on their computers for any further reference. Further, measures need to be taken to ensure confidentiality, integrity and availability of such evidence for a period similar to the paper records. In this respect following may be considered by the auditor:
 - Enable the determination of when and by whom documentation was created, changed or reviewed;

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- Protect the integrity of the information at all stages of the engagement, especially when the information is shared within the engagement team;
 - Prevent unauthorized changes to the engagement documentation; and
 - Allow access to the engagement documentation by the engagement team and other authorized parties as necessary to properly discharge their responsibilities.
- c) There need to be appropriate controls over access to such evidence and eventual destruction after the expiry of the retention period otherwise they could lead to unintentional destruction of evidence or a risk to confidentiality.
- d) Enable the retrieval of, and access to, the documentation during the retention period, particularly in the case of electronic documentation since the underlying technology may be upgraded or changed over time.

Appendix A

Glossary of Terms

Application Development Process

Processes to plan, design, develop, test and implement an application system or a major modification to an application system. It considers matters such as: appropriate controls are designed into the system; the application will process information in a complete, accurate and reliable manner; the application will function as intended; the application will function in compliance with any applicable statutory provisions; the system is developed in compliance with the established systems development life cycle process, etc.

Application Service Provider (ASP)

Application Service Provider (ASP) is a third-party entity that manages and distributes software-based services and solutions to customers across a wide area network from a central data center. A common example is a website that other websites use for accepting payment by credit card as part of their on-line ordering systems.

Access Control List

In computer environment, Access Control List is an internal computerized table of access rules regarding the levels of computer access permitted to users and computer terminals. ACL is a set of data that informs a computer's operating system permissions, or access rights that each user or group has to a specific system object, such as a directory or a file. Each object has a unique security attribute that identifies which users have access to it, and the ACL is a list of each object and user access privileges such as read, write or execute.

Audit Trail

A visible trail of evidence enabling one to trace information contained in statements or reports back to the original input source. It's an electronic or paper log used to record a sequence

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of events from which a history may be reconstructed. For example, a record showing who has accessed a computer system and what operations he or she has performed during a given period of time. Audit trails are useful both for maintaining security and for recovering lost transactions.

Browser

A user interface on a computer that allows navigation of objects. For e.g., Web browser used to access the world wide web, File browser for managing files and related objects, etc.

Computer Assisted Audit Techniques (CAATs)

Computer Assisted Audit Techniques (CAATs) are audit tests performed by or with software, rather than manually, and are important tools for the auditor in performing audits. CAATs tools may include generalized audit software, random number generator, etc. CAATs may use any automated audit technique, such as Random sampling (with physical verification), age analysis, gap analysis, duplicate analysis and data stratification.

Generally, CAATs allow the auditor to access data without dependence on the client's system, test the reliability of client software, and perform audit tests more efficiently.

CAATs may be used in performing various audit procedures including:

- Tests of details of transactions and balances
- Analytical review procedures
- Compliance tests of IT General Controls
- Compliance tests of Application Controls.

Cookies

A small file or part of a file stored on a world wide web user's computer, created and subsequently read by a website server, and containing personal information (like, user identification code, customized preferences, or a record of pages visited). It is also commonly referred to as HTTP cookies, web cookies, tracking cookies.

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Change Management Process

It is control over the IT process of managing changes that satisfies the business requirement to minimize the likelihood of disruption, unauthorized alterations and errors. It is enabled by a management system which provides for the analysis, implementation and follow-up of all changes requested and made to the existing IT infrastructure. The main activities under the process includes identify, analyze and approve change requests, defining changes, design and development, testing, implementation and post implementation review.

Digital Signature

A digital signature is an electronic signature that can be used to authenticate the identity of the sender of a message or the signer of a document, and possibly to ensure that the original content of the message or document that has been sent is unchanged. Digital signatures are easily transportable, cannot be imitated by someone else, and can be automatically time-stamped. The sender cannot easily repudiate it later.

A scanned written signature is not a digital signature.

Domain Name

The unique name that identifies a computer or computers on the Internet. These names appear as a component of a website's URL.

Extranet

Extranet, a very popular means for business partners to exchange information is partially accessible to authorized outsiders. Briefly, it can be understood as a private intranet mapped into the internet or some other transmission system not accessible to the general public, but is managed by more than one administrator(s). An extranet provides various levels of accessibility to outsiders.

Electronic Funds Transfer (EFT)

Electronic Funds Transfer (EFT) refers to the computer-based systems used to perform financial transactions electronically. It is

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a system of transferring money from one bank account directly to another without any paper money changing hands and includes any transfer of funds initiated through an electronic terminal, including credit card, ATM and point-of-sale (POS) transactions, electronic check clearing, etc.

Electronic Data Interchange (EDI)

Electronic Data Interchange (EDI) is a set of standards for structuring information to be electronically exchanged between and within businesses, organizations, government entities and other groups. The standards describe structures that emulate documents, for example purchase orders to automate purchasing. The term EDI is also used to refer to the implementation and operation of systems and processes for creating, transmitting and receiving EDI documents.

Firewall

Firewall can be computer hardware or software, or a combination of both, that prevents unauthorized access to organization's data by outside users. In the normal course of business, organization may receive information to its computer network from outside networks\internet or send information to outside networks\internet from its computer network. All information entering or leaving the company's computer network passes through the firewall, which examines the information and blocks those that do not meet the specified security criteria. In other words, a firewall regulates some of the flow of traffic between computer networks of different trust levels.

With emergence of new technologies like, e-procurement, e-sourcing where organization's system, network, processes are made available to outside people, the risk of unauthorized access to organization's data arises. In such an environment, firewall has been developed to mitigate the risk of unauthorized access form outside users. Several vendors have developed their firewall products which an organization may purchase and use to protect its computer network.

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Internet

Internet is a worldwide, publicly accessible series of interconnected computer networks - a network of networks - in which users at any one computer can, if they have permission, get information from any other computer. It is the world's largest network. It is capable of exchanging mail and data through a common addressing and naming system based on TCP/IP protocols.

Internet Service Provider (ISP)

Internet Service Provider (ISP) is a business or organization that provides to consumers access to the Internet and related services. It is also known as Internet access provider or IAP. In addition to Internet access via various technologies such as dial-up and DSL (Digital Subscriber Line), they may provide a combination of services including domain name registration and hosting, web hosting, internet transit, etc.

Non-repudiation

Non-repudiation is the concept of ensuring that a contract cannot later be denied by either of the parties involved. In regard to computer environment, non-repudiation means that it can be verified that the sender and the recipient were, in fact, the parties who claimed to send or receive the message, respectively. In other words, non-repudiation of origin proves that data has been sent, and non-repudiation of delivery proves that it has been received.

On-line/Off-line

On-line or off-line are states or conditions of a device or equipment or of a functional unit. To be considered on-line, a device must be either:

- Under the direct control of another device; or
- Under the direct control of the system with which it is associated; or
- Available for immediate use on demand by the system without human intervention; or

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- Connected to a system, and is in operation; or
 - Functional and ready for service,
- while a device that is off-line is not.

On-site/Off-site

On-site is place where organization's server, application and other IT facilities are installed. Off-site is the opposite of on-site where IT facilities including servers, application, etc may or may not be installed and it can be a remote location.

Password

In computer environment, password means a sequence of characters, often along with a user name, that one must input to gain access to a file, application, or computer system. Passwords are a popular form of authentication. In order to ensure security, when a password is entered, the computer system is careful not to display the password characters on the display screen so that it is kept secret from those not allowed access.

Plug-ins

A hardware or software module that adds a specific feature or service to a larger system. Plug-in help the browser perform specific functions like, viewing special graphic formats or playing multimedia files. For example, there are number of plug-ins for the Netscape Navigator browser that enables it to display different types of audio or video messages. Other examples include Adobes Acrobat Reader, Real Networks' streaming video player, etc.

Proxy Server

A server that catches web content in order to provide quicker access for users when new requests are made for the same content.

Time Stamp

A scheme that records the day and time when something is received, modified, or accessed, such as a document. It registered the date and time of such event in electronic form.

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Transaction Logs

A transaction log is a history of updates to a database to guarantee recovery of database in case of problems e.g., hardware failure, loss of power, improper backups or improper shutdown, etc. Physically, a log is a file of updates done to the database stored in a stable storage.

Uniform Resource Locator (URL)

An address of a file located on the internet. It is composed of three parts – a protocol, a domain name and a file name.

Website

A Website is a collection of web pages, images or other digital assets that is hosted on one or more web servers, usually accessible via the Internet. All publicly accessible websites are seen collectively as constituting the “World Wide Web”. Each Website contains a home page, which is the first document users see when they enter the site.

Web Server

A server process running at a website which sends out web pages in response to requests from person visiting website using remote browsers. Every Web server has an IP address and possibly a domain name. When remote user inputs the website address in web browser, this sends a request to the server whose domain name matches with website address. The server then fetches the page\data and sends it to user's browser. For example, if a person A wants to visit a web site called www.abc.com, A may use Internet Explorer as a web browser and as a response A will be able to view information sent by web server where web pages relating to www.abc.com are stored.

Web Hosting

A term used for storing and maintaining files, e-mail or domains or a server that is connected with internet.

Appendix B

The Information Technology Act, 2000 (No. 21 of 2000)

An Act to provide legal recognition for transactions carried out by means of electronic data interchange and other means of electronic communication, commonly referred to as "electronic commerce", which involve the use of alternatives to paper-based methods of communication and storage of information, to facilitate electronic filing of documents with the Government agencies and further to amend the Indian Penal Code, the Indian Evidence Act, 1872, the Bankers' Books Evidence Act, 1891 and the Reserve Bank of India Act, 1934 and for matters connected therewith or incidental thereto.

WHEREAS the General Assembly of the United Nations by resolution A/RES/51/162, dated the 30th January, 1997 has adopted the Model Law on Electronic Commerce adopted by the United Nations Commission on International Trade Law;

AND WHEREAS the said resolution recommends *inter alia* that all States give favourable consideration to the said Model Law when they enact or revise their laws, in view of the need for uniformity of the law applicable to alternatives to paper-based methods of communication and storage of information;

AND WHEREAS it is considered necessary to give effect to the said resolution and to promote efficient delivery of Government services by means of reliable electronic records.

BE it enacted by Parliament in the Fifty-first Year of the Republic of India as follows:—

CHAPTER I

PRELIMINARY

1. Short title, extent, commencement and application

(1) This Act may be called the Information Technology Act, 2000.

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(2) It shall extend to the whole of India and, save as otherwise provided in this Act, it applies also to any offence or contravention thereunder committed outside India by any person.

(3) It shall come into force on such date as the Central Government may, by notification, appoint and different dates may be appointed for different provisions of this Act and any reference in any such provision to the commencement of this Act shall be construed as a reference to the commencement of that provision.

(4) Nothing in this Act shall apply to, —

- (a) a negotiable instrument as defined in section 13 of the Negotiable Instruments Act, 1881;
- (b) a power-of-attorney as defined in section 1A of the Powers-of-Attorney Act, 1882;
- (c) a trust as defined in section 3 of the Indian Trusts Act, 1882;
- (d) a will as defined in clause (h) of section 2 of the Indian Succession Act, 1925 including any other testamentary disposition by whatever name called;
- (e) any contract for the sale or conveyance of immovable property or any interest in such property;
- (f) any such class of documents or transactions as may be notified by the Central Government in the Official Gazette.

2. Definitions

(1) In this Act, unless the context otherwise requires, —

- (a) "access" with its grammatical variations and cognate expressions means gaining entry into, instructing or communicating with the logical, arithmetical, or memory function resources of a computer, computer system or computer network;
- (b) "addressee" means a person who is intended by the originator to receive the electronic record but does not include any intermediary;

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- (c) "adjudicating officer" means an adjudicating officer appointed under subsection (1) of section 46;
- (d) "affixing digital signature" with its grammatical variations and cognate expressions means adoption of any methodology or procedure by a person for the purpose of authenticating an electronic record by means of digital signature;
- (e) "appropriate Government" means as respects any matter,—
 - (i) Enumerated in List II of the Seventh Schedule to the Constitution;
 - (ii) relating to any State law enacted under List III of the Seventh Schedule to the Constitution, the State Government and in any other case, the Central Government;
- (f) "asymmetric crypto system" means a system of a secure key pair consisting of a private key for creating a digital signature and a public key to verify the digital signature;
- (g) "Certifying Authority" means a person who has been granted a licence to issue a Digital Signature Certificate under section 24;
- (h) "certification practice statement" means a statement issued by a Certifying Authority to specify the practices that the Certifying Authority employs in issuing Digital Signature Certificates;
- (i) "computer" means any electronic magnetic, optical or other high-speed data processing device or system which performs logical, arithmetic, and memory functions by manipulations of electronic, magnetic or optical impulses, and includes all input, output, processing, storage, computer software, or communication facilities which are connected or related to the computer in a computer system or computer network;
- (j) "computer network" means the interconnection of one or more computers through—
 - (i) the use of satellite, microwave, terrestrial line or other communication media; and

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- (ii) terminals or a complex consisting of two or more interconnected computers whether or not the interconnection is continuously maintained;
- (k) "computer resource" means computer, computer system, computer network, data, computer data base or software;
- (l) "computer system" means a device or collection of devices, including input and output support devices and excluding calculators which are not programmable and capable of being used in conjunction with external files, which contain computer programmes, electronic instructions, input data and output data, that performs logic, arithmetic, data storage and retrieval, communication control and other functions;
- (m) "Controller" means the Controller of Certifying Authorities appointed under sub-section (l) of section 17;
- (n) "Cyber Appellate Tribunal" means the Cyber Regulations Appellate Tribunal established under sub-section (1) of section 48;
- (o) "data" means a representation of information, knowledge, facts, concepts or instructions which are being prepared or have been prepared in a formalised manner, and is intended to be processed, is being processed or has been processed in a computer system or computer network, and may be in any form (including computer printouts magnetic or optical storage media, punched cards, punched tapes) or stored internally in the memory of the computer;
- (p) "digital signature" means authentication of any electronic record by a subscriber by means of an electronic method or procedure in accordance with the provisions of section 3;
- (q) "Digital Signature Certificate" means a Digital Signature Certificate issued under subsection (4) of section 35;
- (r) "electronic form" with reference to information means any information generated, sent, received or stored in media, magnetic, optical, computer memory, micro film, computer generated micro fiche or similar device;

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- (s) "Electronic Gazette" means the Official Gazette published in the electronic form;
- (t) "electronic record" means data, record or data generated, image or sound stored, received or sent in an electronic form or micro film or computer generated micro fiche;
- (u) "function", in relation to a computer, includes logic, control arithmetical process, deletion, storage and retrieval and communication or telecommunication from or within a computer;
- (v) "information" includes data, text, images, sound, voice, codes, computer programmes, software and databases or micro film or computer generated micro fiche;
- (w) "intermediary" with respect to any particular electronic message means any person who on behalf of another person receives, stores or transmits that message or provides any service with respect to that message;
- (x) "key pair", in an asymmetric crypto system, means a private key and its mathematically related public key, which are so related that the public key can verify a digital signature created by the private key;
- (y) "law" includes any Act of Parliament or of a State Legislature, Ordinances promulgated by the President or a Governor, as the case may be. Regulations made by the President under article 240, Bills enacted as President's Act under sub-clause (a) of clause (1) of article 357 of the Constitution and includes rules, regulations, byelaws and orders issued or made thereunder;
- (z) "licence" means a licence granted to a Certifying Authority under section 24;
- (za) "originator" means a person who sends, generates, stores or transmits any electronic message or causes any electronic message to be sent, generated, stored or transmitted to any other person but does not include an intermediary;
- (zb) "prescribed" means prescribed by rules made under this Act;

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- (zc) "private key" means the key of a key pair used to create a digital signature;
 - (zd) "public key" means the key of a key pair used to verify a digital signature and listed in the Digital Signature Certificate;
 - (ze) "secure system" means computer hardware, software, and procedure that—
 - (a) are reasonably secure from unauthorised access and misuse;
 - (b) provide a reasonable level of reliability and correct operation;
 - (c) are reasonably suited to performing the intended functions; and
 - (d) adhere to generally accepted security procedures;
 - (zf) "security procedure" means the security procedure prescribed under section 16 by the Central Government;
 - (zg) "subscriber" means a person in whose name the Digital Signature Certificate is issued;
 - (zh) "verify" in relation to a digital signature, electronic record or public key, with its grammatical variations and cognate expressions means to determine whether—
 - (a) the initial electronic record was affixed with the digital signature by the use of private key corresponding to the public key of the subscriber;
 - (b) the initial electronic record is retained intact or has been altered since such electronic record was so affixed with the digital signature.
- (2) Any reference in this Act to any enactment or any provision thereof shall, in relation to an area in which such enactment or such provision is not in force, be construed as a reference to the corresponding law or the relevant provision of the corresponding law, if any, in force in that area.

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CHAPTER II

DIGITAL SIGNATURE

3. Authentication of electronic records.

(1) Subject to the provisions of this section any subscriber may authenticate an electronic record by affixing his digital signature.

(2) The authentication of the electronic record shall be effected by the use of asymmetric crypto system and hash function which envelop and transform the initial electronic record into another electronic record.

Explanation.—For the purposes of this sub-section, "hash function" means an algorithm mapping or translation of one sequence of bits into another, generally smaller, set known as "hash result" such that an electronic record yields the same hash result every time the algorithm is executed with the same electronic record as its input making it computationally infeasible—

(a) to derive or reconstruct the original electronic record from the hash result produced by the algorithm;

(b) that two electronic records can produce the same hash result using the algorithm.

(3) Any person by the use of a public key of the subscriber can verify the electronic record.

(4) The private key and the public key are unique to the subscriber and constitute a functioning key pair.

CHAPTER III

ELECTRONIC GOVERNANCE

4. Legal recognition of electronic records.

Where any law provides that information or any other matter shall be in writing or in the typewritten or printed form, then, notwithstanding anything contained in such law, such requirement

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shall be deemed to have been satisfied if such information or matter is—

- (a) rendered or made available in an electronic form; and
- (b) accessible so as to be usable for a subsequent reference.

5. Legal recognition of digital signatures.

Where any law provides that information or any other matter shall be authenticated by affixing the signature or any document shall be signed or bear the signature of any person (hen, notwithstanding anything contained in such law, such requirement shall be deemed to have been satisfied, if such information or matter is authenticated by means of digital signature affixed in such manner as may be prescribed by the Central Government.

Explanation.—For the purposes of this section, "signed", with its grammatical variations and cognate expressions, shall, with reference to a person, mean affixing of his hand written signature or any mark on any document and the expression "signature" shall be construed accordingly.

6. Use of electronic records and digital signatures in Government and its agencies.

- (1) Where any law provides for—
 - (a) the filing of any form. application or any other document with any office, authority, body or agency owned or controlled by the appropriate Government in a particular manner;
 - (b) the issue or grant of any licence, permit, sanction or approval by whatever name called in a particular manner;
 - (c) the receipt or payment of money in a particular manner, then, notwithstanding anything contained in any other law for the time being in force, such requirement shall be deemed to have been satisfied if such filing, issue, grant, receipt or payment, as the case may be, is effected by means of such electronic form as may be prescribed by the appropriate Government.
- (2) The appropriate Government may, for the purposes of subsection (1), by rules, prescribe—

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- (a) the manner and format in which such electronic records shall be filed, created or issued;
- (b) the manner or method of payment of any fee or charges for filing, creation or issue any electronic record under clause (a).

7. Retention of electronic records.

(1) Where any law provides that documents, records or information shall be retained for any specific period, then, that requirement shall be deemed to have been satisfied if such documents, records or information are retained in the electronic form, if—

- (a) the information contained therein remains accessible so as to be usable for a subsequent reference;
- (b) the electronic record is retained in the format in which it was originally generated, sent or received or in a format which can be demonstrated to represent accurately the information originally generated, sent or received;
- (c) the details which will facilitate the identification of the origin, destination, date and time of despatch or receipt of such electronic record are available in the electronic record:

Provided that this clause does not apply to any information which is automatically generated solely for the purpose of enabling an electronic record to be despatched or received.

(2) Nothing in this section shall apply to any law that expressly provides for the retention of documents, records or information in the form of electronic records.

8. Publication of rule, regulation, etc., in Electronic Gazette.

Where any law provides that any rule, regulation, order, bye-law, notification or any other matter shall be published in the Official Gazette, then, such requirement shall be deemed to have been satisfied if such rule, regulation, order, bye-law, notification or any other matter is published in the Official Gazette or Electronic Gazette:

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Provided that where any rule, regulation, order, bye-law, notification or any other matter is published in the Official Gazette or Electronic Gazette, the date of publication shall be deemed to be the date of the Gazette which was first published in any form.

9. Sections 6,7 and 8 not to confer right to insist document should be accepted in electronic form.

Nothing contained in sections 6, 7 and 8 shall confer a right upon any person to insist that any Ministry or Department of the Central Government or the State Government or any authority or body established by or under any law or controlled or funded by the Central or State Government should accept, issue, create, retain and preserve any document in the form of electronic records or effect any monetary transaction in the electronic form.

10. Power to make rules by Central Government in respect of digital signature.

The Central Government may, for the purposes of this Act, by rules, prescribe—

- (a) the type of digital signature;
- (b) the manner and format in which the digital signature shall be affixed;
- (c) the manner or procedure which facilitates identification of the person affixing the digital signature;
- (d) control processes and procedures to ensure adequate integrity, security and confidentiality of electronic records or payments; and
- (e) any other matter which is necessary to give legal effect to digital signatures.

CHAPTER IV

ATTRIBUTION, ACKNOWLEDGMENT AND DESPATCH OF ELECTRONIC RECORDS

11. Attribution of electronic records.

An electronic record shall be attributed to the originator—

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- (a) if it was sent by the originator himself;
- (b) by a person who had the authority to act on behalf of the originator in respect of that electronic record; or
- (c) by an information system programmed by or on behalf of the originator to operate automatically.

12. Acknowledgment of receipt.

(1) Where the originator has not agreed with the addressee that the acknowledgment of receipt of electronic record be given in a particular form or by a particular method, an acknowledgment may be given by—

- (a) any communication by the addressee, automated or otherwise; or
- (b) any conduct of the addressee, sufficient to indicate to the originator that the electronic record has been received.

(2) Where the originator has stipulated that the electronic record shall be binding only on receipt of an acknowledgment of such electronic record by him, then unless acknowledgment has been so received, the electronic record shall be deemed to have been never sent by the originator.

(3) Where the originator has not stipulated that the electronic record shall be binding only on receipt of such acknowledgment, and the acknowledgment has not been received by the originator within the time specified or agreed or, if no time has been specified or agreed to within a reasonable time, then the originator may give notice to the addressee stating that no acknowledgment has been received by him and specifying a reasonable time by which the acknowledgment must be received by him and if no acknowledgment is received within the aforesaid time limit he may after giving notice to the addressee, treat the electronic record as though it has never been sent.

13. Time and place of despatch and receipt of electronic record.

(1) Save as otherwise agreed to between the originator and the addressee, the dispatch of an electronic record occurs when it

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enters a computer resource outside the control of the originator.

(2) Save as otherwise agreed between the originator and the addressee, the time of receipt of an electronic record shall be determined as follows, namely :—

(a) if the addressee has designated a computer resource for the purpose of receiving electronic records,—

(i) receipt occurs at the time when the electronic, record enters the designated computer resource; or

(ii) if the electronic record is sent to a computer resource of the addressee that is not the designated computer resource, receipt occurs at the time when the electronic record is retrieved by the addressee;

(b) if the addressee has not designated a computer resource along with specified timings, if any, receipt occurs when the electronic record enters the computer resource of the addressee.

(3) Save as otherwise agreed to between the originator and the addressee, an electronic record is deemed to be dispatched at the place where the originator has his place of business, and is deemed to be received at the place where the addressee has his place of business.

(4) The provisions of sub-section (2) shall apply notwithstanding that the place where the computer resource is located may be different from the place where the electronic record is deemed to have been received under sub-section (3).

(5) For the purposes of this section, —

(a) if the originator or the addressee has more than one place of business, the principal place of business, shall be the place of business;

(b) if the originator or the addressee does not have a place of business, his usual place of residence shall be deemed to be the place of business;

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- (c) "usual place of residence", in relation to a body corporate, means the place where it is registered.

CHAPTER V

SECURE ELECTRONIC RECORDS AND SECURE DIGITAL SIGNATURES

14. Secure electronic record.

Where any security procedure has been applied to an electronic record at a specific point of time. then such record shall be deemed to be a secure electronic record from such point of time to the time of verification.

15. Secure digital signature.

If, by application of a security procedure agreed to by the parties concerned, it can be verified that a digital signature, at the time it was affixed, was—

- (a) unique to the subscriber affixing it;
- (b) capable of identifying such subscriber;
- (c) created in a manner or using a means under the exclusive control of the subscriber and is linked to the electronic record to which it relates in such a manner that if the electronic record was altered the digital signature would be invalidated, then such digital signature shall be deemed to be a secure digital signature.

16. Security procedure.

The Central Government shall for the purposes of this Act prescribe the security procedure having regard to commercial circumstances prevailing at the time when the procedure was used, including—

- (a) the nature of the transaction;
- (b) the level of sophistication of the parties with reference to their technological capacity;

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- (c) the volume of similar transactions engaged in by other parties;
- (d) the availability of alternatives offered to but rejected by any party;
- (e) the cost of alternative procedures; and
- (f) the procedures in general use for similar types of transactions or communications.

CHAPTER VI

REGULATION OF CERTIFYING AUTHORITIES

17. Appointment of Controller and other officers.

- (1) The Central Government may, by notification in the Official Gazette, appoint a Controller of Certifying Authorities for the purposes of this Act and may also by the same or subsequent notification appoint such number of Deputy Controllers and Assistant Controllers as it deems fit.
- (2) The Controller shall discharge his functions under this Act subject to the general control and directions of the Central Government.
- (3) The Deputy Controllers and Assistant Controllers shall perform the functions assigned to them by the Controller under the general superintendence and control of the Controller.
- (4) The qualifications, experience and terms and conditions of service of Controller, Deputy Controllers and Assistant Controllers shall be such as may be prescribed by the Central Government.
- (5) The Head Office and Branch Office of the office of the Controller shall be at such places as the Central Government may specify, and these may be established at such places as the Central Government may think fit.
- (6) There shall be a seal of the Office of the Controller.

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18. Functions of Controller.

The Controller may perform all or any of the following functions, namely:—

- (a) exercising supervision over the activities of the Certifying Authorities;
- (b) certifying public keys of the Certifying Authorities;
- (c) laying down the standards to be maintained by the Certifying Authorities;
- (d) specifying the qualifications and experience which employees of the Certifying Authorities should possess;
- (e) specifying the conditions subject to which the Certifying Authorities shall conduct their business;
- (f) specifying the contents of written, printed or visual materials and advertisements that may be distributed or used in respect of a Digital Signature Certificate and the public key;
- (g) specifying the form and content of a Digital Signature Certificate and the key,
- (h) specifying the form and manner in which accounts shall be maintained by the Certifying Authorities;
- (i) specifying the terms and conditions subject to which auditors may be appointed and the remuneration to be paid to them;
- (j) facilitating the establishment of any electronic system by a Certifying Authority either solely or jointly with other Certifying Authorities and regulation of such systems;
- (k) specifying the manner in which the Certifying Authorities shall conduct their dealings with the subscribers;
- (l) resolving any conflict of interests between the Certifying Authorities and the subscribers;
- (m) laying down the duties of the Certifying Authorities;
- (n) maintaining a data base containing the disclosure record of every Certifying Authority containing such particulars as may be specified by regulations, which shall be accessible to public.

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19. Recognition of foreign Certifying Authorities.

(1) Subject to such conditions and restrictions as may be specified by regulations, the Controller may with the previous approval of the Central Government, and by notification in the Official Gazette, recognise any foreign Certifying Authority as a Certifying Authority for the purposes of this Act.

(2) Where any Certifying Authority is recognised under subsection (1), the Digital Signature Certificate issued by such Certifying Authority shall be valid for the purposes of this Act.

(3) The Controller may, if he is satisfied that any Certifying Authority has contravened any of the conditions and restrictions subject to which it was granted recognition under subsection (1) he may, for reasons to be recorded in writing, by notification in the Official Gazette, revoke such recognition.

20. Controller to act as repository.

(1) The **Controller** shall be the repository of all Digital Signature Certificates issued under this Act.

(2) The Controller shall—

(a) make use of hardware, software and procedures that are secure .iJm intrusion and misuse;

(b) observe such other standards as may be prescribed by the Central Government, to ensure that the secrecy and security of the digital signatures are assured.

(3) The Controller shall maintain a computerised data base of all public keys in such a manner that such data base and the public keys are available to any member of the public.

21. Licence to issue Digital Signature Certificates.

(1) Subject to the provisions of sub-section (2), any person may make an application, to the Controller, for a licence to issue Digital Signature Certificates.

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(2) No licence shall be issued under sub-section (1), unless the applicant fulfills such requirements with respect to qualification, expertise, manpower, financial resources and other infrastructure facilities, which are necessary to issue Digital Signature Certificates as may be prescribed by the Central Government

(3) A licence granted under this section shall—

- (a) be valid for such period as may be prescribed by the Central Government;
- (b) not be transferable or heritable;
- (c) be subject to such terms and conditions as may be specified by the regulations.

22. Application for licence.

(1) Every application for issue of a licence shall be in such form as may be prescribed by the Central Government.

(2) Every application for issue of a licence shall be accompanied by—

- (a) a certification practice statement;
- (b) a statement including the procedures with respect to identification of the applicant;
- (c) payment of such fees, not exceeding twenty-five thousand rupees as may be prescribed by the Central Government;
- (d) such other documents, as may be prescribed by the Central Government.

23. Renewal of licence.

An application for renewal of a licence shall be—

- (a) in such form;
- (b) accompanied by such fees, not exceeding five thousand rupees, as may be prescribed by the Central Government and shall be made not less than forty-five days before the date of expiry of the period of validity of the licence.

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24. Procedure for grant or rejection of licence.

The Controller may, on receipt of an application under sub-section (1) of section 21, after considering the documents accompanying the application and such other factors, as he deems fit, grant the licence or reject the application:

Provided that no application shall be rejected under this section unless the applicant has been given a reasonable opportunity of presenting his case.

25. Suspension of licence.

(1) The Controller may, if he is satisfied after making such inquiry, as he may think fit, that a Certifying Authority has,—

- (a) made a statement in, or in relation to, the application for the issue or renewal of the licence, which is incorrect or false in material particulars;
- (b) failed to comply with the terms and conditions subject to which the licence was granted;
- (c) failed to maintain the standards specified under clause (b) of sub-section (2) of section 20;
- (d) contravened any provisions of this Act, rule, regulation or order made thereunder, revoke the licence:

Provided that no licence shall be revoked unless the Certifying Authority has been given a reasonable opportunity of showing cause against the proposed revocation.

(2) The Controller may, if he has reasonable cause to believe that there is any ground for revoking a licence under sub-section (1), by order suspend such licence pending the completion of any inquiry ordered by him:

Provided that no licence shall be suspended for a period exceeding ten days unless the Certifying Authority has been given a reasonable opportunity of showing cause against the proposed suspension.

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(3) No Certifying Authority whose licence has been suspended shall issue any Digital Signature Certificate during such suspension.

26. Notice of suspension or revocation of licence.

(1) Where the licence of the Certifying Authority is suspended or revoked, the Controller shall publish notice of such suspension or revocation, as the case may be, in the database maintained by him.

(2) Where one or more repositories are specified, the Controller shall publish notices of such suspension or revocation, as the case may be, in all such repositories:

Provided that the data base containing the notice of such suspension or revocation, as the case may be, shall be made available through a web site which shall be accessible round the clock:

Provided further that the Controller may, if he considers necessary, publicise the contents of database in such electronic or other media, as he may consider appropriate.

27. Power to delegate.

The Controller may, in writing, authorise the Deputy Controller, Assistant Controller or any officer to exercise any of the powers of the Controller under this Chapter.

28. Power to investigate contraventions.

(1) The Controller or any officer authorised by him in this behalf shall take up for investigation any contravention of the provisions of this Act, rules or regulations made thereunder.

(2) The Controller or any officer authorised by him in this behalf shall exercise the like powers which are conferred on Income-tax authorities under Chapter XIII of the Income-tax Act, 1961 and shall exercise such powers, subject to such limitations laid down under that Act.

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29. Access to computers and data.

(1) Without prejudice to the provisions of sub-section (1) of section 69, the Controller or any person authorised by him shall, if he has reasonable cause to suspect that any contravention of the provisions of this Act, rules or regulations made thereunder has been committed, have access to any computer system, any apparatus, data or any other material connected with such system, for the purpose of searching or causing a search to be made for obtaining any information or data contained in or available to such computer system.

(2) For the purposes of sub-section (1), the Controller or any person authorised by him may, by order, direct any person incharge of, or otherwise concerned with the operation of, the computer system, data apparatus or material, to provide him with such reasonable technical and other assistance as he may consider necessary.

30. Certifying Authority to follow certain procedures.

Every Certifying Authority shall, —

- (a) make use of hardware, software and procedures that are secure from intrusion and misuse;
- (b) provide a reasonable level of reliability in its services which are reasonably suited to the performance of intended functions;
- (c) adhere to security procedures to ensure that the secrecy and privacy of the digital signatures are assured; and
- (d) observe such other standards as may be specified by regulations.

31. Certifying Authority to ensure compliance of the Act, etc.

Every Certifying Authority shall ensure that every person employed or otherwise engaged by it complies, in the course of his employment or engagement, with the provisions of this Act, rules, regulations and orders made thereunder.

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32. Display of licence.

Every Certifying Authority shall display its licence at a conspicuous place of the premises in which it carries on its business.

33. Surrender of licence.

(1) Every Certifying Authority whose licence is suspended or revoked shall immediately after such suspension or revocation, surrender the licence to the Controller.

(2) Where any Certifying Authority fails to surrender a licence under sub-section (1), the person in whose favour a licence is issued, shall be guilty of an offence and shall be punished with imprisonment which may extend up to six months or a fine which may extend up to ten thousand rupees or with both.

34. Disclosure.

(1) Every Certifying Authority shall disclose in the manner specified by regulations—

- (a) its Digital Signature Certificate which contains the public key corresponding to the private key used by that Certifying Authority to digitally sign another Digital Signature Certificate;
- (b) any certification practice statement relevant thereto;
- (c) notice of the revocation or suspension of its Certifying Authority certificate, if any; and
- (d) any other fact that materially and adversely affects either the reliability of a Digital Signature Certificate, which that Authority has issued, or the Authority's ability to perform its services.

(2) Where in the opinion of the Certifying Authority any event has occurred or any situation has arisen which may materially and adversely affect the integrity of its computer system or the conditions subject to which a Digital Signature Certificate was granted, then, the Certifying Authority shall—

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- (a) use reasonable efforts to notify any person who is likely to be affected by that occurrence; or
- (b) act in accordance with the procedure specified in its certification practice statement to deal with such event or situation.

CHAPTER VII

DIGITAL SIGNATURE

CERTIFICATES

35. Certifying Authority to issue Digital Signature Certificate.

(1) Any person may make an application to the Certifying Authority for the issue of a Digital Signature Certificate in such form as may be prescribed by the Central Government

(2) Every such application shall be accompanied by such fee not exceeding twentyfive thousand rupees as may be prescribed by the Central Government, to be paid to the Certifying Authority:

Provided that while prescribing fees under sub-section (2) different fees may be prescribed for different classes of applicants'.

(3) Every such application shall be accompanied by a certification practice statement or where there is no such statement, a statement containing such particulars, as may be specified by regulations.

(4) On receipt of an application under sub-section (1), the Certifying Authority may, after consideration of the certification practice statement or the other statement under subsection (3) and after making such enquiries as it may deem fit, grant the Digital Signature Certificate or for reasons to be recorded in writing, reject the application:

Provided that no Digital Signature Certificate shall be granted unless the Certifying Authority is satisfied that—

- (a) the applicant holds the private key corresponding to the public key to be listed in the Digital Signature Certificate;

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- (b) the applicant holds a private key, which is capable of creating a digital signature;
- (c) the public key to be listed in the certificate can be used to verify a digital signature affixed by the private key held by the applicant:

Provided further that no application shall be rejected unless the applicant has been given a reasonable opportunity of showing cause against the proposed rejection.

36. Representations upon issuance of Digital Signature Certificate.

A Certifying Authority while issuing a Digital Signature Certificate shall certify that--

- (a) it has complied with the provisions of this Act and the rules and regulations made thereunder,
- (b) it has published the Digital Signature Certificate or otherwise made it available to such person relying on it and the subscriber has accepted it;
- (c) the subscriber holds the private key corresponding to the public key, listed in the Digital Signature Certificate;
- (d) the subscriber's public key and private key constitute a functioning key pair,
- (e) the information contained in the Digital Signature Certificate is accurate; and
- (f) it has no knowledge of any material fact, which if it had been included in the Digital Signature Certificate would adversely affect the reliability of the representations made in clauses (a) to (d).

37. Suspension of Digital Signature Certificate.

(1) Subject to the provisions of sub-section (2), the Certifying Authority which has issued a Digital Signature Certificate may suspend such Digital Signature Certificate,—

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- (a) on receipt of a **request** to that effect from—
 - (i) the subscriber listed in the Digital Signature Certificate; or
 - (ii) any person duly authorised to act on behalf of that subscriber,
 - (b) if it is of opinion that the Digital Signature Certificate should be suspended in public interest
- (2) A Digital Signature Certificate shall not be suspended for a period exceeding fifteen days unless the subscriber has been given an opportunity of being heard in the matter.
- (3) On suspension of a Digital Signature Certificate under this section, the Certifying Authority shall communicate the same to the subscriber.

38. Revocation of Digital Signature Certificate.

- (1) A Certifying Authority may revoke a Digital Signature Certificate issued by it—
- (a) where the subscriber or any other person authorised by him makes a request to that effect; or
 - (b) upon the death of the subscriber, or
 - (c) upon the dissolution of the firm or winding up of the company where the subscriber is a firm or a company.
- (2) Subject to the provisions of sub-section (3) and without prejudice to the provisions of sub-section (1), a Certifying Authority may revoke a Digital Signature Certificate which has been issued by it at any time, if it is of opinion that—
- (a) a material fact represented in the Digital Signature Certificate is false or has been concealed;
 - (b) a requirement for issuance of the Digital Signature Certificate was not satisfied;

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- (c) the Certifying Authority's private key or security system was compromised in a manner materially affecting the Digital Signature Certificate's reliability;
 - (d) the subscriber has been declared insolvent **or** dead or where a subscriber is a firm or a company, which has been dissolved, wound-up **or** otherwise ceased to exist
- (3) A Digital Signature Certificate shall not be revoked unless the subscriber has been given an opportunity of being heard in the matter.
- (4) On revocation of a Digital Signature Certificate under this section, the Certifying Authority shall communicate the same to the subscriber.

39. Notice of suspension or revocation.

- (1) Where a Digital Signature Certificate is suspended or revoked under section 37 or section 38, the Certifying Authority shall publish a notice of such suspension or revocation, as the case may be, in the repository specified in the Digital Signature Certificate for publication of such notice.
- (2) Where one or more repositories are specified, the Certifying Authority shall publish notices of such suspension or revocation, as the case may be, in all such repositories.

CHAPTER VIII

DUTIES OF SUBSCRIBERS

40. Generating key pair.

Where any Digital Signature Certificate, the public key of which corresponds to the private key of that subscriber which is to be listed in the Digital Signature Certificate has been accepted by a subscriber, then, the subscriber shall generate the key pair by applying the security procedure.

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41. Acceptance of Digital Signature Certificate.

(1) A subscriber shall be deemed to have accepted a Digital Signature Certificate if he publishes or authorises the publication of a Digital Signature Certificate—

- (a) to one or more persons;
- (b) in a repository, or otherwise demonstrates his approval of the Digital Signature Certificate in any manner.

(2) By accepting a Digital Signature Certificate the subscriber certifies to all who reasonably rely on the information contained in the Digital Signature Certificate that—

- (a) the subscriber holds the private key corresponding to the public key listed in the Digital Signature Certificate and is entitled to hold the same;
- (b) all representations made by the subscriber to the Certifying Authority and all material relevant to the information contained in the Digital Signature Certificate are true;
- (c) all information in the Digital Signature Certificate that is within the knowledge of the subscriber is true.

42. Control of private key.

(1) Every subscriber shall exercise reasonable care to retain control of the private key corresponding to the public key listed in his Digital Signature Certificate and take all steps to prevent its disclosure to a person not authorised to affix the digital signature of the subscriber.

(2) If the private key corresponding to the public key listed in the Digital Signature Certificate has been compromised, then, the subscriber shall communicate the same without any delay to the Certifying Authority in such manner as may be specified by the regulations.

Explanation.— For the removal of doubts, it is hereby declared that the subscriber shall be liable till he has informed the Certifying Authority that the private key has been compromised.

CHAPTER IX

PENALTIES AND ADJUDICATION

43. Penalty for damage to computer, computer system, etc.

If any person without permission of the owner or any other person who is in charge of a computer, computer system or computer network, —

- (a) accesses or secures access to such computer, computer system or computer network;
- (b) downloads, copies or extracts any data, computer data base or information from such computer, computer system or computer network including information or data held or stored in any removable storage medium;
- (c) introduces or causes to be introduced any computer contaminant or computer virus into any computer, computer system or computer network;
- (d) damages or causes to be damaged any computer, computer system or computer network, data, computer data base or any other programmes residing in such computer, computer system or computer network;
- (e) disrupts or causes disruption of any computer, computer system or computer network;
- (f) denies or causes the denial of access to any person authorised to access any computer, computer system or computer network by any means;
- (g) provides any assistance to any person to facilitate access to a computer, computer system or computer network in contravention of the provisions of this Act, rules or regulations made thereunder;
- (h) charges the services availed of by a person to the account of another person by tampering with or manipulating any computer, computer system, or computer network, he shall be

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liable to pay damages by way of compensation not exceeding one crore rupees to the person so affected.

Explanation.—For the purposes of this section,—

- (i) "computer contaminant" means any set of computer instructions that are designed—
 - (a) to modify, destroy, record, transmit data or programme residing within a computer, computer system or computer network; or
 - (b) by any means to usurp the normal operation of the computer, computer system, or computer network;
- (ii) "computer data base" means a representation of information, knowledge, facts, concepts or instructions in text, image, audio, video that are being prepared or have been prepared in a formalised manner or have been produced by a computer, computer system or computer network and are intended for use in a computer, computer system or computer network;
- (iii) "computer virus" means any computer instruction, information, data or programme that destroys, damages, degrades or adversely affects the performance of a computer resource or attaches itself to another computer resource and operates when a programme, data or instruction is executed or some other event takes place in that computer resource;
- (iv) "damage" means to destroy, alter, delete, add, modify or rearrange any computer resource by any means.

44. Penalty for failure to furnish information return, etc.

If any person who is required under this Act or any rules or regulations made thereunder to—

- (a) furnish any document, return or report to the Controller or the Certifying Authority fails to furnish the same, he shall be liable

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to a penalty not exceeding one lakh and fifty thousand rupees for each such failure;

- (b) file any return or furnish any information, books or other documents within the time specified therefor in the regulations fails to file return or furnish the same within the time specified therefor in the regulations, he shall be liable to a penalty not exceeding five thousand rupees for every day during which such failure continues;
- (c) maintain books of account or records, fails to maintain the same, he shall be liable to a penalty not exceeding ten thousand rupees for every day during which the failure continues.

45. Residuary penalty.

Whoever contravenes any rules or regulations made under this Act, for the contravention of which no penalty has been separately provided, shall be liable to pay a compensation not exceeding twenty-five thousand rupees to the person affected by such contravention or a penalty not exceeding twenty-five thousand rupees.

46. Power to adjudicate.

(1) For the purpose of adjudging under this Chapter whether any person has committed a contravention of any of the provisions of this Act or of any rule, regulation, direction or order made thereunder the Central Government shall, subject to the provisions of sub-section (3), appoint any officer not below the rank of a Director to the Government of India or an equivalent officer of a State Government to be an adjudicating officer for holding an inquiry in the manner prescribed by the Central Government.

(2) The adjudicating officer shall, after giving the person referred to in sub-section (1) a reasonable opportunity for making representation in the matter and if, on such inquiry, he is satisfied that the person has committed the contravention, he may impose such penalty or award such compensation as he thinks fit in accordance with the provisions of that section.

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(3) No person shall be appointed as an adjudicating officer unless he possesses such experience in the field of Information Technology and legal or judicial experience as may be prescribed by the Central Government.

(4) Where more than one adjudicating officers are appointed, the Central Government shall specify by order the matters and places with respect to which such officers shall exercise their jurisdiction.

(5) Every adjudicating officer shall have the powers of a civil court which are conferred on the Cyber Appellate Tribunal under sub-section (2) of section 58, and—

(a) all proceedings before it shall be deemed to be judicial proceedings within the meaning of sections 193 and 228 of the Indian Penal Code;

(b) shall be deemed to be a civil court for the purposes of sections 345 and 346 of the Code of Criminal Procedure, 1973.

47. Factors to be taken into account by the adjudicating officer.

While adjudging the quantum of compensation under this Chapter, the adjudicating officer shall have due regard to the following factors, namely:—

(a) the amount of gain of unfair advantage, wherever quantifiable, made as a result of the default;

(b) the amount of loss caused to any person as a result of the default;

(c) the repetitive nature of the default

CHAPTER X

THE CYBER REGULATIONS APPELLATE TRIBUNAL

48. Establishment of Cyber Appellate Tribunal.

(1) The Central Government shall, by notification, establish one or more appellate tribunals to be known as the Cyber Regulations Appellate Tribunal.

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(2) The Central Government shall also specify, in the notification referred to in subsection (1), the matters and places in relation to which the Cyber Appellate Tribunal may exercise jurisdiction.

49. Composition of Cyber Appellate Tribunal.

A Cyber Appellate Tribunal shall consist of one person only (hereinafter referred to as the Presiding Officer of the Cyber Appellate Tribunal) to be appointed, by notification, by the Central Government

50. Qualifications for appointment as Presiding Officer of the Cyber Appellate Tribunal.

A person shall not be qualified for appointment as the Presiding Officer of a Cyber Appellate Tribunal unless he—

- (a) is, or has been, or is qualified to be, a Judge of a High Court; or
- (b) is or has been a member of the Indian Legal Service and is holding or has held a post in Grade I of that Service for at least three years.

51. Term of office

The Presiding Officer of a Cyber Appellate Tribunal shall hold office for a term of five years from the date on which he enters upon his office or until he attains the age of sixty-five years, whichever is earlier.

52. Salary, allowances and other terms and conditions of service of Presiding Officer.

The salary and allowances payable to, and the other terms and conditions of service including pension, gratuity and other retirement benefits of, the Presiding Officer of a Cyber Appellate Tribunal shall be such as may be prescribed:

Provided that neither the salary and allowances nor the other terms and conditions of service of the Presiding Officer shall be varied to his disadvantage after appointment.

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53. Filling up of vacancies.

If, for reason other than temporary absence, any vacancy occurs in the office of the Presiding Officer of a Cyber Appellate Tribunal, then the Central Government shall appoint another person in accordance with the provisions of this Act to fill the vacancy and the proceedings may be continued before the Cyber Appellate Tribunal from the stage at which the vacancy is filled.

54. Resignation and removal.

(1) The Presiding Officer of a Cyber Appellate Tribunal may, by notice in writing under his hand addressed to the Central Government, resign his office:

Provided that the said Presiding Officer shall, unless he is permitted by the Central Government to relinquish his office sooner, continue to hold office until the expiry of three months from the date of receipt of such notice or until a person duly appointed as his successor enters upon his office or until the expiry of his term of office, whichever is the earliest.

(2) The Presiding Officer of a Cyber Appellate Tribunal shall not be removed from his office except by an order by the Central Government on the ground of proved misbehaviour or incapacity after an inquiry made by a Judge of the Supreme Court in which the Presiding Officer concerned has been informed of the charges against him and given a reasonable opportunity of being heard in respect of these charges.

(3) The Central Government may, by rules, regulate the procedure for the investigation of misbehaviour or incapacity of the aforesaid Presiding Officer.

55. Orders constituting Appellate Tribunal to be final and not to invalidate its proceedings.

No order of the Central Government appointing any person as the Presiding Officer of a Cyber Appellate Tribunal shall be called in question in any manner and no act or proceeding before a Cyber Appellate Tribunal shall be called in question in any manner on

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the ground merely of any defect in the constitution of a Cyber Appellate Tribunal.

56. Staff of the Cyber Appellate Tribunal.

(1) The Central Government shall provide the Cyber Appellate Tribunal with such officers and employees as that Government may think fit

(2) The officers and employees of the Cyber Appellate Tribunal shall discharge their functions under general superintendence of the Presiding Officer.

(3) The salaries, allowances and other conditions of service of the officers and employees of the Cyber Appellate Tribunal shall be such as may be prescribed by the Central Government.

57. Appeal to Cyber Appellate Tribunal.

(1) Save as provided in sub-section (2), any person aggrieved by an order made by Controller or an adjudicating officer under this Act may prefer an appeal to a Cyber Appellate Tribunal having jurisdiction in the matter.

(2) No appeal shall lie to the Cyber Appellate Tribunal from an order made by an adjudicating officer with the consent of the parties.

(3) Every appeal under sub-section (1) shall be filed within a period of five days from the date on which a copy of the order made by the Controller or the adjudicating officer is received by the person aggrieved and it shall be in such form and be accompanied by such fee as may be prescribed:

Provided that the Cyber Appellate Tribunal may entertain an appeal after the expiry of the said period of five days if it is satisfied that there was sufficient cause for not filing it within that period.

(4) On receipt of an appeal under sub-section (1), the Cyber Appellate Tribunal may, after giving the parties to the appeal, an opportunity of being heard, pass such orders thereon as it thinks

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fit, confirming, modifying or setting aside the order appealed against.

(5) The Cyber Appellate Tribunal shall send a copy of every order made by it to" the parties to the appeal and to the concerned Controller or adjudicating officer.

(6) The appeal filed before the Cyber Appellate Tribunal under sub-section (1) shall be dealt with by it as expeditiously as possible and endeavour shall be made by it to dispose of the appeal finally within six months from the date of receipt of the appeal.

58. Procedure and powers of the Cyber Appellate Tribunal.

(1) The Cyber Appellate Tribunal shall not be bound by the procedure laid down by the Code of civil Procedure, 1908 but shall be guided by the principles of natural justice and, subject to the other provisions of this Act and of any rules, the Cyber Appellate Tribunal shall have powers to regulate its own procedure including the place at which it shall have its sittings.

(2) The Cyber Appellate Tribunal shall have, for the purposes of discharging its functions under this Act, the same powers as are vested in a civil court under the Code of Civil Procedure, 1908, while trying a suit, in respect of the following matters, namely:—

- (a) summoning and enforcing the attendance of any person and examining him on oath;
- (b) requiring the discovery and production of documents or other electronic records;
- (c) receiving evidence on affidavits;
- (d) issuing commissions for the examination of witnesses or documents;
- (e) reviewing its decisions;
- (f) dismissing an application for default or deciding it *ex pane*;
- (g) any other matter which may be prescribed.

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(3) Every proceeding before the Cyber Appellate Tribunal shall be deemed to be a judicial proceeding within the meaning of sections 193 and 228, and for the purposes of section 196 of the Indian Penal Code and the Cyber Appellate Tribunal shall be deemed to be a civil court for the purposes of section 195 and Chapter XXVI of the Code of Criminal Procedure, 1973.

59. Right to legal representation.

The appellant may either appear in person or authorise one or more legal practitioners or any of its officers to present his or its case before the Cyber Appellate Tribunal.

60. Limitation.

The provisions of the Limitation Act, 1963, shall, as far as may be, *apply* to an appeal made to the Cyber Appellate Tribunal.

61. Civil court not to have jurisdiction.

No court shall have jurisdiction to entertain any suit or proceeding in respect of any matter which an adjudicating officer appointed under this Act or the Cyber Appellate Tribunal constituted under this Act is empowered by or under this Act to determine and no injunction shall be granted by any court or other authority in respect of any action taken or to be taken in pursuance of any power conferred by or under this Act.

62. Appeal to High Court.

Any person aggrieved by any decision or order of the Cyber Appellate Tribunal may file an appeal to the High Court within sixty days from the date of communication of the decision or order of the Cyber Appellate Tribunal to him on any question of fact or law arising out of such order

Provided that the High Court may, if it is satisfied that the appellant was prevented by sufficient cause from filing the appeal within the said period, allow it to be filed within a further period not exceeding sixty days.

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63. Compounding of contraventions.

(1) Any contravention under this Chapter may, either before or after the institution of adjudication proceedings, be compounded by the Controller or such other officer as may be specially authorised by him in this behalf or by the adjudicating officer, as the case may be, subject to such conditions as the Controller or such other officer or the adjudicating officer may specify:

Provided that such sum shall not, in any case, exceed the maximum amount of the penalty which may be imposed under this Act for the contravention so compounded. (2) Nothing in sub-section (1) shall apply to a person who commits the same or similar contravention within a period of three years from the date on which the first contravention, committed by him, was compounded.

Explanation.—For the purposes of this sub-section, any second or subsequent contravention committed after the expiry of a period of three years from the date on which the contravention was previously compounded shall be deemed to be a first contravention. (3) Where any contravention has been compounded under sub-section (1), no proceeding or further proceeding, as the case may be, shall be taken against the person guilty of such contravention in respect of the contravention so compounded.

64. Recovery of penalty

A penalty imposed under this Act, if it is not paid, shall be recovered as an arrear of land revenue and the licence or the Digital Signature Certificate, as the case may be, shall be suspended till the penalty is paid.

CHAPTER XI

OFFENCES

65. Tampering with computer source documents.

Whoever knowingly or intentionally conceals, destroys or alters or intentionally or knowingly causes another to conceal, destroy or

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alter any computer source code used for a computer, computer programme, computer system or computer network, when the computer source code is required to be kept or maintained by law for the time being in force, shall be punishable with imprisonment up to three years, or with fine which may extend up to two lakh rupees, or with both.

Explanation.—For the purposes of this section, "computer source code" means the listing of programmes, computer commands, design and layout and programme analysis of computer resource in any form.

66. Hacking with computer system.

(1) Whoever with the intent to cause or knowing that he is likely to cause wrongful loss or damage to the public or any person destroys or deletes or alters any information residing in a computer resource or diminishes its value or utility or affects it injuriously by any means, commits hack:

(2) Whoever commits hacking shall be punished with imprisonment up to three years, or with fine which may extend upto two lakh rupees, or with both.

67. Publishing of information which is obscene in electronic form.

Whoever publishes or transmits or causes to be published in the electronic form, any material which is lascivious or appeals to the prurient interest or if its effect is such as to tend to deprave and corrupt persons who are likely, having regard to all relevant circumstances, to read, see or hear the matter contained or embodied in it, shall be punished on first conviction with imprisonment of either description for a term which may extend to five years and with fine which may extend to one lakh rupees and in the event of a second or subsequent conviction with imprisonment of either description for a term which may extend to ten years and also with fine which may extend to two lakh rupees.

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68. Power of Controller to give directions.

(1) The Controller may, by order, direct a Certifying Authority or any employee of such Authority to take such measures or cease carrying on such activities as specified in the order if those are necessary to ensure compliance with the provisions of this Act, rules or any regulations made thereunder.

(2) Any person who fails to comply with any order under sub-section (1) shall be guilty of an offence and shall be liable on conviction to imprisonment for a term not exceeding three years or to a Fine not exceeding two lakh rupees or to both.

69. Directions of Controller to a subscriber to extend facilities to decrypt information.

(1) If the Controller is satisfied that it is necessary or expedient so to do in the interest of the sovereignty or integrity of India, the security of the State, friendly relations with foreign States or public order or for preventing incitement to the commission of any cognizable offence, for reasons to be recorded in writing, by order, direct any agency of the Government to intercept any information transmitted through any computer resource.

(2) The subscriber or any person incharge of the computer resource shall, when called upon by any agency which has been directed under sub-section (1), extend all facilities and technical assistance to decrypt the information.

(3) The subscriber or any person who fails to assist the agency referred to in sub-section (2) shall be punished with an imprisonment for a term which may extend to seven years.

70. Protected system.

(1) The appropriate Government may, by notification in the Official Gazette, declare that any computer, computer system or computer network to be a protected system.

(2) The appropriate Government may, by order in writing, authorise the persons who are authorised to access protected systems notified under sub-section (1).

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(3) Any person who secures access or attempts to secure access to a protected system in contravention of the provisions of this section shall be punished with imprisonment of either description for a term which may extend to ten years and shall also be liable to fine.

71. Penalty for misrepresentation.

Whoever makes any misrepresentation to, or suppresses any material fact from, the Controller or the Certifying Authority for obtaining any licence or Digital Signature Certificate, as the case may be, shall be punished with imprisonment for a term which may extend to two years, or with fine which may extend to one lakh rupees, or with both.

72. Penalty for breach of confidentiality and privacy.

Save as otherwise provided in this Act or any other law for the time being in force, any person who, in pursuance of any of the powers conferred under this Act, rules or regulations made thereunder, has secured access to any electronic record, book, register, correspondence, information, document or other material without the consent of the person concerned discloses such electronic record, book, register, correspondence, information, document or other material to any other person shall be punished with imprisonment for a term which may extend to two years, or with fine which may extend to one lakh rupees, or with both.

73. Penalty for publishing Digital Signature Certificate false in certain particulars.

(1) No person shall publish a Digital Signature Certificate or otherwise make it available to any other person with the knowledge that—

- (a) the Certifying Authority listed in the certificate has not issued it;
or
- (b) the subscriber listed in the certificate has not accepted it; or

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(c) the certificate has been revoked or suspended, unless such publication is for the purpose of verifying a digital signature created prior to such suspension or revocation.

(2) Any person who contravenes the provisions of sub-section (1) shall be punished with imprisonment for a term which may extend to two years, or with fine which may extend to one lakh rupees, or with both.

74. Publication for fraudulent purpose.

Whoever knowingly creates, publishes or otherwise makes available a Digital Signature Certificate for any fraudulent or unlawful purpose shall be punished with imprisonment for a term which may extend to two years, or with fine which may extend to one lakh rupees, or with both.

75. Act to apply for offence or contravention committed outside India.

(1) Subject to the provisions of sub-section (2), the provisions of this Act shall apply also to any offence or contravention committed outside India by any person irrespective of his nationality.

(2) For the purposes of sub-section (1), this Act shall apply to an offence or contravention committed outside India by any person if the act or conduct constituting the offence or contravention involves a computer, computer system or computer network located in India.

76. Confiscation.

Any computer, computer system, floppies, compact disks, tape drives or any other accessories related thereto, in respect of which any provision of this Act. rules, orders or regulations made thereunder has been or is being contravened, shall be liable to confiscation:

Provided that where it is established to the satisfaction of the court adjudicating the confiscation that the person in whose possession, power or control of any such computer, computer system, floppies, compact disks, tape drives or any other accessories

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relating thereto is found is not responsible for the contravention of the provisions of this Act, rules, orders or regulations made thereunder, the court may, instead of making an order for confiscation of such computer, computer system, floppies, compact disks, tape drives or any other accessories related thereto, make such other order authorised by this Act against the person contravening of the provisions of this Act, rules, orders or regulations made thereunder as it may think fit.

77. Penalties or confiscation not to interfere with other punishments.

No penalty imposed or confiscation made under this Act shall prevent the imposition of any other punishment to which the person affected thereby is liable under any other law for the time being in force.

78. Power to investigate offences.

Notwithstanding anything contained in the Code of Criminal Procedure, 1973, a police officer not below the rank of Deputy Superintendent of Police shall investigate any offence under this Act.

CHAPTER XII

NETWORK SERVICE PROVIDERS NOT TO BE LIABLE IN CERTAIN CASES

79. Network service providers not to be liable in certain cases.

For the removal of doubts, it is hereby declared that no person providing any service as a network service provider shall be liable under this Act, rules or regulations made thereunder for any third party information or data made available by him if he proves that the offence or contravention was committed without his knowledge or that he had exercised all due diligence to prevent the commission of such offence or contravention.

Explanation.—For the purposes of this section, —

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- (a) "network service provider" means an intermediary;
- (b) "third party information" means any information dealt with by a network service provider in his capacity as an intermediary;

CHAPTER XIII

MISCELLANEOUS

80. Power of police officer and other officers to enter, search, etc.

(1) Notwithstanding anything contained in the Code of Criminal Procedure, 1973, any police officer, not below the rank of a Deputy Superintendent of Police, or any other officer of the Central Government or a State Government authorised by the Central Government in this behalf may enter any public place and search and arrest without warrant any person found therein who is reasonably suspected or having committed or of committing or of being about to commit any offence under this Act

Explanation.—For the purposes of this sub-section, the expression "public place" includes any public conveyance, any hotel, any shop or any other place intended for use by, or accessible to the public.

(2) Where any person is arrested under sub-section (1) by an officer other than a police officer, such officer shall, without unnecessary delay, take or send the person arrested before a magistrate having jurisdiction in the case or before the officer-in-charge of a police station.

(3) The provisions of the Code of Criminal Procedure, 1973 shall, subject to the provisions of this section, apply, so far as may be, in relation to any entry, search or arrest, made under this section.

81. Act to have overriding effect.

The provisions of this Act shall have effect notwithstanding anything inconsistent therewith contained in any other law for the time being in force.

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82. Controller, Deputy Controller and Assistant Controllers to be public servants.

The Presiding Officer and other officers and employees of a Cyber Appellate Tribunal, the Controller, the Deputy Controller and the Assistant Controllers shall be deemed to be public servants within the meaning of section 21 of the Indian Penal Code.

83. Power to give directions.

The Central Government may give directions to any State Government as to the carrying into execution in the State of any of the provisions of this Act or of any rule, regulation or order made thereunder.

84. Protection of action taken in good faith.

No suit, prosecution or other legal proceeding shall lie against the Central Government, the State Government, the Controller or any person acting on behalf of him, the Presiding Officer, adjudicating officers and the staff of the Cyber Appellate Tribunal for anything which is in good faith done or intended to be done in pursuance of this Act or any rule, regulation or order made thereunder.

85. Offences by companies.

(1) Where a person committing a contravention of any of the provisions of this Act or of any rule, direction or order made thereunder is a company, every person who, at the time the contravention was committed, was in charge of, and was responsible to, the company for the conduct of business of the company as well as the company, shall be guilty of the contravention and shall be liable to be proceeded against and punished accordingly:

Provided that nothing contained in this sub-section shall render any such person liable to punishment if he proves that the contravention took place without his knowledge or that he exercised all due diligence to prevent such contravention.

(2) Notwithstanding anything contained in sub-section (1), where a contravention of any of the provisions of this Act or of any rule,

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direction or order made thereunder has been committed by a company and it is proved that the contravention has taken place with the consent or connivance of, or is attributable to any neglect on the part of, any director, manager, secretary or other officer of the company, such director, manager, secretary or other officer shall also be deemed to be guilty of the contravention and shall be liable to be proceeded against and punished accordingly.

Explanation.—For the purposes of this section,—

- (i) "company" means any body corporate and includes a firm or other association of individuals; and
- (ii) "director", in relation to a firm, means a partner in the firm.

86. Removal of difficulties.

(1) If any difficulty arises in giving effect to the provisions of this Act, the Central Government may, by order published in the Official Gazette, make such provisions not inconsistent with the provisions of this Act as appear to it to be necessary or expedient for removing the difficulty:

Provided that no order shall be made under this section after the expiry of a period of two years from the commencement of this Act

(2) Every order made under this section shall be laid, as soon as may be after it is made, before each House of Parliament.

87. Power of Central Government to make rules.

(1) The Central Government may, by notification in the Official Gazette and in the Electronic Gazette make rules to carry out the provisions of this Act

(2) In particular, and without prejudice to the generality of the foregoing power, such rules may provide for all or any of the following matters, namely:—

- (a) the manner in which any information or matter may be authenticated by means of digital signature under section 5;

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- (b) the electronic form in which filing, issue, grant or payment shall be effected under sub-section (1) of section 6;
- (c) the manner and format in which electronic records shall be filed, or issued and the method of payment under sub-section (2) of section 6;
- (d) the matters relating to the type of digital signature, manner and format in which it may be affixed under section 10;
- (e) the security procedure for the purpose of creating secure electronic record and secure digital signature under section 16;
- (f) the qualifications, experience and terms and conditions of service of Controller, Deputy Controllers and Assistant Controllers under section 17;
- (g) other standards to be observed by the Controller under clause (b) of subsection (2) of section 20;
- (h) the requirements which an applicant must fulfil under sub-section (2) of section 21;
- (i) the period of validity of licence granted under clause (a) of sub-section (3) of section 21;
- (j) the form in which an application for licence may be made under sub-section (1) of section 22;
- (k) the amount of fees payable under clause (c) of sub-section (2) of section 22;
- (l) such other documents which shall accompany an application for licence under clause (a) of sub-section (2) of section 22;
- (m) the form and the fee for renewal of a licence and the fee payable there of under section 23;
- (n) the form in which application for issue of a Digital Signature Certificate may be made under sub-section (1) of section 35;

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- (o) the fee to be paid to the Certifying Authority for issue of a Digital Signature Certificate under sub-section (2) of section 35;
 - (p) the manner in which the adjudicating officer shall hold inquiry under subsection (1) of section 46;
 - (q) the qualification and experience which the adjudicating officer shall possess under sub-section (3) of section 46;
 - (r) the salary, allowances and the other terms and conditions of service of the Presiding Officer under section 52;
 - (s) the procedure for investigation of misbehaviour or incapacity of the Presiding Officer under sub-section (3) of section 54;
 - (t) the salary and allowances and other conditions of service of other officers and employees under sub-section (3) of section 56;
 - (u) the form in which appeal may be filed and the fee thereof under sub -section (3) of section 57;
 - (v) any other power of a civil court required to be prescribed under clause (g) of subsection (2) of section 58; and
 - (w) any other matter which is required to be, or may be, prescribed.
- (3) Every notification made by the Central Government under clause (f) of subsection (4) of section 1 and every rule made by it shall be laid, as soon as may be after it is made, before each House of Parliament, while it is in session, for a total period of thirty days which may be comprised in one session or in two or more successive sessions, and if, before the expiry of the session immediately following the session or the successive sessions aforesaid, both Houses agree in making any modification in the notification or the rule or both Houses agree that the notification or the rule should not be made, the notification or the rule shall thereafter have effect only in such modified form or be of no effect, as the case may be; so, however, that any such modification or

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annulment shall be without prejudice to the validity of anything previously done under that notification or rule.

88. Constitution of Advisory Committee.

(1) The Central Government shall, as soon as may be after the commencement of this Act, constitute a Committee called the Cyber Regulations Advisory Committee.

(2) The Cyber Regulations Advisory Committee shall consist of a Chairperson and such number of other official and non-official members representing the interests principally affected or having special knowledge of the subject-matter as the Central Government may deem fit.

(3) The Cyber Regulations Advisory Committee shall advise—

(a) the Central Government either generally as regards any rules or for any other purpose connected with this Act;

(b) the Controller in framing the regulations under this Act.

(4) There shall be paid to the non-official members of such Committee such travelling and other allowances as the Central Government may fix.

89. Power of Controller to make regulations.

(1) The Controller may, after consultation with the Cyber Regulations Advisory Committee and with the previous approval of the Central Government, by notification in the Official Gazette, make regulations consistent with this Act and the rules made thereunder to carry out the purposes of this Act.

(2) In particular, and without prejudice to the generality of the foregoing power, such regulations may provide for all or any of the following matters, namely: —

(a) the particulars relating to maintenance of data-base containing the disclosure record of every Certifying Authority under clause (m) of section 18;

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- (b) the conditions and restrictions subject to which the Controller may recognise any foreign Certifying Authority under sub-section (1) of section 19;
- (c) the terms and conditions subject to which a licence may be granted under clause (c) of sub-section (3) of section 21;
- (d) other standards to be observed by a Certifying Authority under clause (d) of section 30;
- (e) the manner in which the Certifying Authority shall disclose the matters specified in sub-section (1) of section 34;
- (f) the particulars of statement which shall accompany an application under sub-section (3) of section 35;
- (g) the manner in which the subscriber shall communicate the compromise of private key to the certifying Authority under sub-section (2) of section 42.

(3) Every regulation made under this Act shall be laid, as soon as may be after it is made, before each House of Parliament, while it is in session, for a total period of thirty days which may be comprised in one session or in two or more successive sessions, and if, before the expiry of the session immediately following the session or the successive sessions aforesaid, both Houses agree in making any modification in the regulation or both Houses agree that the regulation should not be made, the regulation shall thereafter have effect only in such modified form or be of no effect, as the case may be; so, however, that any such modification or annulment shall be without prejudice to the validity of anything previously done under that regulation.

90. Power of State Government to make rules.

- (1) The State Government may, by notification in the Official Gazette, make rules to carry out the provisions of this Act.
- (2) In particular, and without prejudice to the generality of the foregoing power, such rules may provide for all or any of the following matters, namely: —
 - (a) the electronic form in which filing, issue, grant receipt or payment shall be effected under sub-section (1) of section 6;

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- (b) for matters specified in sub-section (2) of section 6;
 - (c) any other matter which is required to be provided by rules by the State Government.
- (3) Every rule made by the State Government under this section shall be laid, as soon as may be after it is made, before each House of the State Legislature where it consists of two Houses, or where such Legislature consists of one House, before that House.

91. Amendment of Act 45 of 1860.

The Indian Penal Code shall be amended in the manner specified in the First Schedule to this Act.

92. Amendment of Act 1 of 1872.

The Indian Evidence Act, 1872 shall be amended in the manner specified in the Second Schedule to this Act.

93. Amendment of Act 18 of 1891.

The Bankers' Books Evidence Act, 1891 shall be amended in the manner specified in the Third Schedule to this Act.

94. Amendment of Act 2 of 1834.

The Reserve Bank of India Act, 1934 shall be amended in the manner specified in the Fourth Schedule to this Act.

THE FIRST SCHEDULE

(See section 91)

AMENDMENTS TO THE INDIAN PENAL CODE

(45 OF 1860)

1. After section 29, the following section shall be inserted, namely:—

Electronic record.

"29A. The words "electronic record" shall have the meaning assigned to them in clause (t) of subsection (1) of section 2 of the Information Technology Act, 2000."

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2. In section 167, for the words "such public servant, charged with the preparation or translation of any document, frames or translates that document", the words "such public servant, charged with the preparation or translation of any document or electronic record, frames, prepares or translates that document or electronic record" shall be substituted.
3. In section 172, for the words "produce a document in a Court of Justice", the words "produce a document or an electronic record in a Court of Justice" shall be substituted.
4. In section 173, for the words "to produce a document in a Court of Justice", the words "to produce a document or electronic record in a Court of Justice" shall be substituted.
5. In section 175, for the word "document" at both the places where it occurs, the words "document or electronic record" shall be substituted.
6. In section 192, for the words "makes any false entry in any book or record, or makes any document containing a false statement", the words "makes any false entry in any book or record, or electronic record or makes any document or electronic record containing a false statement" shall be substituted.
7. In section 204, for the word "document" at both the places where it occurs, the words "document or electronic record" shall be substituted.
8. In section 463, for the words "Whoever makes any false documents or part of a document with intent to cause damage or injury", the words "Whoever makes any false documents or false electronic record or part of a document or electronic record, with intent to cause damage or injury" shall be substituted.
9. In section 464,—
 - (a) for the portion beginning with the words "A person is said to make a false document" and ending with the words "by reason of deception practised upon him, he does not know the contents of the document or the nature of the alteration", the following shall be substituted, namely:—

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"A person is said to make a false document or false electronic record—

First—Who dishonestly or fraudulently—

- (a) makes, signs, seals or executes a document or part of a document;
- (b) makes or transmits any electronic record or part of any electronic record;
- (c) affixes any digital signature on any electronic record;
- (d) makes any mark denoting the execution of a document or the authenticity of the digital signature, with the intention of causing it to be believed that such document or part of document, electronic record or digital signature was made, signed, sealed, executed, transmitted or affixed by or by the authority of a person by whom or by whose authority he knows that it was not made, signed, sealed, executed or affixed; or

Secondly—Who, without lawful authority, dishonestly or fraudulently, by cancellation or otherwise, alters a document or an electronic record in any material part thereof, after it has been made, executed or affixed with digital signature either by himself or by any other person, whether such person be living or dead at the time of such alteration; or

Thirdly—Who dishonestly or fraudulently causes any person to sign, seal, execute or alter a document or an electronic record or to affix his digital signature on any electronic record knowing that such person by reason of unsoundness of mind or intoxication cannot, or that by reason of deception practised upon him, he does not know the contents of the document or electronic record or the nature of the alteration. “ ;

- (b) after *Explanation 2*, the following *Explanation* shall be inserted at the end, namely:—

'Explanation 3.—For the purposes of this section, the expression "affixing digital signature" shall have the meaning assigned to it in

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clause (d) of subsection (1) of section 2 of the Information Technology Act, 2000.'

10. In section 466,—

(a) for the words "Whoever forges a document", the words "Whoever forges a document or an electronic record" shall be substituted;

(b) the following *Explanation* shall be inserted at the end, namely:—

*'Explanation.—*For the purposes of this section, "register" includes any list, data or record of any entries maintained in the electronic form as defined in clause (r) of subsection (1) of section 2 of the Information Technology Act, 2000.'

11. In section 468, for the words "document forged", the words "document or electronic record forged" shall be substituted.

12. In section 469, for the words "intending that the document forged", the words "intending that the document or electronic record forged" shall be substituted.

13. In section 470, for the word "document" in both the places where it occurs, the words "document or electronic record" shall be substituted.

14. In section 471, for the word "document" wherever it occurs, the words "document or electronic record" shall be substituted.

15. In section 474, for the portion beginning with the words "Whoever has in his possession any document" and ending with the words "if the document is one of the description mentioned in section 466 of this Code", the following shall be substituted, namely: —

"Whoever has in his possession any document or electronic record, knowing the same to be forged and intending that the same shall fraudulently or dishonestly be used as a genuine, shall, if the document or electronic record is one of the description mentioned in section 466 of this Code."

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16. In section 476, for the words "any document", the words "any document or electronic record" shall be substituted.

17. In section 477A, for the words "book, paper, writing" at both the places where they occur, the words "book, electronic record, paper, writing" shall be substituted.

THE SECOND SCHEDULE

(See section 92)

AMENDMENTS TO THE INDIAN EVIDENCE ACT, 1872

(1 OF 1872)

1. In section 3,—

(a) in the definition of "Evidence", for the words "all documents produced for the inspection of the Court", the words "all documents including electronic records produced for the inspection of the Court" shall be substituted;

(b) after the definition of "India", the following shall be inserted, namely:— 'the expressions "Certifying Authority", "digital signature", "Digital Signature Certificate", "electronic form", "electronic records", "information", "secure electronic record", "secure digital signature" and "subscriber" shall have the meanings respectively assigned to them in the Information Technology Act, 2000.'

2. In section 17, for the words "oral or documentary," the words "oral or documentary or contained in electronic form" shall be substituted.

2. After section 22, the following section shall be inserted, namely:

When oral admission as to contents of electronic records are relevant.

"22A. Oral admissions as to the contents of electronic records are not relevant, unless the genuineness of the electronic record produced is in question."

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4. In section 34, for the words "Entries in the books of account", the words "Entries in the books of account, including those maintained in an electronic form" shall be substituted.

5. In section 35, for the word "record", in both the places where it occurs, the words "record or an electronic record" shall be substituted.

6. For section 39, the following section shall be substituted, namely:

What evidence to be given when statement forms part of a conversation, document, electronic record, book or series of letters or papers.

"39. When any statement of which evidence is given forms part of a longer statement, or of a conversation or part of an isolated document, or is contained in a document which forms part of a book, or is contained in part of electronic record or of a connected series of letters or papers, evidence shall be given of so much and no more of the statement, conversation, document, electronic record, book or series of letters or papers as the Court considers necessary in that particular case to the full understanding of the nature and effect of the statement, and of the circumstances under which it was made."

7. After section 47, the following section shall be inserted, namely:

Opinion as to digital signature where relevant.

"47A. When the Court has to form an opinion as to the digital signature of any person, the opinion of the Certifying Authority which has issued the Digital Signature Certificate is a relevant fact."

8. In section 59, for the words "contents of documents" the words "contents of documents or electronic records" shall be substituted.

9. After section 65, the following sections shall be inserted, namely:

Special provisions as to evidence relating to electronic record.

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'65A. The contents of electronic records may be proved in accordance with the provisions of section 65B.

Admissibility of electronic records.

65B. (1) Notwithstanding anything contained in this Act, any information contained in an electronic record which is printed on a paper, stored, recorded or copied in optical or magnetic media produced by a computer (hereinafter referred to as the computer output) shall be deemed to be also a document, if the conditions mentioned in this section are satisfied in relation to the information and computer in question and shall be admissible in any proceedings, without further proof or production of the original, as evidence of any contents of the original or of any fact stated therein of which direct evidence would be admissible.

(2) The conditions referred to in sub-section (1) in respect of a computer output shall be the following, namely:

- (a) the computer output containing the information was produced by the computer during the period over which the computer was used regularly to store or process information for the purposes of any activities regularly carried on over that period by the person having lawful control over the use of the computer;
- (b) during the said period, information of the kind contained in the electronic record or of the kind from which the information so contained is derived was regularly fed into the computer in the ordinary course of the said activities;
- (c) throughout the material part of the said period, the computer was operating properly or, if not, then in respect of any period in which it was not operating properly or was out of operation during that part of the period, was not such as to affect the electronic record or the accuracy of its contents; and
- (d) the information contained in the electronic record reproduces or is derived from such information fed into the computer in the ordinary course of the said activities.

(3) Where over any period, the function of storing or processing information for the purposes of any activities regularly carried on

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over that period as mentioned in clause (a) of sub-section (2) was regularly performed by computers, whether

- (a) by a combination of computers operating over that period; or
- (b) by different computers operating in succession over that period; or
- (c) by different combinations of computers operating in succession over that period; or
- (d) in any other manner involving the successive operation over that period, in

whatever order, of one or more computers and one or more combinations of computers, all the computers used for that purpose during that period shall be treated for the purposes of this section as constituting a single computer; and references in this section to a computer shall be construed accordingly.

(4) In any proceedings where it is desired to give a statement in evidence by virtue of this section, a certificate doing any of the following things, that is to say,

- (a) identifying the electronic record containing the statement and describing the manner in which it was produced;
- (b) giving such particulars of any device involved in the production of that electronic record as may be appropriate for the purpose of showing that the electronic record was produced by a computer;
- (c) dealing with any of the matters to which the conditions mentioned in subsection (2) relate, and purporting to be signed by a person occupying a responsible official position in relation to the operation of the relevant device or the management of the relevant activities (whichever is appropriate) shall be evidence of any matter stated in the certificate; and for the purposes of this sub-section it shall be sufficient for a matter to be stated to the best of the knowledge and belief of the person stating it.

(5) For the purposes of this section,

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- (a) information shall be taken to be supplied to a computer if it is supplied thereto in any appropriate form and whether it is so supplied directly or (with or without human intervention) by means of any appropriate equipment;
- (b) whether in the course of activities carried on by any official, information is supplied with a view to its being stored or processed for the purposes of those activities by a computer operated otherwise than in the course of those activities, that information, if duly supplied to that computer, shall be taken to be supplied to it in the course of those activities;
- (c) a computer output shall be taken to have been produced by a computer whether it was produced by it directly or (with or without human intervention) by means of any appropriate equipment.

Explanation. For the purposes of this section any reference to information being derived from other information shall be a reference to its being derived therefrom by calculation, comparison or any other process.

10. After section 67, the following section shall be inserted, namely:

Proof as to digital signature.

"67A. Except in the case of a secure digital signature, if the digital signature of any subscriber is alleged to have been affixed to an electronic record the fact that such digital signature is the digital signature of the subscriber must be proved."

11. After section 73, the following section shall be inserted, namely:

Proof as to verification of digital signature.

'73A. In order to ascertain whether a digital signature is that of the person by whom it purports to have been affixed, the Court may direct

- (a) that person or the Controller or the Certifying Authority to produce the Digital Signature Certificate;

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- (b) any other person to apply the public key listed in the Digital Signature Certificate and verify the digital signature purported to have been affixed by that person.

Explanation. For the purposes of this section, "Controller" means the Controller appointed under sub-section (1) of section 17 of the Information Technology Act, 2000'.

12. Presumption as to Gazettes in electronic forms.

After section 81, the following section shall be inserted, namely:

"81 A. The Court shall presume the genuineness of every electronic record purporting to be the Official Gazette, or purporting to be electronic record directed by any law to be kept by any person, if such electronic record is kept substantially in the form required by law and is produced from proper custody."

13. Presumption as to electronic agreements.

After section 85, the following sections shall be inserted, namely:

"85A. The Court shall presume that every electronic record purporting to be an agreement containing the digital signatures of the parties was so concluded by affixing the digital signature of the parties.

Presumption as to electronic records and digital signatures.

85B. (1) In any proceedings involving a secure electronic record, the Court shall presume unless contrary is proved, that the secure electronic record has not been altered since the specific point of time to which the secure status relates.

(2) In any proceedings, involving secure digital signature, the Court shall presume unless the contrary is proved that

- (a) the secure digital signature is affixed by subscriber with the intention of signing or approving the electronic record;
- (b) except in the case of a secure electronic record or a secure digital signature, nothing in this section shall create any presumption relating to authenticity and integrity of the electronic record or any digital signature.

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Presumption as to Digital Signature Certificates.

85C. The Court shall presume, unless contrary is proved, that the information listed in a Digital Signature Certificate is correct, except for information specified as subscriber information which has not been verified, if the certificate was accepted by the subscriber."

14. Presumption as to electronic messages.

After section 88, the following section shall be inserted, namely:

'88A. The Court may presume that an electronic message forwarded by the originator through an electronic mail server to the addressee to whom the message purports to be addressed corresponds with the message as fed into his computer for transmission; but the Court shall not make any presumption as to the person by whom such message was sent.

Explanation.—For the purposes of this section, the expressions "addressee" and "originator" shall have the same meanings respectively assigned to them in clauses (b) and (za) of sub-section (1) of section 2 of the Information Technology Act, 2000.'

15. Presumption as to electronic records five years old.

After section 90, the following section shall be inserted, namely:

"90A. Where any electronic record, purporting or proved to be five years old, is produced from any custody which the Court in the particular case considers proper, the Court may presume that the digital signature which purports to be the digital signature of any particular person was so affixed by him or any person authorised by him in this behalf.

Explanation.—Electronic records are said to be in proper custody if they are in the place in which, and under the care of the person with whom, they naturally be; but no custody is improper if it is proved to have had a legitimate origin, or the circumstances of the particular case are such as to render such an origin probable.

This *Explanation* applies also to section 81A."

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16. For section 131, the following section shall be substituted, namely:

Production of documents or electronic records which another person, having possession, could refuse to produce.

"131. No one shall be compelled to produce documents in his possession or electronic records under his control, which any other person would be entitled to refuse to produce if they were in his possession or control, unless such last-mentioned person consents to their production."

THE THIRD SCHEDULE

(See section 93)

**AMENDMENTS TO THE BANKERS' BOOKS EVIDENCE ACT '
891**

(18 OF 1891)

1. In section 2

(a) for clause (3), the following clause shall be substituted, namely:

'(3) "bankers' books" include ledgers, day-books, cash-books, account-books and all other books used in the ordinary business of a bank whether kept in the written form or as printouts of data stored in a floppy, disc, tape or any other form of electro-magnetic data storage device;

(b) for clause (8), the following clause shall be substituted, namely: '(8) "certified copy" means when the books of a bank,

(a) are maintained in written form, a copy of any entry in such books together with a certificate written;:: the foot of such copy that it is a true copy of such entry, that such entry is contained in one of the ordinary books of the bank and was made in the usual and ordinary course of business and that such book is still in the custody of the bank, and where the copy was obtained by a mechanical or other process which in itself ensured the accuracy of the copy, a further certificate to that effect, but where the book from which such copy was prepared

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has been destroyed in the usual course of the bank's business after the date on which the copy had been so prepared, a further certificate to that effect, each such certificate being dated and subscribed by the principal accountant or manager of the bank with his name and official title; and

- (b) consist of printouts of data stored in a floppy, disc, tape or any other electro-magnetic data storage device, a printout of such entry or a copy of such printout together with such statements certified in accordance with the provisions of section 2A.'

2. After section 2, the following section shall be inserted, namely:

Conditions in the printout.

"2A. A printout of entry or a copy of printout referred to in sub-section (8) of section 2 shall be accompanied by the following, namely:

- (a) a certificate to the effect that it is a printout of such entry or a copy of such printout by the principal accountant or branch manager; and
- (b) a certificate by a person in-charge of computer system containing a brief description of the computer system and the particulars of
 - (A) the safeguards adopted by the system to ensure that data is entered or any other operation performed only by authorised persons;
 - (B) the safeguards adopted to prevent and detect unauthorised change of data;
 - (C) the safeguards available to retrieve data that is lost due to systemic failure or any other reasons;
 - (D) the manner in which data is transferred from the system to removable media like floppies, discs, tapes or other electro-magnetic data storage devices;

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- (E) the mode of verification in order to ensure that data has been accurately transferred to such removable media;
 - (F) the mode of identification of such data storage devices;
 - (G) the arrangements for the storage and custody of such storage devices;
 - (H) the safeguards to prevent and detect any tampering with the system; and
 - (I) any other factor which will vouch for the integrity and accuracy of the system.
- (c) a further certificate from the person in-charge of the computer system to the effect that to the best of his knowledge and belief, such computer system operated properly at the material time, he was provided with all the relevant data and the printout in question represents correctly, or is appropriately derived from, the relevant data."

THE FOURTH SCHEDULE

(See section 94)

AMENDMENT TO THE RESERVE BANK OF INDIA ACT, 1934

(2 OF 1934)

In the Reserve Bank of India Act, 1934, in section 58, in sub-section (2), after clause (p), the following clause shall be inserted, namely:

"(pp) the regulation of fund transfer through electronic means between the banks or between the banks and other financial institutions referred to in clause (c) of section 45-1, including the laying down of the conditions subject to which banks and other financial institutions shall participate in such fund transfers, the manner of such fund transfers and the rights and obligations of the participants in such fund transfers;"

2

Technical Guide on Audit in Telecom Industry - Revenue, Fixed Assets and Related Operating Costs

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Foreword

Telecommunication today forms a quintessential component of the basic infrastructure of modern economies. Telecommunication plays an important role in developing the modern economic order by eliminating distance and the associated time constraint. The Indian telecom industry has a growth rate of 45%, which is the highest in the world. India with a strong population of over 1.1 billion, has become one of the most dynamic and promising telecom markets of the world.

Telecom Sector being highly technology driven, involves technical complexities peculiar to the telecom industry mainly in the area of revenue recognition, amortisation of assets etc., for which adequate guidance is required to be given. I am happy to note that the Auditing and Assurance Standards Board of the Institute has brought out this Technical Guide on Audit in Telecom Industry. Such industry specific guidance will go a long way in helping the members understand the basic concepts and peculiarities of the industry concerned for performing the attest function effectively.

I wish to place my appreciation to CA. Harinderjit Singh, Chairman, Auditing and Assurance Standards Board, members of the Auditing and Assurance Standards Board for bringing out this Technical Guide. I am sure that this Technical Guide would be useful to the members and other interested readers.

New Delhi
January 23, 2009

CA. Ved Kumar Jain
President, ICAI

Preface

The Indian telecommunications industry is one of the fastest growing in the world and India is projected to become the second largest telecom market globally by 2010.

In view of the complexity associated with telecom industry, it is imperative for a professional accountant to understand the basic features of the industry to deal appropriately with critical financial reporting issues relating to revenue recognition and capitalisation of different kinds of fixed assets. Keeping this in mind, the Auditing and Assurance Standards Board has brought out this Technical Guide on Audit in Telecom Industry. This Technical Guide contains extensive guidance on all significant aspects such as the regulatory framework in which the telecom companies operate, audit approach and procedures for risk assessment, revenues and receivables, fixed assets etc. The Guide contains an extensive glossary of terms for enhanced understanding of the readers. The Appendix to the Technical Guide contains guidelines for obtaining licenses for various telecom services, Adjusted Gross Revenue Computation Sheet and Format of Auditor's Report.

I am extremely grateful to CA. Usha Rajeev, CA. Nishant Singhal and CA. Rajnish Baweja for taking out time out of their professional and personal commitments and preparing the basic draft of this Technical Guide.

I am certain that the readers, especially members of the Institute, connected to the telecom sector would find this Technical Guide immensely useful.

New Delhi
January 27, 2009

CA. Harinderjit Singh
Chairman,
Auditing and Assurance Standards Board

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Part – I

Framework of Telecom Industry

Chapter 1

Telecom Industry in India

Evolution of Telecom Industry

1.1 The telecommunications industry has seen a rapid growth since the last decade due to a series of events lead by the regulations surrounding the industry. The enactment of the Indian Telegraphy Act, 1885, and the Indian Wireless Telegraphy Act, 1933 which provided the legal framework for regulation of the telecommunications industry (both of which were administered by the Department of Telecom (DoT), Ministry of Communications were the first major events in the Indian scenario. The Department of Telecommunications (DoT) and the Department of Posts (DoP) earlier combined under the Postal & Telegraph (P&T) Board were separated in 1985 by setting up separate boards. Subsequently in 1986, Mahanagar Telephone Nigam Ltd. (MTNL) was set up for telephone services in Delhi and Mumbai representing about 22 percent of the telephones in the country at that time, and the Overseas Communications Services (OCS) was converted into a corporation as Videsh Sanchar Nigam Limited (VSNL). The Telecom Commission was established as an executive body under the Ministry of Communications and Information Technology to make policy decisions and to accelerate the development of all aspects of the sector, except those of allocation of radio frequency spectrum among defence, aviation, radio and television, police, government owned companies and private operators, which was the responsibility of the Wireless Planning Commission under the Ministry of Communications and Information Technology.

1.2 July, 1991 saw the Government adopt a new Economic Policy with a view to:

- improve India's competitiveness in the global market,
- undertake a growth led export drive,

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- attract foreign investment,
- strengthen Indian industry to compete globally,
- shift away from the policy of import substitution, and
- automatically approve 51% equity to foreign companies in telecom equipment manufacturing.

1.3 Thereafter a New Telecom Policy was announced in May 1994 which brought a series of reforms to the telecommunications industry which had a thrust on independent regulation, competition and investment facilitation. The Indian telecom story, if put on a time scale, will look like as detailed below:

Pre-reform	Partial Deregulation	Further Deregulation	Take-off
Pre-1994	1994-1999	1999-2002	2002 onwards
<ul style="list-style-type: none"> • MTNL- Mumbai and Delhi; DTS elsewhere • No mobile service • NLD-DoT per/BSNL • ILD-VSNL 	<ul style="list-style-type: none"> • 4 private fixed service providers with less than 1% market share • 2 GSM mobile players in each circle • 13 players start mobile service • National Telecom Policy (NTP) 1994 • TRAI constituted 1997 • National Telecom Policy, 1994 	<ul style="list-style-type: none"> • Licenses converted to revenue sharing • Private sector share less than 5% in revenue terms • Competition in NLD and ILD • Licenses in Revenue share • 4 mobile operators/ circle • NTP 1999 • BSNL formed 2001 • Internet Telephony 2002 • FDI-49% New Telecom Policy, 1999 	<ul style="list-style-type: none"> • Calling Party Pays • CDMA launch • 3-6 operators in each circle • Intra-circle merger guidelines • Unified Licensing • Broadband Policy 2004 • FDI - 74% 2005 • Unified Licensing Regime • 3G Licensing in progress

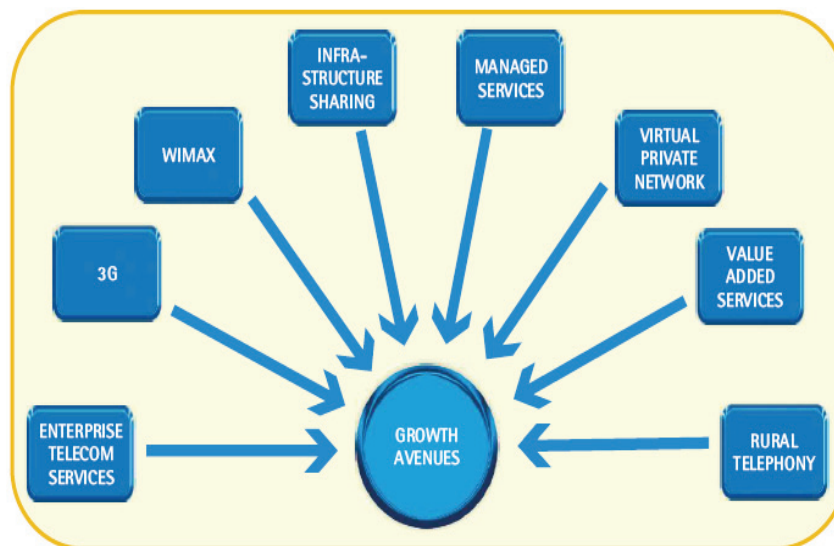
Sustainable Factors driving growth in Telecom Sector

1.4 The Indian telecommunications industry is growing at the fastest pace in the world and India is expected to become the second largest telecom market globally by 2010. Forthcoming services such as 3G and WiMax will further augment the growth rate. The world's leading telecom handsets manufacturers such as Nokia, Samsung, Motorola and LG have their presence in India, along with leading global service companies and infrastructure majors, such as Vodafone, AT&T, Ericsson, Alcatel, Singapore Telecom and Siemens.

1.5 On June 18, 2008, India reached the target of having 300 million telephone subscribers, becoming the second largest telecommunications network in the world after China. India is adding around 8.5 million to 10 million new mobile subscribers to the network each month, emerging as one of the fastest growing telecom markets in the world. According to the report titled **'Mobile BRIC*: Extreme Growth Ahead'**. India is expected to be the second largest mobile market in the BRIC nations, with 560 million mobile users, by 2012 (after China with 800 million users). The market saw a growth rate of 33 per cent over previous year and recorded a compounded annual growth rate (CAGR) of 22 per cent for the period beginning from 2002-03 to 2006-07. This growth has resulted in the revenues of the segment growing two-fold, in the past three years. It is projected that the industry will generate revenues worth US\$ 43 billion in 2009-10. India's overall tele-density stood at 26.89 per cent in June 2008, and the government has plans to raise the tele-density to 40-45 per cent by 2010, thereby offering greater growth opportunities for service providers to exploit the large untapped potential. The Indian telecom sector offers unprecedented opportunities for foreign companies in various areas, such as 3G, virtual private network, international long distance calls, value added services, etc.

* BRIC – Brazil, India and China

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1.6 Following factors have led to rapid growth of telecom sector in the Indian industry:

- a. Favourable macro-economic fundamentals and demographics:
 - Strong economic growth and rising incomes,
 - By 2020, working age population to rise to 65%,
 - Low tele-density relative to Asian peers,
- b. Progressive Policy and Regulation:
 - Independent Regulation,
 - Consistency policy framework,
 - Favourable investment climate,
- c. Rising affordability:
 - Declining ARPU's,
 - Lowering cost of handsets,
 - Growing popularity of pre-paid format.

Key Operators in the Indian Market

1.7 Key operators which provides various telecom services in the Indian market are:

- Bharat Sanchar Nigam Limited (BSNL) - Incumbent service provider and world's 7th largest telecommunications company providing comprehensive range of services in India. Its services include Wireline, CDMA mobile, GSM Mobile, Internet, Broadband, Carrier services, MPLS-VPN, VSAT, VoIP services, IN services, etc.;
- Bharti Airtel Limited - Integrated operator with presence in all the segments. It leads the Mobile segment in the country;
- Vodafone - Second largest private telecom player in the GSM segment after Bharti Airtel;
- Idea Cellular - Large private sector telecom player in the GSM segment;
- Mahanagar Telephone Nigam Limited (MTNL) - State owned operator covering the cities of Mumbai and Delhi. Provides both Mobile and Fixed line services;
- Reliance Communications Limited - Largest operator in India in the CDMA segment;
- TATA Teleservices Limited - Integrated operator (with VSNL) with presence in all segments. Provides CDMA in 20 Circles.

1.8 The company wise % market share in India as on October 31, 2008 was as detailed below:

Group Company	Total Subscribers	Market Share
Airtel (GSM)	80,199,747	25.04%
Reliance (CDMA+GSM)	57,427,888	17.93%
Vodafone Essar (GSM)	56,703,506	17.70%
BSNL (GSM)	39,836,494	12.44%

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IDEA (GSM)	31,582,937	9.86%
Tata (CDMA)	30,162,845	9.42%
Aircel (GSM)	14,659,298	4.58%
MTNL (GSM)	3,743,879	1.17%
Spice (GSM)	3,637,129	1.14%
BPL (GSM)	1,807,902	0.56%
HFCL (CDMA)	374,334	0.12%
Shyam (CDMA)	194,434	0.06%
Total (All India)	320,330,393	100.00%

CDMA figures include WLL services. Source: India-Cellular.com

Chapter 2

Legal Framework

Institutional Framework

2.1 The telecommunications industry in India is subject to extensive government regulation. A number of Government authorities have regulatory responsibilities for various aspects of the industry. The principal regulatory authorities are Department of Telecommunication (DoT) of the Ministry of Communications and Information Technology and the Telecommunication Regulatory Authority of India (TRAI).

2.2 The responsibilities of DoT include as under:

- formulating and enforcing industry policies, regulations and technical standards;
- granting telecommunications service licenses;
- supervising the operations and quality of service (quality of service comes under the TRAI charter) of telecommunications service providers;
- allocating and administering telecommunications resources such as Spectrum and numbers; and
- maintaining fair and orderly market competition among service providers.

2.3 The Telecommunications Regulatory Authority of India was established in 1997, TRAI acts as an independent autonomous body to create and nurture conditions for growth of telecommunications in the country in a manner and at a pace which will enable India to play a leading role in emerging global information society. One of the main objectives of TRAI is to provide a fair and transparent policy environment which promotes a level playing field and facilitates fair competition.

2.4 The functions of the TRAI include the following:

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- recommend the need and timing for introduction of new service provider;
- recommend the terms and conditions of licence to a service provider;
- ensure technical compatibility and effective inter-connection between different service providers;
- regulate arrangement amongst service providers of sharing their revenue derived from providing telecommunication services;
- fix the terms and conditions of inter-connectivity between the service providers;
- ensure compliance of terms and conditions of licence;
- recommend revocation of licence for non-compliance of terms and conditions of licence;
- lay down and ensure the time period for providing local and long distance circuits of telecommunication between different service providers;
- facilitate competition and promote efficiency in the operation of telecommunication services so as to facilitate growth in such services;
- protect the interest of the consumers of telecommunication service;
- monitoring the quality of service and conducting periodical survey of services provided by the service providers;
- inspect the equipment used in the network and recommend the type of equipment to be used by the service providers;
- maintain register of interconnect agreements and of all such other matters as may be provided in the regulations;
- keep register maintained under clause (I) open for inspection to any member of public on payment of such fee and compliance of such other requirements as may be provided in the regulations;
- settle disputes between service providers;

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- render advice to the Central Government in matters relating to development of telecommunication technology and any other matter significant to the telecommunication industry in general;
- levy fees and other charges at such rates and in respect of such services as may be determined by regulations;
- ensure effective compliance of universal service obligations;
- recommend technological improvements in the services provided by the service providers;
- efficient management of available spectrum.

2.5 Under the TRAI Amendment Ordinance, 2000, “The Telecom Disputes Settlement and Appellate Tribunal” (TDSAT) was formed to regulate the telecommunication services, adjudicate disputes, dispose off appeals, protect the interests of service providers and consumers to promote and ensure orderly growth of the telecom sector along with TRAI.

2.6 TDSAT has been empowered with the following powers:

- a. to adjudicate any dispute:
 - i. between a licensor and a licensee,
 - ii. between two or more service providers,
 - iii. between a service provider and a group of consumers,
- b. hear and dispose off appeals against any direction, decision or order of TRAI under this Act.

Decisions of TDSAT are appealable to the Supreme Court of India.

2.7 The Central Government or a State Government or a local authority or any person may take an application to the TDSAT for adjudication of any dispute referred above.

2.8 The Central Government or a State Government or a Local Authority or any person aggrieved by any direction, decision or

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order made by TRAI may prefer an appeal to the TDSAT.

2.9 Refer to Appendix I for detailed Guidelines issued for International Long Distance Service Licenses, National Long Distance Service Licenses, Cellular Mobile Telephone Service Licenses, Internet Service Licenses and Unified Access Service Licenses.

Licensing Requirements

2.10 Telecom industry is regulated by the Ministry of Communications and Information Technology, Government of India through the Telecom Regulatory Authority of India (TRAI). TRAI regulates the telecom business through licensing requirements. A telecom company can provide only those services and in such telecom circles, for which license has been granted to it. Any telecom operator intending to enter into telecom business has to fulfill the following licensing requirements:

- Foreign equity in the paid up capital of the licensee company should not, at any time during the entire licence period, exceed such percentage of total equity as has been mentioned in the licence agreement or as decided by the Government of India from time to time;
- Licensee shall have a minimum paid up equity capital of such amount as has been mentioned in the licence agreement or as decided by the Government of India from time to time;
- The Licensee Company and its promoters shall have to maintain a combined net worth as prescribed in the licence agreement or as decided by the Government of India from time to time; and
- Licence shall be valid only for the period, services and for telecom circles mentioned in the agreement.

Fees

2.11 As per the financial terms and conditions of the Licence agreement, a telecom operator has to pay the following fees:

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Entry Fees: This is a one time fee which an operator is required to pay before signing the agreement as specified by Department of Telecommunications. The amount of fee may be as prescribed from time to time.

License Fees (Revenue Share): In addition to the Entry fee, a licensee is also required to pay licence fee on quarterly basis in the form of revenue share at the prescribed rate on the Adjusted Gross Revenue (AGR), viz.:

- For first three quarters of the financial year - within 15 days of completion of the relevant quarter on actual revenue on accrual basis.
- For last quarter - by 25th of March of each financial year, on estimated basis but not less than the payment made in the 3rd quarter.

2.12 Each quarterly instalment of the Licence Fee is payable based on the AGR, duly certified, along with an affidavit by a representative of the Licensee, authorised by a resolution passed by the Board of Directors of the Licensee Company.

2.13 The Licence Fee varies based on the type of service and classification of telecom circles as may be prescribed from time to time. AGR includes installation charges, late fees, sale proceeds of handsets, revenue on account of interest and dividend, value added services, supplementary services, access or interconnection charges, roaming charges, revenue from permissible sharing of infrastructure and any other miscellaneous revenue, without any set off for related item of expense, etc. For arriving at the AGR, following expenses only are allowed as deduction:

- Charges actually paid to other operators including PSTN (Public Switched Telecom Network) related call charges, Access Charges actually paid to other eligible / entitled telecommunication service providers (not applicable from April 1, 2008), and roaming revenue actually passed on to the other eligible/entitled telecommunication service providers;

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- Service Tax on provision of service and sales tax actually paid to the Government if component of sales tax and service tax has been included in the Gross Revenue; and
- As per the recent TDSAT judgement, the pass through charges can be allowed on accrual basis. However the matter is now pending with the Supreme Court of India.

2.14 The telecom companies are also required to submit the following documents to Controller of Communication Accounts (CCA):

- a. On quarterly basis:
 - Audited statement of Revenue and License Fees,
 - Auditor's Report,
 - Affidavit duly signed by authorised signatory as per the Board's resolution,
 - Operator-wise details of actual Interconnection Usage Charge (IUC) payment.
- b. On annual basis:
 - Audited annual accounts,
 - Reconciliation of Gross Revenue (GR), AGR and audited accounts, within seven working days of signing the audited annual accounts.

Radio Spectrum Requirement

2.15 The spectrum is allotted for various purposes: analog TV broadcasts get a certain slot (from 54 to 88 MHz, 174 to 216 MHz and 470 to 806 MHz), FM radio gets a certain slot (88 to 108 MHz), AM radio gets a certain slot (535 to 1700 kHz). Telecommunication systems also require a certain amount of electromagnetic bandwidth to operate; accordingly cellular communications (mobile phones) get certain slots.

As the world becomes increasingly wireless (with cordless phones, cell phones, wireless internet, GPS devices, etc), allocation of the available spectrum to each technology becomes increasingly contentious. Each user community (usually Mobile

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Service Providers) wants more bandwidth in order to be able to sell and service more units. For any given slot of bandwidth, there is a limited amount of data that can be shared in that bandwidth, so vendors want more bandwidth so that they can handle more devices in a given area.

Radio Spectrum Charges

2.16 In addition to Entry Fee and Licence Fee, the Licensee is also required to pay fees and royalty for the use of radio frequencies on the basis of specified percentage of AGR as per the details prescribed by the Wireless Planning and Co-ordination Wing (WPC) of DoT. The spectrum charges for Global System for Mobile Communications (GSM) is collected as a percentage of AGR while for Code Division Multiple Access (CDMA) spectrum, a percentage of AGR as well as fixed charges for point to point links (microwave access) and backbone links of all Unified Access Service Licence (UASL) licensees using CDMA spectrum.

2.17 The Spectrum Charges are required to be paid in advance on quarterly basis within 15 days of the beginning of relevant quarter on the basis of estimated AGR. Spectrum charges are levied on the AGR of the full circle despite allocation of additional spectrum that may have been made for a city/part of licensed area. The Government of India is considering of levying fixed charges for allocation of spectrum.

Calculation of Interest/Penalty on Delayed Payment

2.18 Penal interest to be levied for delayed payments is on the same terms and conditions as in the main DoT license agreement. However, for the time being, the work of computation of interest/penalty/short payment, etc., will continue to be done by the DoT and any demands on this account will be raised only by the DoT.

Financial Bank Guarantee and Performance Bank Guarantee

2.19 Further, licensee has to submit Performance Bank

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Guarantee (PBG) and Financial Bank Guarantee of prescribed amount as has been mentioned in the licence agreement. Auditors need to examine the licence agreement to ensure that there is no default, w.r.t., financial and other conditions specified in the agreement as any default may lead to suspension / cancellation of license and the very existence of the company may be in jeopardy.

Subscriber Verification

2.20 TRAI has issued detailed guidelines, w.r.t., verification of subscribers at the time of acquisition, such as, obtaining and verification of Proof of Identification / Proof of Residence from the subscribers. The compliance with these guidelines is mandatory for every operator. As such, the auditors should review that the company has proper controls for verification of identity and address of the subscriber, at the time of acquisition of customer, so that, compliance with the TRAI guidelines is ensured.

Routing of Call

2.21 Telecom Company has to route the call through the trunk allotted by the other telecom company for transmission of calls to other telecom company's network. There are dedicated trunks for carrying Local, NLD, ILD calls. A telecom company can not route local calls either through NLD or ILD trunk and vice versa. Any violation of these conditions may attract penalty.

Metering and Billing Audit

2.22 In order to bring standardisation and transparency in the metering and billing procedures being followed by various operators, TRAI developed a regulation "Quality of Service (Code of Practice for Metering and Billing Accuracy) Regulation, 2006", which has benchmarks for metering and billing system. The salient features of the Code are as follows:

- Before a customer is enrolled as a subscriber of any telecommunication service, he shall be provided in advance with detailed information relating to the tariff for using that service. Further, the service provider shall

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inform the customer in writing, within a week of activation of service, the complete details of his tariff plan;

- Where a value-added service (e.g., download of content, such as a film clip or ring tone) or entry to an interactive service (such as a game) can be selected through a choice of the service user (e.g., by dialling a specific number) then the charge for the service must be provided to the customer before he commits to use the service;
- The services provided to the customer and all subsequent changes therein shall be those agreed with him in writing prior to providing the service or changing its provisions;
- All the charges must be consistent with published tariff applicable to the user;
- Payments made by a post-paid customer shall be credited to his account immediately for cash payment and within reasonable time in case of cheque payment. For pre-paid customers, top-up credit shall be applied to a customer's account within 15 minutes of its application;
- Where the service provider unilaterally intends to restrict or cease service to the customer, a notice shall be provided to the customer in advance of such action so that the customer has reasonable time to take preventive action to avoid restriction or cessation of service;
- The service provider shall have a documented process for identifying, investigating and dealing with billing complaints and creating appropriate records thereof;
- Reliability performance of the total metering and billing system should be within the tolerances specified by TRAI;
- The telecom company shall submit the compliance of code of practices adopted to TRAI on yearly basis;
- The TRAI has notified a panel of agencies capable for auditing the metering and billing system to certify the adequacy of Metering and Billing System of Telecom Company; and
- The telecom companies shall arrange audit of their

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Metering and Billing System in compliance with this regulation on an annual basis through any one of the auditors notified by TRAI and an audit certificate thereof shall be furnished to TRAI not later than 30th June of every year.

Quality of Service (QoS) Parameters

2.23 Telecom Regulatory Authority of India (TRAI) has prescribed quality of service parameters for various Basic Wireline and Wireless and Cellular Mobile Telephone Services (CMTS), e.g. provision of telephone, fault repair, grade of service, call completion rate, response time to customer for assistance network performance, billing complaints and customer perception of services, etc. The auditors need to acquaint themselves with these parameters, analyse the relevant data and report the adverse features observed to the management.

Part – II

Audit Approach and Procedures

Chapter 3

Audit in Telecom Industry – Initial Aspects

Understanding Telecom Business

3.1 Prior to accepting an engagement, the auditor needs to obtain a preliminary knowledge of the industry, nature of company's ownership, management and operations, and need to consider whether a level of knowledge of the business adequate to perform the audit can be obtained. Following acceptance of the engagement, more detailed information needs to be obtained.

3.2 The Standards on Auditing as issued by the Institute of Chartered Accountants of India holds its relevance for all telecom audits. It establishes standards on:

- what is knowledge of the business,
- its importance to auditor and its team,
- its relevance to all phases of audit, and
- manner of obtaining and using it.

3.3 Standard on Auditing (SA) 300, "Planning an Audit of Financial Statements" states that:

"6. The auditor shall establish an overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan.

7. In establishing the overall audit strategy, the auditor shall:

- a. Identify the characteristics of the engagement that define its scope,
- b. Ascertain the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required,
- c. Consider the factors that, in the auditor's professional

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judgment, are significant in directing the engagement team's efforts,

- d. Consider the results of preliminary engagement activities and, where applicable, whether knowledge gained on other engagements performed by the engagement partner for the entity is relevant, and
 - e. Ascertain the nature, timing and extent of resources necessary to perform the engagement.
8. The auditor shall develop an audit plan that shall include a description of:
- a. The nature, timing and extent of planned risk assessment procedures, as determined under SA 315 "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment",
 - b. The nature, timing and extent of planned further audit procedures at the assertion level, as determined under SA 330 "The Auditor's Responses to Assessed Risks", and
 - c. Other planned audit procedures that are required to be carried out so that the engagement complies with SAs."

3.4 Standard on Auditing (SA) 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environments" states that:

"3. The objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels, through understanding the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement. This will help the auditor to reduce the risk of material misstatement to an acceptably low level".

Understanding the entity is an iterative process, continuing throughout the entire duration of the audit.

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3.5 Paragraph 11 of SA 315 provides as follows:

- “11. The auditor shall obtain an understanding of the following:
- a. Relevant industry, regulatory, and other external factors including the applicable financial reporting framework.
 - b. The nature of the entity, including:
 - i. its operations,
 - ii. its ownership and governance structures,
 - iii. the types of investments that the entity is making and plans to make, and
 - iv. the way that the entity is structured and how it is financed; to enable the auditor to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements.
 - c. The entity's selection and application of accounting policies, including the reasons for changes thereto. The auditor shall evaluate whether the entity's accounting policies are appropriate for its business and consistent with the applicable financial reporting framework and accounting policies used in the relevant industry.
 - d. The entity's objectives and strategies, and those related business risks that may result in risks of material misstatement.
 - e. The measurement and review of the entity's financial performance.

Each year, the auditor's understanding of the entity should be updated and details of significant changes should also be documented.

3.6 Obtaining the required knowledge of the business is a continuous and cumulative process. To the extent practicable, the auditor needs to obtain the required knowledge at the start of the

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engagement. Major portion of the information is gathered at the planning stage. As the audit progresses, the information already obtained should be updated. It is ordinarily refined and added to in later stages of the audit as the auditor and the members of his audit team learn more about the business.

3.7 An auditor can obtain knowledge of the industry and the entity from a number of sources. e.g.:

- previous experience with the industry and entity,
- discussions with senior personnel, internal audit personnel, other auditors, legal and other advisors who have provided services to the entity or within the industry,
- publications related to the industry,
- legislation and regulations significantly affecting entity,
- visit to the entity's premises,
- documents provided by the entity (for e.g. minutes of meeting, promotional literature, prior years' financial and annual reports, internal management reports, etc.)

3.8 Knowledge of the client's business is also important to identify areas of special audit emphasis, to evaluate reasonableness of accounting estimates and management representations and to make judgments' regarding appropriateness of accounting policies and disclosures. The auditor makes judgments' about many matters throughout the course of audit where knowledge of business is important, for e.g., considering business risks, developing the overall audit plan and audit programme, determining a materiality level, assessing appropriateness of audit evidence and judging its relevance to related financial statement assertions, identifying related parties and related party transactions, evaluating accounting estimates and management representations, etc.

3.9 To make effective use of knowledge about the business, the auditor should consider how it affects the financial statements taken as a whole and whether the assertions in the financial

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statements are consistent with the auditor's knowledge of the business.

3.10 The auditor may obtain understanding of the client's business under the four broad categories as below:

- Market overview,
- Strategy,
- Value Creating Activities,
- Financial Performance.

Market Overview

3.11 It refers to the competitive environment in which the entity operates, understanding of the regulatory framework, and the macro-economic factors which may impact the entity. There is substantial competition in the Indian telecommunications industry and is expected to continue with the increase in number of operators, expansion of area of coverage and services offered. The competition ranges in a number of different areas:

- services and features offered to customers
- pricing - tariff plans
- customer service
- quality of technical support systems
- network coverage and capacity

3.12 High competitive intensity results in higher churn rates, higher customer acquisition costs and an increased pressure on margins. The focus in the competitive market is shifting from customer acquisition to customer retention through various measures like reduction in tariffs, network coverages, effective back-end support services, etc. Tariffs have consistently moved downwards to match the competition. Since pricing is an important factor, all pricing initiatives undertaken by the competition are analysed and reciprocated.

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3.13 Telecom industry is subject to significant and extensive regulation by the Government. The DoT currently regulates all matters relating to licensing, ownership and operation of telecommunication networks, including granting, assignment, maintenance, transfer, renewal of licenses; ownership interests in licensed operators and frequency spectrum allocations.

3.14 The Government has created autonomous bodies such as the TRAI to monitor the industry and lay down guidelines for the operators to offer services. In addition to the TRAI, the Government also constituted the Telecom Dispute Settlement Appellate Tribunal (TDSAT) as an autonomous body to regulate and adjudicate matters in the industry, including issues related to tariffs and interconnection.

3.15 Telecommunication licenses reserve broad discretion in favour of the Government to influence the conduct of businesses by private operators by giving it the right to modify, at any time, the terms and conditions of licenses and take over entire services, equipment and networks or terminate or suspend licenses, if necessary or expedient, in public interest or in the interest of national security or in the event of a national emergency, war or similar situation. The licenses are for fixed periods and renewable for additional terms at the discretion of the Government.

Strategy

3.16 It includes understanding of goals and objectives, organisational design and governance framework of the entity. In telecom industry, strategy is a major determinant which does have an impact on the risks at present and on the future periods. Depending on the strategy, the near future of the entity can be more or less challenging and uncertain. It is important that organisational design and governance are appropriately aligned to the goals and objectives of the organisation.

3.17 The telecom operators are directed and controlled by the Company's management in the best interest of stakeholders and

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others ensuring greater transparency and timely financial reporting. The Board of Directors is responsible for its governance. Besides being a statutory requirement, the Company looks upon Corporate Governance as a distinctive brand and benchmark in profile of corporate excellence. It understands that governance is a necessary discipline and proper governance would lead to effectiveness and transparency in its functioning.

Value Creating Activities

3.18 The activities that underpin financial performance, e.g. how the Company services its customers, its distribution network, its supply chain network etc. The network (supply chain) and successful innovation are currently critical to the performance of telecom operators. The retention of key employees may be a critical factor for certain operators. However, majority operators are concerned with the cost level of their operations with the employee related expenditure as a major factor.

3.19 The industry is highly dynamic and subject to rapid and significant changes in technology. Although the operators strive to keep its technology in accordance with the latest international technological standards, the technologies currently employed may become obsolete or subject to competition from evolution of new technologies in the future. The cost of implementing new technologies, upgrading the networks or expanding capacity is significant and could adversely affect results of operations. In addition, ability to respond to technological changes may depend upon ability to obtain additional financing and licenses which again is dependent on several other factors.

Financial Performance

3.20 Financial measures & risk information are used to manage financial performance of and entity. The telecom business is highly capital intensive and has long gestation period. It requires additional financing to complete roll-out plans for new networks and expand and upgrade its existing networks. The actual amount

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and timing of future capital requirements may differ from its estimates as a result of:

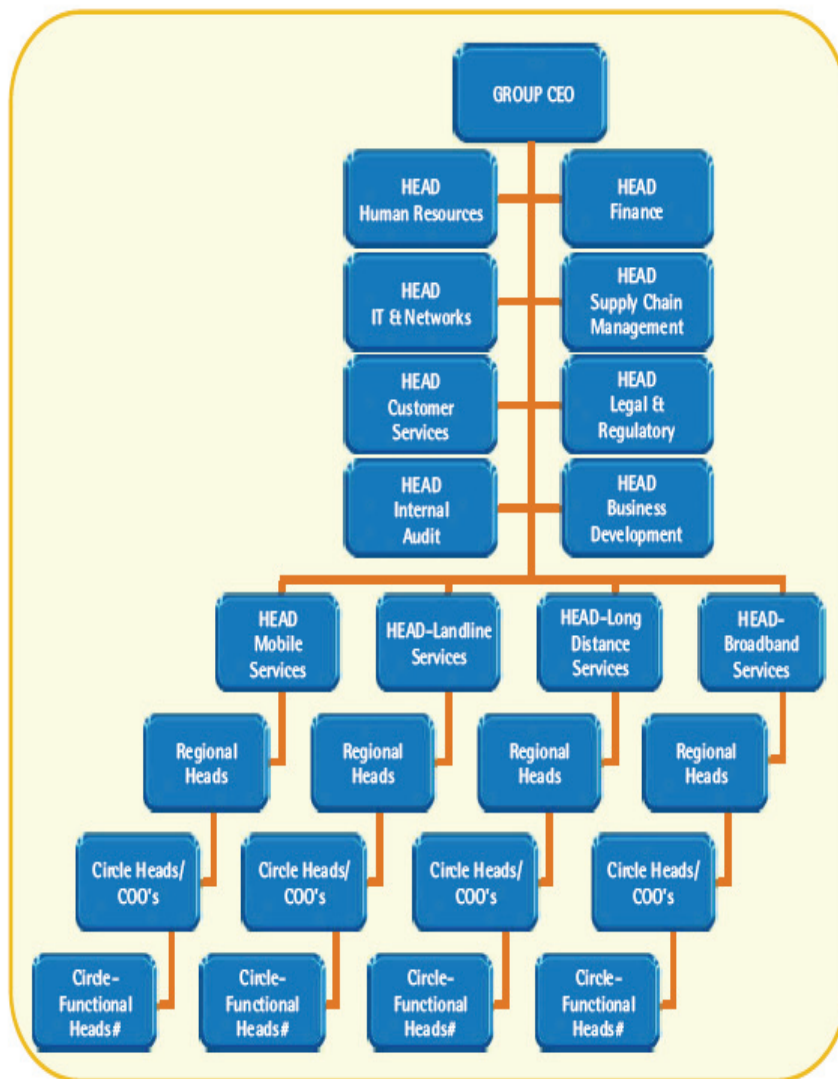
- unforeseen delays,
- cost overruns,
- unanticipated expenditure,
- regulatory changes,
- engineering design changes,
- technological changes,
- additional market developments, and
- new opportunities in the industry,

3.21 The above structure and the information gathered will help form the audit attention to keep risks that may be evident at the initial stage, which the auditor needs to be aware of. It is likely that some of these may be pure business risks, with no impact on the financial statements, while others may need to be understood and addressed during the course of audit.

A Typical Organisation Structure of a Telecom Company

3.22 Successful Telecom Environment Management requires key processes and best practices that help organisations to maintain control in a constantly changing industry. Organisations looking for best in class telecom environment management must focus on achieving the most efficient and effective practices for their telecom and IT environment if growth and success are in their future plans. The organisation structure adopted may vary from one telecom company to the other based on type and scale of operations. However an illustrative overview of Corporate Structure of an entity offering variety of telecom services is presented below. The Organisation structure of the entity under audit needs to be clearly understood, as the flow of information, authority, delegation of responsibilities and segregation of duties are all dependent on this.

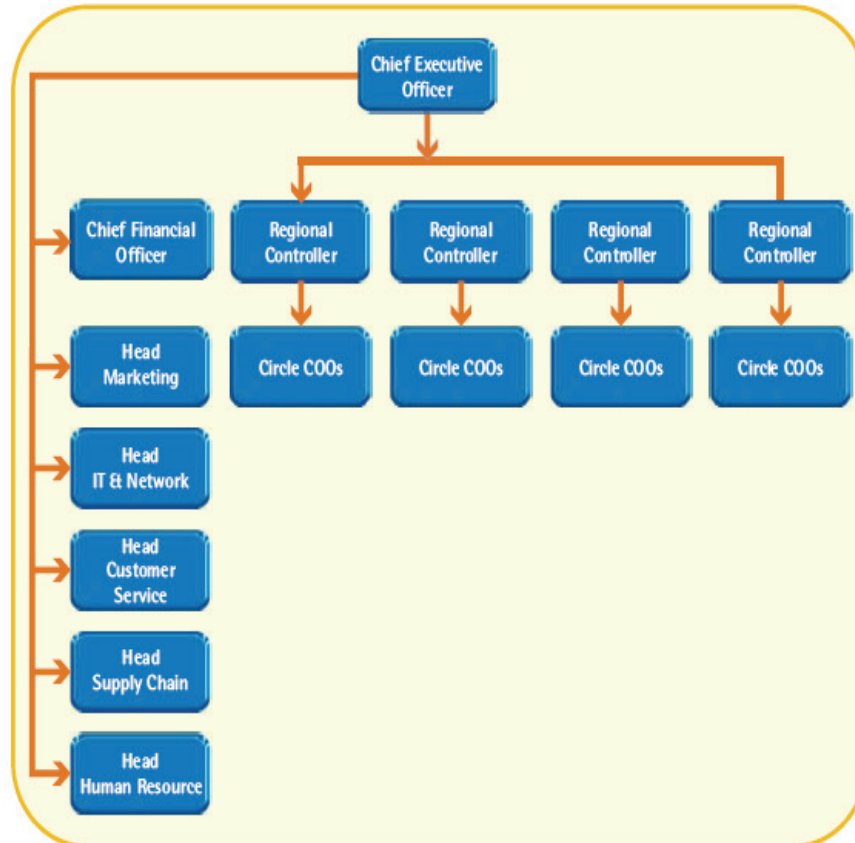
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Functional Heads would include Heads of various functions within a Circle i.e., Finance, Supply & Chain Management, IT & Networks, Human Resources, Legal & Regulatory, Customer Services, etc.

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The organisation structure of a telecom company operating only in Mobile Services segment is illustrated below:



Need for Information Technology (IT) Experts in the Audit

3.23 Telecom organisations are highly dependent on technology for their entire business life cycle. There are number of complex applications, operating systems, databases, reporting and reconciliation tools used in a typical telecom organisation. A few of them are listed below:

- Enterprise Resource Planning (ERP) Applications. e.g. Oracle e-business suite, SAP,

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- Postpaid Rating and Billing Applications. e.g. BSCS, Arbor,
- Prepaid Rating and Billing Applications. e.g. Intelligent Network (IN),
- Electronic recharge applications and solutions. e.g. UTIBA,VOMS,
- Switches and its components. e.g. MSC, HLR ,VLR, AuC,
- Interconnect billing system. e.g. INTEC,
- Mediations for conversion of Switch data into readable format from the billing applications,
- SMSC,
- Customer Relationship Management applications (CRM),
- Reporting tools and applications,
- Reconciliation tools and applications,
- Data Warehouses for collecting and maintaining huge volume of data generated on a daily basis.

3.24 The organisations are heavily dependent on the above applications for carrying out their day to day operations i.e. service delivery, accounting, reconciliations, management reporting, error resolution, customer acquisitions, provisioning, etc. The smooth and error free working of these applications is vital for telecom companies. These applications are also responsible for providing the base data for preparing the books of accounts for the organisation. For instance, the Postpaid Billing System would provide details of the postpaid revenue, subscriber receivables, subscriber security deposits, etc. Hence from the perspective of audit of financial statements, it is imperative to ensure that these complex systems and related reporting tools generate, capture and provide complete, accurate, valid and timely information for financial reporting.

3.25 As a part of the audit of financial statements, it is important to ensure that the financially significant applications and related databases generate, capture and provide complete, accurate, valid and timely information for financial reporting. In view of the technology-intensive nature of the telecom industry, it is preferable

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to engage those specialists who have the expert knowledge of working of these complex systems, risks attached to each of these systems and the requisite skills to audit these systems to address the relevant audit risk.

3.26 Generally, the specialists would be called upon to perform the following scope of work in the financial audit of a Telecom organisation:

1. Information Technology General Controls (ITGC):
 - Identifying key risks related to IT,
 - Gathering and documenting information about the client's systems and IT general controls and related risks, including entity-level controls over IT,
 - Determining financial significant applications and scoping the work over IT general controls,
 - Evaluating and validating IT general controls.
2. Evaluating and validating automated application Controls.
3. Testing the integrity of system generated data and reports used in key manual controls or in the generation of manual journal entries.
4. Revenue Assurance Controls review.
5. Data Analysis use of CAATs.

3.27 In planning an audit that includes the involvement of specialists, the following need to be agreed upon:

- The testing plan and resource allocation for IT general controls, automated controls, automated accounting procedures, report testing, revenue assurance etc.,
- IT related issues and risks that should be given particular attention,
- How control weaknesses identified should be documented and reported.

Chapter 4

Risk Assessment and Internal Control

Audit Risk

4.1 Audit risk contains two key elements:

- The risk that the financial statements contain a material misstatement (inherent and control risk); and
- The risk that the auditor will not detect such a misstatement (detection or engagement risk).

4.2 To reduce audit risk to an acceptably low level, the auditor has to:

- Assess the risks of material misstatement; and
- Limit detection risk. This may be achieved by performing procedures that respond to the assessed risks at the financial statement, class of transactions, account balance and assertion levels.

4.3 Auditors are required to assess the risks of material misstatement at two levels. The first is at the overall financial statement level, which refers to risks of material misstatement that relate pervasively to the financial statements as a whole and potentially affect many assertions. The second relates to risks identifiable with specific assertions at the class of transactions, account balance, or disclosure level. This means that for each account balance, class of transactions and disclosure, an assessment of risk (such as high, moderate, or low) should be made for each individual assertion being addressed.

Components of Audit Risk

4.4 The major components of audit risk are described below:

1. *Inherent Risk* refers to susceptibility of an assertion to a

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misstatement that could be material, individually or when aggregated with other misstatements, assuming that there are no related controls. Inherent risk is addressed at both the financial statement level and at the assertion level. These are the business and other risks that arise from the entity's objectives, nature of operations and industry, the regulatory environment in which it operates and its size and complexity. The risks of material misstatement will vary based on the nature of the account balance or class of transaction. Risks of particular concern to the auditor might include:

- Complex calculations which could be misstated,
- High value inventory,
- Accounting estimates that are subject to significant measurement uncertainty,
- A lack of sufficient working capital to continue operations,
- A declining or volatile industry with many business failures, and
- Technological developments that might make a particular product obsolete.

2. *Control Risk* refers to the risk that the entity's internal control system will not prevent, or detect and correct on a timely basis, a misstatement that could be material, individually or when aggregated with other misstatements.

The entity should identify and assess its business and other risks (such as fraud) and respond by designing and implementing a system of internal control. Entity level controls such as board oversight, IT general controls, and HR policies are pervasive to all assertions whereas activity level controls generally relate to specific assertions. Some control risk will always exist because of the inherent limitations of any internal control system. The auditor is required to understand the entity's internal control and perform procedures to assess the risks of material

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misstatement at the assertion level.

3. *Detection Risk* refers to the risk that the auditor will not detect a misstatement that exists in an assertion that could be material, either individually or when aggregated with other misstatements. The acceptable level of detection risk for a given level of audit risk bears an inverse relationship to the risks of material misstatement at the assertion level. The auditor identifies assertions where there are risks of material misstatement and concentrates audit procedures on those areas. In designing and evaluating the results of performing procedures, the auditor should consider the possibility of:

- Selecting an inappropriate audit procedure,
- Misapplying an appropriate audit procedure, and
- Misinterpreting the results from an audit procedure.

4.5 Risk-based audits require practitioners to understand the entity and its environment, including internal control. The purpose is to identify and assess the risks of material misstatement of the financial statements. Because risk assessment requires considerable professional judgment, this phase will require the time of the audit partner and senior audit personnel in identifying and assessing the various types of risk and then developing the appropriate audit response.

4.6 The risk assessment phase of the audit involves the following steps:

- Performing client acceptance or continuance procedures;
- Planning the overall engagement;
- Performing risk assessment procedures to understand the business and identify inherent and control risks;
- Identifying relevant internal control procedures and assessing their design and implementation (those controls that would prevent material misstatements from occurring or detect and correct misstatements after they have occurred);

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- Assessing the risks of material misstatement in the financial statements;
- Identifying the significant risks that require special audit consideration and those risks for which substantive procedures alone are not sufficient;
- Communicating any material weaknesses in the design and implementation of internal control to management and those charged with governance; and
- Making an informed assessment of the risks of material misstatement at the financial statement level and at the assertion level.

Parts of the risk assessment phase of the audit can often be carried out well before the year end.

4.7 The time involved in performing risk assessment procedures may be offset by reducing, or even eliminating, audit work in low risk areas. The knowledge and insight gained can also be used to provide the entity's management with practical comments and recommendations on how to minimise or reduce risk.

4.8 An effective risk assessment process requires that all members of the engagement team be involved and that they communicate effectively. The audit team¹ should meet or talk together on a regular basis to share their insights. This can be achieved through:

- A team planning meeting to discuss the overall audit strategy and detailed audit plan, brainstorm how fraud could occur, and design audit procedures that may detect whether such fraud did in fact occur; and
- A team debriefing meeting (towards or at the end of the fieldwork) to discuss the implications of audit findings, identify any indications of fraud and determine the need (if any) to perform any further audit procedures.

¹ Even in cases of audit engagements performed exclusively by one person (the practitioner), the same general principles will apply.

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Risk Assessment

4.9 In a telecom industry, following is an illustrative list of key risks which persists and may require special audit response:

- Introduction of innovative products (Bill Plans, Value Added Services, etc.) and services involving commissioning of new systems for provisioning;
- Dependency on real time Networks and IT systems wherein breakdown in control environment, security breach or controls can impact provisioning of customer services further leading to increase in customer churn;
- Functionality of the highly complex technical systems supporting the business (e.g. Post-paid & Prepaid customers billing systems, Interconnect billing system, etc.);
- Accounting for complex transactions, borrowing instruments, derivative contracts, acquisition revenue and costs in line with GAAP, forward covers and hedges including swaps, equipment supply contracts, network outsourcing contracts, etc.;
- Inaccuracy in forecasting returns from prospective infrastructure investments including optic fibres, wireless spectrum licenses, etc.;
- Managing of assets by outsourced vendors/agencies leading to risk of misappropriation / loss of large base of assets spread across wide geography;
- Litigations by and against the companies with customers, customer forums, tax and regulatory authorities, etc.;
- Compliance with regulatory conditions specified by TRAI and its financial implications;
- Management override of controls leading to Fraud Risk, roaming fraud, bypass hacking and bypass fraud, SMS fraud, SIM card cloning, credit card and subscription fraud, etc.;

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- Inappropriate provisioning in the financial statements for revenue and receivables and obsolete capital inventories which constitutes major components of a telecom business;
- Complex tax computations, given the entity structures, business operations, industrial undertakings, tax holiday periods, etc.;
- Complex and significant contract terms & conditions which might not be fully reflected in financial accounting and disclosures;
- Committed capex and lower than expected demand, declining ARPU's and fixed capital charges could result in impairing the financial health of operators;
- Business information security due to handling of customer data at various levels and by various outside (third party) agencies - franchisees, channel partners, etc.;
- Challenges with respect to customer service and timely resolution (including closure) of complaints, else-wise leading to huge customer dissatisfaction, customer churn and revenue loss;
- Non-timely identification and action for preventing revenue leakages from potential earnings - post-paid, prepaid, interconnect and roaming billing systems.

Information Technology Controls

4.10 Information Technology General Controls (ITGC) contribute indirectly to ensuring that the underlying financial statement assertions of completeness, accuracy, cutoff, existence occurrence, rights & obligations and presentation and disclosure are met. Effective ITGC is the basis of ensuring continued effectiveness of the application controls and automated accounting procedures that depend on computer. ITGC are also important when manual controls depend on application-generated information. If reliance on automated application controls, automated accounting procedures, or manual controls that depend on application-generated information is planned,

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validation of relevant ITGCs is required.

4.11 Testing of ITGC's has to follow a phased approach i.e.:

- Identifying key risks related to IT;
- Gathering and documenting information about the client's systems and IT general controls and related risks, including entity-level controls over IT;
- Identifying significant applications that have impact on the financial statements and related disclosures and scoping the work over IT general controls;
- Evaluating and validating IT general controls;
- Observations in ITGC and its impact on the timing, nature and extent of audit procedures.

Each of these phases are discussed in detail in the paragraphs below:

Identifying Key Risks related to IT

4.12 Following a risk-based audit approach, it is important to identify the key risks related to IT as the starting point of the audit. Key risks are identified based on auditor's knowledge about the business and the related business cycles of the organisation under audit. For telecom companies the following may be categorised as key risks related to IT:

- i. Complex systems that are automatically interfaced to each other and hence require batch processing (scheduled or otherwise) to transfer data completely and accurately.
- ii. The organisations send or receive financially significant data across the network.
- iii. Huge volume of data to be managed and backed up on a daily basis.
- iv. Frequent changes to master data upon changes in bill plans, introduction of new bill plans, new promotional offers etc.
- v. Introduction of new applications for effectiveness and efficiency of operations.

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- vi. A number of centrally managed applications as well as a number of decentralised and geographically dispersed applications.
- vii. 24×7 working environment.
- viii. Division of work responsibilities among the IT department of the telecom companies and third party vendors.
- ix. Frequent Network upgradations, scalability enhancements.
- x. A number of third party and in-house developed applications.

Documenting Information about the Client's Systems and IT General Controls

4.13 Having understood the key risks related to IT, the auditor should:

- Gather sufficient and reliable information about the overall functioning of the IT function, roles and responsibilities, third party agreements etc.;
- Understand and evaluate controls put in place by management to address the IT risks;
- Understand and evaluate the broader entity level controls, for instance, the Chief Technology/ Information Officer being invited to attend the Board of Directors meetings and discuss the IT issues;
- Evaluate whether any of the key risks have not been addressed by management or has only been partially addressed i.e. indicative of a control design weakness.

All the above should be documented as part of the audit planning process.

Identifying Significant Applications that have Impact on the Financial Statements and Related Disclosures

4.14 It is important for the auditor to keep in mind the objective of performing the ITGC review. To reiterate:

“Information Technology General Controls (ITGC) contributes

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indirectly to ensuring that the underlying financial statement assertions of Completeness, Accuracy, Cut-off, Existence Occurrence, Rights & Obligations and Presentation and Disclosure are met.

Effective ITGC is the basis of ensuring continued effectiveness of the application controls and automated accounting procedures that depend on computer. ITGC are also important when manual controls depend on application-generated information.” In other words ITGC review is being performed to obtain audit comfort over the financial statement assertions in the financial statements. Since the comfort is required on financial statement assertions, it is only the financially significant applications that need to be scoped in as part of ITGC.

4.15 In a Telecom organisation the following applications would typically be scoped in as part of ITGC:

- Switch (MSC),
- Mediation,
- Postpaid Billing Systems e.g. Arbor, BSCS,
- Interconnect Billing Systems e.g. INTEC,
- Prepaid Billing Systems e.g. IN and related provisioning applications,
- Electronic Recharge systems e.g. UTIBA, VOMS, and
- Financial Accounting and Reporting applications e.g. Oracle financials, SAP.

4.16 Audit teams should document a clear link between key ITGC and:

- Key automated application controls and interfaces,
- Key automated accounting procedures, and
- System generated data and reports used in key manual controls or in the generation of manual journal entries.

Based on the documentation of this link, other applications may be scoped in / scoped out for ITGC purposes.

Evaluating and validating IT General Controls

4.17 ITGC has to be conducted under the following four domains:

Control over Computer Operations

- Overall management of Computer Operations activities,
- Batch scheduling and processing,
- Real-time processing,
- Backup and problem management,
- Disaster Recovery.

Controls over Access to Programs and Data

- Management of security activities,
- Security administration,
- Data security,
- Operating system security,
- Network security,
- Physical security.

Controls over change management

- Management of maintenance activities,
- Specification, Authorisation and Tracking of Change Requests,
- Construction,
- Testing and Quality Assurance,
- Program Implementation,
- Documentation and Training,
- Segregation of Duties.

Controls over program development

- Overall management of Program Development activities,
- Project initiation, analysis and design,
- Construction/ Package Selection,

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- Testing and Quality Assurance,
- Data conversion,
- Program Implementation,
- Documentation and Training, and
- Segregation of duties.

4.18 Relevant ITGC typically include granting and removing user access rights, administering system security, enforcing password controls, segregating IT functional responsibilities, and monitoring direct access and security change activities. Weaknesses in relevant ITGC could compromise the effectiveness of management's segregation of duties, controls or other related control objectives by permitting inappropriate access rights.

Observations in ITGC and its impact on the Audit Approach

4.19 Because of the pervasive nature of the IT, control weaknesses in ITGC would have impact on the financial statement assertions. In light of the exceptions in ITGC, it may be difficult to place reliance on automated application controls. However each and every observation in ITGC review needs to be discussed in terms of its potential impact on audit, the materiality of the exception, the compensating controls and mitigating factors, if any and the further audit procedures required in the area. The further audit procedures could include amongst the following:

- Testing of the compensating controls, if in the judgment of the auditor, the compensating control would address the audit risk arising from the exception. Before testing the compensating control the auditor should determine, whether the compensating control can be relied upon for the purposes of the audit. This is done by understanding and evaluating the design of the control;
- Calculating the materiality of the observation. This has to be done by understanding the nature of the observation and identifying the period for which the observation was not remediated. If in the judgment of the

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auditor, the amount related to the observation is not material to impact the true and fair view of the financial statements, there may not be any further work required;

- Increase in substantive testing i.e. substantive analytics and/ or test of details. For instance a client has many “superusers” in their IT department whose access rights enable them to create, process and delete transactions in all significant business processes without leaving an audit trail. Even if functional duties are properly designed and segregated amongst the operating and financial personnel involved in the client's transaction processes, the desired level of control may not be achieved if the risks of “superuser” access are not adequately mitigated by other IT and/or business process controls. In such a situation, it may be required to extract a dump of transactions created by “superuser” and determine if the transactions were approved and in normal course; and
- Auditors also need to assess the impact of observations on reporting on Internal Controls under Clause 4 of Companies (Auditor's Report) Order, 2003, as amended by the Companies (Auditor's Report) (Amendment) Order, 2004, issued by the Central Government of India in terms of sub-section (4A) of Section 227 of 'The Companies Act, 1956' of India.

4.20 The impact of the ITGC observations on audit and further audit work should be clearly documented in the audit working papers.

Automated Application Controls

What are automated application controls?

4.21 Automated application controls, as the name suggests are the controls that reside within the application and are performed automatically by the application. Automated application controls can be of the following nature:

- Inherent application controls, and

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- Configurable application controls.

4.22 Inherent application controls are the controls that are inbuilt into the application code and are part of the standard application installation. These controls cannot be configured to be turned off.

4.23 Configurable application controls on the other hand are control features that can be customised to suit the requirements of the business. Some applications are highly configurable but where the application provides greater security and control features, such features may not be optimally utilised.

4.24 In a telecom organisation, the auditors may want to test the automated application controls as substantial audit comfort can be obtained if the automated application controls are working fine or have been configured appropriately to meet the needs of the client and address the risks in the underlying business processes. Controls may need to be tested for the following applications:

- Billing Applications - Postpaid and Prepaid,
- Financial Accounting and Reporting Applications e.g. Oracle financials, SAP.

4.25 Automated application controls are influenced to a greater degree by the effectiveness of information technology general controls (ITGC) and may require manual follow up for resolution. They should ideally be tested in conjunction with their associated manual based controls to determine whether there is a proper balance of control (e.g. a transaction is rejected or flagged and there is a manual research and follow up process with a documented resolution).

4.26 Some examples of automated application control methods for satisfying the objectives of completeness, accuracy, validity and restricted access are as follows:

Completeness

- Sequential numbering of transactions so that every transaction can be uniquely identified in the system and the system will not accept duplicate numbers, or numbers

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outside the set range. Missing numbers are reported for investigation and followed up as needed;

- Control total balancing of number of transactions input into the system. The following are some examples of control total balancing techniques:
 - Hash totals,
 - Batch is entered into the system and total is calculated again and compared to first totals to ensure data is transferred from the source system to the destination system completely,
 - Edit checks to identify potential duplicate transactions such as invoice payments.

Accuracy

- Edit checks which could include limit checks, reasonableness checks, existence checks, format checks;
- Matching of customers, vendors, part numbers, invoices, and purchase orders to existing data;
- Control total balancing of data within transactions which are input into the system.

The following are some examples of control total balancing techniques:

- Hash totals,
- Batch is entered into the system and total is calculated again and compared to first totals to ensure data is transferred from the source system to the destination system completely.

Validity

- Transactions routed along a workflow approval process for processing by employees with appropriate authority;
- Matching customer data against an existing data file (historical data, standing data, data from another organisation/system, prior data matching).

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Restricted Access

- Formal authorisation by application owner is required for access to specific accounting records. Management reviews access rights periodically to ensure only authorised individuals have access for carrying out their duties. Exceptions noted are investigated and resolved;
- Access controls include a proper segregation of duties (access only the information needed to perform the job function, i.e. responsibilities for approving, processing, handling assets should be divided among employees);
- Access controls such as user IDs and passwords are utilised and specific to each application. Passwords should be changed periodically and must not be replaced by previously used passwords. Multiple failures to log on invalidate the user ID and reported via an exception report. Management to investigate and resolve all items.

Testing of the Automated Application Controls

4.27 Testing the automated application controls require an expert knowledge of the application in terms of the inherent and configurable controls. Further the auditor needs to be aware of the various possible configurations and the impact of a particular combination on the business cycle.

4.28 It is more important to be aware of the configurations because each and every application installation is unique and is governed by the configuration. A configuration that is required by one installation may not be required at all in the other installation. Awareness of these configurations is vital for reaching appropriate conclusions about the working of the application controls.

4.29 The following approach needs to be adopted in testing of the automated application controls:

- Identify the financially significant applications by identifying which business cycles are impacted by the application;
- Identify the application's interfaces as they are often linked to other systems that in turn need controls to ensure that

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all inputs are received for processing and all outputs are distributed appropriately;

- Testing of the automated application controls by performing a walkthrough should be done in the test environment. However the auditor need to first of all perform audit procedures to ensure that the test environment is the exact replica of the live environment and the results of the testing done in the test environment would not be different from the results, had the testing been done in the live environment. This can be done by ensuring that the configuration in the test environment and the live environment are matching and there are procedures to ensure that the test environment is replicated with the live environment (both the application and database) on a regular basis. In case the latest replication done by the organisation does not have all the relevant changes / information required for the purposes of audit, then the auditor should consider requesting for a fresh replication.

Interface Controls

4.30 Consideration should be given to automated application controls within an application as well as interface controls between applications and databases. In telecom companies, there can be interfaces between various applications eg., interface between the billing systems and General Ledger, interfaces between two billing systems etc. Interface controls are critical in helping to ensure the completeness and accuracy of data transfer, as well as the validity of the data received. Interface controls can be manual or automated as the data transfer may be manually initiated and the value / record count may be reconciled manually or through application batch totals. If reconciled through application batch totals, there needs to be a report stating the result as the system will not self-correct. The following are some of the automated application controls employed to ensure data transmission is transferred from the source system, and received by the destination system in a complete and accurate manner.

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Edit checks

4.31 Edit checks used by destination systems to restrict receipt of interface data from only certain, predefined source systems. This is normally done by the use of system recognition codes (e.g. IP addresses and database pointers). This would also be considered a validity control as it ensures the validity of the data received.

- Edit checks built into the destination system to disallow the acceptance of files that are not for the correct date. i.e., the system won't accept yesterday's file again if today's are not ready;
- Edit checks built into data transmission. For example, the destination system can calculate control totals and record counts of data received from valid sources. The destination system compares the totals and counts back to the source system. The source system compares the control totals against its own calculated information. If the totals are the same, the source system will send a confirmation back to the destination system. If the totals are not the same, the destination system will not process the data. This will ensure that transmission was complete and accurate. For this area, also consider Resubmission Controls;
- Edit checks using file headers/footers. File headers can summarise the information that is included in the files sent from source systems. The information for example can include, number of records, total amount fields, total debits, total credits, file sizes, etc. The destination system imports the file for record basis, individually computing edit check calculations. When the calculated information matches the header or footer, the information will go to the next stage of the validation process (See Data Validation Controls). If the data does not match refer to the Resubmission Controls.

Resubmission Controls

4.32 A very important follow-up control should exist to ensure that when the above controls detect failures in communications,

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the destination system will let the source system know to resubmit the original data transmission. In this scenario, the source system should ignore the original message, as this could lead to duplicate processing of transaction data.

Data Validation Controls

4.33 All data received by source systems should go through data validation controls or edit checks. These edit checks could include numeric fields that check for other characters, date fields that check whether the data is in the correct format, etc. Company numbering formats should also be checked against the business rules. There should be business rules that will apply on all data fields received by the source system. For example, a customer number must be between 1000001 and 1099999. These same controls should also be applied for resubmission activities.

Assessing the Reliability of System Generated Information, Including Information used in the Execution of Manual Controls, Manual IT Dependent Controls and Financial Reporting

4.34 Telecom organisations use and rely upon information produced by the information systems in form of various reports such as IN Balance report, Billing revenue, Postpaid MOUs, Prepaid MOUs, Prepaid Usage, VAS Usage, Acquisition report, churn report, recharge report, debtors ageing report, etc. This information is used for carrying out monitoring controls and entity level control activities such as business performance reviews.

4.35 Accuracy, completeness and reliability of this information would ensure the effectiveness of the control activities based on these reports / information. Information required for financial reporting purposes is also produced by these applications, for instance, based on the information contained in the IN Balance report, the corresponding liability for unearned revenue is recognised. Similarly, the debtors ageing report generated out of post paid billing systems would be used for making provision for bad and doubtful debts. This information would also be used by auditors to perform audit procedures.

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4.36 It is essential for auditors to obtain an understanding of the sources of the information that management use and evaluate and how management obtains comfort that the information is reliable for their purposes. Thus, the auditor needs to obtain audit evidence about the accuracy and completeness of the underlying information by performing following procedures:

- A. Understand the nature and source of the underlying information. There would be some information that would be generated on a routine basis by the applications i.e. the reports would be predefined and would be available to the management at predefined intervals or as and when the management requires such information. There can be some reports/ information produced on ad-hoc basis as requested by the users. The queries for the reports may be written by the IT Team upon request by the management. The reports those are generated regularly and are a part of standard reports of the application are inherently more reliable as compared to the ad-hoc reports. However, the auditor should test the relevant ITGC like controls over access to program and data, program change management and program development before reaching to such a conclusion.
- B. Depending on how management obtains comfort that the underlying information is complete and accurate, the auditor should perform all or combination of some of the following procedures to gather sufficient and appropriate audit evidence about the reliability of the underlying information:
 - I. Test the relevant application controls and information technology general controls that management relies on when using this approach, the auditor should perform all of the following:
 - i. Assess the reliability of the source data by testing key manual and automated controls. This will most often involve testing the effectiveness of key manual and automated

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controls designed to ensure the completeness, accuracy and validity of the source data;

- ii. Validate that the program or systems, in the routine, function as intended and draw information from appropriate, reliable data sources;
- iii. Test the effectiveness of key ITGC designed to support the ongoing integrity and reliability of both the system(s) and source data, and revalidate the automated program logic any time it is changed.

Some examples of the procedures stated above include:

- i. Performing substantive tests, such as tracing the output to source documents or by reconciling it to independent, reliable sources (eg., testing the accuracy of an aging report by comparing to circularisation results or by tracing back to sales invoices);
- ii. Replicating the output by running own independent queries or programs on the actual source data;
- iii. Evaluating the logic of the program/routine by perhaps:
 - a. Inspecting application system configurations,
 - b. Inspecting vendor system documentation,
 - c. Interviewing program developers (usually not enough by itself).
- iv. Running sample transactions (test decks) through the program or routine and comparing the output to expectations.

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- II Obtain comfort on how management validates or corroborates the underlying information through independent objective sources:
 - i. Management may gain comfort that the information they are using is reliable from checks that they perform themselves using a reliable independent source;
 - ii. Another possible approach is to rely on procedures performed by management to validate or corroborate the underlying information. The auditor should first be satisfied that management is using a sufficiently rigorous process, and then obtain comfort on how they:
 - a. Compare the underlying information to reliable sources external to the organisation;
 - b. Compare the underlying information to internal information that is reliable and verifiable;
 - c. Rely on corroboration by individuals with the requisite knowledge, experience and analytical skills who are not involved with the process and systems that generate the underlying information.

Examples:

- i. Management may be able to identify inaccuracy in roaming revenue report based on the information provided by the Data Clearing House (DCH) as well as by information received from roaming partners;
- ii. Management may be performing trend analysis of various KPIs e.g., churn, ARPU, SMS Revenue, Roaming revenue, Prepaid revenue, Postpaid revenue, activations etc.

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The figures are compared over a period and also against the budgets. Any unexpected fall, rise may be investigated to identify whether there is a possible reporting error. Some of the information may be corroborated with other sources as well, for instance, the fresh activations may be corroborated with the dealer incentive on fresh activations.

The auditor should plan and perform audit procedures, as needed, to validate the effectiveness of management's procedures for corroborating the underlying information.

- III Perform own substantive testing of the underlying information:
 - i. In limited circumstances, the auditor may determine that it is appropriate to assess the reliability of underlying information used in a control by validating it through substantive testing. Such a determination should consider the results of procedures the auditor performed to obtain an understanding of internal controls to plan audit procedure. In obtaining this understanding, the auditor should consider an entity's use of information technology to initiate, record, process and report transactions or other financial data. If the auditor becomes aware of evidence that calls into question the expected reliability of the underlying information used in the manual controls and manual IT dependent controls, substantive testing alone may not be an effective approach;
 - ii. The auditor may be able to gain a low to moderate level of assurance from a BPR or manual control by testing the effectiveness

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- of control and substantive testing of the underlying information throughout the audit period. At a minimum, the auditor should substantively test the information as many times as the operation of the BPR or manual control. For example, if the auditor is testing a monthly control three times throughout the year, then he should substantively test the underlying information for the same three instances of the control;
- iii. Considerations for determining the nature of the substantive tests and increasing the frequency of the testing of the underlying information at the minimum include:
- a. the source and expected reliability of the underlying information (e.g., is it sourced from systems independent of the financial reporting process; is it straightforward or complex; etc); and
 - b. the importance and level of desired comfort from the BPR or manual control (i.e. the more important and the higher the level of comfort desired, the more frequent the underlying information should be tested).

Revenue Assurance Controls Review

Need for a Revenue Assurance Function in Telecom Organisations

4.37 The telecommunications industry is undergoing a major revolution. New technologies, new products and services and entirely new business models are making existing risk management activities like usage tracking, billing tracking and fraud prevention measures, obsolete. Revenue assurance has

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always played an important role in telecom risk management and several other factors, as mentioned below, have brought it to the forefront:

- Continued scrutiny and pressure by regulators mean that the telecom companies should be able to point specifically and definitively to prove the numbers they report to stockholders and the public;
- Increasing pressure to show performance and reduced operating budgets is making it critical for management to exploit all areas of potential revenue realisation. For most telcos surviving in today's competitive market requires them to discover any way possible to increase earnings. By determining how revenues are being missed, Revenue Assurance (RA) can generate an essential source of previously unrealised income;
- The struggle of existing revenue management systems to keep up with the continuing breakneck pace of technological and marketing innovation. Each month, hundreds of new technologies, products, price plans and marketing approaches force network and systems managers to continuously stretch and challenge their revenue management capabilities.

Revenue Assurance

4.38 Revenue Assurance is a combination of organisational structure, processes, technology and information responsible for understanding and monitoring the entire revenue process. Revenue assurance essentially cuts across all functional areas. Revenue Assurance in a telecom organisation is explained below:

- To assure management that there is no leakage in particular area,
- To determine the probability that leakage is occurring in a particular area,
- To identify potential leakage situations as quickly as possible in order to effectively escalate them for leakage management to see and understand what is going on,

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- To identify those areas where leakage might occur in the future and take action to prevent that from happening,
- To investigate a suspected leakage situation and determine the extent, risk and root causes associated with it,
- To determine the appropriate treatment of a known leakage situation, and
- To remedy a known leakage situation when it is determined to be the best course of action.

Importance of Revenue Assurance Controls

4.39 As per the Standards on Auditing issued by the Institute of Chartered Accountants of India, the auditor should obtain an understanding of the accounting and internal control systems sufficient to plan the audit and develop an effective audit approach. The auditor should use professional judgment to assess audit risk and to design audit procedures to ensure that it is reduced to an acceptably low level. Auditors would be interested in Revenue Assurance controls from the following perspectives:

- Revenue Assurance Controls are one of the most important and distinguished facet of the overall internal control environment in a telecom organisation;
- An effective Revenue Assurance function address audit risks in the area of revenue. Revenue being one of the key risk area in audit of telecom companies, the auditors obviously are interested to review whether the revenue assurance controls are effective to be able to place reliance on them;
- Revenue process in telecom companies is complex and highly automated. It is effective, efficient and most appropriate for auditors to adopt a control based approach in audit of revenue area in a telecom organisation as against adopting a manual substantive audit approach. In adoption of a control based approach whereby management controls over the audit area are tested and

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relied upon, revenue assurance controls are the controls that the auditor should intend to rely upon and test;

- A breakdown in the revenue assurance controls would indicate the auditor, the areas where he needs to focus more to obtain audit comfort; and
- The results of the revenue assurance work can be used by auditor for corroborating the numbers reported in financial statements.

Risks addressed by Revenue Assurance

4.40 Risks in Revenue and Receivable Cycle There are a number risks related to revenue leakage, revenue management and revenue maximisation in the revenue cycle that need to be addressed by telecom companies. A number of these risks are addressed by revenue assurance. Let us take a closer look at the possible risks that are addressed by Revenue Assurance (RA).

Mobile and Fixed Line Telcos

- CDRs may not be generated for all the chargeable calls resulting from incorrect suppression of CDRs at the Switch Level;
- There may be unauthorised activity at the switch resulting into revenue loss, subscriber may be active only on switch but not on billing application resulting into calls not being rated at the Billing Package Level and getting rejected;
- Subscriber may not be charged for the services availed;
- Subscriber active on Billing but not active on switch will not be able to make calls leading to dispute, bad debts and related costs. The Client may lose the subscriber to competition;
- Revenue/ Postpaid CDRs may be filtered at Mediation resulting into revenue loss/ leakage;
- Since the call flows from Switch to Mediation to Billing in CDR Files, there is a possibility that the Files and the CDR within Files are not transferred from Switch to Mediation and from Mediation to Billing resulting into revenue loss;

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- The calls made by the subscriber may be rated differently from the approved and communicated rates. This may result into revenue loss in case of under billing or subscriber dissatisfaction and related costs like subscriber care calls, waivers, losing subscriber to the competition, in cases of over billing;
- CDRs may be rejected due to various reasons at billing system and the same may not be re-rated;
- Incorrect billing may even lead to Regulatory issues;
- Calls may be rated for wrong jurisdiction e.g. a Local code may be defined as an STD Code and hence wrongly charged and vice versa. This may result into revenue loss or subscriber dispute. The IUC Payout and the recovery against the same from the Subscriber may be affected;
- Billing may not be done for all the Billable customers leading to loss of revenue to that extent. Further, in case, these customers are billed later on, there is possibility of delay in collection and increased cost of collection;
- Subscriber's online balance decrement for the calls that the subscriber makes might be different from the approved and communicated rates. This may result into revenue loss in case of under decrement or subscriber dissatisfaction and related costs like customer care calls, waivers, losing subscriber to the competition, in cases of over decrement;
- Roaming online decrement may be incorrect resulting into revenue leakage or subscriber dissatisfaction;
- There can be a risk that incorrect talk values are transferred to the subscriber on recharges. This can be resulting from incorrect configurations in the system;
- The amount transferred to subscriber on electronic recharge / easy recharge may not be deducted from the dealer online account resulting into revenue loss;
- Subscriber may be able to utilise more or decremented more than the available balance in the account;

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- Services of the customers like GPRS and SMS may not be barred at the defined threshold due to command failures and hence resulting into negative balance and consequent revenue loss to the organisation;
- Unauthorised adjustments may be given to the subscriber resulting in revenue leakage;
- Rentals for services such as GPRS, Roaming etc., may not be charged to the customer leading to revenue loss to the organisation, similarly there can be instances of duplicate charging resulting to customer dispute and related costs like customer care calls, waivers, losing subscriber to the competition, in cases of over decrement;
- Incoming and Outgoing calls of the customer may not be barred on time leading to chance that the customer would accordingly delay the recharging;
- Incorrect Rating of CDRs at Interconnect billing system resulting into settlement disputes with other operators;
- Incomplete processing of CDR Files at Interconnect billing system resulting into under billing to the operators as well as reconciliation issues / settlement issues of IUC with other operators;
- Incorrect charging of Content Download CDRs may result into revenue leakage or subscriber dissatisfaction;
- The amount paid to the vendor for VAS download may not be correspondingly recovered from the subscriber; and
- Over invoicing by the vendor may not be detected.

Carrier Services - NLD and ILD

- The distance band and TIER ID mapping for new and existing codes may be incorrect and hence may lead to incorrect billing;
- The rates configured in Interconnect billing system against each TIER ID and product ID may be incorrect leading to inaccurate rating and hence incorrect revenue and access charges;

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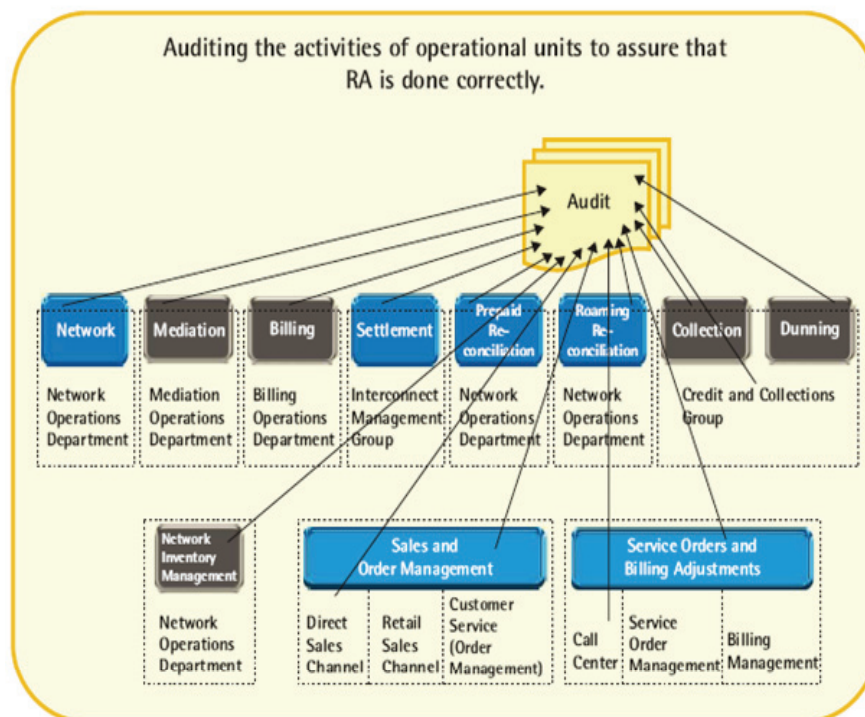
- Billable Trunk Groups may not be configured at all the instances i.e. Switch , Mediation and Interconnect billing system and hence leading to either incorrect CDR Filtration or rejection of CDRs due to TG Not Found cases. All this would lead to revenue loss to the organisation;
- Since the call flows from Switch to Mediation to Billing in CDR Files there is a possibility that the files and the CDR within files are not transferred from Switch to Mediation and from Mediation to Billing resulting into revenue loss;
- CDRs may be rejected due to various reasons at Interconnect billing system and the same may not be re-rated;
- Any traffic going towards International Carriers would be originated from Domestic Operators or International Carriers (Incoming Hubbing). ILD traffic originated from NLD operators may not match with Outgoing traffic given to ILD operators leading to revenue loss to the organisation;
- Any traffic that flows in from International Carriers would either be terminated on Domestic operators or International Carriers (Incoming Hubbing). Similarly, any traffic flowing out to International Carriers would be originated from Domestic Operators or International Carriers (Incoming Hubbing). If the same does not reconcile then there would be revenue loss to the organisation; and
- All the calls originated at the switch may not be billed to the operator and hence leading to under invoicing and revenue loss to the organisation.

4.41 List of risks detailed above, is an indicative list of risks that are faced by telecom companies and addressed by revenue assurance. Auditor should understand these and any other risks that are addressed by revenue assurance and the possible impact of these risks on the audit of financial statements.

Controls Performed by Revenue Assurance Function

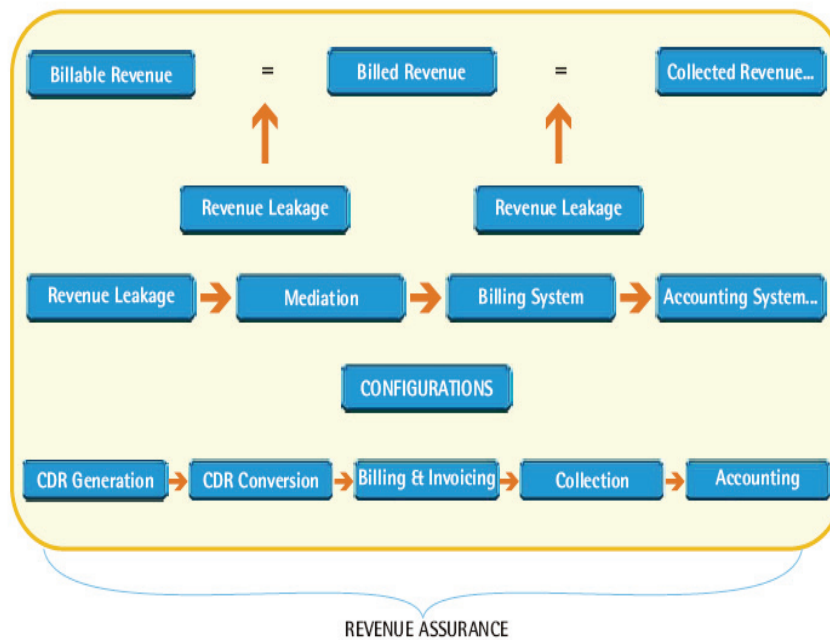
4.42 Revenue Assurance is an important control function for the telecom companies. The RA function cuts across departmental and technology barriers and encompasses the following major operational areas in its pervasive domain:

- Network operations,
- Mediation,
- Postpaid billing,
- Prepaid billing,
- Interconnect,
- Roaming reconciliation,
- Collections and settlement,
- Dunning,
- Fraud,
- Cross system synchronization, and
- End-to-end revenue management chain.



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4.43 The main objective of the RA function would be to ensure that the Billable revenue equals the Billed revenue and Collected revenue. There would be leakage (Potential and Actual) in every area. RA needs to identify and plug these leakages and continuously monitor the revenue stream to detect any further sources of revenue leakage as well as ensuring that there is no leakage in areas already corrected.



Performing Review of the Revenue Assurance Controls

4.44 That the auditors of telecom organisation need to be aware of revenue assurance controls and should test these controls as part of the audit engagement can hardly be over emphasised. The revenue assurance controls are performed manually by the RA team. RA may make use of macro based spreadsheets, access or ACL based applications to expedite their routine operational work especially since the volume of data that is being managed and reconciled by RA cannot be handled without the use of automated tools.

4.45 In performing a review of the revenue assurance controls,

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the auditor should first of all understand and evaluate the overall revenue process in the organisation. This would include but not limited to understanding the flow of CDR movement, the network elements, various billing applications, the organisational structure, structure of the RA department, relevance attached to RA in the overall control environment in the organisation, RAs role in new product testing, RAs role in revenue accounting, controls being performed by RA, use of automated tools to perform RA controls, monitoring mechanism put in place by management to review the activities of RA, Resolution mechanism i.e. how RA reports to and how management responds to the issues raised by RA etc.

4.46 The collection of audit information will include:

- Interviews with the people performing and managing RA activities,
- Interviews with people responsible for overseeing the RA activities,
- Review of RA documentation and procedures manuals, and
- Review of RA reporting schedules, results and resolution log.

4.47 This information would be the starting point for planning the approach to be taken in performing the RA controls review. The greater the relevance attached to RA by the management, the higher would be the level of audit comfort, the auditors would like to obtain from testing of the RA Controls. The RA control testing would cover all the revenue streams of the business. The auditor should develop a detailed audit plan indicating the Control objective, RA activities and Validation procedure to test the RA Controls. The results of the validation procedure should be documented and observations if any should be discussed with the management to obtain their comments as well as to identify any mitigating controls that the auditor would need to test to obtain comfort over the area.

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Audit Plan - Revenue Assurances (RA) Controls

4.48 The auditor should develop a detailed audit plan indicating the Control objective, RA activities and Validation procedure to test the RA Controls. The results of the validation procedure should be documented and observations if any should be discussed with the management to obtain their comments as well as to identify any mitigating controls that the auditor would need to test to obtain comfort over the area.

4.49 An illustrative Audit plan indicating the control objective, activities performed by RA and validation procedure is given below:

Post Paid

Control Objective	Activities Performed by RA	Validation Procedures
CDRs are generated at switch for all the successful calls made.	<ol style="list-style-type: none">1. RA performs monitoring of B tables to check for CDR suppression parameter,2. RA also makes test calls and further traces CDR generation for all possible scenarios to ensure CDRs are being generated in switch for all call types.	<ol style="list-style-type: none">1. Inquire from RA, the make of switch in the circle and accordingly inquire about the parameters checked in B table audit,2. Examine the working papers for proof of reconciliation performed,3. Additionally also ensure that any variances observed by RA have been properly escalated and close looped,4. Check for properly documented call scenarios & their mapping to actual CDRs in TT files.
Basic parameter settings for all sub-	RA should perform Switch vs. Billing- VAS reconciliation for the following features. All	<ol style="list-style-type: none">1. Inquire about the reconciliation activity and understand the following:<ul style="list-style-type: none">• Frequency of the

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scribers is correct on switch	<p>mismatches found are further send to Provisioning team for rectifications.</p> <ol style="list-style-type: none"> 1. STD, 2. ISD, 3. National Roaming, 4. Regional Roaming, 5. International Roaming, 6. CLIP(Caller Line Identification Presentation), 7. CLIR (Caller Line Identification Restriction) 8. PRBT, 9. Fax, 10. Data, 11. Safe Custody, 12. Voice Mail (Additional reco to be done with customers configured on VMS server also), 13. Call Conference/ MPTY(Multiparty), 14. SMS (Separate reconciliation for SMS MO(Originating) & MT(Terminating), 15. Group SMS, 16. CUG (Closed user groups), 17. MMS (Separate reconciliation with MMS server also), 18. GPRS, 19. WAP. <p>Also check for any additional VAS features specific to operator or</p>	<p>activity,</p> <ul style="list-style-type: none"> • What parameters / VAS services are included, • How is the reconciliation performed (Access queries, ACL Tool or any other customized program for reconciliation etc.), • Who makes the changes in the reconciliation logic in case of reconciliation of new parameters/ VAS services introduced, • Escalation Matrix and TAT and service level agreements with other departments for closure of mismatches, • Tolerable limits of mismatches, • How RA keeps track of open cases and repeat observations, • What steps are taken to analyse and rectify the root cause of the problem to ensure minimum mismatches in future. <p>2. Examine the following:</p> <ul style="list-style-type: none"> • In case the RA teams are using access or ACL, verify the logic used to perform these Reconciliations,
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	circle for which such reconciliations are being performed.	<ul style="list-style-type: none"> • Evidence that mismatches have been appropriately escalated and followed up till all observations are closed, • Process Note/ approvals for all Direct activations/ provisioning done at the Switch.
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Prepaid

Prepaid Customers Profile on Switch is correct	<p>RA may verify through reconciliation that all prepaid customers have appropriate parameters defined in switch,</p> <p>i. Identification as prepaid/postpaid Ericsson: S Type-9&10" and OICK-10,50" Nokia: Determined by "Category" parameter and IN flag. Siemens: INMOC & INMTC Flag. Additionally prepaid and postpaid numbers may also be segregated on the basis of Separate IMSI series.</p> <p>ii. Checking of Camel profile Ericsson: Camel profile decrementing of Prepaid customer while roaming. Nokia: Determines the ability of a customer to Roam,</p> <p>iii. Unbarring of Incoming and</p>	<ol style="list-style-type: none"> 1. Examine working papers of the above activities and their subsequent escalation and rectification, 2. Check if RA is covering all the required scenarios and inquire if any additional exception reports are being generated, 3. Inquire of any other compensating controls put in place by RA to gain comfort, if any of the above reconciliations
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	<p>outgoing Voice & SMS facilities for “0” balance & Grace customers (determined by organisation policy, that what features should be available to customers in such state),</p> <p>iv. Other VAS features: Status of other VAS features should be in accordance with the Status of customer or any balance threshold limits as set by circle. E.g. an unregistered customer or a grace customer has limited or no features available. Similarly circles having offline charging may define threshold limits in the system. They bar specific features of customers whenever the threshold limits are crossed,</p> <p>v. Parameters and status of pre on post customers.</p>	<p>are skipped,</p> <p>4. Also examine sample logics of generating these exception reports.</p>
--	--	---

Interconnect

Control Objective	Activities Performed by RA	Validation Procedures
All files are received from switch and processed in Interconnect billing system	1. Separate reports are generated from switch, mediation & Interconnect billing system giving details of each TT file & number of CDRs in each file that have been processed. File wise CDR count is only available in Ericsson	<p>1. Confirm with RA about the reconciliation & subsequent resolution process of these CDR files,</p> <p>2. Check if all such streams for all MSCs are considered for</p>

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	<p>switch report,</p> <p>2. RA performs the following reconciliation:</p> <p>i. Mediation & Interconnect billing system,</p> <p>ii. To ensure all files pushed from mediation have been rated at Interconnect billing system. Additionally count of CDRs pushed by mediation to those rated in Interconnect billing system is also matched,</p> <p>iii A trend analysis of Filtered CDRs at mediation is done to check for any unexpected spikes in the filtered CDR count, which may indicate inconsistencies in the filtration rules definition.</p> <p>3. There are scenarios where more than 1 file generating stream (charging Unit) is present in MSC, i.e., 1 MSC may also have parallelly 2 or more TT files each with its own sequence numbers.</p>	<p>reconciliation,</p> <p>3. Examine RA work files for evidences of following reconciliations:</p> <p>i. Gaps in file sequence numbers,</p> <p>ii. Duplicate File sequence numbers,</p> <p>iii. Reconciliation of mediation reports with billing reports for each file wise count of CDRs pushed by mediation to those rated in billing.</p> <p>4. Also ensure that all observations are immediately escalated to concerned teams and RA also keeps track of resolved and unresolved cases to ensure 100% rectification before each month.</p>
Roaming		
Control Objective	Activities Performed by RA	Validation Procedures
Rates for new	RA may perform the following activities in case of	1. Inquire about the new

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operators are correctly configured in the billing systems (pre & post)	agreement with a new operator: <ul style="list-style-type: none">• Validate the IR24/IR32 documents and match the CDRs for all successful call scenarios,• Check Test TAP files for format and rating as per information in AA14 document.	operators who have entered into a roaming agreement in the audit period, <ol style="list-style-type: none">2. Examine working papers for validation of IR documents and test TAP files,3. Examine close looping of issues.
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Results of Revenue Assurance Controls Review and Impact on Audit

4.50 In case the auditor finds control weaknesses during RA controls testing, after considering the compensatory controls, the observations should be discussed with the management. Based on the management comments, the observations need to be close looped by documenting the impact on nature, timing and extent of audit procedures, if any, along with documentation of alternate audit procedures that may have to be conducted.

4.51 Each and every observation in the RA controls review needs to be discussed in terms of it's potential impact on audit, the materiality of the exception, the compensating controls and mitigating factors, if any and the further audit procedures required in the area. The further audit procedures could include amongst the following:

- Testing of the compensating controls, if in the judgment of the auditor, the compensating control would address the audit risk arising from the exception. Before testing the compensating controls, the auditor should determine, whether the compensating controls can be relied upon for

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the purposes of audit. This is done by understanding and evaluating the design of the control;

- Calculating the materiality of the observation. This has to be done by understanding the nature of the observation and identifying the period for which the observation was not remediated. If in the judgment of the auditor, the amount related to the observation is not material to impact the true and fair view of the financial statements, there may not be any further work required. For instance, if it is identified that rating on a particular bill plan was not happening correctly then the materiality of the observation needs to be calculated. For these purposes the nature of the observation i.e., by what amount the rating was inaccurate, was it for all the type of calls (Local, STD, ISD) or for any particular type of call, what is the subscriber base on the bill plan, for what time period did the exception continued etc., would help to determine the materiality of the observation;
- Increase in substantive testing; and
- Auditors also need to assess the impact of observations on reporting on Internal Controls under Clause 4 of Companies (Auditor's Report) Order, 2003, as amended by the Companies (Auditor's Report) (Amendment) Order, 2004, issued by the Central Government of India in terms of sub-section (4A) of Section 227 of 'The Companies Act, 1956' of India.

4.52 The impact of the RA observations on audit and further audit work should be clearly documented in the Audit working papers.

Data Analysis

4.53 Data Analysis, is another area where information technology expertise can be leveraged while carrying out audit procedures in a telecom organisation. The basic approach is to identify the conditions that should not be present in the entity's data files, if the controls were working properly. By analysing the

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entity's data, we can identify where controls may not have been working properly or that they have been overridden. Data analysis can be done by designing certain queries which when run on entity's databases will throw up exceptions which can then be further looked into to determine, if there is break down in controls. Many telecom companies have either implemented or are in the process of implementing such data analysis tools. Following are some of the examples of Data Analysis based tests which can be conducted using CAATs:

- Tests to determine if transactions were authorised based on the user responsible for entering transaction,
- Matching of purchase order, invoice and receiving advice,
- Purchase orders present, where required,
- Duplicate transactions,
- Payments for goods or services to vendors not in the entity's vendor master file,
- Invalid dates, or dates outside specified range,
- Lack of required approvals, and
- Identification of transactions passed by a particular ID such as "superuser".

Chapter 5

Audit of Revenue and Receivables

Background

5.1 Few years ago, the telecom sector was relatively easy to define and explain. It comprised of two different types of operators:

- Fixed line (or wireline) operators - That provided traditional phone lines to the home / corporate customers over a copper wire. The major players were State held / government funded corporations;
- Mobile (or wireless) operators - Providing relatively costly mobile phone service to individual subscribers.

The sector has been ever-changing since then, not just in the technology but in the nature of the business. Privatisation has opened the market to newer entrants (the alternative network operators or altnets), thus increasing competition.

5.2 The operators are now focused on the business potential from smaller or niche part of the market. New products and services are being launched every day, for example, IPTV, Mchek, 3G services, bundled offers etc. Healthy competition and strict regulatory regime has forced the operators to:

- Keep a close check on the pricing structures,
- Constantly innovate/ offer customised products & schemes for both market acquisition as well as customer retention,
- Provide best possible customer service, and
- Elaborately spend on promotion of products.

The rate of development of telecom companies together with increasing complexity of the products and services offered, create

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an inherent risk over capturing and measurement of revenue.

Revenue & Receivable - An Inherently Risky Audit Area

5.3 Revenue & Receivables in the telecom industry are inherently risky audit areas due to the following reasons:

- a. Complexity of the systems necessary to capture a billable event (phone call, video download, SMS etc),
- b. Complexity of pricing or tariffing arrangements (depending on destination, time of day; is the service within your monthly allowance/bundle or outside?),
- c. The ever-changing complexity of the offerings available from service providers,
- d. Customer portability, within and across countries, and
- e. Low value and high volume transactions and receivables base.

5.4 Our audit procedures should be focused on getting comfort on the following financial statement assertions:

Revenue	Receivables
Completeness	Completeness
Accuracy	Accuracy
Cut off	Valuation
Valuation	Rights & Obligations
Existence / Occurrence	Presentation and Disclosure
Presentation and Disclosure	

Auditing Revenue & Receivables of Telecom Industry

5.5 The discussion is broadly categorised as follows:

- Products & Services - offered today in the sector, categorised broadly into:

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- Mobile Services,
 - Fixed Line Services.
- Network Overview - structure of a telecom network, to the extent it is relevant to the revenue cycle, again categorised broadly into:
 - Mobile Services,
 - Fixed Line Services.
- Revenue Cycle - explaining its key stages and related risks, and
- Auditing Considerations - Specific financial audit risks and typical audit procedures for each revenue & receivables related account balance in the financial statements specific to telecom industry.

Products & Services

5.6 The products and services in the telecom sector can broadly be split into,

- a. Mobile (or wireless) Services,
- b. Fixed line (or wireline) Services.

Mobile (or wireless) Services

5.7 Definition - A communication network that links two or more mobile devices (handset) by a radio based technology within the area of coverage. The main advantage of mobile or wireless communication is the mobility of the user, since both the terminal (handset) used and access to the telecom network are basically independent of a fixed location.

Types of Operators

Following are the different type of operators other than traditional mobile network operators:

- a. *Joint Operators*: Operators that provide both fixed line and mobile services. For example BSNL, MTNL, Bharti Airtel, Reliance etc. Conventionally, many of these operators have managed the fixed line and mobile operations as if they were two separate businesses. This trend is starting

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to change as these operators consider taking the 'quad play' (phone, broadband, IPTV and mobile) proposition to the market. Many companies are indicating they will merge management teams and offer seamless services;

- b. *Mobile Virtual Network Operators (MVNOs)*: A Mobile Virtual Network Operator is a company that does not own a licensed frequency spectrum, but resells wireless services under their own brand name, using the network of another mobile operator. It is effectively the equivalent of a reseller in the fixed line sector. For example, Virgin Mobile, etc. MVNOs tend to service the prepay mobile market as they do not own the sophisticated infrastructure to develop and offer more advanced 2.5G and 3G services. The billing relationship between the MVNO and its customer is often managed by the mobile operator whose network the MVNO is utilising to deliver service.

Types of Products and Services

- a. Voice - In addition to the basic telephony service, offers often include free add-ons such as call waiting, call identifier and messaging service. Some mobile operators are starting to offer VoIP through partnerships with companies such as Skype,
- b. Video Calls,
- c. SMS,
- d. MMS,
- e. Content download,
- f. Internet Access, and
- g. Television.

Fixed Line (or wireline) Services

5.8 Definition - A fixed communication network physically links two or more static devices (telephones, facsimile machines, computers, television) by electric cable (copper) or optical fibre. Originally the fixed telephone network was an analogue network, which generally only carried voice traffic. Gradually the technology

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has moved towards digital networks. Operators have invested significant amounts in the construction of integrated digital networks capable of carrying data traffic as well as voice.

Types of Operators

- a. *Incumbents*: Traditionally every country had one fixed line operator which was government owned the PTT. Deregulation has resulted in the break-up of these monopolies and the sector has experienced increased levels of competition and innovation. The traditional government-owned operators are referred to as incumbents;
- b. *Alternate Network Operators (Altnets)*: The newer entrants are called alternative network operators or “altnets”. Examples of these operators in India are Bharti Airtel, Reliance etc;
- c. *Resellers*: Incumbents and altnets have constructed and own their network infrastructure. There are also service providers who do not own network infrastructure. These companies purchase capacity from either the incumbents or altnets and resell it to their customers. Such service providers are generally referred to as resellers. Resellers tend to develop territory to territory and are not global or regional brands. Currently, there are no such resellers in India.

Types of Products and Services

- a. Home
 - Voice Service - Also known as Plain Old Telephone Services (“POTS”) available on fixed or mobile phones. Offers often include free add-ons such as call waiting, call identifier and messaging service;
 - VOIP - Similar to voice service except that voice conversations are routed over the Internet or through any other IP-based network. The calls can be routed to a laptop or IP compatible phone. The costs of longer distance and international calls are

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much lower than a traditional voice service;

- Internet Access - This may take the form of:
 - Dial-up - the customer uses a modem to connect a computer to a telephone line and dials into an Internet service provider's ("ISP") node, for example, MSN or Yahoo, to establish a modem-to-modem link, which is then routed to the Internet;
 - Digital Subscriber Line (DSL) - technology that provides digital data transmission over the wires of a local telephone network.
- TV - Increasingly, telecom operators are moving into the entertainment business by offering subscription or pay per view TV access. For fixed line operators, this is generally through IPTV. For mobile operators it is through DVB-H.

b. Business

- Leased Lines - These are physical symmetric telecom lines connecting two locations (A and B) together, each side of the line being permanently connected to the other. They are suited for high-volume traffic, and can be used for telephone, data or internet services. The leased lines are often referred to as "point to point" circuits. They are increasingly being replaced by VPN;
- Virtual Private Network (VPN) - This is a private communications network that connects multiple sites securely. It is often used within a company, or by several companies or organisations, to communicate confidentially over a publicly accessible network. Now that encryption technologies have developed, it is no longer necessary to have dedicated fixed point-to-point circuits. Many corporates are opting for the VPN;
- Facsimile (FAX) - This is a relatively more economic offering as the telecom company does

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not need to build dedicated lines from A to B. It can use the existing network to offer the service to its customer, hence making it more cost effective. Though not the latest technology, faxing stills plays an important role in business in transmitting paper documents between companies; and

- **Hosting and Managed Solutions** - Hosting is a managed service that runs internet servers, allowing organisations and individuals to access internet content, using either the telecom operator's servers or their own servers located in the telecom operator's data centre. There are various levels of service and various kinds of solutions offered.

Types of Customer - Both Mobile and Fixed Line Services

5.9 There are three main types of customers serviced by both fixed line and mobile operators. These are:

- *Residential or retail customers* - the main services used by retail or residential customers include voice, Internet access, texting and content downloads;
- *Corporate customers* - the needs of a corporate customer are very different to those of a private customer. They can range from small and medium size enterprises (SMEs) to large corporations employing thousands of people; and
- *Other telecom operators* - no telecom operator in the world has an end-to-end network that connects every person or corporation. Yet we all expect to be able to make a call or send an email to anybody in the world. In order to be able to connect us, telecom operators interconnect with each others networks to carry phone calls and data. Accessing other operators networks is called interconnection for fixed line operators and roaming for mobile operators.

Billing Methods

5.10 Following are the billing / charging methods currently

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prevailing in the telecom industry:

- Connection/Installation - One-off fee charged when the customer signs up for service with a new telecom service provider;
- Call charges - Calculated according to the duration, type and destination of phone usage. These are usually billed in arrears on each invoice. Per call rates may vary from customer to customer depending upon the bill plan opted;
- Per event charges - Billed for each time the customer sends a text message (SMS) or picture message (MMS) or downloads content. These are usually billed in arrears on each invoice;
- Bundled offer - The customer receives a monthly allowance of minutes, texts, downloads etc., for a fixed monthly charge; and
- Line rental - Fixed amount billed periodically as set out in customer's contract. These are usually billed in advance on each invoice.

Table - Billing: An illustration of a bill raised to a customer

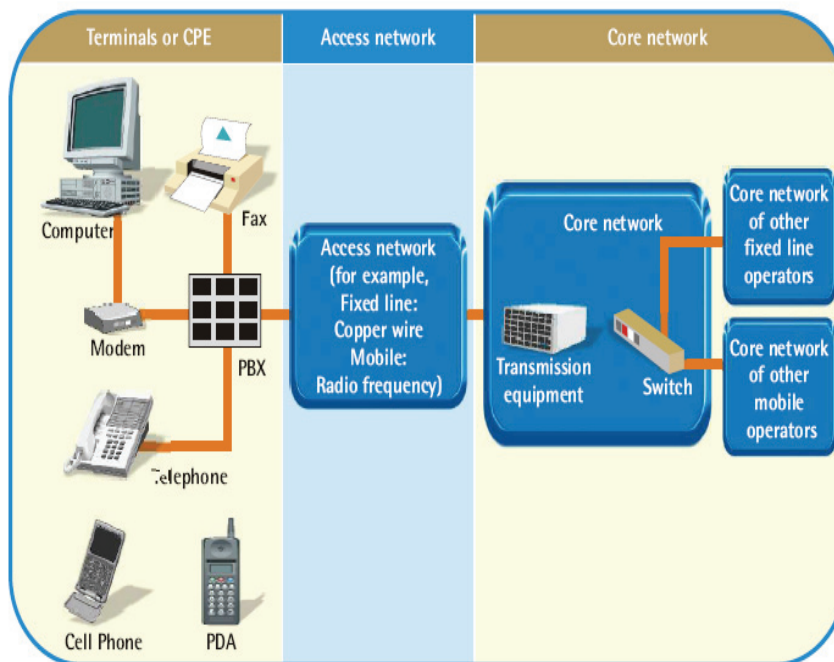
Account Summary				
Previous Balance (Rs.)	Payments (Rs.)	This Month's Charges	Amount Payable by Due Date (Rs.)	Amount Payable after Due Date (Rs.)
5,710.98	5,711.00	4,525.86	4,525.86	4,675.86
This Month's Charges				
One Time Charges				0.00
Monthly Charges				295.00
Usage Charges				
Call Charges				1,395.41
Value Added Services				126.60
Roaming				2,289.88
Credits				0.00
Discounts				0.00
Adjustments				0.00
Late Fee				0.00
Total Charges				4,106.89
Service Tax				410.76
Education Cess				8.21
This Months Charges				4525.86

Network Overview

5.11 A telecom network is a very complex computer system. Indeed, the pace of ongoing technological change means that this complexity is increasing by the day. Here we will simply outline the major components, particularly where they are relevant to the revenue cycle.

Generic Network Structure

5.12 Mobile and fixed line network structures are distinct from each other. However, there are certain components which are common in both. A generic network structure consists of three components, as shown in the diagram:



5.13 *Terminals or Customer Premises Equipment (CPE):* Customers access the network using a terminal. This is often a handset, but it could be a fax machine, computer, PDA device, Cable TV set-top box etc. Terminals are sometimes referred to as Customer Premises Equipment "CPE".

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5.14 *Access Network*: The access network is the direct point of connection between the phone (terminal) and the network. If using landline then the access network is likely to be the phone line (copper wire or fibre optic cable) that runs from home or office. If using mobile then the access network will be wireless, transmitting call by means of radio frequencies.

5.15 *Core Network*: Once there is access to the network, the phone call (or text message, email) will generally flow through the core network to its destination. The core networks of fixed line and mobile operators are similar and generally include the following components:

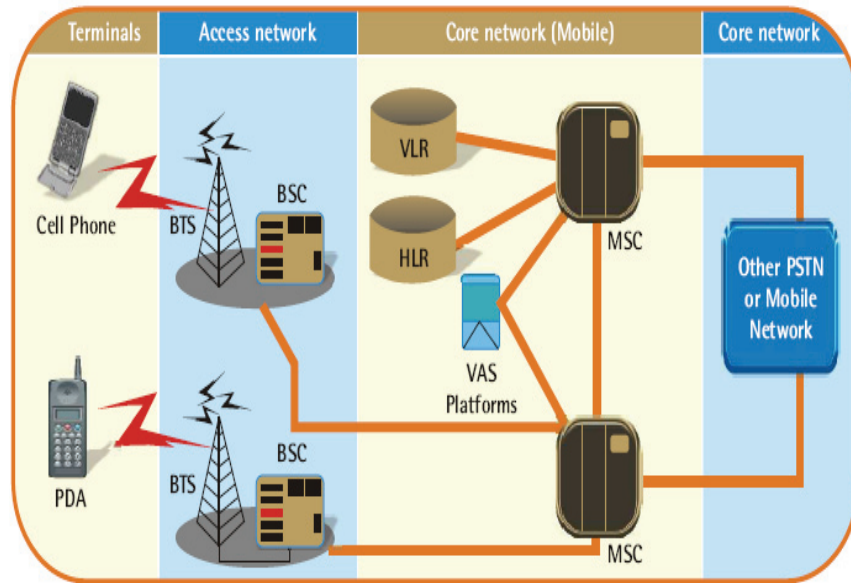
- Switching equipment - The switch captures important billing information for voice calls and also determines the route of calls;
- Transmission equipment - This enhances the capacity of the infrastructure;
- Infrastructure such as cable and duct - This is core infrastructure that carries the traffic across the network.

Mobile Telecom Network

5.16 The basic components of a Mobile Telecom Network are illustrated in the diagram below:



Flow in a Mobile Telecom network



5.17 Each of the components of the flow in mobile telecom network has been explained as follows:

1. **Terminals:** Mobile networks are accessed using a mobile phone or similar hand-held device. Terminals are increasingly used for receiving and sending data. The types of terminals would include mobile handsets, data cards etc. Any mobile handset would have the following major components:
 - a. *Subscriber Identity Module (SIM)* - Smart card which carries all the subscriber specific information. Its major functions include identification of the current user of the mobile network / handset, storing personal information of the user, permanent storage of subscriber's IMSI and Authentication key (Ki), semi permanent storage of system information e.g. current Location Area Identity (LAI), telephone directory, short messages etc.;
 - b. *Mobile Equipment (ME)* - ME provides the radio

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and processing needed to access the GSM network, plus a Man Machine Interface (MMI) to enable the user to access services. Specific functions include serving as a radio transceiver, power control, call handling, man-machine interface, display, keypad, speech transducers, interfaces to external equipment e.g., laptops, palmtops etc.

2. **Radio Access Network (RAN):** The mobile access network, which is virtual or wireless, is referred to as the Radio Access Network (RAN). The RAN is a collection of cell sites that overlap. As we walk along and talk on a mobile phone, the phone call is handed over between the cells to ensure the continuity of the call.
3. **Base Transceiver Stations (BTS):** BTS provides GSM radio coverage within a cell. It comprises of radio transmitting and receiving equipment (including antennas) and associated signal processing. Its specific functions include radio transceiving and signal processing. A mobile phone accesses the core mobile network by means of radio signals transmitted by Base Transceiver Stations (BTS), sometimes referred to as mobile masts. In 3G networks, the BTS equivalent is called a Node B. A BTS contains the equipment for transmitting and receiving radio signals (transceivers), antennas, and equipment for encrypting and decrypting communications with the Base Station Controller (BSC).
4. **Base Station Controller (BSC):** BSC connects the BTS to the Mobile Switching Centres (MSC). It is a small switch with enhanced processing capability. It acts as a local concentrator of traffic and provides local switching to effect handover between a number of BTSs. Its responsibilities include co- ordination and control of a number of BTSs, traffic concentration and low level switching operations. The BSC not only provides a physical link between the MSC and BTS or Node B, but

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also manages the call and control radio frequency power level in the BTS or Node B. A number of BSCs can be served by a single MSC.

5. **Mobile Switching Centres (MSC):** MSC is an ISDN switch with significantly enhanced processing capability. An MSC will parent a number of BSCs and is responsible for call handling of the mobile subscribers within its domain. This includes generating call charging records for billing. Specific responsibilities of the MSC include generation of call records and inter BSC & inter MSC handover of calls. The MSC captures important billing information for voice calls and also determines the route of calls. The functions of the MSC are the same as those of the switch in the local exchange of the fixed line network.

The call details / data recorded in MSC is called Call Data Record. The CDRs include:

- A – number,
- B – number,
- Start time,
- End time,
- Kb (Data) used, and
- Others.

Further, the types of CDRs include:

- Mobile Originating Call MOC (Billable),
- Mobile Terminating Call MTC (Non Billable in Home Circle),
- SMSMO – Billable,
- SMSMT- Non Billable other than when in form of Content,
- Call Forwarding Billable,
- Emergency Calls Police, Fire Brigade etc.,
- Transit Calls, and
- Roaming Calls.

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6. **HLR and VLR:** The MSC validates the identity of the subscriber before connecting the call by drawing information from two key databases: the Home Location Register (HLR) and Visitor Location Register (VLR).

HLR is an intelligent database and service control function responsible for management of each subscriber's records and control of certain services. It is a central database that contains the details of every SIM card issued by the mobile operator that is authorised (provisioned) to use the network. It carries subscription details for a subscriber and location information enabling the routing of calls. Responsibilities of the HLR include management of service profiles, mapping of subscriber identities (MSDN, IMSI), execution of supplementary service logic e.g., barred incoming and passing subscription records to VLR.

When a person makes a call, the HLR validates whether the customer can access the network or not. When a person receives a call, the HLR will also work out where the person is geographically located and tells the network which cell to send the call to, so that the person receives it.

The VLR is a similar mechanism that handles calls when customer is in another country / region. VLR is an intelligent database and service control function. It stores (on a temporary basis) the information needed to handle calls set up or received by sets registered with it. This includes their International Mobile Subscriber Identities (IMSI), current Location Area Identities (LAIs) and supplementary service entitlements.

7. **Intelligent Network (IN):** An Intelligent Network is a telephone network architecture in which the service logic handling a call is located separately from the switching facilities. In an Intelligent Network (IN), the logic for controlling telecom services migrates from traditional switching points to computer-based, service- independent platforms. This provides network operators an open platform provisioned with generic service components that

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can interoperate with elements from different vendors. This platform can be used to develop new and different services. IN platforms can capture non-voice usage services such as content downloads, ringtones etc. IN generally works in the following way:

- a. Once a call is originated, the switch determines whether it is a normal call or a call for an IN service;
- b. This is done based on a profile information obtained from the HLR;
- c. A normal call is completed as usual by connecting to the called party;
- d. If it is an IN call, the switch then queries the IN control point asking for further instructions; and
- e. The IN completes its processing, e.g., checks the validity of the pre-paid card and then instructs the switch to complete the call.

Access Techniques in a Mobile Network

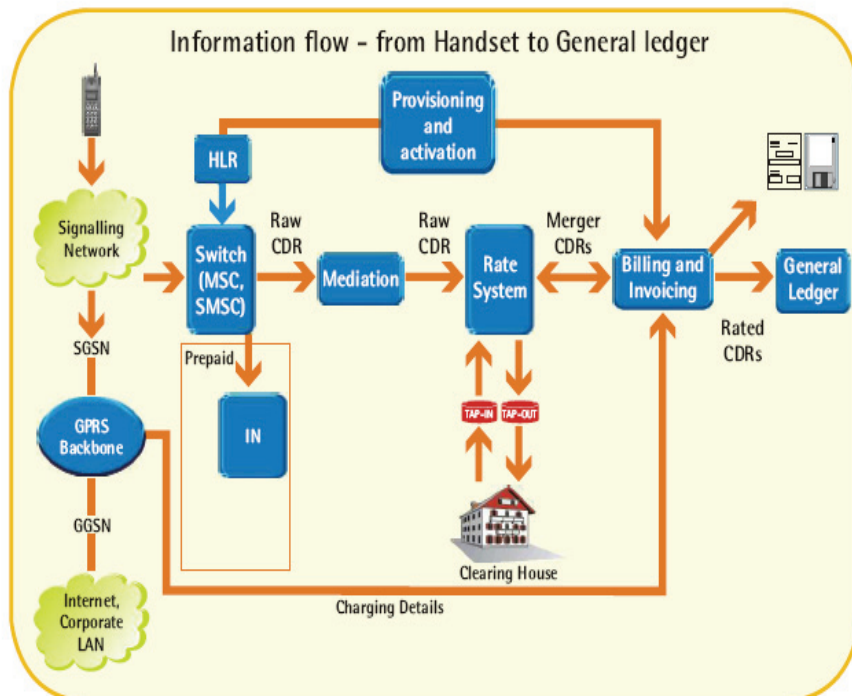
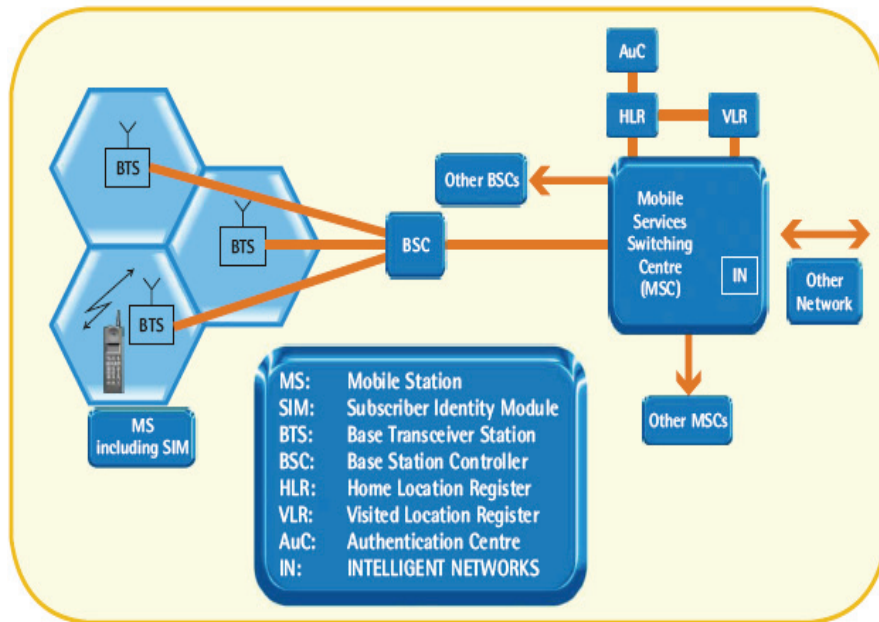
5.18 Different access techniques in a mobile network are:

- a. *Global System for Mobile communications (GSM)*: Under this access technique, the set of standards are set by European Telecommunication Standard Institute specifying the infrastructure for cellular services. This technique is getting used in more than 200 countries; and
- b. *Code Division Multiple Access (CDMA)*: Radio signals associated with a call are spread across a single broad frequency spectrum. Each call in the spectrum is differentiated from other calls in that spectrum by assigning a unique code to each call's signal.

Route of a Call Route - from Handset to MSC

5.19 The route of each call has been illustrated in the diagram below:

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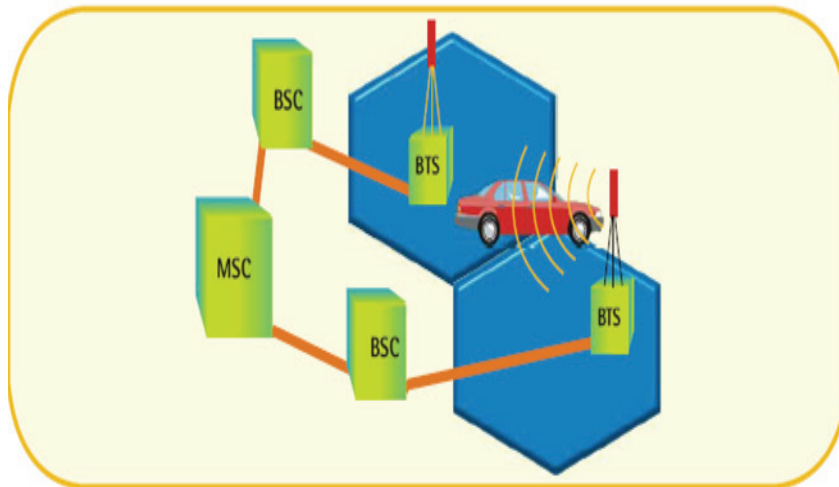
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Switching of an on-going call to a different channel or cell

5.20 A call is continued, without any interruption, even if the customer moves from one BTS's range to another. The Continuity of the call is managed by a call handover process. There are four phases of a call hand-over:

- a. Base Station Controller (BSC) decides a hand-over is needed, as the customer is going out of the range of the BSC,
- b. A Second mobile connection is established, with another BSC in the range which the customer is moving into,
- c. The MSC connects to new mobile connection, and
- d. The initial mobile connection is closed.

Following picture illustrates the call handover process:



Roaming on mobile networks

5.21 When a mobile network sends traffic to a fixed line network, this is also called interconnect. Roaming is a variant of interconnect where mobile telephone customers are granted access to other networks either locally (national roaming) or abroad (international roaming), without physical connection of the

two networks. Provided the two operators have a roaming agreement, customers are allowed to access the other network while abroad. The operator in the host country will charge your service provider when you access its network, either to make or receive calls. Your operator then charges you roaming fees, even to receive calls. Therefore, mobile operators will have both roaming revenues as well as roaming costs, in addition to those from interconnect.

Fixed Line Networks

5.22 Each of the components of the Fixed line network has been explained as follows:

1. *Terminals or Customer Premises Equipment (CPE)*: In fixed line networks, CPE generally includes landline telephones, modems, Cable TV set-top boxes and private branch exchanges (PBX). At home, customer generally accesses the fixed line service provider through a land line phone (connected through the phone jack). Fixed line service provider's network may also be accessed via a PC and modem for internet service. In office, probably access to fixed line service provider's network is generally made via land line phone, fax and through PC;
2. *Local Loop*: The access part of a fixed line network is fixed, providing a physical link between the terminal and the rest of the network. At home generally the access to the network is made through a copper wire running from customer premises to the local exchange (switching centre). This copper wire is often referred to as the "local loop" or "last mile". In office, access to the network is generally made through a dedicated leased line or Virtual Private Network (VPN). The access will typically be over a fibre optic cable.
3. *Core Network*: The Core network includes:
 - Switching equipment / IN Platforms
 - Transmission equipment
 - Infrastructure such as cable and duct.

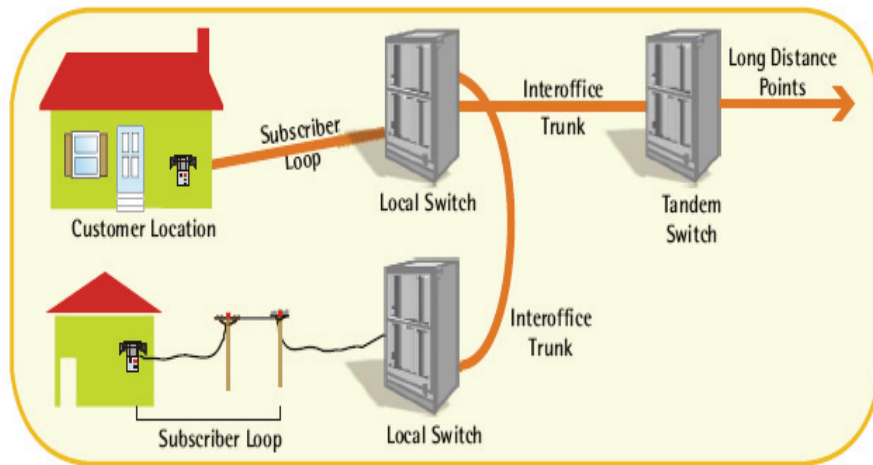
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Types of Network

1. Switched Network
2. Dedicated Circuits.

5.23 Switched networks consist of customer premises equipment, the subscriber loop, local and tandem switches and trunks between switches.

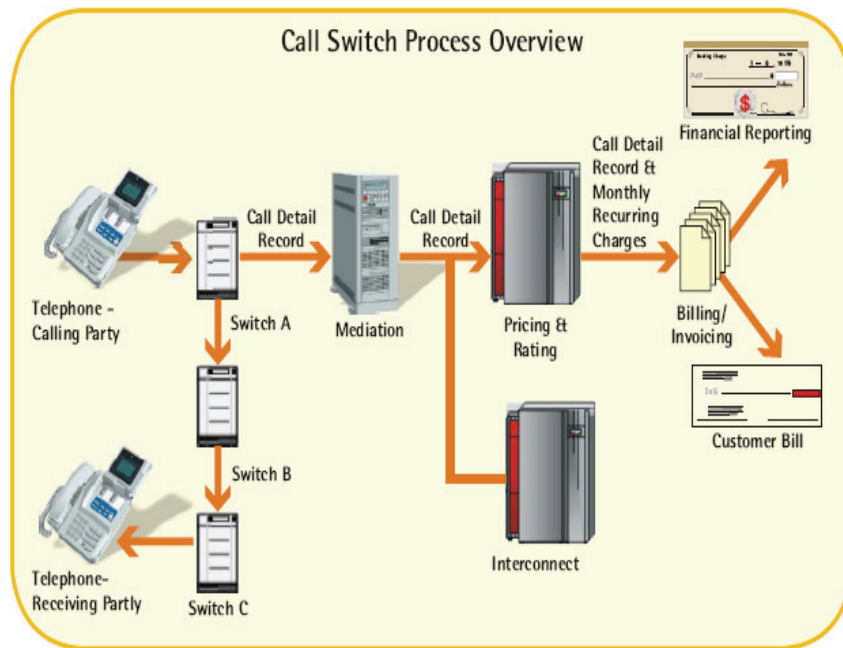
The network flow of a switched network is illustrated in the diagram below:



An end user may reach any other end user anywhere on the network by dialling a telephone number.

- a. Public switched network Allows any end user to reach any other end user. This is “open” in the sense that access is not restricted to only members of a particular user group; and
- b. Private switched networks Allows end users to reach only other end users that are members of a “closed” group. Typical call routing relies on dialling fewer digits than are needed in the public network.

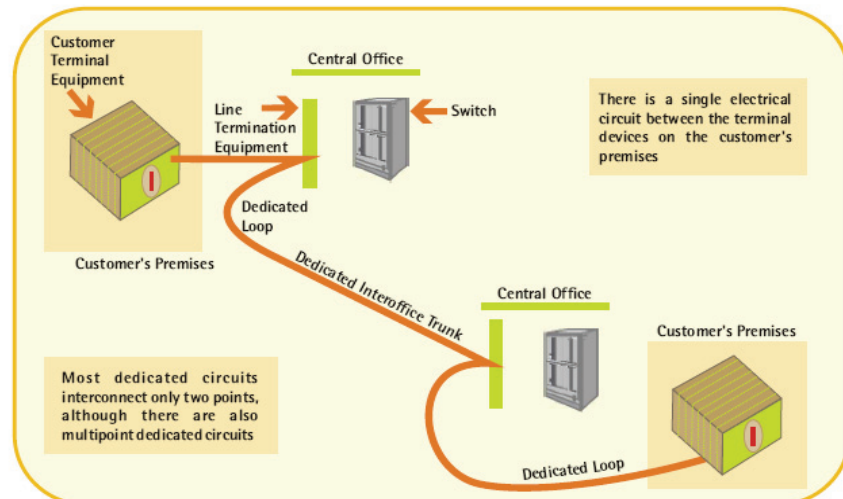
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Dedicated circuits

5.24 The end user may only reach the destination at the other end of the same circuit. No switching takes place.

The network flow of a dedicated circuit is illustrated in the diagram below:



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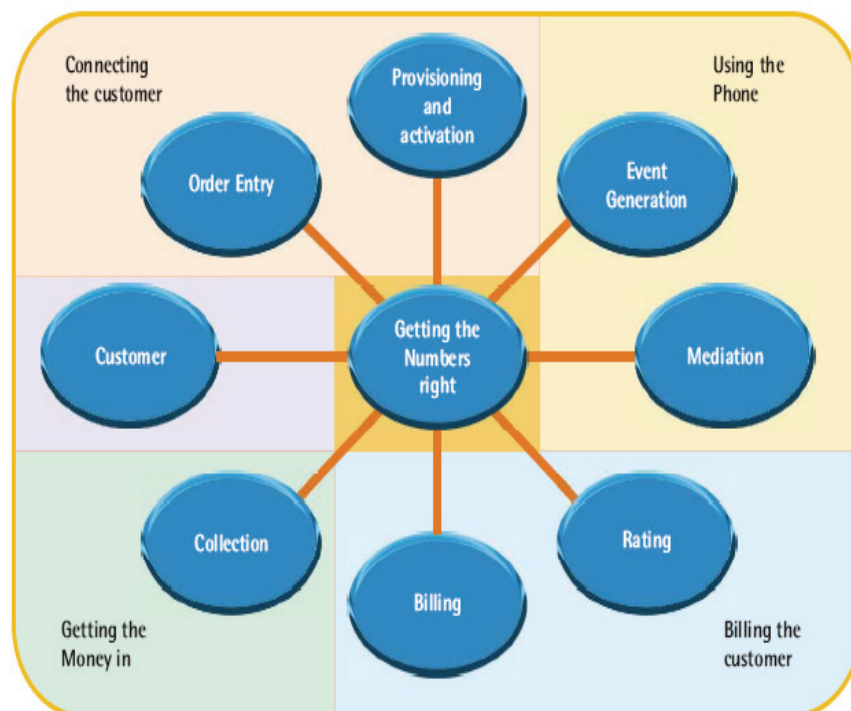
Revenue Cycle

5.25 In order to provide high-quality services and bill its customers, a telecom company needs to have a number of sequentially interlinked processes in place. These processes are known as the Revenue Cycle.

These processes start and end with the customer. They all need to run correctly in order to retain happy customers, and derive revenue from them.

The components of the revenue cycle apply to both small and large telecom operators. The main differences relate to the number and complexity of the services provided. This will have an impact on the processing capacity of the systems, and the complexity of the internal control mechanisms required to monitor the effectiveness and efficiency of the processes.

5.26 Revenue Cycle has been illustrated as below:



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5.27 As it becomes clear from the above diagram that the Revenue Cycle has 5 main stages:

- a. Connecting the customer,
- b. Using the phone,
- c. Billing the customer,
- d. Getting the money, and
- e. Getting the numbers right.

Connecting the Customer

Stage 1: Reaching the Customer and offering products

5.28 For the products to be sold, each company needs to perform certain sales & marketing activities, to make the product attractive and reachable to the customers. Following are the example of few sales and marketing assurance questions:

- How are new products developed? Who can develop them?
- How is new pricing approved?
- What ensures all new products & services can be utilised by our customers?
- How do you know the billing systems have been updated with the correct products or pricing?
- How do we know what commissions we need to pay our dealers?

Each of the decisions above may have direct /indirect implications on the audit.

Stage 2: Connecting the Customer - Order entry

5.29 For this process to be successful, the companies need to ensure that they have recorded the required details completely and accurately. These include:

- a. Name and address
- b. Pricing plan

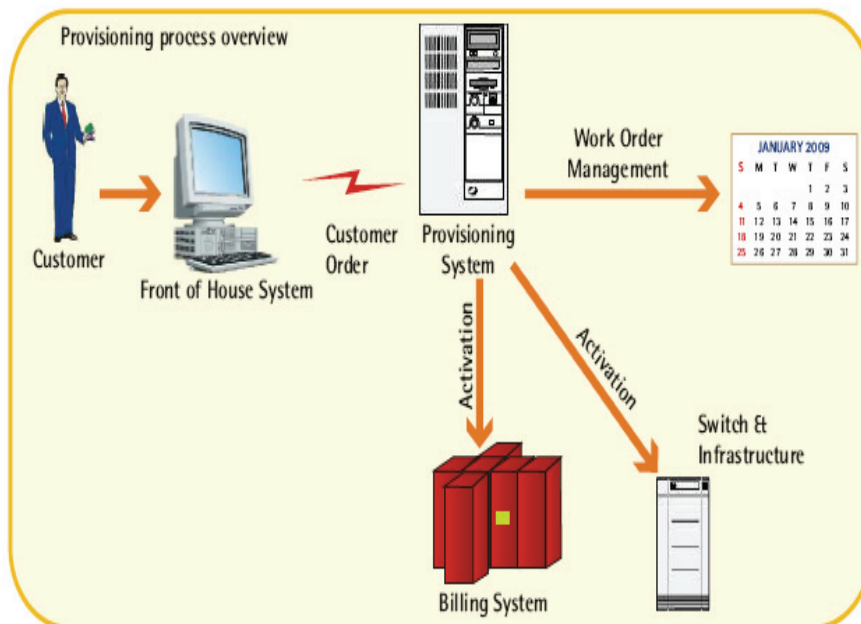
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- c. Billing details
- d. Equipment to be included
- e. Location
- f. Starting time of the services - based on time (if any) required to install and activate equipment, verify identification proofs, creditworthiness and assigning credit limits (if any).

Stage 3: Connecting the Customer - Provisioning and activation

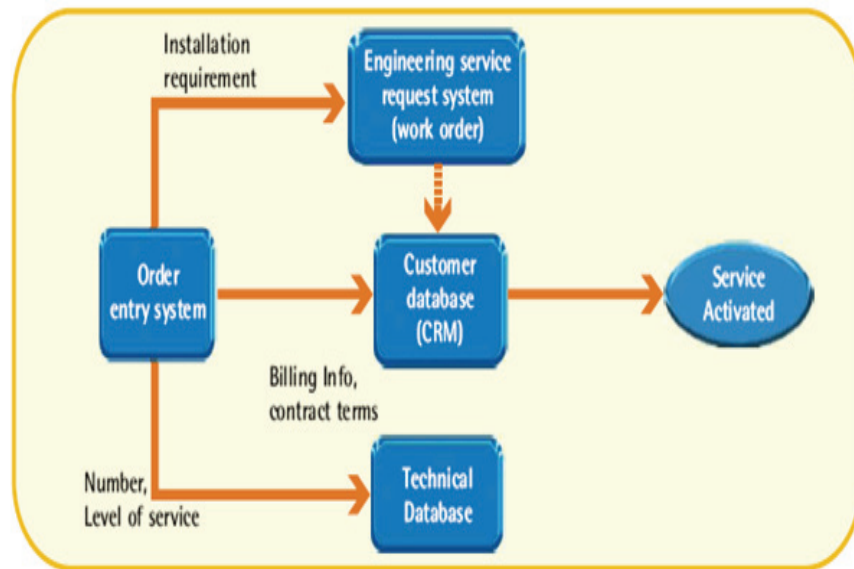
5.30 Provisioning is the process by which the customer is activated on the network for service. It is the process of successfully completing a customer's 'request for service'. Provisioning generally involves the following activities:

- Logging the service request,
- Providing the infrastructure to meet the service request,
- Integration of the service into the network, and
- Update of the billing systems for the new service.



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5.31 It is also the process by which customer details are input to the other business support systems- CRM, technical database billing etc.



5.32 Following are the examples of assurance questions in relation to provisioning:

- How do we ensure the customer has been provided with the correct products and pricing?
- How do we know what products and services are available for the customer?
- How do we know the customer is not a credit risk?
- How do we know we are charging/quoting the customer the right amount?
- How do we determine all the necessary information has been captured?
- What ensures a customer is being billed for the services they are using?
- How do we know we are not billing a customer for a service/product that we haven't delivered?
- How do we know the service has been activated?

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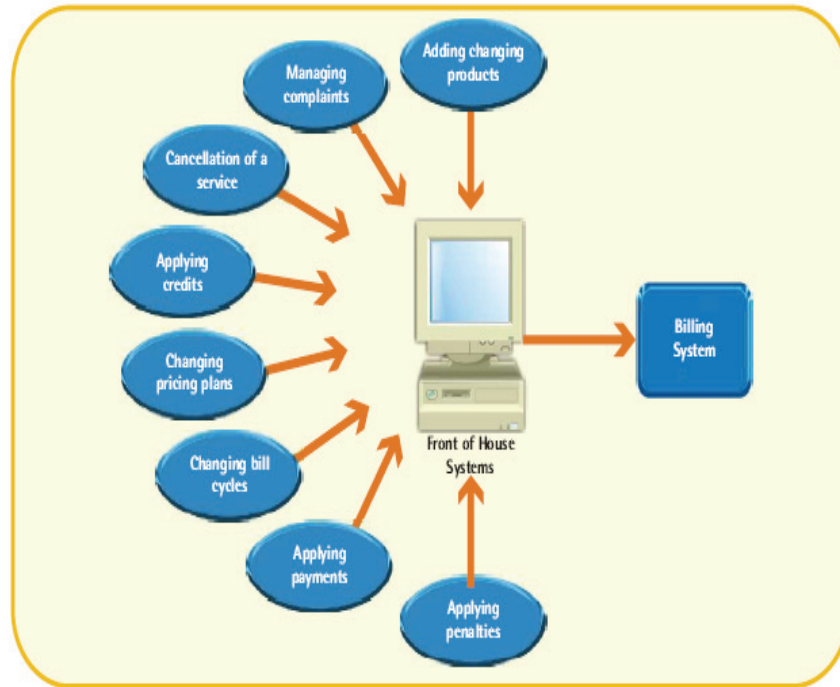
5.33 Activation of the service that is technically possible or ready for service ("RFS"), may be carried out automatically via the switch or the HLR. To provide more complex services, this will require engineer involvement, which will involve some additional complexity and time.

5.34 Pre-provisioned: In some cases, the telecom operator will reserve phone numbers and complete the necessary procedures to provision the SIM card on the various operating system platforms before a customer has requested the service. This allows telecom operators to activate new customers more quickly when they request service. If you move into a new house that already had telecom service, then generally the phone connection will have been provisioned before, hence connection is quicker.

5.35 Provisioning mobile customers: As mobile phone customers are not physically connected to the network, the phone's SIM card is the mechanism by which the customer's service is activated onto the network. Every SIM number in the world has a unique number so only one customer can be connected to one network via a SIM. The SIM may already be pre-provisioned when the handset is shipped to the store. Once the phone is switched on, the customer is automatically connected to the network. This is often the case with handsets included in a prepaid packs.

Otherwise the assistant in the store needs to call the operator's customer services department with the SIM number so that the handset can be provisioned to the network.

5.36 *FoH Activities*: There may be certain other interventions / activities by the Customer care team (in other words Front of house (FoH) activities), which may affect the provisioning process/ other components of the revenue cycle. Some of the FoH activities which may affect the Revenue cycle are illustrated below:



5.37 Some of the assurance questions in relation to FoH activities/ customer care are:

- Were the changes appropriately approved?
- Was the person authorised to make the change?
- Are changes to services and credits approved?
- How do we know all changes will get processed and end up on the customers bill?

Using the Phone

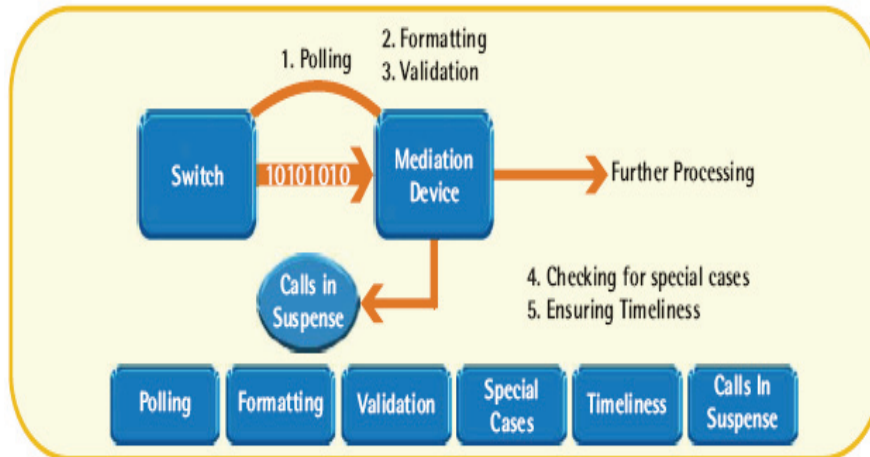
Stage 4 and 5: Using the Phone - Event generation processes & Mediation

5.38 For voice, systems used to record event information are based around the Switch, basically a large computer that not only routes and manages the calls, but also records all events generated by that switch. The Call Detail Record (CDR) captured

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by the switch represents the start of an accounting record for financial reporting purposes.

The key aspects of this process are shown in the diagram and explained below:



- Polling** - All CDRs recorded in all the switches must be transferred to the information processing and billing systems in a complete and timely way, on a fixed schedule this is known as polling. The mediation device polls the switches on a regular basis to send over the CDRs for processing via strict polling schedules;
- Formatting** - Since every switch manufacturer uses its own technology, the mediation device translates the files retrieved from the switches into a uniform format. This is called the formatting process;
- Validation of the CDRs**- Validation means that all fields of a CDR are checked, whether these contain values that are to be expected. If the mediation device is unable to repair an incomplete CDR, it will drop these in so-called suspense buckets or error buckets for further manual or automatic processing before transferring back into the regular process again. The mediation process is furthermore

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essential to monitor the accurate content of the CDRs at the beginning of the process, since, the further incorrect CDRs progress through the rating and billing process, the more difficult and costly it will be to restore or delete the CDRs, particularly if the volumes are high;

- d. *Checking for special cases* - The mediation device also checks whether there are duplicate files and connects CDRs that are related such as very long calls or calls over different time periods for which more than one CDR was generated;
- e. *Ensuring timeliness* - Customers will not accept that their events are only being charged months after the actual date of the event. This is particularly the case with international roaming charges for calls being made while being abroad. There are mostly arrangements in place whereby CDRs have to be provided to the home country telecom company within a specific time frame. CDR files are therefore verified on the sequential numbering and date of the content; and
- f. *Calls in suspense (error buckets)* - Whenever the mediation is unable to format or validate a CDR, it will “drop” these CDRs in an 'error bucket' for further analysis and restoration. This mostly requires manual interface and judgement on whether the CDR should be restored or deleted.

5.39 Following can be examples of assurance questions in relation to Switch & Mediation. Main focus is on the completeness & accuracy of the call capture and transferring this information to down stream systems:

- What ensures all calls are captured?
- How do we know the correct information has been populated in the call record?
- How do we ensure all call records are collected & distributed to downstream systems for billing?

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- How do we ensure the calls are sent to the correct downstream system?
- How is the reference data within the switch maintained?
- How are reference table changes made?
- Who is authorised to make changes in reference tables (if any)?
- How are errors investigated?

Billing the Customer

Stage 6: Rating

5.40 After the mediation device has ascertained that only uniform and complete CDRs are being used, the CDRs are transferred to the rating engine. The rating system computes the cost of the event based on the information contained in the CDR in combination with the rating table and the line number databases that maintain the number ranges of the telecom company. The cost is then inserted in the appropriate field in the CDR.

5.41 This system uses rating tables to represent the standard price plans from the telecom company. The rating tables may be very complex, depending on the number of tariffs and conditions the telecom company has set up. Rates may depend on the time of the day (peak, off-peak), the network used (on-net, off-net), origination (roaming), the destination (zone, local, interlocal, regional, national, international/country), type of event (regular, 0800, 0900, content), set-up costs, etc. These rate tables do not contain any information about specific arrangements with the customers. The rating engine therefore only rates the CDRs based on standard tariffs, without taking into account any flat rate, free minutes or other discounts plans agreed with customers. This will be done later in the billing system based on the (individual) pricing plans for each customer.

5.42 Following can be examples of assurance questions in relation to rating:

- How are rate table changes made?

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- Who has access to make changes to rating and pricing tables?
- How do we know we have applied the correct call rate?
- How do we ensure all calls are rated and priced?
- How do we ensure the correct customer pricing is included?
- How are errors investigated?
- How do we know filtered records should not be billed?

Stage 7: Billing

5.43 Telecom companies normally have hundreds of thousands to millions of customers who need to receive their invoices on a periodical basis, mostly monthly, bi-monthly or quarterly. To be able to process these invoices on a timely basis, most telecom companies use billing groups/cycles to divide the customer base up into manageable sizes.

5.44 The first group will receive their bill at the start of the month, while the last group will receive the bill at the end of the month. At the end of the month the first billing group will therefore have 30 days of unbilled events that will only be billed at the start of the next month. The system that calculates and formats the bill is called the billing system. This system pulls the standard rated information from the storage system, the pricing plans and billing formats, per customer from the customer database and calculates the costs as per the pricing arrangement.

5.45 As with the rating engine, this system generally requires extensive and reliable computing capacity, based on the complexity of the pricing plans and the size of the client base. The billing system retrieves the data stored after the rating process, and then uses it to calculate and format the bill to be sent to the customer, in accordance with the pricing plan agreed upon.

5.46 Following can be examples of assurance questions in relation to billing:

- Have all calls been billed?

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- Are all customers being billed?
- Are all physical invoices produced?
- How do we monitor the billing process to ensure all tasks are undertaken?
- Are all the charges on the bill valid?
- Are the non-usage charges accurate?
- Have all the non-usage charges being applied - including recurring and non- recurring charges?
- How do we know the bills look right?

Getting the Money

Stage 8: Getting the money in - Collection

5.47 With millions of customers, the telecom company may have a large number of total outstanding invoices with relatively small amounts per invoice. The outstanding balances can be quite substantial. Payments made by customers need to be credited against the outstanding balances. Given the nature of the balances, an automated system using direct debits is preferable for telecom companies. In practice, in some territories, the number of direct debit customers may be relatively limited, and manual activities may still be required to process other forms of payment, such as cheques and telephone debit card payments.

5.48 In order to control the outstanding debtor balances, the telecom companies require a system that monitors the outstanding balances on a continuous basis and that supports the company to take appropriate actions when payments terms are exceeded. This system or process is generally called a dunning system. However, collection issues can also arise with customers acting in good faith, for example, where the customer does not agree with the invoice or is dissatisfied with service. In these instances, it is important that the telecom company has a good customer relations department that will take timely and

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appropriate action to resolve any complaints, thus managing and mitigating the risk of non- payment from these types of customers. Often in these cases the customer will be given a credit (goodwill or otherwise) that will be applied on the following month's bill.

5.49 During the collection process, the telecom company has to deal with a large number of customers with bills that are relatively small in value. The total balances can therefore be large and collection of overdue payments might be a very tedious process. Accordingly, each telecom company has to maintain a long & penetrating collections network, which can either be in-built or outsourced to a professional agency or based on an agency model where there could be commission based representatives collecting on Company's behalf.

Getting the Numbers Right

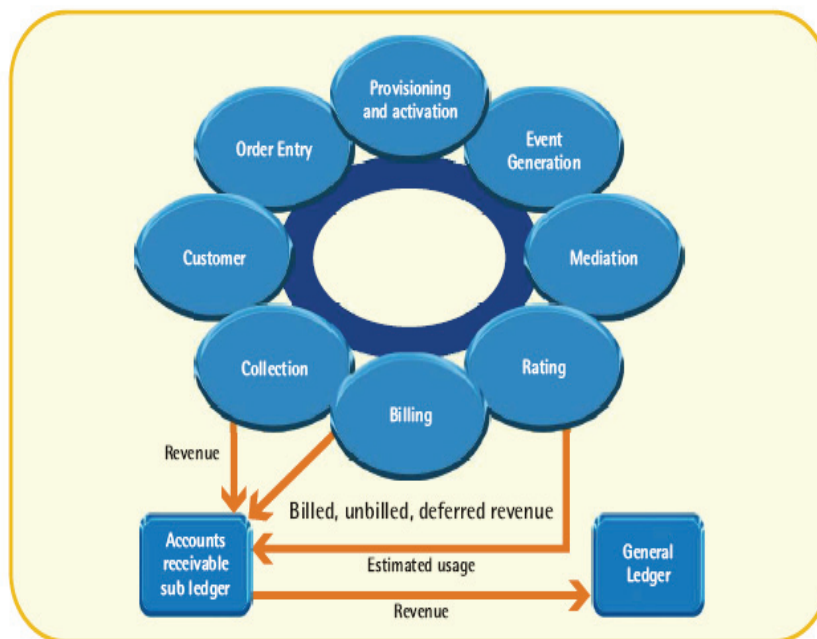
Stage 9: Getting the numbers right Accounting for the Financial Impact / Financial Posting

5.50 This is the final stage of the Revenue Cycle. It involves recording of revenue numbers in Financial books. For auditors other than system specialists, probably this stage is the starting point for the audit of revenue.

5.51 Accounting for the revenue normally takes place based on information from the billing and collections systems. Revenue postings are broken down by:

- Product,
- Usage or network & connection,
- Billed & unearned.
- Billed & earned, and
- Un-billed & earned.

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5.52 Following can be examples of assurance questions in relation to financial posting:

- How do we know the revenue postings are correctly classified?
- How do we know all postings have been received?
- Does the sub-ledger and account ledgers reconcile?
- Do the postings appear reasonable? What analysis is performed?
- How do we know the values are correct?

5.53 Aspects to consider for accounting of revenue are:

- a. When revenue is recorded in the general ledger,
- b. Treatment of the different items (specially items of special nature),
- c. Dealing with unbilled revenue,
- d. Analysing the data, and

- e. Automated and manual payments.

Additional Aspects

5.54 Some of the additional aspects are:

- a. Interconnect: when the telecom company has to deal with other networks that are physically connected,
- b. Roaming: when customers travelling abroad use the services of agreed local operators, and
- c. Pre-paid services: They are not billed and therefore have a somewhat different Revenue Cycle.

Interconnect

5.55 Operators interconnect with each other for completion of calls. Types of Interconnect include:

- Local interconnect,
- National / International interconnect, and

Interconnect Usage Charges (IUC) includes:

- Carrier charges,
- Termination charges, and
- Access Deficit charge (ADC).

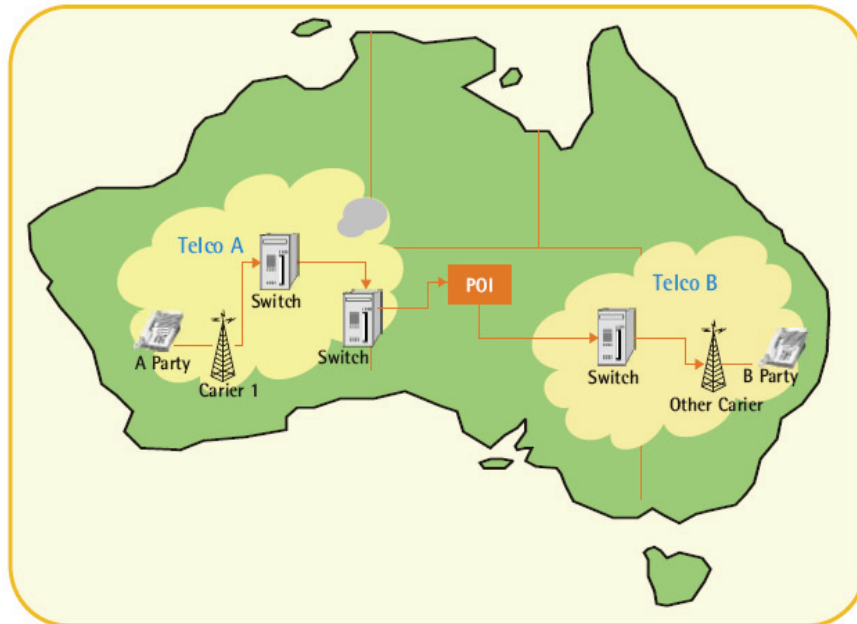
5.56 IUC rates are defined by the Telecom Regulatory Authority of India (TRAI) and are revised from time to time. Interconnect activities involve the following:

- Traffic generated between two physically connected networks is handled by gateway switches, with similar characteristics to ordinary switches, at both ends of the networks. These switches record CDRs that will be used for the billing of originating and terminating traffic between the telecom companies;
- The telecom company of the customer originating the call will charge their customer for delivering the call to the other network. These events flow through the regular Revenue Cycle sub-processes like any other event;

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- The other operator (where the call terminates) will charge home operator (where the call originates) for terminating the call, i.e. for allowing access to its network; and
- The amount billed by the other telecom companies is verified by the home Telecom company by comparing it to the details on its own gateway switch recordings. It is usual for differences to be noted between the operators systems. These can arise for many different reasons and make the audit of both interconnect revenue and interconnect costs difficult and at times judgemental.

Example of an Interconnect



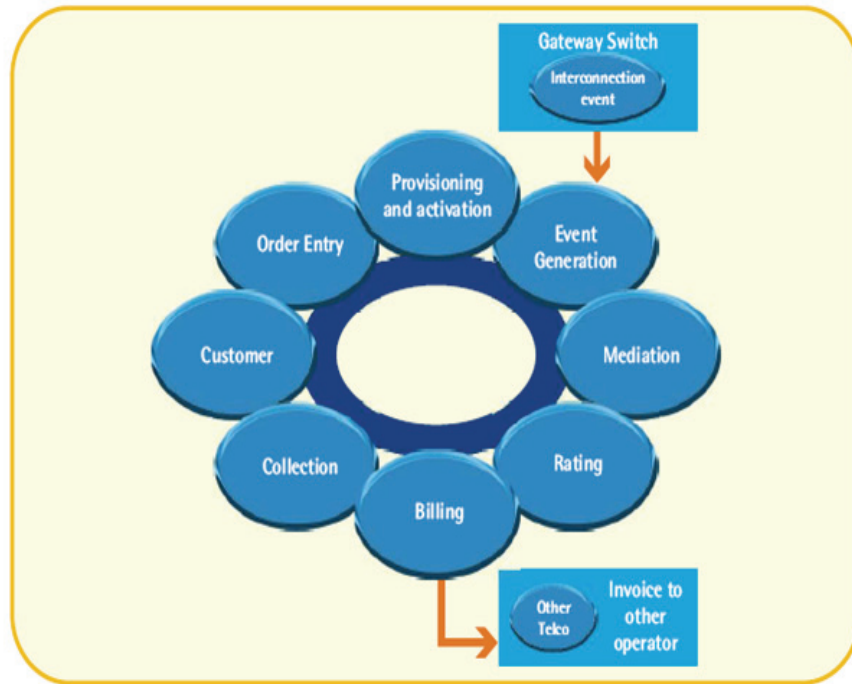
Example's Narration:

- Telco A customer makes a call to Telco B customer,
- This call is forwarded through several switches before being passed through to Telco B via a designated Point of Interconnect (POI),

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- Telco B then terminates the call within it's network, and
- This situation will generate revenue for Telco B and a cost for Telco A.

5.57 Relationship of Interconnect into Revenue Cycle is shown in the diagram below:



5.58 Interconnect - the risks

The main additional risks that relate to interconnect activities are:

- The telecom systems may not have recorded the same information, for example, one or both of the operators dropping CDRs at the switch, the operators cutting off at different dates, hence comparing information that will require specific reconciliation,
- The pricing arrangements may have a number of charging mechanisms that might be misinterpreted by either party. Particularly when large amounts of traffic are running over other networks, the financial impact of disputes can be

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significant.

5.59 Following are the examples of Interconnect assurance questions:

- Are we receiving revenue for all the traffic carried?
- Are the correct rates applied to the call traffic carried?
- Are the records from other carriers valid?
- Do we reconcile all carrier statements?
- Are we receiving all payments in a timely manner?
- Is the amount paid to the other carriers correct?
- Are all records processed end-to-end?

5.60 Auditors should be focused on ensuring that all costs have been recorded and that revenue is not inappropriately recorded. Hence, on the costs side, it is usual to focus on ensuring carrier disputes have been understood and whether the “worst case” cost scenario has been recorded.

5.61 At the same time, the auditor will be focussed on assessing if it is appropriate for an operator to record interconnect revenue on all or part of a balance that is being disputed. In assessing the appropriateness of recording these revenues, we need to consider the evidence in support that it is probable that the cash payment in respect of the revenue will be settled. This is further complicated by the fact that some operators do not settle their interconnect balances with cash. Instead they agree to balance the traffic on a periodic basis.

5.62 As you can imagine, it is very usual for operators to have differences in the data captured by their respective systems. Most operators, either individually or as an industry norm in their territory, have a rule of thumb to agree to settle invoices, provided the difference is below a certain threshold. This could be an absolute amount or a percentage of the balance. The auditor needs to ensure that such periodic settlements are happening and necessary impact in the Profit & loss account has been taken. Conversely, in case the matter is under dispute then based on the information & explanations available, the auditor needs to use its

own judgment and decide whether creation of a provision in the books is necessary.

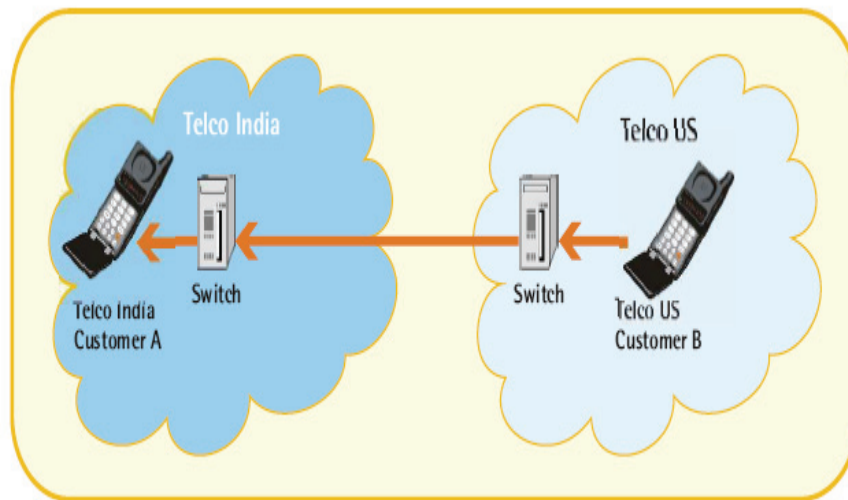
Roaming

5.63 Roaming is a variant of interconnection whereby mobile telephone customers are granted access to other networks either locally (national roaming) or abroad (international roaming) without physical connection of the two networks. The customer is allowed to directly connect to the other network provided that the two telecom companies have agreed to do so. Roaming provides the ability to make and receive voice calls, send and receive data, or access other services when away from the home network.

5.64 Types of Roaming:

- National Roaming from a mobile operator to another mobile operator in the same country; and
- International Roaming onto other foreign mobile operators than your national subscription.

Example International Roaming



Example's Narration:

- A roaming customer is also able to receive calls (local and

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international).

- A fee is applied by the local operator on the calls received by the roaming customer.

5.65 Terminology relating to roaming is explained below:

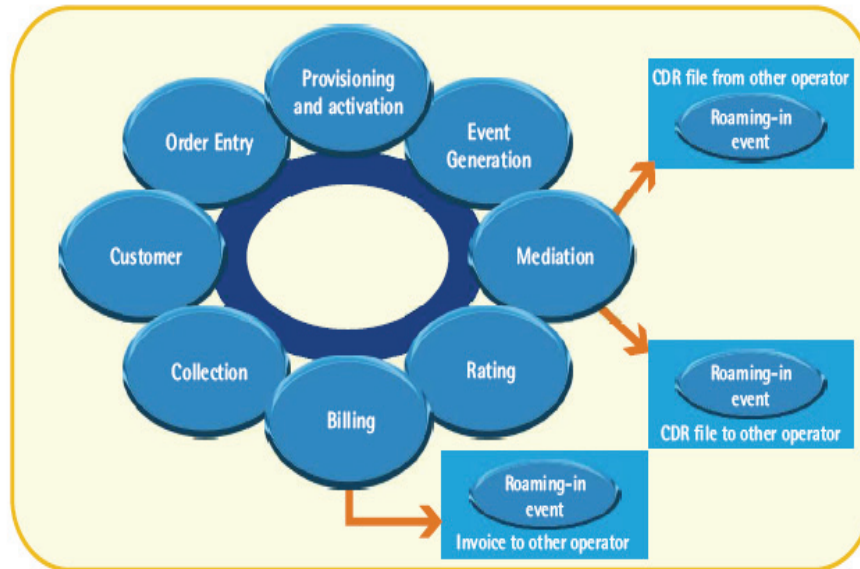
- Home Network : Our Client's Network
- Foreign Network : Any network other than our client
- Inroamer : Subscriber of foreign network coming into the client's network and using it
- Outroamers : Subscriber of the client going to a foreign network and using it
- Tap-in file : A file containing CDRs for your clients Outroamers
- Tap-out file : A File containing CDRs for Inroamers into your clients network
- Clearing house : Central agency co-ordinating Roaming File exchange & settlement between operators. It is an intermediary which helps the Mobile Operators in Roaming Settlement

5.66 Roaming Risks are depicted in the following table:

Risk Examples	Caused Examples
Difficulty of verifying revenue	Charges made through remote independent clearing house
Timeliness of customer billing	Call details submitted to home operator long after call took place
Disputes between operators	Different interpretations of roaming agreements
Regulator intervention	Customer complaints over high roaming charges

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5.67 Relationship between Roaming and Revenue Cycle is shown by the following diagram:



Pre-paid Mobile Services

5.68 The prepaid mobile service Revenue Cycle differs significantly from the post paid Revenue Cycle in several respects, as shown in this modified diagram:



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5.69 Is it not unusual that the controls and processes around tracking calling balances are weak and the customer can access the network for service after the prepaid credit has been depleted. This can result in free service being given and the inappropriate recognition of revenue (because there is no arrangement to bill prepay customers).

Auditing Considerations

5.70 Generally, the following heads under the financial statements get covered during audit of revenue & receivables:

Balance Sheet	Profit & Loss Account
Assets	Income
Subscriber Receivables	Prepaid Revenue
Other Receivables	Post Paid Revenue
Advance Revenue	Roaming Revenue
Unbilled Revenue	Interconnect Usage Charge
Liabilities	Infrastructure Sharing
Provision for bad & doubtful debts	Activation Income
Security Deposit - Subscribers	Processing Fee
Service tax payable	Hardware Sales (VSAT, Sim Cards)
Unamortised License fees	Leased Line Services
	Expense
	Interconnect Usage Charge
	Roaming Expense
	Infrastructure Sharing
	VAS Revenue share
	Dealer Commission
	License fees expense

Specific financial audit risks and typical audit procedures for each revenue & receivables related account balance in the Financial Statements has been explained below:

Balance Sheet

Assets

Subscriber Receivables

5.71 The balance comprises of net receivables from subscribers, for billings done in the normal course of business. The gross receivable balance, i.e., balance outstanding out of actual billings to customers, is to be reduced by the Provision for Bad & Doubtful debts created by the management.

5.72 Following are the audit procedures of special relevance in Telecom industry engagements:

- a. General Ledger (GL) vs. Billing system reconciliation All transactions with and balances of subscribers are recorded in the billing system. However, the financial statements are prepared based on the General Ledger. Therefore it is critical that reconciliations of balances & transactions are prepared and reviewed by the management on a regular basis. And the reconciling items are properly accounted for / adjusted in the books.

Audit procedures should include testing the reconciling items in the balance reconciliation and ensuring that there are no adjustable reconciling items which remain unadjusted as at the year end and which may materially affect the true & fair view of the financial statements. Generally, following are the valid reconciling items in GL vs. Billing system balance reconciliation:

- i. Waiver Posted in the billing system but not recorded in general ledger: Normally waivers are recorded in GL based on billing to the customer. However, the effect of waiver takes place in the billing system, as soon as it is posted. Accordingly, the waivers posted after the last billing date for the respective bill cycle, till the period end form a reconciling item in the GL Vs Billing system reconciliation. In case the Company follows a policy

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for accruing such waivers, then there is a possibility that this reconciling item may even not appear in the reconciliation.

The amount for such reconciling item is determined based on Waiver Reports from the billing system.

- ii. Late payment charges (LPC) The Company may have a policy of recording Late payment fees as revenue in GL, only on actual receipt basis. However, the Late payment fees once charged to a customer remains in the billing system. Accordingly, LPC billed but not recovered till period end may form a reconciling item.

The amount for such reconciling item is determined based on mapping of subscriber-wise collection details with the respective outstanding LPC amounts.

- iii. Bad Debts written-off Bad Debts entry may be passed in GL in one month, but the corresponding impact in the billing system may come in the next month leading to a reconciling item in the GL vs. Billing system reconciliation.

The amount for such reconciliation item is determined based on approved subscriber-wise details for bad debts written off, identified from system based report in accordance with the Company's policy.

- iv. Grossing up of negative balances - Negative balances of subscribers are grossed up in GL for disclosure purposes. However, net amounts still continue to appear in the billing system. Accordingly, to the extent balances are grossed up form a reconciling item.

The amount for such reconciliation item is determined based on subscriber- wise balance

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reports extracted from the billing system.

- b. Provision for Bad & doubtful debts: Generally, the nature of receivable balances in a telecom industry is such that there are low value high volume receivable balances. Accordingly, reasonable assessment of the recoverability of such balances becomes critical.

Provision for Bad & doubtful debts is created in accordance with Company's policy in relation to the same. Following are the general guidelines for testing:

- i. Generally, companies follow a policy of creating provision for debts older than certain age limit. The ageing buckets are obtained from the billing system reports. The auditor may test the accuracy of the ageing buckets. Auditor may also test the configuration of ageing reports obtained from the billing system;
- ii. Further, the auditor should insist obtaining original reports from the billing system and re-perform / get re-performed the provision calculation in his presence;
- iii. Subscriber-wise adjustment for security deposits (if any) should be ensured while calculating provision as the amount is adjustable at the time of final recovery from the customer;
- iv. Service tax reversal on the amount determined should also be ensured.

Other Receivables

5.73 The balance comprises of net receivables from customers other than subscribers. The balance includes receivables from other operators on account of roaming, Interconnect usage charges (IUC), infrastructure sharing etc., and from Channel partners.

5.74 Following are the audit procedures of special

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relevance in Telecom industry engagements:

- a. Account balance reconciliation Companies generally follow a time cycle for reconciling the balances with IUC & roaming parties. Our audit procedures should include testing the reconciling items in the latest possible reconciliations by reference to the respective source documents and assessing the possible impact on financial statements. Further, regularity of settlements should be given weightage while using professional judgment for assessing the possible financial impact.
- b. Provision for Bad & doubtful debt - Other receivables balance mainly includes balances receivable from other operator for roaming, IUC, infrastructure sharing etc. Following are the items of special relevance in telecom industry:
 - i. The balances generally being material and number of operators being limited, the auditor may assess recoverability of all outstanding balances;
 - ii. Settlement schedule / Settlement pattern with each operator should be carefully analysed. Operators with which settlements are not done on a regular basis, should be reviewed closely for provisioning purposes;
 - iii. The auditor may insist for balance confirmations from the operators / data clearing house;
 - iv. The Company may follow provisioning based on ageing of balance. In that case, the auditor may test the accuracy of the ageing buckets;
 - v. The auditor should insist obtaining original reports from the system and re- perform / get re-performed the provision calculation in his presence;
 - vi. Generally, terms of agreement with the operator allows for adjustment of receivable balances against corresponding payable balance (if any). The auditor may refer to terms of agreement and

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ensure that necessary adjustments have been made while computing provision for bad & doubtful debts;

- vii. There may be an arrangement for 'only gross settlement with the operator', i.e, payable balances are not allowed to be adjusted against receivable balance. In such cases, both receivable and payable balances should be considered separately and assessment for provisioning should be done individually;
- viii. There may be an arrangement for settlements amongst operators for 'only adjustment against transactions', i.e. without any cash settlement. The auditor may analyse the transaction pattern with the operator and assess the reasonability of the provision created against the outstanding balance; and
- ix. Service tax reversal on the amount determined should also be ensured.

Advance Revenue / Income received in Advance / Advance Billing and Prepaid Card Revenue

5.75 This balance comprises of revenue received in advance on account of:

- a. Advance billings to post-paid customers For instance, Company may have a policy to bill the bill plan rentals one month in advance or there may be a bill plan where rental for specific period may have been taken upfront in advance;
- b. The unutilised balance of prepaid customers;
- c. The unutilised balance out of amounts recovered from dealers for e-recharges/ other online services,

5.76 Following are the audit procedures of special relevance in Telecom industry engagements:

- a. Revenue recognised out of advance revenue should

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include:

- i. Time based pro-rata amount attributable to the current year - out of the revenue collected during the year; and
- ii. Time based pro-rata amount attributable to the current year - out of the revenue collected in the previous years.

It should be ensured that the amount recognised as revenue should not be greater than the amount actually collected/billed.

- b. Prepaid subscribers - System vs. General Ledger (GL) reconciliation: All transactions with and balances of prepaid subscribers are recorded in the prepaid customer's system. However, the financial statements are prepared based on the General Ledger. Therefore it is critical that reconciliations of balances & transactions are prepared and reviewed by the management on a regular basis. And the reconciling items are properly accounted for / adjusted in the books.

5.77 The audit procedures should include testing the reconciling items in the balance reconciliation and ensuring that there are no adjustable reconciling items which remain unadjusted as at the year end and which may materially affect the true & fair view of the financial statements. Generally, following are the valid reconciling items in GL vs. Prepaid customer's system balance reconciliation:

- i. Market Stock of recharge vouchers The Company may follow an accounting policy of recording prepaid liability as soon as a recharge voucher is sold in the market (primary sale). However, the balance in the system gets affected only when the recharge voucher is utilised by the customer (tertiary sale). Accordingly, there will be a reconciling item in the balance reconciliation relating to Recharge coupons sold but not yet utilised by the end customers and are still lying in the market.

The amount for such reconciling item is determined based

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on reports obtained from the prepaid system, showing the activation status of recharge vouchers issued.

- ii. Market stock start up kits Similar to recharge vouchers, there may be a reconciling item relating to recharge component in Start-up-kits for prepaid customers.

The amount for such reconciling item is determined based on reports obtained from the prepaid system, showing the utilisation status of recharge vouchers issued.

- iii. E-recharges by prepaid customers in circles other than the home circle: A Company may follow an inter-unit settlement cycle different from the period closure dates. Accordingly, a system GL reconciliation on a date other than the inter-unit settlement date, may lead to a reconciling item relating to transactions recorded in system post the inter-unit settlement date till the reconciliation date. Reason being the transactions post inter-unit settlement date would affect the system balance; however the transactions in the GL would be recorded in the next inter-unit settlement cycle. Such reconciling item may not arise in case the company follows a policy of provisionally recording such inter-unit entries and also in case the inter-unit settlement date is the same as reconciliation date.

The amount for such reconciling item is determined using system based Recharges report received from other circles, filtered based on the home circle's customers being the recipient of the recharge transaction.

Unbilled Revenue

5.78 As explained earlier, owing to large number of subscriber's telecom companies divide the post-paid customer base into different bill cycles having different billing dates. However, the general ledger is generally closed on a particular date which is different from the billing cycle dates. Accordingly, following the accrual concept, companies accrue the unbilled revenue for usage by customers between the last billing dates till the general ledger closure date.

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The billing systems generally provide with unbilled reports as on a particular date. The audit procedures may also include the following:

- i. Comparing the balance with the proportional revenue computed based average revenues from bill runs in the recent past.
- ii. Comparing the balance with unbilled revenues booked in the previous GL closure, adjusted with extra-ordinary items / events and normal growth rate.

Liabilities

Provision for Bad & Doubtful debts

5.79 This balance comprises of provision created based on management's estimate of receivable balances considered to be doubtful for recovery / non-recoverable. The audit procedures in relation to Provision for bad & doubtful debts has already been discussed above along with subscriber & other receivables.

Security Deposit Subscribers

5.80 Telecom companies generally accept Security deposit from post-paid subscribers, which is refundable / adjustable at the time when the subscriber churns out of the network. Generally, a subscriber-wise detail of such security deposit is maintained in the billing system for post-paid subscribers. Entries in the General ledger are passed manually based on such reports and that too after specific time intervals.

5.81 General Ledger (GL) vs Billing system reconciliation All transactions with and balances of subscribers are recorded in the billing system. However, the financial statements are prepared based on the General Ledger. Therefore it is important that reconciliations of both balances as well as transactions are prepared and reviewed by the management on a regular basis. And the reconciling items are properly accounted for / adjusted in the books.

5.82 The audit procedures should include testing the reconciling

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items in the balance reconciliation and ensuring that there are no adjustable reconciling items which remain unadjusted as at the year end and which may materially affect the true & fair view of the financial statements. Ideally, there should not be any reconciling items in this GL vs Billing system balance reconciliation.

Service Tax Payable

5.83 Service tax is chargeable on each transaction involving delivery of a taxable service. Service tax is deposited to the concerned authority only on recovery from customers. At the time of billing to customer, the service tax is recorded under Service tax payable account. The amount continues to appear as a liability till the time the corresponding receivable balance is collected from the customer.

Movement in Service Tax Payable Account

5.84 The auditor may gain comfort over movement in Service tax payable balance. Following are the items of special relevance:

- Credits in GL's service tax account are recorded based on system based reports for both prepaid & post-paid customers;
- Debits are in the form of payments to authority. The amount of payment is again determined based on collections report from the billing system for post-paid subscribers. For Prepaid subscribers the payment amount is determined based on sales summary report. Generally, collections are also mapped with actual collections in bank; and
- Opening balance may be verified from previous year's financial statements.

Service Tax Rationalisation

5.85 The closing balance of service tax payable may be correlated with the corresponding receivable balance. The closing receivable balance applied with the applicable service tax rates, should give out the closing service tax payable balance.

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Unamortised Licence Fees

5.86 Some Telecom companies had paid one-time telecom licence fees / entry fees. Generally such entry fee gets amortised over the period of licence. The charge for each year is computed and entries in GL are passed based on amortisation calculations. The auditor may refer the licence documents and other related correspondence to:

- Verify the amount, licence period etc., and
- Ascertain whether there are no terms & conditions which may affect such amortisation.

Profit & Loss Account

Prepaid Revenue

5.87 The balance comprises of revenue from prepaid customers on account of call usage, rentals, roaming rentals, value added services usage, balance forfeiture etc. A transaction by a prepaid customer gets recorded on an almost real time basis in the prepaid customer's billing system. Entries are periodically made in the GL based on specific reports received from the system.

5.88 Prepaid revenue recorded based on specific reports extracted from the system may be cross checked for reasonability by comparing the revenue balance with the derived revenue computed based on movement analysis of the Prepaid customer's advance revenue balance.

Overall prepaid revenue (containing all revenue components) derived using Prepaid customer's advance revenue balance is computed as follows:

Opening Prepaid customer's advance revenue balance :	XXXX
Add: Recharges made during the year :	XXXX
Less: Closing Prepaid customer's advance revenue balance :	XXXX
Derived prepaid revenue :	XXXX

Post Paid Revenue

5.89 The balance comprises of revenue from postpaid customers on account of call usage, rentals, roaming rentals, value added services usage, other charges etc, net of billing level adjustments & waivers. A transaction by a post-paid customer gets recorded on real time / batch processing basis in the post-paid billing system. Entries are periodically made in the GL based on specific reports received from the system (e.g., Billing summary report, adjustment report, etc.).

Roaming Revenue

5.90 Customers are allowed usage while roaming beyond their home territory. The network operator whose network is utilised while roaming, bills the home operator at agreed rates. Accordingly, roaming revenue for any operator would be revenue from usage of its network by subscribers of other operators. The other operator may be national/international. All rates are determined based on specific agreements & legal regulations.

5.91 Generally, settlements within operators for all roaming transactions, in the normal course of business, are done through a data clearing house specifically appointed for the purpose. Entries are recorded by all the operators based on report from the data clearing house. Further, balance reports are also circulated by the clearing house on a regular basis for confirmation / reconciliation.

5.92 Roaming revenue may be cross checked by reference to Tap-out reports sent by the data clearing house.

Interconnect Usage Revenue (IUC revenue)

5.93 Customer of one operator is allowed to make calls to customers of other operators. The billing is done only by the operator from whose network the call was generated. However, for a call to complete, the other operator's network also gets utilised. However, the other operator has no right to bill the call originating customer. Accordingly, the other operator bills the home operator an Interconnect usage charge for all calls originating from home operators network & terminating in its

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network.

5.94 The IUC revenue for a particular operator would include a charge on operator, at an agreed rate, for all calls originating in any other operator but terminating in its network. IUC revenue is recorded periodically based on reports from a system used particularly for tracking & billing IUC revenue & cost.

5.95 Following are the audit procedures of special relevance in Telecom industry engagements:

- a. IUC revenue booked may be analysed by applying the standard rates on time duration summary reports extracted from the system; and
- b. As already discussed along with IUC debtors, the audit procedures should include testing the reconciling items in the latest possible account balance reconciliation / settlement, by reference to the respective source documents and assessing the possible impact on financial statements. Regularity of settlements should also be given due importance.

Infrastructure Sharing Revenue

5.96 In telecom industry, huge capital is required to create the network for providing telecom services. In order to minimise the requirement of huge funds for building up costly infrastructure, for reaching out to new consumers and to control costs in view of declining tariffs, the telecom operators are resorting to sharing of infrastructure. Sharing of infrastructure is a method wherein two or more telecom companies create a pool of passive infrastructure, i.e. Towers, Dark Fiber etc., and make use thereof on payment of agreed charges on the basis of quantum of usage.

5.97 The infrastructure sharing on fair, transparent and commercial terms ensures that consumers get choice of service, quality as well as affordability. On the other hand, the operators get an attractive commercial proposition and an opportunity to expand coverage & reach of their services.

5.98 Companies share infrastructure including towers, facilities,

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etc. with other operators. The operator having the ownership/ right over the property, bills infrastructure sharing cost (both capital & operating expenditure) to the operators availing the facility. Infrastructure sharing revenue / cost is calculated based on the agreed terms & conditions. Entries in the books are made based on such calculations.

5.99 The telecom operators generally have proper agreement for sharing of infrastructure facilities. Network usage details are properly generated and provided along with the bill to the infrastructure sharing partners.

As already discussed along with Infrastructure sharing debtors, the audit procedures should include testing the reconciling items in the latest possible account balance reconciliation / settlement, by reference to the respective source documents and assessing the possible impact on financial statements. Further, regularity of settlements should be given weightage while using professional judgment for assessing the possible financial impact.

Activation Revenue

5.100 At the time of activation of a new customer, companies may charge activation charge to the customers. The amount of activation revenue is calculated based on reports from both Prepaid & post-paid billing systems.

5.101 The auditor may perform substantive analytical procedures for activation revenue. Expected activation revenue can be calculated using activation count reports from the system and standard activation revenue under each plan. Difference between actual and expected revenue may be investigated. Exceptions found during the course of investigation may be disposed off by the auditor using his professional judgement.

Processing Fee

5.102 Companies may charge processing fees from prepaid customers on every recharge made. The amount of processing revenue is calculated based on reports from the prepaid billing system.

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5.103 The auditor may perform substantive analytical procedures for processing fees revenue. Expected processing fees revenue can be calculated using recharge count reports from the system and standard processing fees rates under each type of recharges. Difference between actual and expected revenue may be investigated. Exceptions found during the course of investigation may be disposed off by the auditor using his professional judgement.

Hardware Sales (VSAT, Sim Cards)

5.104 Companies may earn revenue from sale of hardware equipments. Invoicing and recording for such a sale is made in the same way as a normal sales transaction in any other industry.

Interconnect Usage Charge (IUC Expense)

5.105 In the same way as IUC revenue, each operator has to bear an IUC cost. The IUC cost for a particular operator would include a charge on an operator, at an agreed rate, for all calls originating in its network but terminating in any other operator's network. Interconnect Usage Charges consist of following factors:

5.106 Access Deficit Charges (ADC charges): The National Telecom Policy 1999, requires telecom companies to have access to telephony even in the rural areas. Since BSNL was the only service provider in rural areas and its revenues were not enough to cover up the fixed costs, Access Deficit Charges (ADC) have been introduced by TRAI from May 1, 2003 for a limited period to give time to incumbent operators for rebalancing the tariff during a transition period. The ADC regime w.e.f. April 1, 2007 is as follows:

- No ADC on outgoing ILD calls,
- ADC on incoming ILD calls- as may be prescribed from time to time,
- ADC on revenue share of AGR of all Access License, NLD, and ILD - as may be prescribed from time to time,
- Revenue from rural wire-line subscribers will not form the part of AGR for the purpose of ADC, and

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- AGR will be the same as defined in the License except above. Similarly, the payment of ADC based on AGR has to be made on quarterly basis to BSNL by other operators. However the ADC amount of revenue from urban wire-line subscriber will be retained by the respective service providers.

Note: Effective from April, 2008, ADC charges are not applicable for local calls and effective from October 1, 2008, ADC charges are not applicable on incoming ILD calls also.

5.107 Carrier Charges (NLD / ILD charges): The carriage charge is the amount paid to the long distance carrier by the cellular and fixed telephone operator. The carriage cost depends on the distance of the call and IUC agreement between Telecom Companies. The rates may be as prescribed from time to time.

5.108 Call Termination Charges: Termination charges are the charges paid to Mobile Operators for NLD and ILD calls terminating on their network. Every Telecom company has to pay interconnection charges (IUC) on all local/NLD/ILD calls terminating on other telecom company's network as per the schedule of fee notified by TRAI. Similarly it will receive the IUC from other operators for all local/ NLD/ ILD calls terminated on its network on the rates and basis prescribed from time to time.

5.109 IUC Charges are paid as per the mutually agreed terms between the telecom companies and based on reconciliation between CDR data of both the companies. Also, generally telecom companies mutually agree the range of variation below which the payments are made without reconciliations based on CDRs.

5.110 IUC cost is recorded periodically based on reports from a system used particularly for tracking & billing IUC revenue & cost.

5.111 Following are the audit procedures of special relevance in Telecom industry engagements:

- a. IUC cost booked may be analysed by applying the standard rates on time duration summary reports extracted

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from the Interconnect billing system;

- b. As already discussed along with IUC debtors, the audit procedures should include testing the reconciling items in the latest possible account balance reconciliation / settlement, by reference to the respective source documents and assessing the possible impact on financial statements. Regularity of settlements should also be given due importance; and
- c. The auditor may also verify whether there exists a proper system for verification and payment of IUC.

Roaming Expense

5.112 In the same way as roaming revenue, each operator has to bear roaming expenses. Roaming expense for any operator would be a charge for its subscriber's usage of any other operator's network, while roaming out its home territory. The other operator may be national / international. All rates are determined based on specific agreements & legal regulations.

5.113 Generally, settlements within operators for all roaming transactions, in the normal course of business, are done through a data clearing house specifically appointed for the purpose. Entries are recorded by all the operators based on report from the data clearing house. Further, balance reports are also circulated by the clearing house on a regular basis for confirmation / reconciliation.

5.114 Roaming expense can be cross checked by reference to Tap-in reports received from the data clearing house.

Infrastructure Sharing Expense

5.115 In telecom industry, huge capital is required to create the network for providing telecom services. In order to minimise the requirement of huge funds for building up costly infrastructure, for reaching out to new consumers and control costs in view of declining tariffs, the telecom operators are resorting to sharing of infrastructure. Sharing of infrastructure is method wherein two or more telecom companies create a pool of passive infrastructure, i.e. Towers, Dark Fiber etc. and make use thereof on payment of

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agreed charges on the basis of quantum of usage.

5.116 The infrastructure sharing on fair, transparent and commercial terms ensures that consumers get choice of service, quality as well as affordability. On the other hand, the operators get an attractive commercial proposition and an opportunity to expand coverage & reach of their services.

5.117 Companies share infrastructure including towers, facilities, etc. with other operators. The operator having the ownership / right over the property, bills infrastructure sharing cost (both capital & operating expenditure) to the operators availing the facility. Infrastructure sharing cost / revenue is calculated based on the agreed terms & conditions. Entries in the books are made based on such calculations.

5.118 The telecom operators generally have proper agreement for sharing of infrastructure facilities. Network usage details are properly generated and generally provided along with the bill to the infrastructure sharing partners.

5.119 As already discussed along with Infrastructure sharing debtors, our audit procedures may include testing the reconciling items in the latest possible account balance reconciliation / settlement, by reference to the respective source documents and assessing the possible impact on financial statements. Further, regularity of settlements should be given weightage while using professional judgment for assessing the possible financial impact.

Value Added Service (VAS) Revenue share expense

5.120 Companies enter into an agreement with VAS providers, wherein the revenue for VAS usage is shared based on agreed proportions. Billing to customers is done by the operator providing service to the customer. The revenue earned by the operator may be passed on to the VAS provider based on fixed ratio / percentage / any other proportion. Calculations for VAS revenue share cost is done based on the terms of agreements and using reports from the billing systems. Entries in the books are made based on such calculations.

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The auditor may perform substantive analytical procedures for VAS revenue share expense. Expected VAS revenue share expenses can be calculated using VAS usage count reports from the system and revenue share rates for each type of service from each type of vendor. Difference between actual and expected expense may be investigated. Exceptions found during the course of investigation may be disposed off by the auditor using his professional judgement.

Dealer Commission

5.121 The Companies may enter into agreements with agents / channel partners for giving remuneration in the form of commission / percentage of collections / fixed amount per new connection etc. Generally, calculations for dealer commission is done based on the terms of agreements and using reports from the billing systems & reports from the customer service delivery team (if any).

5.122 The auditor may perform substantive analytical procedures for dealer commission expense. Expected dealer commission expense can be calculated by using system reports, customer service delivery reports and commission structure containing rates for each type of transaction with the dealer. Difference between actual and expected expense may be investigated. Exceptions found during the course of investigation may be disposed off by the auditor using his professional judgement.

License Fees Expense

5.123 All telecom companies have to pay licence fees for telecom operations. This may be paid in the form of:

- i. Fixed amount paid upfront at the time of entry into the market, and
- ii. Variable amount calculated based on the revenue.

5.124 Generally, calculations for licence fees expense is done based on the applicable licence fees rates, revenue computation methods, licence period etc.

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5.125 There are guidelines issued by the Telecom Regulatory Authority of India (TRAI) for calculation of Adjusted Gross Revenue (AGR), based on which licence fees payable is determined. Refer Appendix II for a specimen AGR calculation sheet.

Passive Links Charges (Point of Interconnection)

5.126 Every off net call (i.e. calls to other operators network) has to be routed through 'Point of Interconnection' (POI) as per TRAI guidelines. For obtaining POI, port and other charges are payable to other telecom company as agreed, mutually subject to overall ceiling laid down by TRAI. This has following structure:

Port Charges

5.127 All telecom companies can demand POIs from other operators on payment of charges as mutually agreed subject to ceiling laid down by TRAI except BSNL who generally does not pay to other operators but charges for the POIs provided, located at BSNL.

5.128 Entries for port charges in General ledger are passed based on port-wise calculations. The amounts are calculated based on the TRAI guidelines (prescribed from time to time), number of ports utilised and mutual agreements with parties. The Company's technical / network operations team may confirm the number of ports utilised. The same may also be confirmed by the other operator.

Active Link Charges

5.129 In addition to Port Charges, a telecom company has to pay Active Link Charges to BSNL. These are the links of Licensed Telecom Service Providers for which transmission equipment of service provider is installed in BSNL's exchange premises and their network is connected through it. The rental charges of infrastructure in this case have been streamlined and are given below:

- i. *Charges for sharing of building space:* The Licensed Telecom Service Providers are given space (bay) for

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installation of their various equipments. The charges vary based on the category of the city. The rates may be as prescribed from time to time.

ii. *Electricity and miscellaneous charges:* These charges include the sharing of following services:

- DC power at -48V up to 10 A/ transmissions bay,
- AC power for lights, fans, testing instruments etc.,
- Air-conditioning charges (sharing of existing air-conditioning system),
- Generator Backup,
- Earthing charges (Tapping from exchange earth bar is allowed), and
- Fire equipment (Sharing in case of requirement).

Charges for providing these facilities are varying as per the category of city. The rates may be as prescribed from time to time.

iii. *Charges for tower sharing:*

- Charges per antenna may be as prescribed from time to time, and
- The charges are multiplied by no. of antennas in case multiple antennas are installed by Licensed Telecom Service Providers.

iv. *Charges for duct sharing:*

- Telecom operators have to take permission to lay their OFC cable, 50 mm pipe inside the BSNL exchange premises after paying a refundable security;
- All the charges discussed above are applicable w.e.f. 1st April, 2006 with a provision of a prescribed annual increase every year i.e., 1st April, 2007 onwards and are payable in advance every year; and
- Entries for Active link charges in the General

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Ledger are passed based on link-wise calculations. The account balance reconciliation with BSNL may also be looked into for any differential, which may require any provisioning to be done.

However, in case of operators other than BSNL, the aforesaid charges are paid based on mutually agreed terms and conditions.

Passive Link Charges

5.130 Apart from Port Charges and Active Link Charges, telecom operators have to pay following charges to BSNL for providing passive link connectivity for 'Pols' between BSNL and telecom operator:

- Infrastructure Charges for passive links with HDSL modem, and
- Infrastructure Charges for passive link with HDSL modem, with minimum infrastructure sharing charges up to 5 E1s.

The rates of the above may be as prescribed from time to time.

Entries for Passive link charges in the General Ledger are passed based on link-wise calculations. The account balance reconciliation with BSNL may also be looked into for any differential, which may require any provisioning to be done.

The auditor may also verify that the company has applied the ports/other infrastructure based on the proper planning and estimated requirement, so that, the excessive payment is not made for unwarranted infrastructure.

However, in case of operators other than BSNL, the aforesaid charges are paid based on mutually agreed terms and conditions.

Chapter 6

Audit of Fixed Assets

Introduction

6.1 Telecom is a highly capital intensive industry. The industry has seen exponential growth in the last few years with a manifold growth in the subscriber base and expansion in geographical area coverage. Infrastructure of a telecom business holds the key for facilitating end services to its subscribers, whether be it in mobile services, fixed line services, long distance or broadband services.

6.2 Nowadays most of these infrastructure facilities are getting managed by network equipment vendors like Ericsson and Nokia, wherein contracts are entered between the telecom operator (Bharti Airtel Limited, Vodafone Essar, Idea Cellular Limited, etc.) and vendor for designing, planning, supply, installation, commissioning and upgradation of the array of increasingly complex and sophisticated communications and equipments. They also offer telecom IT solutions. The solutions and services portfolio comprises of the remote monitoring of servers, security operations and network operations, providing data centre services (including server hosting, server management and storage management), IT helpdesk services and end-to-end connectivity and fulfilling all telecom and communication requirements.

6.3 The competitive environment for these managed services help ensuring high service delivery and removing operational inefficiencies. The managed services could have the following advantages:

- smooth management of technological complexity,
- opportunity to strengthen core competency,
- reduction in financial outlay, and
- touching base with new processes and technology.

Concepts of Fixed Assets in Telecom Sector

6.4 There are certain industry specific terminologies used in the Fixed Assets of a telecom business which are detailed below for wider understanding of the concepts:

Asset Retirement Obligation (ARO)

6.5 “An Asset Retirement Obligation is a legal obligation (i.e. a liability) for the cost of retiring (i.e. settling) a tangible long-lived asset that results from the acquisition, construction, or development and (or) the normal operation of that long lived asset”. The companies need to recognise the ARO liability in the period in which the asset was acquired. The liability equals the market value, and if that is not available, the present value of cash flows will be required to extinguish the liability. An asset equal to the liability is added to the Balance Sheet, and depreciated over the life of the asset. In Indian scenario, most of the telecom operators are making provision for ARO under the category of 'Plant & Machinery' in their books of accounts.

Erlang

6.6 An Erlang is a unit of traffic density in a telecommunications system. One erlang is the equivalent of one call (including call attempts and holding time) in a specific channel for 3,600 seconds in an hour. The 3,600 seconds need not be, and generally are not, in a contiguous block. In digital communications, the voice signals are compressed. This makes it possible for one channel to carry numerous calls simultaneously by means of multiplexing.

For example, if a group of user made 30 calls in one hour, and each call had an average call duration of 5 minutes, then the number of erlangs this represents is worked out as follows:

Minutes of traffic in the hour	=	number of calls * duration
Minutes of traffic in the hour	=	30 * 5
Minutes of traffic in the hour	=	150
Hours of traffic in the hour	=	150 / 60

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Hours of traffic in the hour = 2.5
Traffic figure = 2.5 Erlangs

6.7 Erlang traffic measurements are made in order to help telecommunications network designers understand traffic patterns within their voice networks. This is essential if they are to successfully design their network topology and establish the necessary trunk group sizes.

6.8 In the Indian scenario, some of the telecom operators have entered into erlang based payment contracts with their strategic vendors/partners who provide infrastructure and managed services.

Provisional Capitalisation

6.9 The concept of provisional capitalisation is unique to telecom industry. To put a 'site on air' or to lay down telephony or broadband cables, there are various hardware equipments, software and services which are involved. All such items / services are required to be capitalised. Usually, the technical department prepares a detailed capital installation report / memorandum which provide details like site configuration, equipments installed (including the numbers of each component), software's utilised and nature of services (electrical, civil work, etc.) for capitalisation etc.

6.10 After capitalisation of such items and services in the system (in the normal course basis the process and accounting discussed above), a site-wise comparison is done between actual capitalisation with the capital installation report / memorandum. Based on this comparison, items pending to be capitalised are determined capitalised in the GL on a provisional basis. This concept of accounting for such identified items and services is known as provisional capitalisation.

6.11 The amount provisionally capitalised needs to be reviewed on a regular basis to ascertain whether the capitalisation has been actualised and uploaded in the Fixed Assets Register. In case all bills have been received, the amount can be reversed in GL.

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Whereas in case no bills have been received and none are expected against such provisional capitalisation, the amount may be considered for a reversal depreciation on provisional capitalisation items and needs to be computed as per the company's policy.

Indefeasible Rights of Use (IRU)

6.12 An indefeasible right of use is a contractual agreement between the operators of a communications cable, such as submarine communications cable or a fiber optic cable and a client. The IRU shall mean the exclusive, unrestricted, and indefeasible rights to use the relevant capacity (including equipment, fibers or capacity for any legal purpose. It refers to the bandwidth purchased after the submarine cable system has sealed the Construction and Maintenance Agreement (C&MA) among owners or after the system came into service and where the un-owned capacity is available. IRU may also be purchased from the existing owner. The right of use is indefeasible, so, as the capacity purchased is also non returnable, maintenance cost incurred becomes payable and inrefusable.

6.13 In plainer language, the purchase of an IRU gives the purchaser the right to use some capacity on a telecommunication cable system, including the rights to lease that capacity to someone else. However, with that right comes, an obligation to pay a proportion of the operating cost and a similar proportion of the costs of maintaining the cable including any costs incurred in repairing the cable after mishaps. Companies that buy a leased line between say, London and New York do not buy an IRU they lease capacity from a telecommunications company that themselves may lease a larger amount of capacity from another company (and so on), until at the end of the chain of contracts there is a company that has an IRU, or wholly owns a cable system.

Last Mile

6.14 The last mile is the final leg of delivering connectivity from a communications provider to a customer. Usually referred to by

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the telecommunications and cable television industries, it is typically seen as an expensive challenge because "fanning out" wires and cables is a considerable physical undertaking. In countries employing the metric (as opposed to the imperial) measurement system, the phrase "last kilometre" is sometimes used. Because the last mile of a network to the user is also the first mile from the user to the world, the word, "first mile" is sometimes used.

6.15 To solve the problem of providing enhanced services over the last mile, some companies have been mixing networks for decades. One example is Fixed Wireless Access, where a wireless network is used instead of wires to connect a stationary terminal to the wireline network. Various solutions are being developed which are seen as an alternative to the "last mile" of standard incumbent telecommunications providers: these include WiMAX and BPL (Broadband over Power Line) applications. Mentioned below are some of the existing last mile delivery systems:

- Wired Systems (including dielectric guides):
 - Local Area Networks,
 - Community Access Cable Television Systems,
 - Optical Fibre.
- Wireless Delivery Systems:
 - Light Waves and Free Space Optics,
 - Radio Waves,
 - One-way (broadcast) Radio and Television Communications,
 - Satellite Communications,
 - Broadcast versus Point-to-Point.

Gateways

6.16 In telecommunications, the term gateway has the following meaning:

- in a communication network, a network node equipped for

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interfacing with another network that uses different protocols;

- a gateway may contain devices such as protocol translators, impedance matching devices, rate convertors, fault isolators, or signal translators as necessary to provide system interoperability. It also requires the establishment of mutually acceptable administrative procedures between both networks; and
- a protocol translation/mapping gateway interconnects networks with different network protocol technologies by performing the required protocol conversions.

Gateways also called protocol convertors can operate at any layer of the OSI model. The job of a gateway is much more complex than that of a router or switch. Typically, a gateway must convert one protocol stack into another.

6.17 Gateways work on all seven OSI layers. The main job of a gateway is to convert protocols among communications networks. A router by itself transfers, accepts and relays packets only across networks using similar protocols. A gateway on the other hand can accept a packet formatted for one protocol (e.g. AppleTalk) and convert it to a packet formatted for another protocol (e.g. TCP/IP) before forwarding it. A gateway can be implemented in hardware, software or both, but they are usually implemented by software installed within a router. A gateway must understand the protocols used by each network linked into the router. Gateways are slower than bridges, switches and (non-gateway) routers.

Local Loop

6.18 In telephony, the local loop (also referred to as a subscriber line) is the physical link or circuit, that connects from the demarcation point of the customer premises to the edge of the carrier or telecommunications service provider network. At the edge of the carrier network in a traditional PSTN (Public Switched Telephone Network) scenario, the local loop terminates in a circuit switch housed in an ILEC (Incumbent Local Exchange Carrier) CO (Central Office). Traditionally, the local loop was wireline in nature from customer to central office, specifically in the form of an

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electrical circuit (i.e., loop) provisioned as a single twisted pair in support of voice communications. However, modern implementations may include a digital loop carrier system segment or fiber optic transmission system known as fiber-in-the-loop.

6.19 The local loop may terminate at a circuit switch owned by a CLEC (Competitive LEC) and housed in a POP, which typically is either an ILEC CO or a "carrier hotel". A local loop may be provisioned to support data communications applications, or combined voice and data such as digital subscriber line (DSL).

6.20 Local loop connections can be used to carry a range of services, including:

- Analog voice and signalling used in traditional POTS,
- Integrated Services Digital Network (ISDN), and
- Variants of Digital Subscriber Line (DSL).

6.21 The term "local loop" is sometimes used for any "last mile" connection to the customer, regardless of technology or intended purpose. Hence the phrase "wireless local loop". Examples of "wireless local loop" are LMDS, WiMAX, GPRS, HSDPA, DECT.

Auditing Fixed Assets in Telecom Industry

6.22 Audit of Fixed Assets of a telecom company would revolve around the following broad categories:

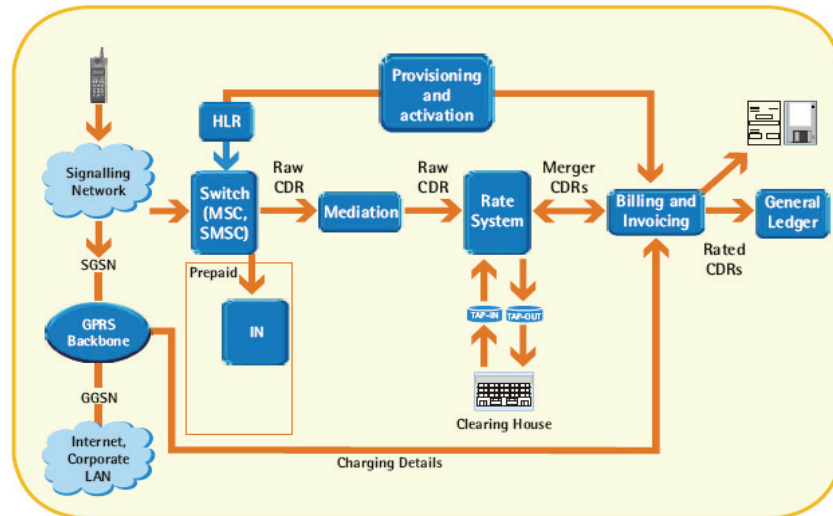
- Network Overview & Network Structure,
- Fixed Assets Cycle,
- Risks in Telecom Fixed Assets Cycle,
- Capitalisation of Fixed Assets,
- Audit considerations,
- Fixed Assets Register,
- Key Reconciliations, and
- Change in Location of Fixed Assets.

Network Overview and Network Structure

6.23 The network of a telecom business is spread into

Mobile

Overview of a Mobile Environment:



6.24 The mobile phone (also called a wireless phone or cellular phone) is a short-range, portable electronic device used for mobile voice or data communication over a network of specialised base stations known as cell sites. This sector which includes voice services, value added and data services such as SMS, mobile internet service, e-mail, conferencing, GPRS service, etc., majorly comprises of the following hardware equipments to facilitate end subscriber services BTS Towers, Radio Antennas, MSC, Green Shelters, DG Sets, etc. Mobile Network can be used without regard to location, using Radio frequencies. There are 2 Multiple Access technologies used in a mobile business which are as under

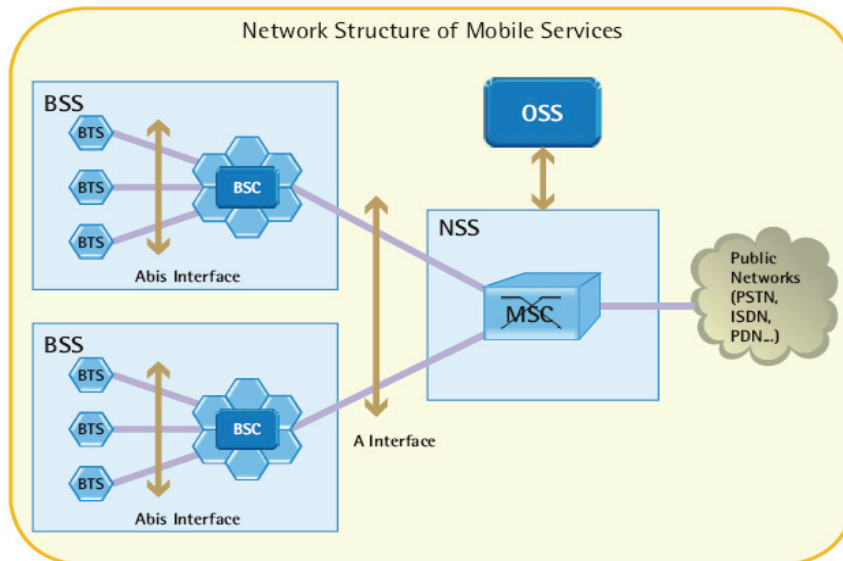
- a. *Global System for Mobile communications (GSM):* Earlier known as Groupe Special Mobile, GSM is a set of standards set by European Telecommunication Standard Institute specifying the infrastructure for cellular services. The GSM Association estimates that 82% of the global mobile market uses the standard. GSM is used by over 3 billion people across more than 212 countries and territories. Its ubiquity makes international roaming very

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common between mobile phone operators, enabling subscribers to use their phones in many parts of the world. Today, globally GSM services are primarily being offered on following frequencies 900 MHz and 1,800 MHz in Europe and Asia and 850 MHz and 1,900 MHz bands in North America and Latin America. GSM technology uses the SIM (Subscriber Identity Module) and gives liberty to subscribers to switch to various handsets and transfer contacts and other important data as well. (Major service providers Bharat Sanchar Nigam Limited, Bharti Airtel Limited, Vodafone Essar, Idea Cellular Limited, AT&T, Singtel, Cable and Wireless, etc.).

- b. *Code Division Multiple Access (CDMA)*: Radio signals associated with a call are spread across a single broad frequency spectrum. Each call in the spectrum is differentiated from other calls in that spectrum by assigning a unique code to each call's signal. CDMA is handset locked and entire set is to be bought with the handset that can be prepaid or postpaid. (Major service providers Reliance Infocomm Limited, TATA Indicom, MTNL Garuda, etc.).

6.25 Detailed below are some of the key technical elements which form a mobile network / architecture:



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- A. *Mobile Station (MS)*: Mobile Station comprises all user equipment and software needed for communication with a Wireless telephone network. In 2G system MS refers to Mobile Phone and in 3G system MS refers to User Equipment. The Mobile Station consists of four main components:
- a. *Mobile Terminal*: offers common functions that are used by all the service, the Mobile Station offers. It is equivalent to the network termination of an ISDN access and is also the end point of the radio interface;
 - b. *Terminal Equipment*: is a peripheral device of the Mobile Station and offers services to the user. It does not contain any functions specific to GSM;
 - c. *Terminal Adaptor*: hides radio specific characteristics;
 - d. *Subscriber Identity Module (SIM)*: is a personalisation of the Mobile Station which carries all the subscriber specific information. Major functions of a SIM are: to identify the current user of an MS, store personal information e.g. abbreviated dialling codes (telephone directory), permanent storage of subscribers IMSI and Authentication Key (Ki) and semi permanent storage of system information e.g. current Location Area Identity, telephone directory, short messages, etc.
- B. *The Network Switching System (NSS)*: The Network Switching System is a system of electronic components that connects telephone calls and is thus responsible for performing call processing and subscriber related functions. Thus it carries out switching functions and manages the communications between mobile phones and the Public Switched Telephone Network. It includes the following functional units:
- a. *Home Location Register (HLR)*: HLR is an

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intelligent database and service control function responsible for management of each subscriber's records and control of certain services. It has the current subscriber status and associated VLR. It carries subscription details for a subscriber and location information enabling the routing of calls. There are two kinds of data in HLR permanent and temporary. Responsibilities of HLR include: services that subscriber has requested or been given, management of service profiles, mapping of subscriber identities (MISDN, IMSI), execution of supplementary service logic, e.g. incoming barred and passing subscriber records to VLR. However HLR data is stored for as long as a subscriber remains with the mobile phone operator;

- b. *Mobile Services Switching Center (MSC)*: MSC is an ISDN switch with (significantly) enhanced processing capability. It is responsible for handling voice calls and SMS as well as other services (such as conference calls, FAX and circuit switched data). The MSC sets up and releases the end-to-end connection, handles mobility and hand-over requirements during the call and takes care of charging and real time pre-paid account monitoring. The network element performs the telephony switching functions of the GSM network and manages communication between GSM and other network. The MSC is also responsible for toll ticketing, network interfacing, common channel signalling, location updation, call handling of mobile subscribers within its domain, echo canceller operation control, gateway to SMS between SMS centers and subscribers and generating call charging records (for billing). An MSC will parent a number of BSC's;
- c. *Mobile Switching Centre Server (MSS)*: The Mobile Switching Centre Server or MSS Server is a soft

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switch variant of Mobile Switching Centre, which provides circuit-switched calling, mobility management, and GSM services to the mobile phones roaming within the area that it serves. MSC Server functionality enables split between control (signalling) and user plane (bearer in network element called as Media Gateway), which guarantees more optimal placement of network elements within the network;

- d. *Gateway Mobile Services Switching Center (GMSC)*: A network element used to interconnect two GSM networks. The gateway is often implemented in an MSC. The MSC is then referred to as the GMSC;
- e. *Visitor Location Register (VLR)*: VLR is an intelligent database and service control function. It stores (on a temporary basis) the information needed to handle calls set up or received by MS's registered with it. This includes their International Mobile Subscriber Identities (IMSI), current Location Area Identities (LAI's) and supplementary service entitlements. Responsibilities of the VLR include: MSRN, location where mobile station has registered, information for supplementary service parameters (if any), IMSI, TMSI, HLR or global title and Authentication Key;
- f. *Authentication Center (AUC)*: The Authentication Centre or AUC is a function to authenticate each SIM card that attempts to connect to the GSM core network (typically when the phone is powered on). Once the authentication is successful, the HLR is allowed to manage the SIM and services described above. An encryption key is also generated that is subsequently used to encrypt all wireless communications (voice, SMS, etc.) between the mobile phone and the GSM core network. If the

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authentication fails, then no services are possible from that particular combination of SIM card and mobile phone operator attempted. There is an additional form of identification check performed on the serial number of the mobile phone described in the EIR section below, but this is not relevant to the AUC processing. Proper implementation of security in and around the AUC is a key part of an operator's strategy to avoid SIM cloning;

- [illegible]

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provides connectivity with a transport network such as the PSTN or the Internet.

- a. *Base Station Controller (BSC)*: The network element which is a small switch (with enhanced processing capability) provides all the control functions and physical links between the MSC and BTS. The BSC provides functions such as handover, cell configuration data, control of radio frequency (RF) power levels in Base Transceiver Stations, traffic concentration and low level switching operations.



- b. *Base Transceiver Station (BTS)*: The BTS is the radio equipment (transceivers and antennas) needed to service each cell in the network. It is thus a network element which handles the radio interface to the mobile station thereby encoding, encrypting, multiplexing, modulating and feeding the RF signals to the antenna. The network can be that of any of the wireless communication technologies like GSM, CDMA, WAN, WiFi, WiMAX, etc. The function of a BTS primarily includes frequency hopping, random access

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detection and uplink radio channel measurements.



A BTS has the following units:

- i. TRX Transceiver:* Quite widely referred to as DRX (driver receiver). Basically does transmission and reception of signals. Also does sending and reception of signals to/from higher network entities (like base station controller in mobile telephony);
- ii. Power Amplifier:* Amplifies the signal from DRX for transmission through antenna. May be integrated with DRX;
- iii. Combiner:* Combines feeds from several DRXs so that they could be sent out through a single antenna. They are used for reduction of number of antenna used;
- iv. Duplexer:* Used for separating sending and receiving signals to/from antenna. It does sending and receiving signals through the same antenna ports (cables to antenna);
- v. Antenna:* Antenna is also considered as part of BTS;

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- vi. *Alarm Extension System:* It collects working status alarms of various units in BTS and extends them to operations and maintenance (O&M) monitoring stations. The components of an alarm extension system have been illustrated below:



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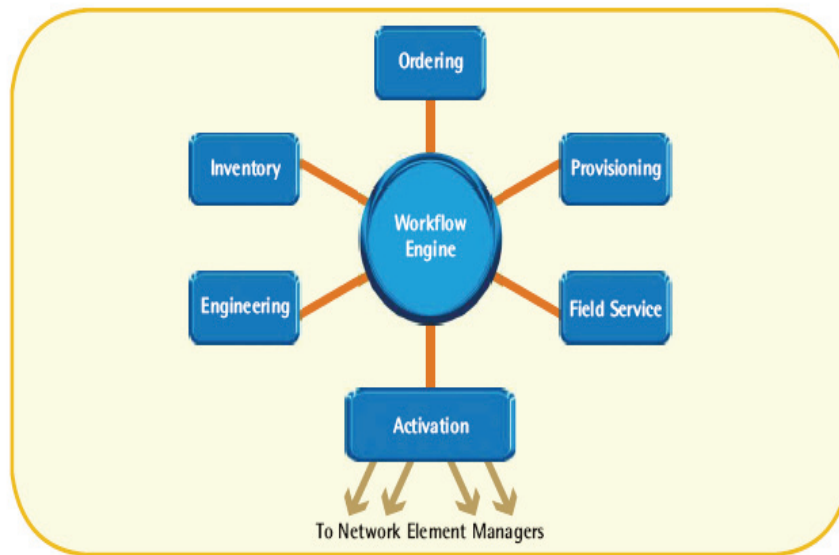
- D. *The Operation and Support System (OSS)*: The term Operation and Support System most frequently describes “network systems” dealing with the telecom network itself, supporting processes such as maintaining network inventory, provisioning services, configuring network components and managing faults. For traditional telecom service providers, OSS were mainframe based systems designed to support telephone company staff members to automate their daily jobs such as order processing, line assignment, line testing and billing, etc. The complementary term Business Support System is a newer term and typically refers to “business systems” dealing with customers, supporting processes such as taking orders, processing bills and collecting payments. The two systems together are often abbreviated BSS/OSS or simply B/OSS. B/OSS plays a critical role to support operations of a service provider and its increasing business services including voice, data, VOIP and multi-media.

Functions of an OSS solution may include the following components:

- Order processing, accounting, billing and cost management,
- Network inventory, service provision, design and assign,
- Network discovery and reconciliation, trouble and fault management,
- Network elements, asset and equipment anagement, field service management.

Most of the Operation Support Systems are designed based on the Telecommunications Management Network (TMN) model. To better define OSS and BSS for future business and technology development, the Tele Management Forum is working on a newer model to replace the aging TMN. Refer diagram below for a business support system.

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Fixed Line

6.26 Land-line or fixed-line telecommunication is over 125 years old and, until the recent past, was defined as a telephone line that travelled through metal wire or optical fibre as part of a nationwide telephone network. This is distinguished from a mobile cellular line, where the medium used is the airwaves. The term landline is also used to describe a connection between two or more points that consists of a dedicated physical cable, as opposed to an always-available private link that is actually implemented as a circuit in a wider switched system (usually the public switched telephone network). Fixed-line telephony companies now also provide broadband data and voice as well as managed networking services to enterprise customers, as well as wholesale network capacity, all over fixed wirelines.

6.27 Fixed-line telecommunication will continue to be a huge industry, because the major players provide the backbone, i.e. fibre optic network, for the Internet, and fixed lines still provide the fastest data speeds by far. However, consumer business models are changing due to the evolution of voice and data transport technology. People are moving from fixed wireline phones to mobile phones and opting for lower-priced VoIP service in their homes thus causing local and long distance revenue growth to decline. On the flipside, fixed-telephony players are seeing an

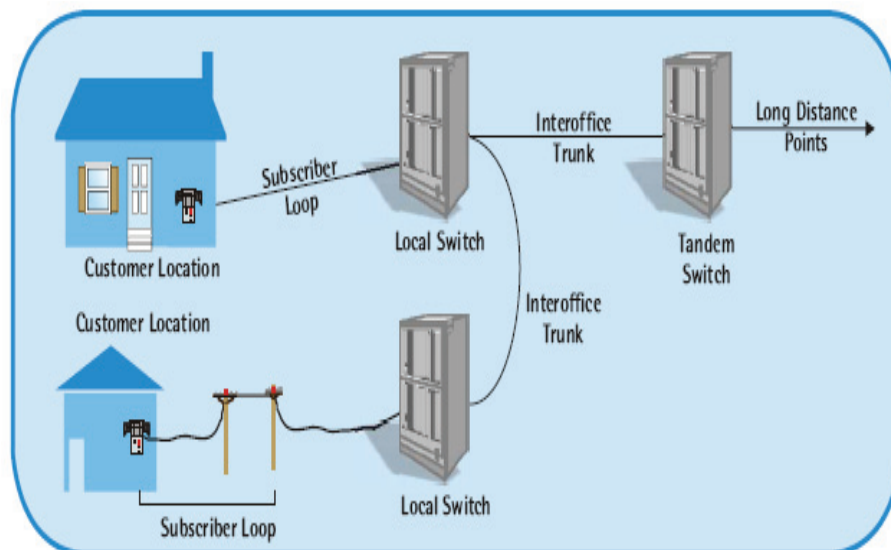
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explosion in data service revenues, and are ultimately looking at providing the famous triple play-broadband Internet, voice, and video over an IP network-to consumers. Carriers are looking at increasing data sales faster than their declining circuit-switched voice revenues. (Major service providers Bharat Sanchar Nigam Limited, Bharti Airtel Limited, Vodafone Essar, TATA Indicom, etc.).

Network Structure of Fixed Line Services

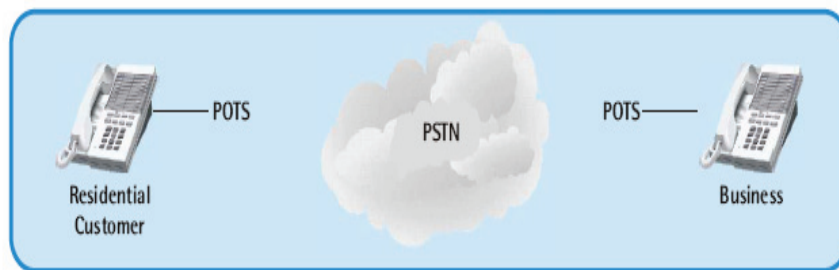
6.28 This is a basic telephony which uses two types of network - switched networks and dedicated private line circuits.

- A. Switched network is a type of network that provides switched communication system and in which users are connected with each other through circuits, packets switching and control devices. Examples are - public switch telephone network and private switched telephone network. The switched network consists of subscriber premises equipment, subscriber loop, local and tandem switches and trunks between switches. An end user may reach any other end user anywhere on the network by dialling a telephone number. (Details of switching technologies are detailed in paragraphs to follow).



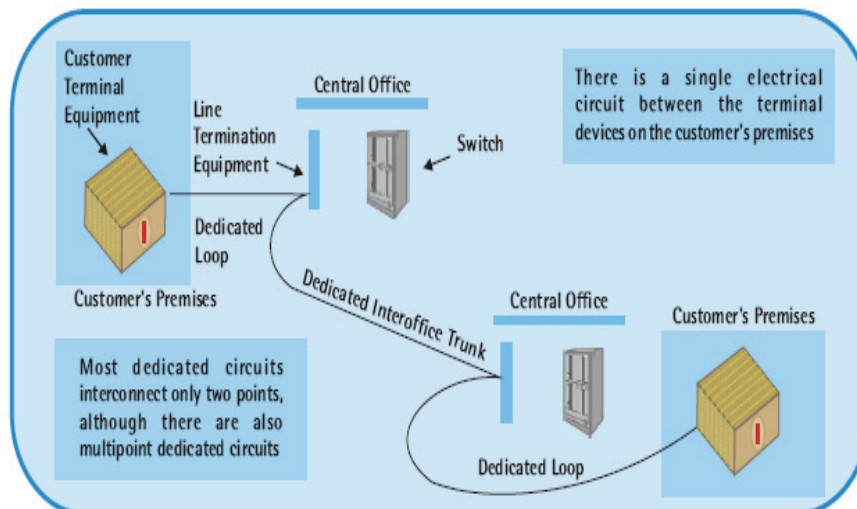
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- i. **Public Switched Telephone Network:** Network of the world's public circuit-switched telephone networks, in much the same way that the Internet is the network of the world's public IP-based packet-switched networks. Originally a network of fixed-line analog telephone systems, the PSTN is now almost entirely digital, and now includes mobile as well as fixed telephones.



- ii. **Private Switched Telephone Network:** Allow end users to reach only other end users that are members of a dialling fewer digits than are needed in the public network.

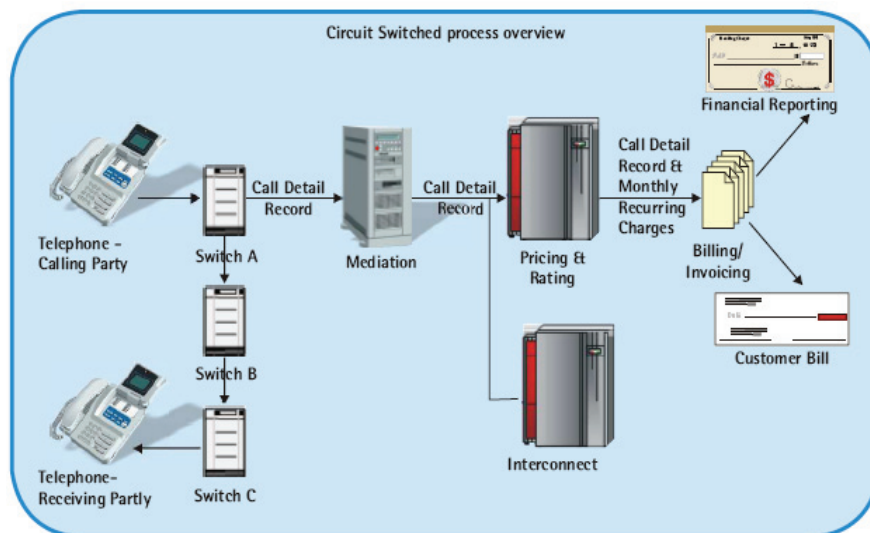
- B. **Dedicated Circuits:** The end user may only reach the destination at the other end of the same circuit. No switching takes place.



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Switching Technologies

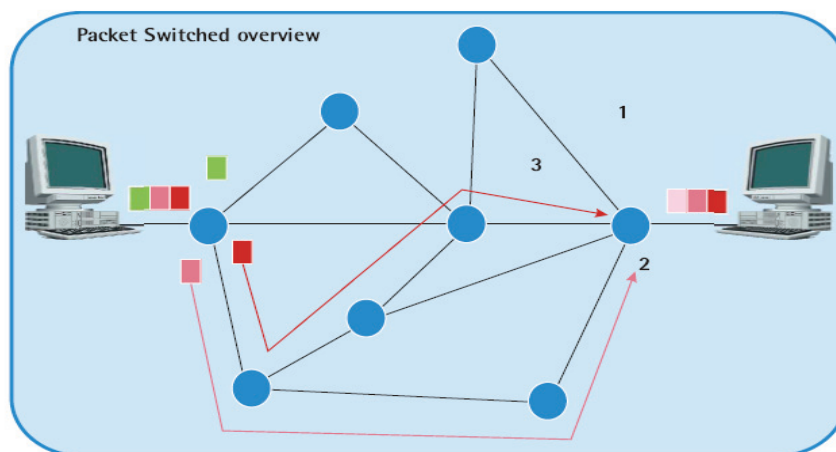
6.29 *Circuit Switching:* In telecommunications, a circuit switching network is one that establishes a fixed bandwidth circuit (or channel) between nodes and terminals before the users may communicate, as if the nodes were physically connected with an electrical circuit. It establishes connections between links, on demand and as available, in order to establish an end-to-end circuit between devices. The connections are temporary, continuous, and exclusive in nature. The connections are temporary as they are established and maintained only for the duration of the logical session, or call. They are continuous as they provide a specific amount of bandwidth, or capacity, continuously for the duration of the call. They are exclusive as the connection and the associated bandwidth are committed to only that call, i.e., are not shared with other transmissions. Circuit switches were developed for uncompressed, real-time voice communications, but will support any type of information transfer. Common examples of circuit switches include Private Branch Exchanges (PBXs) and Central Office Exchanges (COs or COEs). All messages take the same path. Examples of Circuit Switch are Public Switched Telephone Network, Integrated Systems Digital Network, Circuit Switched Data and High Speed Circuit Switched Data.



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- A. ***Packet Switching:*** Packet switching is a network communications method that splits data traffic (digital representations of text, sound, or video data) into chunks, called packets that are then routed over a shared network. There is no fixed route that a packet takes to get its destination. To accomplish this, the original message/data is segmented into several smaller packets. Each packet is then labelled with its destination and the number of the packet. This precludes the need for a dedicated path to help the packet find its way to its destination. Each packet is dispatched and may go via different routes. At the destination, the original message/data is reassembled in the correct order, based on the packet number.

Packet switching is used to optimise the use of the channel capacity available in digital telecommunication networks such as computer networks, to minimise the transmission latency (i.e. the time it takes for data to pass across the network), and to increase robustness of communication. The most well-known use of packet switching is the Internet and local area networks. The Internet uses the Internet protocol suite over a variety of data link layer protocols. For example, Ethernet and frame relay are very common. Newer mobile phone technologies (e.g., GPRS, I-mode) also use packet switching. Asynchronous Transfer Mode (ATM) also is a virtual circuit technology, which uses fixed-length cell relay connection oriented packet switching.



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6.30 There are two basic types of Packet Switching:

- A. *Virtual Circuit Packet Switching Networks:* An initial setup phase is used to set up a route between the intermediate nodes for all the packets passed during the session between the two end nodes. In each intermediate node, an entry is registered in a table to indicate the route for the connection that has been set up. The packets passed through this route, have short headers, containing only a virtual circuit identifier (VCI). Each intermediate node passes the packets according to the information that was stored in its table, in the setup phase and according to the packets header content. In this way, packets arrive at the destination in the correct sequence.
- B. *Datagram Packet Switching Networks:* This approach uses a different, more dynamic scheme, to determine the route through the network links. Each packet is treated as an independent entity, and its header contains full information about the destination of the packet. The intermediate nodes examine the header of the packet, and decide the next hop of this packet. In the decision two factors are taken into account:
 - The shortest way to pass the packet to its destination - protocols is used to determine the shortest path to the destination; and
 - Finding a free node to pass the packet to - in this way, bottlenecks are eliminated, since packets can reach the destination in alternate routes. Thus, in this method, the packets don't follow a pre-established route, and the intermediate nodes (the routers) don't have pre-defined knowledge of the routes that the packets should be passed through.

Long Distance

6.31 Long distance in telecommunications refers to telephone calls made outside a certain area, usually characterised by an area code outside of a local call area (known in the United States

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as a local access and transport area or LATA). Long-distance calls usually carry long-distance charges which, within certain nations, vary between phone companies and are the subject of much competition. International calls are calls made between different countries, and usually carry much higher charges. These calls are charged to the calling party unless the called party accepts a collect call.

6.32 While there have traditionally existed long-distance carriers who provided only long-distance services, today most if not all of the Baby Bells can offer service for all long- distance classes as well as local service, competing with the long-distance carriers. While the benefit of this arrangement is simplicity of billing and support for the customer, long-distance carriers can often offer lower rates or money-saving service plans.

6.33 In telephony, the long-distance operator is a telephone operator available to assist with making long distance telephone calls, answering billing questions, making collect calls and other functions, including emergency assistance. The major long distance service providers in India are Bharat Sanchar Nigam Limited, Mahanagar Telephone Nigam Limited, RailTel Corporation, Bharti Airtel Limited, Reliance Communications Limited, Videsh Sanchar Nigam Limited, etc.

6.34 Small customers with minimal Long Distance needs may access the network on a switched basis (i.e., long distance services provided over your local phone lines), while larger customers may find it more economical to access the network on a dedicated basis (i.e., users must install a dedicated line used for Long Distance calls).

Broadband

6.35 Broadband is a high speed, high capacity transmission medium that can carry signals from multiple independent network carriers. This is done on a single coaxial or fibre- optic cable by establishing different bandwidth channels. It is used to transmit data, voice and video over long distances simultaneously and comprises of MSU, Optic Fibre Cable, SDH Equipment (for

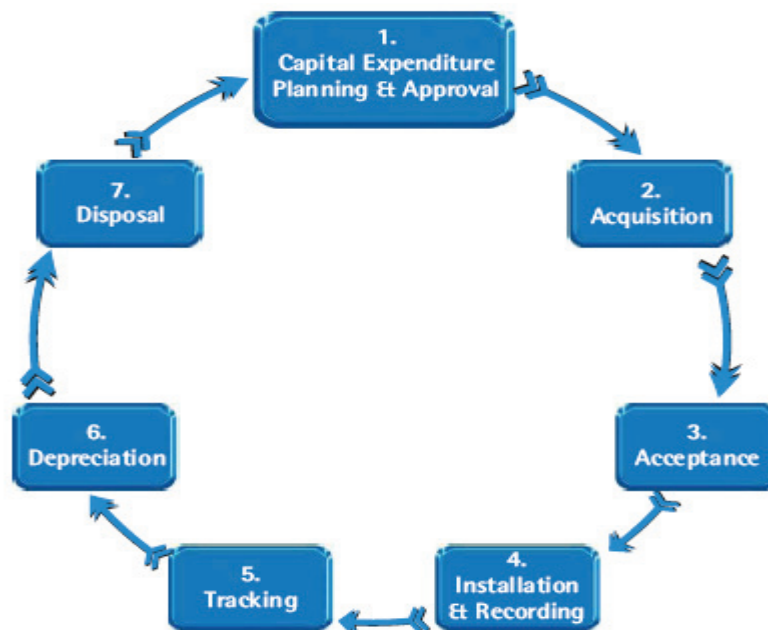
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connecting nationwide sites), POI Equipment, VSAT Equipment, etc. The major service providers within this segment are Bharat Sanchar Nigam Limited, Bharti Airtel Limited, Dishnet Wireless Limited, Gateway Systems (India) Pvt. Ltd., etc.

6.36 It is essential that the network overview and structure is clearly understood for the specific telecom entity, depending on the nature of services being provided to be able to audit the fixed assets.

Fixed Assets Cycle

6.37 The Fixed Asset cycle of a telecom company is almost the same as that of any other business entity. This Fixed Asset cycle broadly comprises of the following stages Budgeting, Procurement, Acquisition, Recording, Accounting, Reporting and Disposal of an asset. Each stage of an asset's life has different accounting, reporting and management responsibilities. There may be certain inter-linkages between each of the stages and each stage logically flows into the next stage. Fixed asset life cycle in a telecom company has been illustrated as follows:



Capital Expenditure Planning and Approval (CAPEX)

6.38 CAPEX planning is a complex process often involving considerable levels of expenditure and exposure to risk. Capital Expenditure planning helps companies manage capital expenditures on an overall basis. It enables the management to monitor progress and gain visibility into the implications of delaying / accelerating capital spending.

6.39 Since, capital expenditures involve huge cash outlay and blockage of funds for years; there is close scrutiny at all levels of management. All Capital projects are to be analysed for Return on Investment, risk evaluation measures like payback period, internal rate of return, net present value etc. Executive Committees may periodically review corporation-wide capital projects to ensure the expenditure is in the right direction.

6.40 Generally, capital budgets are compared with the actual expenditures on a monthly basis and significant differences analysed. Such practices help detecting misuse of funds, if any.

6.41 Discretionary capital spending, such as purchase of furniture or computer equipment, is generally decentralised and is controlled by restricting spending authority to appropriate levels of responsibility.

6.42 Thus, capital expenditure planning and capex approvals in telecom industry would basically include:

- Strategic Network Planning,
- Capacity Forecasting,
- Capex approval by the Network Planning Department,
- Determination of Costing,
- Approval by functional heads and top management.

Acquisition

6.43 The acquisition stage of fixed assets would include:

- Vendor Selection:
 - contracts covering circles / states,

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- contracts for specific items BTS, antenna, cables, etc.
- Placing of orders:
 - bulk purchase orders,
 - purchase of specific items based on provision of services.
- Receipt of Inventory:
 - in warehouses (stores),
 - at construction sites.

Acceptance

6.44 Acquired capital items are accepted by reference to the Purchase Orders raised to the vendor. Any defected / broken items are generally not accepted and are covered under the quality standard parameters as mentioned in the Purchase order / agreement. Receipt of goods may take place either in stores or at construction sites. At the time of receipt, a Material Receipt Note (MRN) is prepared which forms the basis for accounting further.

Installation and Recording

6.45 The installation of capital equipments requires expertise to provide end-to-end service from engineering and deployment to maintenance. The installation of capital inventory would include:

- Issue of warehouse inventory to construction sites (purpose of issuance i.e. whether a fresh issuance or for expansion, repair or replacement needs to be documented),
- Installation of capital inventory as per the configurations set by the Network (Technical) Department,
- Preparation of Installation Certificates,
- Capitalisation of capital inventory in GL and updating details in the Fixed Assets Register,
- Provisional Capitalisation based on the standard Bill of Material,

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- Calculation of Depreciation, and
- Review of policies and procedures relating to movement of fixed assets between different locations.

Tracking

6.46 One of the very important stages of fixed assets cycle is the tracking. Tracking telecom assets is an important concern of every operator, regardless of size and its severity of location. Fixed assets are defined as any 'permanent' object that a business uses internally including but not limited to computers, tools, software or office equipment.

6.47 Many operators face a significant challenge to track location, quantity, condition, maintenance and depreciation status of their fixed assets, since inventory is voluminous and located / kept at various locations which could be highly prone to thefts, damages (either environmental or intentional), etc. A popular approach to tracking of fixed assets utilises serial numbered asset tags, often with bar codes for easy and accurate reading.

6.48 However both types of capital inventory (a) lying at sites and stores which have not been capitalised, or (b) which are capitalised to a particular location / site, are tracked by operators manually and through details maintained in the software systems especially designed for the same. Whenever an asset is received in stores or at sites, the same is given a unique asset number with the date of receipt and location details. Similarly, physical asset is tagged for identification. In case of movement of inventory from stores to sites or at the point of capitalisation, the details of asset location are simultaneously changed.

6.49 Further, site locations and stores are guarded by the security agencies and records maintained by the store keeper (in case of warehouse) / security guard (in case of sites) for physical movement of personnel and equipments. Also in cases where inventory is moved for repairs or for replacements, the fixed asset records are simultaneously changed.

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6.50 Further, as a practice and to keep a strict control over the fixed assets, the telecom operators often prepare a plan for physical verification of fixed assets. This plan is to be made depending upon the requirements, locations and other factors for physical verification in a phased manner wherein assets are to be physically verified either by internal team of personnel from a department other than the dealing department (in the presence of Head of Department) or by external agencies. During the course of physical verification, count of inventory is done both ways floor to tag and tag to floor. Thereafter, a complete report along-with the reconciliation of physical assets with Fixed Assets Register is submitted to management for corrective actions and adjustments in the books of account.

6.51 The common issues which are faced by telecom operators due to which there are differences in capital inventories and physical verification could be the following geographical spread (process is time consuming), frequent transfer of assets from one site location to another without updation of records and reconciliation of physical inventory with the Fixed Assets Register.

6.52 An auditor of a company needs to ensure that the physical verification process is sufficient enough to covers all the category of assets located at all the site locations and within the warehouses. They may bring to the notice of the management any flaws in the physical verification process, which may further lead to loss of control over inventory or even monetary losses. Physical verification report should be reviewed by the statutory auditor. Any, differences highlighted in the report should be analysed & enquired into. Further, the impact of differences should be assessed for any adjustments to be made in the books of account.

Depreciation

6.53 As per an Accounting Standard (AS) 6 “Depreciation Accounting” issued by the Chartered Accountants of India, “Depreciation is a measure of the wearing out, consumption or other loss of value of a depreciable asset arising from use, effluxion of time or obsolescence through technology and market changes. Depreciation is allocated so as to charge a fair

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proportion of the depreciable amount in each accounting period during the expected useful life of the asset. Depreciation includes amortisation of assets whose useful life is pre-determined". Depreciation has a significant effect in determining and presenting the financial position and results of operations of an enterprise. Depreciation is charged in each accounting period by reference to the extent of the depreciable amount, irrespective of an increase in the market value of the assets.

6.54 In a telecom business, calculation of depreciation on various assets is quite cumbersome. As discussed above, since assets and their details are generally maintained in IT application software within the Fixed Assets Module, hence depreciation calculation is also done via the same software, wherein rate of depreciation charge is configured as per the accounting policy decided by the company management. When the relevant program in application software is run, depreciation on various fixed assets is automatically calculated and report generated which gives the desired results. Simultaneously, Fixed Asset Register also gets updated with the depreciation charge and provides the net book value as at the particular date. It is important for the auditor to test the IT system configuration whether the charge of depreciation is uploaded appropriately and calculated accurately.

Disposal

6.55 The last stage of fixed assets is the ultimate disposal of fixed assets. Telecom network inventory is slightly different from inventory in the "bricks-and-mortar". When one thinks about physical inventory, one generally considers that inventory itself has intrinsic value that can be realised by its sale.

6.56 The telecom company may enter into contracts wherein old/damaged fixed assets may be replaced by a strategic partners/ vendors providing warranty coverage / maintenance services. In such cases, adjustments in values may be made in the books of account and fixed assets register may be updated.

6.57 There could be other cases where assets may be

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destroyed or damaged and are not covered by such contracts. These assets may be required to be sold as a scrap. Actual loss on sale of such assets should be recorded basis the comparison of the net book value and sale price. Further such loss should be disclosed properly and fixed assets register should be updated.

Risks in Telecom Fixed Assets Cycle

6.58 The fixed assets of a telecom business are spread across geographical locations, which apart from obsolescence are prone to theft, sabotage, physical damages and operational damages. Some of the potential risks attached to fixed assets of a telecom business are enumerated hereunder:

Acquisition of Fixed Asset / Inventory

- Recorded fixed asset acquisitions do not represent fixed assets acquired by the entity due to which validation of such assets is not possible (validity);
- Not all the fixed assets acquired have been recorded in the books of account which may lead to incomplete records being maintained by an entity (completeness);
- Acquisitions may be incorrectly expensed thereby impacting the profit and loss account;
- Fixed assets recorded in wrong asset or expense accounts (classification). Misclassification of fixed assets to conceal unauthorised purchases;
- Fixed assets acquisitions are not recorded in the appropriate period;
- No formalized budgets are communicated to cost centre holders which could result in budget overruns;
- Asset acquisitions are not done in accordance with the Company's approval limits and Capex policy (authorisation);
- Asset acquisitions may not be suitable to fulfil the purpose for which they have been acquired due to technological changes and which eventually makes the inventory to be sold / scrapped at a loss;

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- Taxation allowances may not be correctly applied. Thus all valid tax allowances may not be claimed;
- Acquisition documentation may be lost or otherwise not communicated to appropriate personnel; and
- Acquired assets may not be adequately / incorrectly recorded / programmed w.r.t. sites, asset ID, location and location ID, description of asset, quantity of assets, amount of asset, useful life of the asset and rate of depreciation in the fixed assets register which may lead to probable issues like - identification of assets, and incorrect accounting of gross block and depreciation thereof.

Depreciation of Fixed Assets

- Incorrect provisioning of rates of depreciation in the fixed assets module thereby calculating and providing wrong depreciation charge. Thus anticipated useful life may be incorrectly set, establishing an unreasonable period during which the cost of the asset is depreciated. For e.g. if as per the accounting policy of the company an asset amounting to less than Rs. 5,000 is required to be depreciated over a period of 12 months and is actually depreciated in the month of installation, then there is a wrong charge of depreciation which has an impact in the current period as well as future period financial statements;
- Incorrect method of depreciation programmed in the systems module which would lead to incorrect levy of depreciation on assets. For e.g. programming of written down value method instead of straight line depreciation method;
- Depreciation charges are invalid wherein access rights for change in the depreciation period and other rights are open / provided to other personnel apart from the Fixed Assets Manager;
- No regular review / monitoring of reports generated by the IT system's for accuracy and completeness of the depreciation levied on the assets. Also exceptional items of depreciation are not tracked and reviewed which may even

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- lead to recording of depreciation in the wrong period; and
- Wrong classification of fixed asset which may lead to wrong computation of depreciation charge.

Disposal and Transfer of Fixed Assets

- Recorded fixed asset disposals do not represent actual disposals since there do not exist any clear criteria, in writing, for identification and disposal/transfer of damaged, obsolete or unneeded inventory. Also pre-numbering disposal documentation may be incomplete, unauthorised and unprocessed;
- Fixed assets disposal and scrapping of old and obsolete assets are not recorded. Equipment disassembled and used for spare parts is not independently checked from the fixed assets records;
- Assets transferred from one location to another location within the company may not be appropriately controlled, wherein inventory is transferred from one location to another without change in the location in the Fixed Assets Register / inventory records which may leads to misappropriation of assets and differences in Inventory during the course of physical verification;
- Fixed assets disposals are not recorded in the appropriate period, thereby leading to non-timely updation of records. This may happen since asset related transactions before and after the end of an accounting period are not scrutinised and/or reconciled to ensure complete and consistent recording in the appropriate accounting period;
- Transfer or sale of assets may not be in accordance with the regulatory requirements resulting in fines and penalties; and
- Assets and related accounts may be charged or credited with incorrect amounts. Also accounting classifications may be incorrect.

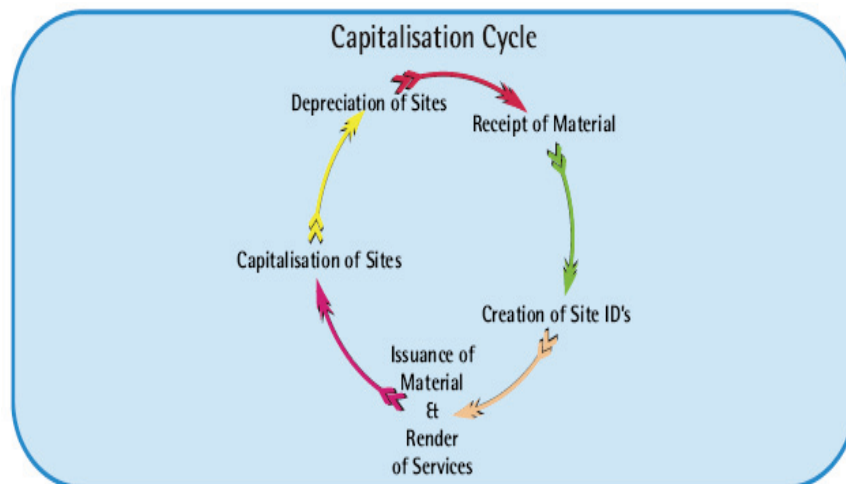
Capitalisation of Fixed Assets

6.59 Since being a capital intensive industry and high volumes of business with enormous transactions, the fixed assets register

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and accounting of telecom cannot be developed and run in simple spreadsheets. Depending on the size of asset portfolio, the financial impact of these asset management challenges can be significant resulting in incorrect profits, taxes, and insurance covers. Further, asset accounting is complex and time consuming process. Thus, for the purpose of preparation and maintenance of fixed assets records, coupled with an objective of reduction in the complexity, increase productivity as well as accuracy in accounting of fixed assets, various software companies have launched automated applications such as ERP based Inventory and Fixed Assets Module which apart from data input and reports generation for information, process the transaction, allocates the asset to a defined class and cost centre, track financial or non-financial information (such as warranty information, physical location and service dates), calculates the depreciation and track historical transactions for each asset.

6.60 In a telecom industry, 'Plant and Machinery' forms the major category of fixed assets comprising almost 90% of the total gross block value and charge of depreciation. This trend is across all service segments of the industry mobile, fixed line, long distance and network services. Hence the main focus on the capitalisation front would be 'Plant and Machinery' which is provided in the paragraphs to follow. The sequencing for capitalisation of fixed assets is detailed hereunder which is generally followed by most of the telecom companies in India:



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Receipt of Material

6.61 Materials for telecom equipments are either received at the warehouse or at the construction sites. However in both the cases there is a three way matching of quantity which is done i.e. PO vs MRN vs invoice. For materials received at Stores material quantity and value as per invoice is matched with the PO raised. Material is thereafter unloaded and a gate entry number is generated for each invoice. Thereafter, material is physically verified as to the quantity. Excess and shortages, if any, are informed to the vendor.

6.62 For material received at Construction Sites delivery challan, invoice, installation certificate, etc. is sent by the vendor to supply chain department for preparation of MRN. After preparation of MRN, the details are uploaded in the system for invoice tracking and clearances thereof.

Creation of Site ID's

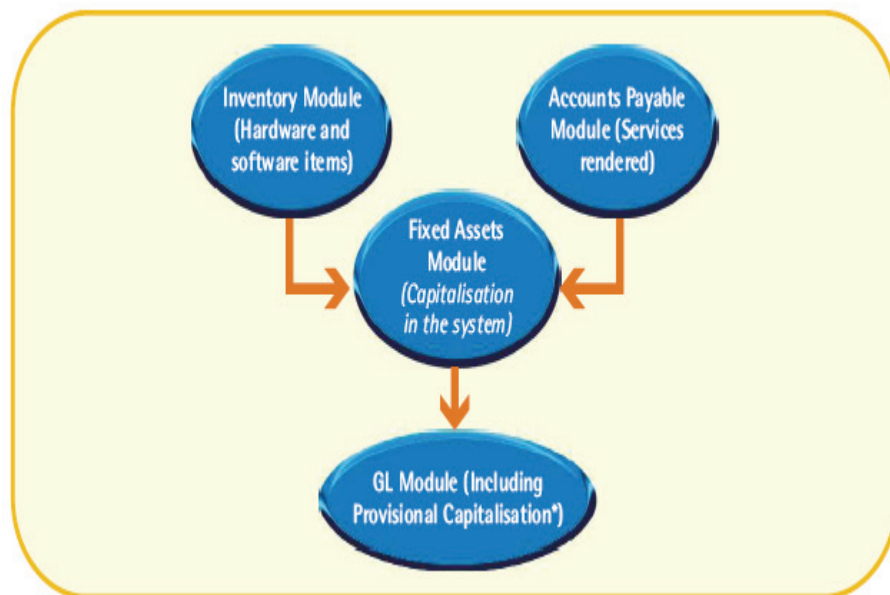
6.63 The site location for facilitation of services to subscribers and other end users are decided by the Technical department. To ensure site-wise tracking a unique system ID is created for each site to be installed, since issuance of material is thereafter done on basis of the site ID's created.

Issuance of Material (installation) and Render of Services

6.64 Materials are issued to sites for construction, basis the Technical requisition against which a Non Returnable Gate Pass cum material challan is prepared. Parallel to the issuance of such materials, the Inventory module is also updated for capital items and amounts transferred to the respective site ID's in the Fixed Assets module. In case of services rendered at sites, the accounting entries are not routed through Inventory module since there are no inventories involved in such transactions, but the same are routed through the Accounts Payable module with a specific mention of the site ID to which services rendered pertain to.

Capitalisation of Sites

6.65 All the new asset items whether from the Inventory module or from the Accounts Payable module are allocated a unique running asset number. This activity is done manually in the system and is not automatically generated. Material issued to sites or services rendered will be capitalised in the gross block basis the 'date on air' as confirmed by the Technical department for each site. Thus, for the purpose of capitalisation, backend programs are run from the Inventory module and Accounts Payable module wherein capital inventory (in the form of Capital Work in Progress) is transferred to the Fixed Assets module. For the sites which are still in progress and are yet to be 'put on air', will remain parked as Capital Work in Progress.



Depreciation of Sites

6.66 Depreciation program is run within the Fixed Assets Module to automatically calculate depreciation on assets capitalised at site locations for the period and depreciation on assets previously capitalised. Post this program run, entry is passed in the General Ledger basis the depreciation report

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extracted. However, assets which are either provisionally capitalised or capitalised outside the system, depreciation is calculated manually (preferably in MS Excel sheet) and posted into the General Ledger.

Advantages of Automated Fixed Asset Accounting System in Telecom

6.67

- It maintains perfect accounting for Fixed Assets,
- Gives complete control over physical assets spread across distributed locations,
- Gives information of maintenance costs,
- Takes care of statutory requirements like depreciation, insurance, etc.,
- Quickly and accurate by record, track, depreciate, and analyse locations assets with minimal efforts and gives the end users a tremendous flexibility, with multiple features and powerful reporting tools,
- Functionality allows the user to update and maintain records of the existing Fixed Assets with an option to create and maintain new assets,
- Keeps track of each asset in different locations, its costs, calculate depreciation, disposals, gain/loss on sale of asset,
- Handy in maintaining accurate accounting of Fixed Assets, and
- Highly scalable and efficient application, which enhances overall productivity of the organisation.

Audit Considerations

6.68 Fixed Assets in a telecom company would comprise of the following Balance Sheet and Profit & Loss items. Specific audit procedures for these account balances have been mentioned below:

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Balance Sheet	Profit and Loss Statement
<ul style="list-style-type: none"> • Gross Block: (majorly constituting the category of 'Plant and Machinery' inclusive of telecom specific - Erlang based capitalisation/ de-capitalisation, accounting for Asset Retirement Obligation (ARO), Provisional Capitalisation), Indefeasible Rights of Use, etc.; • Accumulated Depreciation; • Capital Work in Progress (inclusive of capital inventory lying at construction sites, inventory lying in stores and capital advances). 	<ul style="list-style-type: none"> • Depreciation charge: (comprising of depreciation on fixed assets, effect of depreciation basis erlang computations, Asset Retirement Obligations and Provisional Capitalisation).

6.69 In order to reduce audit risk to an acceptably low level, the auditor should determine overall responses to assessed risks at the financial statement level, and should design and perform further audit procedures to respond to assessed risks at the assertion level. The overall responses and the nature, timing, and extent of the further audit procedures are matters for the professional judgement of the auditor.

6.70 Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time. Hence in a telecom industry where volumes w.r.t. fixed asset balances are quite high, it is generally advisable to perform substantive analytical tests.

6.71 In designing substantive analytical procedures, the auditor needs to consider the following matters:

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- The suitability of using substantive analytical procedures given the assertions;
- The reliability of the data, whether internal or external, from which the expectation of recorded amounts or ratios is developed;
- Whether the expectation is sufficiently precise to identify a material misstatement at the desired level of assurance;
- The amount of any difference in recorded amounts from expected values that is acceptable.

6.72 Paragraphs below are the suggestive steps for audit of additions to fixed assets. However documentation of work done is of a paramount importance and all audit steps and work done need to be documented as per the Standards on Auditing issued by the Institute of Chartered Accountants of India.

Capitalisation

6.73 For verification of capitalisation and performing substantive analytical procedures, the auditor may obtain a schedule of capitalisation of sites / locations. This is usually prepared “site-wise” which captures details like site locations, site ID's, date of capitalisation, amount capitalised, components capitalised at each site (for e.g. antenna's, BTS, racks, green shelters, tower, civil work, cables, ducts, etc.) along-with their configurations.

6.74 To check the completeness of capitalisation, the auditor may obtain Technical Certificates which contains details of all the sites / locations and the total number of sites / locations capitalised during the period. The site-wise analysis may be mapped to ensure that all sites mentioned in the certificate have been covered and capitalised properly and vice versa. Exceptions to this may be enquired into and adjustments in the books may be considered.

6.75 To check the accuracy of capitalisation and for performing analytical procedures, the auditor may obtain Standard Bill of Material (which contains standard configuration for each kind of a site). The auditor, by using the standard bill of material, may ensure that components forming part of the sites (as per the

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Technical Certificate) have been properly capitalised. If the same have not been done, then provisional capitalisation schedule may be referred. Exceptions to this may be enquired into and adjustments in the books may be considered.

6.76 The amounts capitalised may be analysed on average cost basis. General guidelines for performing the analytical procedures are as follows:

- Average cost of each type of material could be computed based on past three purchase orders;
- Actual cost may be compared site-wise, component-wise (in terms of quantity, amount, length etc) with average cost calculated;
- Difference may be investigated. Necessary disposal of differences could be done considering auditor's judgement and concept of materiality;
- Documentation standards as well as controls should be ensured considering the quantum of data involved and amount of capitalisation.

6.77 There could be scenarios where no values are assigned to certain components installed at sites / locations. The auditor may check whether there has been any capital asset movement of the component from / to another site. In that case, following may be ensured

- Necessary approvals have been taken from all the appropriate departments;
- Documents confirming physical movement have been properly retained. The same may be reviewed by the auditor as a part of its substantive procedures;
- Necessary updations in the Fixed Assets Register have been made w.r.t. site location, site ID, amount of component, etc.

Any exceptions to the above may be considered for assessing the possibility of under/ over capitalisation.

6.78 The auditor should also perform Non-statistical sampling

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with an objective to get comfort on the capitalisation. The population should be the entire actual capitalisation (Fixed Asset additions) during the period. The sample size & selection method should be carefully selected considering factors like materiality levels, amount of capitalisation, value of each capitalisation line item, no. of items capitalised, audit methodology etc.

Depreciation

6.79 Companies calculate depreciation on each individual asset following the method and rates of depreciation adopted.

6.80 The auditor may decide about the verification steps based on his professional judgement, level of comfort desired, adjustments in the area in the past etc. General guidelines for verification are as follows:

- Depreciation calculations could be recomputed for each asset applying the applicable depreciation rates, period of depreciation etc. The auditor may also decide verification on a sample basis; and
- Substantive analytical tests could also be performed to gain overall comfort over depreciation expense.

6.81 An analytical procedure could be checking reasonability of depreciation - The actual expense can be compared with expected depreciation expense computed, based on the value, estimated life, remaining life and depreciation rate of the assets at a block level. Differences between actual depreciation and expected depreciation could be enquired and necessary adjustment in financials may be considered.

6.82 Expected depreciation can be computed considering the following:

- Opening Gross Block may be reduced with assets fully depreciated in the previous years and assets getting fully depreciated in the current year;
- Assets getting fully depreciated during the period Remaining Net Block will be the amount of depreciation; and

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- Additions during the period Actual depreciation expense may be considered in place of expected depreciation as computed above. Otherwise the differential may become a valid reconciling item.

Fixed Assets Register

6.83 The Fixed Assets Register in a telecom company is generally maintained in its system's Fixed assets module. The Fixed assets data may become so voluminous that it cannot be captured in manual spread sheets. However, the fixed assets data can be retrieved from the system and can be used for verification and analysis. A Fixed Assets Register includes the following details:

- Site ID,
- Site Location,
- Asset ID,
- Asset Description,
- Date of Capitalisation,
- Quantity Capitalised,
- Useful Life of the Asset,
- Rate of Depreciation,
- Gross Block,
- Depreciation charge,
- Accumulated Depreciation, and
- Net Block.

6.84 Generally, the asset register is configured in such a manner that all individual items capitalised on a site are capitalized as separate line item. However for keeping control over capitalisation on each site, all line items are tagged to the respective site IDs. Accordingly, data extracted from system could be used for analysis of capitalisation on each site.

6.85 From a CARO perspective, the auditor may ensure the following:

- Maintenance of proper records in the form of Fixed Assets Register showing full particulars, including the following

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apart from quantitative details and situation of fixed assets:

- Identification of Asset,
 - Proper classification under account head,
 - Location of Asset,
 - Quantity capitalized,
 - Original Cost,
 - Rates of Depreciation*,
 - Depreciation written off to date,
 - Particulars of sale, discard, demolition, etc.
- Whether these fixed assets have been physically verified by the management at reasonable intervals; whether any material discrepancies were noticed on such verification and if so, whether the same have been properly dealt with in the books of account;
 - If substantial part of the fixed assets have been disposed off during the year, whether it has affected the going concern;
 - Whether physical verification of inventory has been conducted at reasonable intervals by the management;
 - Whether proper records are maintained and whether any material discrepancies were noticed on physical verification and if so, whether the same have been properly dealt in the books of account;
 - Is there an adequate internal control procedure commensurate with the size of the company and nature of its business, for the purchase of inventory and fixed assets;

* rate of depreciation may be checked by the auditor in the fixed assets register, since there is a possibility that based on nature of assets, the rates could vary (to be mentioned in the accounting policy of the company) and hence defined useful life which would compute the depreciation on a particular asset. For e.g. assets valuing less than Rs 5,000, the same are either to be depreciated in the month of purchase or spread over a period of one year for depreciation. Hence in this case the depreciation needs to be defined accordingly in the system.

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- Whether aggregate original cost and depreciation to date recorded in assets register tally with the figures shown in the books of account;
- Year since which records are being maintained;
- Are proper records maintained for assets located in residential premises of employees and directors; and
- Are records maintained for items of assets fully depreciated but not sold.

Key Reconciliations

Capitalisation and Depreciation Reconciliation

6.86 As discussed above, Fixed Assets Register in a Telecom industry is voluminous in terms of number of line items for each site and number of sites. Accordingly, the register is maintained in its Enterprise Resource Planning (ERP) system.

6.87 Generally, transactions are entered into one module of the ERP which either automatically flow into or manually pushed into other modules. For instance - all transactions are entered into the Fixed Assets Module and thereafter via a program run are transferred to General Ledger (GL) Module, Similarly transactions flow from inventory module to Fixed Assets module.

6.88 Further, all details of Fixed Assets are stored in the Fixed Assets Module and accounting is done in the General Ledger module. The financial statements are prepared based on General Ledger module. Accordingly, to form an opinion on the financial statements, the auditor should test the closing balance reconciliation between Fixed Assets module and the General ledger module.

6.89 This reconciliation is generally prepared manually (commonly known as Fixed Assets vs General Ledger Reconciliation) and forms part of the management's critical internal control activity before any financial reporting. The reconciliation should be prepared for both Gross Block and accumulated depreciation.

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6.90 The auditor should test each of the reconciling items in the reconciliation, assess its validity and consider the possible impact on the financial statements. Following are the general guidelines in relation to testing the reconciling items:

- There may be certain entries which are passed only in the General Ledger Module and are not routed through the Fixed Assets Module. Reasons could be disclosure entries, pending decisions on allocation to assets, posting delays in the Fixed Assets Module due to IT related issues, etc. For these specific entries, the Company may separately track details like location, quantity, value of asset, depreciation charge, etc. In such cases, the auditor may consider its opinion under CARO;
- There could be other reconciling items which are passed only in the Fixed Assets Module and not recorded in the General Ledger Module. Generally, there should not be any such reconciling items. However in case there are any, then validity of the same should be assessed, amount should be verified by reference to the source documents and possible impact on the financial statements as well as on the audit opinion may be considered;
- The FA vs GL reconciliations (both Gross Block and Depreciation) are prepared with certain reports extracted from the Fixed Assets Module. The auditor may review the FA GL reconciliation from the original reports generated from the system; and
- The reconciling item in the FA vs GL Reconciliation for Depreciation should be the depreciation impact on reconciling items in FA vs GL reconciliation for Gross block.

Inventory (Capital Work in Progress) Reconciliation

6.91 Items which are not capitalised during the period closure form part of Capital Work in Progress and disclosed accordingly in the fixed assets category.

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6.92 There is a separate module known as Inventory Module (apart from Fixed Assets Module) within the system which records the details and value of materials lying at warehouse and materials sent to the construction sites.

6.93 Generally, transactions are entered into one module of the ERP which either automatically flow into or manually pushed into other modules. For instance- all transactions are entered into the Fixed Assets Module and thereafter via a program run are transferred to General Ledger (GL) Module, similarly transactions flow from inventory module to Fixed Assets module.

6.94 Entry in this module is done at the time of receipt of material. This reconciliation is generally prepared manually (commonly known as Inventory vs General Ledger Reconciliation) and forms part of the management's critical internal control activity before any financial reporting.

6.95 The auditor should test each of the reconciling items in the reconciliation, assess its validity and consider the possible impact on the financial statements. Following are the general guidelines in relation to testing the reconciling items:

- There are certain entries passed only in the General Ledger Module and are not routed through the Inventory Module. Reasons could be disclosure entries, pending decisions, posting delays in the Fixed Assets Module due to IT related issues, etc. For these specific entries, the Company may separately track details like location, quantity, value of asset, depreciation charge, etc. In such cases, the auditor may consider its opinion under CARO;
- There could be other reconciling items which are passed only in the Inventory Module and not recorded in the General Ledger Module. The validity of such reconciling items should be assessed, amount should be verified by reference to the source documents and possible impact on the financial statements as well as on the audit opinion may be considered; and
- The Inventory vs GL reconciliation is prepared using

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certain reports extracted from the system. The auditor may review the Inventory GL reconciliation from the original reports generated from the system.

Change in Location of Fixed Assets

6.96 There could be certain possible situations like:

- inventory moved from warehouse to a construction site, but again sent to another construction site without updation of initial movement in the company's records (Fixed Assets Register);
- excess inventory at a construction site moved to another site without updation of initial movement of company's records;
- inventory moved from warehouse for a referred site but in an emergency situation relocated to another site without updation of initial movement of company's records;
- inventory moved to a heavy traffic site from its initial site during the peak hours (e.g. festivals, etc.) or due to some other requirement at other site.

6.97 In all the above cases it is important that fixed assets register is updated immediately subsequent to the occurrence of transaction, since in such movements there is a possibility of loss of control over the asset.

6.98 The auditor must ensure that such movements are properly approved and necessary updations are made in the fixed assets register. Further, Company's control over such movements and its tracking mechanism may be understood and tested. The results of such testing may be helpful in audit planning as well as in forming opinions.

Appendices

Appendix I

1.1 Guidelines for International Long Distance Services Licence

The government has issued guidelines (No.10-21/2005-BS-I/48 dated 14th December, 2005) for issue of licence for International Long Distance Service. These guidelines include, amongst other matters, the following:

- The applicant must be an Indian company, registered under the Companies Act, 1956;
- The applicant company can apply for only one licence for ILD service;
- The licence for ILD service shall be issued on non-exclusive basis, initially for a period of 20 years, with automatic extension of the licence by a period of 5 years subject to satisfactory performance in accordance with terms & conditions of the licence particularly in regard to Quality of Service (QoS) parameters;
- The applicant company shall submit, a detailed network Roll Out plan. The roll out obligations stipulate receipt and delivery of traffic from / to all the exchanges in the country which can be ensured through at least one gateway switch having appropriate interconnection with at least one National Long Distance Operators/ Access Service Providers and meeting the quality of service regulations and network to network interface requirement within three years from the effective date of licence;
- The applicant company shall pay one time non-refundable Entry Fee of Rs 2.5 crores before the signing of the licence. A processing fee of Rs. 50,000 is also payable by the applicant;
- In addition, unconditional Bank Guarantee (BG) of Rs. 2.50 crores shall be given which will be released on fulfilment of the roll out obligations. Non-fulfilment of roll out obligations will result in encashment of the bank guarantee by the licensor. This will be without prejudice to any other action,

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which the licensor may consider appropriate for the failure of licensee to fulfil the licence conditions;

- The applicant company itself shall have a networth as well as paid up capital of Rs. 2.5 crores on the date of application and shall submit the certificate to that effect from Company Secretary/ Company's statutory Auditor along with the application for licence. The minimum networth & paid up capital shall be maintained during currency of licence;
- In addition to entry fee described above, the annual licence fee including USO contribution, @ 6% of the Adjusted Gross Revenue (AGR) shall be payable. The quarterly instalments of licence fee for the first three quarters of a financial year shall be payable by the Licensee within 15 days of the completion of the relevant quarter of the year. This fee shall be paid by the Licensee on the basis of actual revenues (on accrual basis) for the quarter duly certified with an affidavit by a representative of the Licensee, authorised by a Board resolution coupled with General Power of Attorney. However, for the last quarter of financial year, the Licensee shall pay the licence fee by 25th March on the basis of expected revenues for the quarter, subject to a minimum payment equal to the actual revenue share paid for the previous quarter. For delayed payment beyond the said due dates, penalty as stipulated in licence for delayed payments will apply. The Licensee shall adjust and pay the difference between the payment made and actual amount duly payable (on accrual basis) for the last quarter of the Financial year within 15 days of the end of the said quarter. The Licensor shall have the right to inspect books of accounts of the Licensee, and, in addition have an independent audit conducted to ascertain the correctness of the licence fee paid;
- Full details of the settlement regime through accounting rate mechanisms shall be required to be filed by the ILD service licensee with the Licensor on regular basis. All bilateral settlements between the ILD service licensee and other foreign partner (carrier) shall be through normal banking channels in a transparent manner;
- The applicant company shall submit Financial Bank

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Guarantee (FBG) of Rs. 20 crores, one year after the date of signing the licence agreement or before the commencement of service, whichever is earlier, in the prescribed proforma given in the Licence Agreement. The FBG shall be valid for a period of one year and shall be renewed from time to time for such amount as may be directed by the Licensor. The amount of FBG shall be equivalent to the estimated sum payable for two quarters towards licence fee;

- ILD service provider can enter into an arrangement for leased lines with the Access Providers/NLD service provider. Further, ILD Service Providers can access the subscribers directly only for provision of international Leased Circuits/Close User Groups (CUGs). Leased circuit is defined as virtual private network (VPN) using circuit or packet switched (IP Protocol) technology apart from point to point non-switched physical connections/transmission bandwidth. Public network is not to be connected with leased circuits/CUGs;
- The licensees (who are International Long Distance, National Long Distance, Basic or Cellular Mobile Telephone service operators) can have only one Switch to perform the functions of ILD/ NLD/Cellular/ Basic services provided that the switch is located at the same station and separate accounts of all the operations are maintained by duly apportioning the costs between various service. Separate TAX and Gateway switch is not mandatory; and
- The charges for access or interconnection with other networks shall be based on mutual agreements between the service providers subject to the restrictions issued from time to time by TRAI under TRAI Act, 1997.

In case of not adhering to Licence conditions envisaged below, the licence(s) granted to the company shall be deemed as cancelled and the licensor shall have the right to encash the performance/financial bank guarantee(s) and the licensor shall not be liable for loss of any kind:

- i. There shall be a non-obstante clause in the licence which confers powers upon the licensor to cancel the licence under certain defined circumstances;

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- ii. In order to ensure that at least one serious resident Indian promoter subscribes reasonable amount of the resident Indian shareholding, such resident Indian promoter shall hold at least 10 per cent equity of the licensee company;
- iii. The Company shall acknowledge compliance with the licence agreement as a part of Memorandum of Association of the Company. Any violation of the licence agreement shall automatically lead to the company being unable to carry on its business in this regard. The duty to comply with the licence agreement shall also be made a part of Articles of Association;
- iv. Chief Technical Officer (CTO)/Chief Finance Officer (CFO) shall be resident Indian citizens. The Licensor can also further notify key positions to be held by resident Indian citizens;
- v. The Company shall not transfer the following to any person/ place outside India:
 - a. any accounting information relating to subscriber (except for roaming/billing) (Note: it does not restrict a statutory disclosure of financial nature);
 - b. user information (except pertaining to foreign subscribers using Indian Operator's network while roaming); and
 - c. details of their infrastructure/network diagram except to telecom equipment suppliers/manufacturers who undertake the installation, commissioning etc., of the infrastructure of the licensee Company on signing of non- disclosure agreement.
- vi. The Company when entering into roaming agreements with service providers outside India must provide, on demand, the list of such users (telephone numbers, in case of foreign subscribers using Indian Operator's network while roaming);
- vii. The Company must provide traceable identity of their subscribers. However, in case of providing service to roaming subscriber of foreign Companies, the Indian Company shall endeavour to obtain traceable identity of roaming subscribers from the foreign company as a part of

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- its roaming agreement;
- viii. No traffic (mobile and landline) from subscribers within India to subscribers within India shall be hauled to any place outside India. For this purpose, location of satellites serving India for domestic traffic shall not be treated as outside India;
- ix. No Remote Access (RA) shall be provided to any equipment manufacturer or any other agency out side the country for any maintenance/repairs by the licensee. However, RA may be allowed for catastrophic software failure (such as failure to boot up etc.) which would lead to major part of the network becoming non- functional for a prolonged period, subject to meeting the following conditions:
 - a. An identified Government agency (Intelligence Bureau) will be notified, when RA is to be provided;
 - b. Remote Access password is to be enabled for a definite period only and only for access from pre-approved locations of the Original Equipment Manufacturer (OEM) Vendors and only for the equipments specifically under repair/maintenance;
 - c. The control of Remote Access i.e. activation, transfer of data, termination etc. shall be within the country and not at a Remote location, abroad;
 - d. The Government agency will be given all support to record the transactions for on-line monitoring;
 - e. Any equipment or software that forms be permitted to have remote access under any circumstances;
 - f. The terms catastrophic software failure, major part of the network, and prolonged period used under this clause shall be as defined by LICENSOR from time to time.
- x. It shall be open to the Licensor to restrict the Licensee Company from operating in any sensitive area from the National Security angle;
- xi. In order to maintain the privacy of voice and data, monitoring shall only be upon authorisation by the Union Home Secretary or Home Secretaries of the States/Union Territories; and

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- xii. For monitoring traffic, the licensee company shall provide blind access of their network and other facilities as well as to books of accounts to the security agencies.

The Licensor may, without prejudice to any other remedy available to it for the breach of any conditions of ILD service licence, by a written notice of 60 days issued to the licensee at its registered office, terminate the licence under any of the following circumstances:

If the licensee:

- a. fails to commission or deliver the service within the time period(s) specified in the licence;
- b. fails to perform any obligation(s) under the licence including remittance of timely payments of fee and other dues due to the Licensor;
- c. fails to rectify, within the time prescribed, any defect as may be pointed out to the licensee by the Licensor;
- d. goes in liquidation or ordered to be wound up;
- e. is recommended by TRAI for termination of licence for non compliance of the terms and conditions of the licence; and
- f. fails to comply with FDI norms.

The fee/ royalty for the use of spectrum and possession of wireless telegraphy equipment shall be separately payable as per the details and prescription of Wireless Planning & Coordination Wing. The fee/royalty for the use of spectrum /possession of wireless telegraphy equipment depends upon various factors such as frequency, link length, area of operation, etc.

1.2 Guidelines for National Long Distance Services Licence:

Similar guidelines are issued for NLD licence vide guidelines No.10-21/2005-BS-I/ 47 dated 14th December 2005. Some of the guidelines are:

- The applicant must be an Indian company, registered under the Companies Act, 1956;
- The applicant company can apply only for one licence for National Long Distance Service;

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- The licence for NLDO shall be issued on non-exclusive basis, for a period of 20 years, extendable by 10 years at one time, for inter-circle Long Distance operations within the territorial jurisdiction of India;
- The applicant company shall pay one time non-refundable Entry Fee of Rs 2.5 crores before the signing of the Licence. The applicant company shall pay a processing fee along with the application of Rs. 15,000;
- The applicant company shall also submit business plan along with its funding arrangement for financing the project;
- The applicant company shall have a minimum network as well as paid up equity capital of Rs. 2.5 Crores on the date of the application and shall submit the certificate to that effect from Company Secretary/Company's statutory Auditors along with the application for licence. The minimum network and paid up capital shall be maintained during currency of licence;
- In addition to entry fee described above, the annual licence fee including USO contribution, @ 6% of the Adjusted Gross Revenue (AGR) shall be payable. Licence fee shall be payable in four quarterly instalments during each financial year. The quarterly instalments of licence fee for the first three quarters of a financial year shall be payable by the Licensee within 15 days of the completion of the relevant quarter of the year. This fee shall be paid by the Licensee on the basis of actual revenues (on accrual basis) for the quarter duly certified with an affidavit by a representative of the Licensee, authorised by a Board resolution coupled with General Power of Attorney. However, for the last quarter of financial year, the Licensee shall pay the licence fee by 25th March on the basis of expected revenues for the quarter, subject to a minimum payment equal to the actual revenue share paid for the previous quarter. For delayed payment beyond the said due dates, penalty as stipulated in licence for delayed payments will apply. The Licensee shall adjust and pay the

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difference between the payment made and actual amount duly payable (on accrual basis) for the last quarter of the Financial year within 15 days of the end of the said quarter. The Licensor shall have the right to inspect books of accounts of the Licensee, and, in addition have an independent audit conducted to ascertain the correctness of the licence fee paid;

- The applicant company shall submit Financial Bank Guarantee (FBG) of Rs. 20 crores, one year after the date of signing the licence agreement or before the commencement of service whichever is earlier in the prescribed Proforma given in the Licence Agreement. Initially, FBG shall be valid for a period of one year and shall be renewed from time to time for such amount as may be directed by the Central Government;
- NLD service Licensee shall be required to make own suitable arrangements/ agreements for leased lines with the Access Providers for last mile. Further, NLD Service Providers can access the subscribers directly only for provision of Leased Circuits/Close User Groups (CUGs). Leased circuit is defined as virtual private network (VPN) using circuit or packet switched (IP Protocol) technology apart from point to point non-switched physical connections/transmission bandwidth. Public network is not to be connected with leased circuits/CUGs. It is clarified that NLD service Licensee can provide bandwidth to other telecom service licensee also;
- The licensees (who are International Long Distance, National Long Distance, Basic or Cellular Mobile Telephone service operators) can have only one Switch to perform the functions of ILD/ NLD/Cellular/ Basic services provided that the switch is located at the same station and separate accounts of all the operations are maintained by duly apportioning the costs between various service. Separate TAX and Gateway switch is not mandatory. NLD service providers are permitted to deploy circuit switched or managed Packet Switched network to engineer their

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NLD networks; and

- The charges for access or interconnection with other networks shall be based on mutual agreements between the service providers subject to the restrictions issued from time to time by TRAI under TRAI Act, 1997.

In case of not adhering to Licence conditions envisaged below, the licence(s) granted to the company shall be deemed as cancelled and the licensor shall have the right to encash the performance/financial bank guarantee(s) and the licensor shall not be liable for loss of any kind:

- i. There shall be a non-obstante clause in the licence which confers powers upon the licensor to cancel the licence under certain defined circumstances;
- ii. In order to ensure that at least one serious resident Indian promoter subscribes reasonable amount of the resident Indian shareholding, such resident Indian promoter shall hold at least 10 per cent equity of the licensee company;
- iii. The Company shall acknowledge compliance with the licence agreement as a part of Memorandum of Association of the Company. Any violation of the licence agreement shall automatically lead to the company being unable to carry on its business in this regard. The duty to comply with the licence agreement shall also be made a part of Articles of Association;
- iv. Chief Technical Officer (CTO)/Chief Finance Officer (CFO) shall be resident Indian citizens. The Licensor can also further notify key positions to be held by resident Indian citizens;
- v. The Company shall not transfer the following to any person/ place outside India:
 - a. any accounting information relating to subscriber (except for roaming/billing) (Note: it does not restrict a statutorily required disclosure of financial nature);
 - b. user information (except pertaining to foreign subscribers using Indian Operator's network while roaming); and

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- c. details of their infrastructure/network diagram except to telecom equipment suppliers/manufacturers who undertake the installation, commissioning etc. of the infrastructure of the licensee Company on signing of non-disclosure agreement.
- vi. The Company when entering into roaming agreements with service providers outside India must provide, on demand, the list of such users (telephone numbers, in case of foreign subscribers using Indian Operator's network while roaming);
- vii. The Company must provide traceable identity of their subscribers. However, in case of providing service to roaming subscriber of Foreign Companies, the Indian Company shall endeavour to obtain traceable identity of roaming subscribers from the foreign company as a part of its roaming agreement;
- viii. No traffic (mobile and landline) from subscribers within India to subscribers within India shall be hauled to any place outside India. For this purpose, the location of satellites serving for domestic traffic shall not be treated as outside India;
- ix. No Remote Access (RA) shall be provided to any equipment manufacturer or any other agency outside the country for any maintenance/repairs by the licensee. However, RA may be allowed for catastrophic software failure (such as failure to boot up etc.) which would lead to major part of the network becoming non- functional for a prolonged period, subject to meeting the following conditions:
 - a. An identified Government agency (Intelligence Bureau) will be notified, when RA is to be provided;
 - b. Remote Access password is to be enabled for a definite period only and only for access from pre-approved locations of the Original Equipment Manufacturer (OEM) Vendors and only for the equipments specifically under repair/maintenance;

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- c. The control of Remote Access i.e. activation, transfer of data, termination etc. shall be within the country and not at a remote location, abroad;
 - d. The Government agency will be given all support to record the transactions for on-line monitoring;
 - e. Any equipment or software that forms part of the overall monitoring shall not be permitted to have remote access under any circumstances; and
 - f. The terms catastrophic software failure, major part of the network, and prolonged period used under this clause shall be as defined by LICENSOR from time to time.
- x. It shall be open to the Department of Telecommunications to restrict the Licensee Company from operating in any sensitive area from the National Security angle;
 - xi. In order to maintain the privacy of voice and data, monitoring shall only be upon authorisation by the Union Home Secretary or Home Secretaries of the States/ Union Territories; and
 - xii. For monitoring traffic, the licensee company shall provide blind access of their network and other facilities as well as to books of accounts to the security agencies.

The Licensor may, without prejudice to any other remedy available to it for the breach of any conditions of NLD service licence, by a written notice of 60 days issued to the licensee at its registered office, terminate the licence under any of the following circumstances:

If the licensee:

- a. fails to commission or deliver the service within the time period(s) specified in the licence;
- b. fails to perform any obligation(s) under the licence including remittance of timely payments of fee and other dues due to the Licensor;
- c. fails to rectify, within the time prescribed, any defect as may be pointed out to the licensee by the Licensor;
- d. goes in liquidation or ordered to be wound up;

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- e. is recommended by TRAI for termination of licence for non-compliance of the terms and conditions of the licence; and
- f. fails to comply with FDI norms.

The fee/ royalty for the use of spectrum and possession of wireless telegraphy equipment shall be separately payable as per the details and prescription of Wireless Planning & Coordination Wing. The fee/royalty for the user spectrum /possession of wireless telegraphy equipment depends upon various factors such as frequency, hop and link length, area of operation, etc.

1.3 Guidelines for Cellular Mobile Telephone Service Licence

Following are the broad guidelines for issue of Licence for provision of CMTS in India:

- The bidder must be an Indian company, registered under the Indian Companies Act, 1956;
- The total foreign equity should not exceed 74% of the total paid-up equity of the company. The management control of the company shall lie in the Indian hands for the complete duration of license;
- The bidder company can apply for any number of service areas subject to fulfilment of all the conditions of entry;
- The license for CMTS will be issued on non-exclusive basis, for a period of 20 years, further extendable by 10 years at one time at the discretion of licensing Authority on mutually agreed terms and conditions, for providing service within the territorial jurisdiction of licensed service area;
- The bidder and promoters of bidder company should have a combined net-worth of amount indicated in Annex-II. The net-worth of only those promoters shall be counted who have at least 10% equity stake or more in the total equity of the company. Here networth shall mean as the sum total, in Indian Rupees, of paid up equity capital and free reserves. While counting Net-worth the foreign currency shall be converted into Indian Rupees at the prevalent rate indicated by the Reserve Bank of India as on the date of invitation of the bids;
- The successful bidder will be required to pay one time

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Entry Fee based on the final bid before signing the Licence Agreement;

- In addition to the Entry fee described above, the Licensee shall also pay License fee annually @ 10/8/6% of “Adjusted Gross Revenue” for the Category A/B/C telecom circles respectively as Revenue Share generated from the service in accordance with the procedure prescribed in the License Agreement document;
- Further, royalty for the use of spectrum for point to point links and access links (other than Cellular Service Spectrum) shall be separately payable as per the details and prescription of Wireless Planning & Coordination Wing. The fee/royalty for the use of spectrum /possession of wireless telegraphy equipment depends upon various factors such as frequency, hop and link length, area of operation etc. Authorisation of frequencies for setting up Microwave links by Cellular Operators and issue of licenses shall be separately dealt with WPC Wing as per existing rules;
- The bidder company shall submit Financial Bank Guarantee (FBG) of amount equal to Rs. 50, 25 and 15 Crores for category 'A' 'B' & 'C' service areas before the date of signing the licence agreement in the prescribed Proforma given in the Licence Agreement. Initially, FBG shall be valid for a period of one year and shall be renewed from time to time for such amount as may be directed by the Licensor. The bidder shall also submit Performance Bank Guarantees (PBG) of amount equal to Rs. 20, 10 and 2 Crores for category 'A' 'B' & 'C' service areas as prescribed in the license agreement before signing the license;
- Direct Interconnectivity among all service providers in a service area has been permitted for terminating traffic of each other subject to any regulations issued from time to time by Telecom Regulatory Authority of India (TRAI) under TRAI Act, 1997 as amended from time to time. Interconnection among Operators shall be as per mutual agreement between them;
- The frequencies shall be assigned by WPC from the designated bands prescribed in National Frequency

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Allocation Plan - 2000. (NFAP-2000). A cumulative maximum of upto 4.4 MHz + 4.4 MHz will be permitted. Based on usage, justification and availability, additional spectrum upto 1.8 MHz + 1.8 MHz making a total of 6.2 MHz +6.2 MHz, may be considered for assignment, on case by case basis, on payment of additional license fee;

- The charges for access or interconnection with other networks shall be based on mutual agreements between the service providers subject to any regulations issued from time to time by TRAI under TRAI Act, 1997, as amended from time to time;
- LICENSOR shall have the right to take over the SERVICE, equipment and networks of the LICENSEE or revoke/terminate/suspend the LICENCE either in part or in whole of the Service area in the interest of national security or in case of emergency or war or low intensity conflict or any other eventuality in public interest as declared by the Government of India. Provided any specific orders or direction from the Government issued under such conditions shall be applicable to the LICENSEE and shall be strictly complied with. Further, the LICENSOR reserves the right to keep any area out of the operation zone of the service if implications of security so require;
- LICENSEE will ensure that the Telecommunication installation carried out by it should not become a safety hazard and is not in contravention of any statute, rule or regulation and public policy;
- The LICENSEE shall take measures that prevent the objectionable, obscene, unauthorised or any other content, messages or communications infringing copyright, intellectual property etc., in any form, from being carried on his network, consistent with the established laws of the country. Once specific instances of such infringement are reported to the LICENSEE by the authorised agencies, the Licensee shall ensure that the carriage of such material on his network is prevented immediately. The LICENSEE is obliged to provide, without any delay, tracing facility to trace nuisance, obnoxious or malicious calls, messages or communications transported through his equipment and network. Any damages arising

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out of default on the part of LICENSEE in this regard shall be payable by the licensee; and

- In case any confidential information is divulged to the LICENSEE for proper implementation of the Agreement, it shall be binding on the Licensee and its employees and servants to maintain its secrecy and confidentiality.

Eligibility Criteria, General Conditions and the Bidding Process:

- i. The minimum net-worth of the bidder company and its promoters (networth of only such promoters having not less than 10% share in the equity capital of the bidder company shall be added) and paid up equity capital of the bidder company should be at least as below:

Paid up Equity capital of the Bidding Company.	Service Areas (one or more in each category) for which bid can be submitted.
3 Crores	C
5 Crores	B and C
10 Crores	A, B and C

Note: A bidder company, which meets the minimum requirement of paid up equity for a service area of one category, may bid for any number of service areas of that or lower category.

Net-worth	Total Minimum Net-worth required
Rs. 30 Crores for each Category C Service Area Rs. 50 Crores for each Category B Service Area Rs. 100 Crores for each Category A Service Area	$100X + 50Y + 30Z$ where X, Y & Z is respectively the Number of A, B & C Service Areas bided for

- ii. A promoter company cannot have stakes in more than one Bidder Company for the same service area;
- iii. The existing licensees cannot bid for the same service area;
- iv. The bidder must comply with the technical specifications, commercial, financial and operating conditions as laid down by the licensor;

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- v. There shall be no restriction on number of licenses that can be awarded to a bidder company;
- vi. Minimum roll-out obligation: In Telecom Circles, at least 10% of the District Headquarters (DHQs) will be covered in the first year and 50% of the District Headquarters will be covered within three years of effective date of License. The licensees shall also be permitted to cover any other town in a District in lieu of the District Headquarters. Coverage of a DHQ/town would mean that at least 90% of the area bounded by the Municipal limits should get the required street as well as in-building coverage. In Metros, 90% of the service area shall be covered within one year of the effective date. The District Headquarters shall be taken as on the effective date of license; and
- vii. The bidder company and/or its promoters should have experience in telecom sector.

Pre-Qualification Round: The bidders shall be pre-qualified if they meet the prescribed eligibility criteria such as, Financial strength, minimum roll out obligation, technical plan, business plan and other conditions as specified in the Tender Document Earnest money Bank Guarantee (EMBG) shall be returned to the bidders who fail in the pre-qualification round. No weightage shall be attached to the pre-qualification criteria.

Financial Bidding:

- i. The bidding process shall be structured as “Informed Ascending Bidding Process.” The pre-qualification bid as well as the first Financial Bid with EMBG will be submitted by the bidders in separate sealed covers. The pre-qualification Bid and Financial Bids of pre-qualified bidders as also Financial Bids in every subsequent round of financial bidding shall be opened in the presence of bidders' representatives, who should carry a letter of authority from the bidder company authorising them to attend the bid opening and shall be made public;
- ii. The highest pre-qualified offer in the first financial bid shall

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be treated as 'Reserve Price' for subsequent round of bidding. If there are four or more pre-qualified bidders, excepting the lowest bidder, others will qualify for the second round of financial bidding. In case, there are less than four pre-qualified bidders, all will qualify for second round of financial bidding;

- iii. The successful bidders in the first round of financial bidding shall submit a Second Financial Bid for the second round of financial bidding, the bid amount to be quoted in this round will have to be equal to more than the 'Reserve Price'. The bidder who do not bid equal to or more than the 'Reserve Price' shall be disqualified for the further round of bidding. Bidders will, however not be permitted to reduce the bid amount from their financial bid in the first round; in the event of such happenings, his EMBG shall be encashed and earnest money shall be forfeited;
- iv. All the bidders who have quoted more than the 'Reserve Price' in the second round of financial bidding will be short-listed. If there are three or more such short-listed bidders, excepting the lowest bidder others will qualify for the third round of financial bidding. In case, there are only two short-listed bidders, both will qualify;

In case, there is only one short-listed bidder, there will be no third round of bidding.

- v. The bidders, who qualify for bidding for the third round, shall be required to submit the third and conclusive financial bid. The highest bidder of the third round financial bidding will be declared successful for grant of license;

The successful bidder shall deposit at least 20% of the bid amount by the close of the office hours on the next working day without waiting for a formal demand from the licensor in this regard. The balance 80% of the bid amount must be paid within 10 days of the final bid opening.

- vi. In case the successful highest bidder does not pay the due amount of 20% as above within the given time, his EMBG

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shall be encashed and the amount of EMBG shall be forfeited and the said bidder will be dis-qualified from the bidding process for license of the concerned service area. In case the said bidder pays 20% of the bid amount as above within the given time but subsequently backs out and does not pay the balance amount of the quoted entry fee as well as sign the license agreement by the prescribed date after fulfilling other requirements of furnishing FBG & PBG, then his EMBG shall be encashed and the amount realised shall be forfeited, the 20% of the bid amount paid as above shall also be forfeited and the said bidder shall be dis-qualified from the bidding process for license of the concerned service area without any further notice. The successful bidders of the previous round without dropping any bidder shall be asked to bid once again for a further round of financial bidding and the highest bidder of this round will then be declared successful for grant of licence. This process shall continue till the license is awarded; and

- vii. In case there is a tie in the conclusive round of bidding, the bidder who quoted higher amount in the previous round shall be declared successful for award of license.

In the service areas, where more than one licences are to be awarded, the first highest bidder, next highest bidder and so on in the third and conclusive round shall be declared successful to sign the license provided that the difference in entry fee quoted between the highest and other such bidders is less than 25%. The higher of the bidders shall operate the service in 900 MHz band against the vacant slot(s) and lower of successful bidder in 1800 MHz as fourth operator. In case the difference in entry fee quoted by the successful bidders is lower than 25% than the highest bidder, there shall be another round of financial bidding from amongst successful bidders of previous round.

Example 1: West Bengal Circle there are two licenses on offer.

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The highest successful bidder will be granted first license for 900 MHz Band. The next highest bidder, if he has quoted entry fee within the range of 25% difference from the first highest bidder, will be granted second license for 1800 MHz Band; however, if the difference is more than 25%, a further round of bidding will take place for which all the bidders who participated in the third round, except the one who is already successful for first license, will participate.

Example 2: Andaman & Nicobar Circle there are three licenses on offer.

The highest successful bidder will be granted first license for 900 MHz Band. Such of the next two highest bidders, who have quoted entry fee within the range of 25% difference from the first highest bidder, will be granted second license for 900 MHz Band and third license for 1800 MHz band, in that order; however, if the difference is more than 25% a further round of bidding will take place for which all the bidders who participated in the third round, except for those who are already successful for the first one or two licenses, will participate.

In every successive round of bidding, the bidders can only exceed or retain the bid amount of previous bid, lowering their bid or backing out unless ineligible will attract forfeiture of EMBG.

The Earnest Money Bank Guarantees as below shall be submitted by the bidders separately against each license bided for:

Category of Service	Area Amount of EMBG
A	20 Crores,
B	10 Crores,
C	2 Crores.

1.4 Guidelines for Internet Service Licence

There are two licences under Internet, namely, ISP licence with telephony and ISP licence without telephony. Under ISP licence with telephony, the service provider can provide voice services in addition to the normal internet services.

Internet telephony is service to process and carry voice signals offered through public internet by use of personal computer or IP based customer premise equipments connecting the following:

1. PC to PC within or outside India,
2. PC in India to telephone outside India, and
3. IP based terminal connected to similar nodes within or outside India.

Internet Telephony is a different service in its scope, nature and kind from real time voice service as offered by other licensed operators like BSO CMSO, NLDO, ILDO and PMRTS.

The following are outside and do not fall under Internet Telephony service:-

- i. Voice communication from anywhere to anywhere by means of dialling a telephone number (PSTN/ISDN/PLMN) as defined in National Numbering Plan,
- ii. Originating the voice communication service from a Telephone in India,
- iii. Terminating the voice communication to Telephone within India,
- iv. Establishing connection to any Public Switched Network in India,
- v. Dial up lines with outward dialling facility from nodes, and
- vi. Interconnectivity between ISPs who are permitted to offer Internet Telephony Services and the ISPs who are not permitted to offer Internet Telephony Services.

The other licence conditions are similar for both the licenses and are briefly summarised as follows:

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- A Company registered in India under the Companies Act, 1956 is eligible to provide Internet service;
- Foreign equity, if any, shall be as per the Government policy and guidelines from time to time. At present, the foreign equity is permitted to the extent of 74%;
- There is no requirement of the applicant company having any prior experience in information technology or telecommunication services;
- Separate licences shall be granted to any applicant company for each service area. For this purpose, the country has been divided into separate service areas in three categories as mentioned below:
 - i. Category "A" This covers the territorial jurisdiction of the Union of India except specified areas that may be notified to be excluded from time to time;
 - ii. Category "B" Any of the 20 Territorial Telecom Circles, four Metro Telephone Districts of Delhi, Mumbai, Calcutta or Chennai and four major telephone districts of Ahmedabad, Bangalore, Hyderabad or Pune are Category 'B' Service areas. The four Metro Telephone Districts (Delhi, Mumbai, Calcutta & Chennai) are not part of any Telecom Circle, whereas the four major Telephone Districts (Ahmedabad, Bangalore, Hyderabad & Pune) are part of respective Telecom Circle;
 - iii. Category "C" Any Secondary Switching Area (SSA) of DOT with geographical boundaries as on 1.4.98, will form a separate category "C" Service Area.
- The ISP will be required to set up his nodes i.e., Routes/servers within the geographical limits of the service area. An applicant company may be granted any number of licences. Also, there shall be no limit on number of licences that can be granted in a particular service area. The leased line subscribers shall be from within the service area. However, the ISP can offer dial up service from any

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part of the country;

- Existing E-Mail and VSAT Service Licensees may also obtain separate ISP Licence for any number of the above mentioned service areas subject to fulfilment of eligibility criteria;
- The processing fees are Rs. 5,000/- (Rupees FIVE Thousand only);
- Direct interconnectivity between two separately licensed ISPs shall be permitted. Authorised Public/Government organisations will be allowed to provide INTERNET Gateway access including international leased circuits directly without going through VSNL Gateways. Private ISPs are allowed to provide such International Gateways after obtaining Security clearance for which the Interface of Private ISPs shall only be with the Telecom Authority;
- The licensee may obtain the transmission link on lease from DOT, Licensed Basic Service Operators, Railways, State Electricity Boards, National Power Grid Corporation or any other operator specially authorised to lease such lines to the ISPs. The licensee may also establish its own transmission links within its service area for carrying traffic originated and terminated by his subscribers, provided that such capacities are not available from any other authorised agencies and subject to permission of Telecom Authority;
- An ISP may provide Internet Service to any VSAT subscriber (who could be served by a shared hub commercial service provider or captive private VSAT network), if the VSAT is located within the service area of the ISP. For this purpose, a direct interconnection of VSAT or VSAT-hub through leased line obtained from an authorised provider to the ISP's node/server shall be permitted only for the flow of Internet traffic. The existing licence for Closed Users Group Domestic 64 KBPS Data Network via INSAT Satellite Systems does not grant long distance carrier rights to the licensee. The ISP shall provide to the Telecom Authority a monthly statement of VSAT subscribers served with their locations and details of

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leased line interconnection with the VSAT hub. The VSAT hub, however, need not be located in the service area of the ISP;

- Resources required for interconnecting the licensee's network to the network of upstream internet access providers (DOT/VSNL etc.) or any other service provider licensed by the Authority including time frame for provision of the same, will be mutually agreed between the parties concerned. The resources may refer to include but not limited to physical junctions, PCM derived channels, private wires, leased lines, data circuits other network elements. The licensee shall apply for and obtain the network resources from the concerned parties. The tariff of such network is outside the scope of this licence agreement. Licensor will have no obligation for such resources from other parties;
- The validity of licence is initially for a period of fifteen years unless otherwise terminated. If requested by the licensee, extension may be granted by the TELECOM AUTHORITY on suitable terms and conditions for a period of five years or more at a time;
- Access to internet through authorised Cable Operator shall be permitted without additional licensing subject to applicable Cable Laws (The Cable Television Networks (Regulation) Act, 1995) as modified from time to time;
- 'Last mile' linkages shall be freely permitted within local area either by fibre optic or radio communication for ISPs. In case of radio links, clearance from WPC wing of the DoT shall be required to be obtained by the ISPs to avoid frequency interference;
- It will be the responsibility of the licensee to obtain IP address, domain name etc. from the competent authority. In case the IP addresses are taken from the Department of Telecommunications, the same are non-portable and have to be returned to DoT at the termination of connectivity contract;

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- The Telecom Authority has decided to waive the Licence Fee for a period up to 31.10.2003. For those ISPs also who obtain licences prior to 01.11.2003, a nominal licence fee of One Rupee per annum will become payable from 01.11.2003. For access and other charges including MODEM charges payable to the DOT/ MTNL/VSNL/other service provider at the prescribed rates, bills will be raised directly by the DOT/MTNL/VSNL/other service provider and shall be a matter between the Licensee and such service provider(s);
- A performance bank guarantee of Rs. 2.00 crores for category 'A' Service Area, Rs. 20.00 lakhs for each category 'B' Service Area and Rs. 3.00 lakhs for each category 'C' Service Area valid for two years from any Scheduled Bank.; and
- ISPs will be free to fix their own tariff. The tariff shall be left open to be decided by market forces. However, the TRAI (Telecom Regulatory Authority of India) may review and fix a tariff at any time during the validity of the licence which shall be binding on the Licensee.

1.5 Guidelines for Unified Access Services Licence

- The applicant must be an Indian company, registered under the Indian Companies Act, 1956;
- The applicant company can apply for Licence in more than one service area subject to fulfilment of all the conditions of entry;
- The applicant company shall pay a processing fee of Rs. 15,000/-;
- The total composite foreign holding should not exceed 74 per cent;
- The licence for Unified Access Services shall be issued on non-exclusive basis, for a period of 20 years, extendable by 10 years at one time within the territorial jurisdiction of a licensed Service Area;
- No single company/ legal person, either directly or through

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its associates, shall have substantial equity holding in more than one LICENSEE Company in the same service area for the Access Services namely; Basic, Cellular and Unified Access Service. 'Substantial equity' herein will mean 'an equity of 10% or more'. A promoter company/ Legal person cannot have stakes in more than one LICENSEE Company for the same service area;

- The applicant company shall have a minimum paid up equity capital of Rs. 10 crores, Rs. 5 crores and Rs. 3 crores for Category A, B and C service areas respectively;
- The applicant and promoters of applicant company should have a combined net-worth of amount as detailed in the Table below:

Net-worth	Total Minimum Net-worth required
Rs.30 Crores for each Category C Service Area	100 X+50 Y+30 Z where X,Y & Z is respectively the Number of A, B & C Service Areas for which either LOI/ Licence have been issued or applied for in the name of applicant.
Rs.50 Crores for each Category B Service Area	
Rs.100 Crores for each Category A Service Area	

- The network of only those promoters shall be counted who have at least 10% equity stake or more in the total equity of the company. Here network shall mean as the sum total, in Indian Rupees, of paid up equity capital and free reserves. While counting ne-worth the foreign currency shall be converted into Indian Rupees at the prevalent rate indicated by the Reserve Bank of India as on the date of Application received. The minimum network & paid-up capital shall be maintained during currency of the Licence;
- The applicant will be required to pay one time non-refundable Entry Fee based on the Letter of Indent (LOI) before signing the Licence Agreement, as mentioned in the Licence agreement for different states;

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- The Licensee shall pay Licence fee annually @ 10/8/6% of Adjusted Gross Revenue (AGR) for category A/B/C service areas respectively excluding spectrum charges.

Licence Fee shall be payable in four quarterly instalments during each financial year (FY). Quarterly instalment of licence fee for the first three quarters of a financial year shall be paid within 15 days of the completion of the relevant quarter. This Fee shall be paid by the LICENSEE on the basis of actual revenue (on accrual basis) for the quarter, duly certified with an affidavit by a representative of the LICENSEE, authorised by the Board Resolution coupled with General Power of Attorney. However, for the last quarter of the financial year, the LICENSEE shall pay the Licence Fee by 25th March on the basis of expected revenue for the quarter, subject to a minimum payment equal to the actual revenue share paid of the previous quarter.

Any delay in payment of Licence Fee, or any other dues payable under the LICENCE beyond the stipulated period will attract interest at a rate which will be 2% above the Prime Lending Rate (PLR) of State Bank of India existing as on the beginning of the financial year (1st April) in respect of the licence fees pertaining to the said financial year. The interest shall be compounded monthly and a part of the month shall be reckoned as a full month for the purpose of calculation of interest.

In case, the total amount paid on the self-assessment of the LICENSEE as quarterly LICENCE Fee for the 4 (four) quarters of the financial year, falls short by more than 10% of the payable LICENCE Fee, it shall attract a penalty of 50% of the entire amount of short payment. This amount of short payment along with the penalty shall be payable within 15 days of the date of signing the audit report on the annual accounts, failing which interest shall be further charged as per terms of Condition in above paragraph 16. However, if such short payment is made good within 60 days from the last day of the financial year, no penalty shall be imposed.

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- The Fee/royalty payable towards [Wireless Planning and Coordination Wing (WPC)] WPC Charges shall be payable at such time(s) and in such manner as the WPC Wing of the DoT may prescribe from time to time;
- The LICENSEE shall pay spectrum charges in addition to the Licence Fees on revenue share basis as notified separately from time to time by the WPC Wing. However, while calculating 'AGR' for limited purpose of levying spectrum charges based on revenue share, revenue from wireline subscribers shall not be taken into account.

Further royalty for the use of spectrum for point to point links and other access links shall be separately payable as per the details and prescription of Wireless Planning & Coordination Wing. The fee/ royalty for the use of spectrum/ possession of wireless telegraphy equipment depends upon various factors such as frequency, hop and link length, area of operation and other related aspects etc. Authorization of frequencies for setting up Microwave links by Licensed Operators and issue of Licenses shall be separately dealt with WPC Wing as per existing rules.

The Fees, charges and royalties for the use of spectrum and also for possession of Wireless Telegraphy equipment shall be separately securitised by furnishing FBG of an amount equivalent to the estimated sum payable annually in the proforma annexed, to WPC, valid for a period of one year, renewable from time to time till final clearance of all such dues.

- The applicant company shall submit Financial Bank Guarantee (FBG) of amount equal to Rs. 50, 25 and 5 Crores for category 'A' 'B' & 'C' service areas respectively before the date of signing the licence agreement in the prescribed Proforma given in the Licence Agreement. Initially, FBG shall be valid for a period of one year and shall be renewed from time to time for such amount as may be directed by the Licensor. The applicant shall also submit Performance Bank Guarantees (PBG) of amount equal to Rs. 20, 10 and 2 Crores for category 'A' 'B' & 'C'

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service areas respectively in the prescribed Proforma given in the Licence Agreement before signing the licence. PBG shall be valid for a period of three year and shall be renewed from time to time. FBG and PBG must be from any Scheduled Bank or Public Financial Institution duly authorised to issue such Bank Guarantee;

- Licensee shall ensure “Roll-out obligations” that
 - i. At least 10% of the District Headquarters (DHQs) will be covered in the first year and 50% of the District Headquarters will be covered within three years of effective date of Licence;
 - ii. The choice of District Headquarters/towns to be covered and further expansion beyond 50% District Headquarters/towns shall lie with the Licensee depending on their business decision; and
 - iii. There is no requirement of mandatory coverage of rural areas.

On completion of one year from the effective date of Licence and meeting the coverage criteria stipulated for first year, the PBG shall be reduced to Rs.10/5/1 crores for category 'A'/B'/C' service areas on self-certification provided by the Licensee. Further on fulfilling the roll out obligations as stipulated in clause 34 of Licence agreement, the balance PBG shall be released on receipt of test certificate / test certificates issued by TEC in respect of coverage.

- The Licensee shall commission the Applicable Systems within one year from the effective date of the Licence. However, the Licensee may start providing service to customers at any time without the need of specific approval of the Licensor;
- Liquidated damages: In case the Licensee fails to bring the Service or any part thereof into commission (i.e., fails to deliver the service or to meet the required coverage

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criteria/ network roll out obligations) within the period prescribed for the commissioning, the Licensor shall be entitled to recover LD charges @ Rs. 5 Lakh (Rupees: Five Lakhs) per week for first 13 weeks; @ Rs 10 lakhs for the next 13 weeks and thereafter @ Rs. 20 lakhs for 26 weeks subject to a maximum of Rs. 7.00 crores. Part of the week is to be considered as a full week for the purpose of calculating the LD charges. For delay of more than 52 weeks the Licence may be terminated under the terms and conditions of the Licence agreement. The week shall mean 7 Calendar days (from midnight) Monday to Sunday; both days inclusive and any extra day shall be counted as full week for the purposes of recovery of liquidated damages;

The Licensor may also impose a financial penalty not exceeding Rs. 50 crores for violation of terms and conditions of licence agreement. This penalty is exclusive of Liquidated Damages as prescribed above.

- For wireless operations in Subscriber access network, the frequencies shall be assigned by WPC wing of the Department of Telecom from the frequency bands earmarked in the applicable National Frequency Allocation Plan and in coordination with various users. Initially a cumulative maximum of upto 4.4 MHz + 4.4 MHz shall be allocated in the case of TDMA based systems @ 200 KHz per carrier or 30 KHz per carrier or a maximum of 2.5 MHz + 2.5 MHz shall be allocated in the case of CDMA based systems @ 1.25 MHz per carrier, on case by case basis subject to availability;

Additional spectrum beyond the above stipulation may also be considered for allocation after ensuring optimal and efficient utilisation of the already allocated spectrum taking into account all types of traffic and guidelines / criteria prescribed from time to time. However, spectrum not more than 5 + 5 MHz in respect of CDMA system or 6.2 + 6.2 MHz in respect of TDMA based system shall be allocated to any new Unified Access Services Licensee. The spectrum shall be allocated in 824-844 MHz paired

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with 869 - 889 MHz, 890 - 915 MHz paired with 935 – 960 MHz, 1710 1785 MHz paired with 1805 1880 MHz;

In the event, a dedicated carrier for micro-cellular architecture based system is assigned in 1880 - 1900 MHz band, the spectrum not more than 3.75 + 3.75 MHz in respect of CDMA system or 4.4 + 4.4 MHz in respect of TDMA system shall be assigned to any new Unified Access Services Licensee.

- The Licensee may enter into suitable arrangements with other service providers to negotiate Interconnection Agreements whereby the interconnected networks will provide the following:
 - a. To meet all reasonable demand for the transmission and reception of messages between the interconnected systems;
 - b. To establish and maintain such one or more Points of Interconnect as are reasonably required and are of sufficient capacity and in sufficient numbers to enable transmission and reception of the messages by means of the Applicable Systems; and
 - c. To connect, and keep connected, to their Applicable Systems.

The terms and conditions of interconnection including standard interfaces, points of interconnection and technical aspects will be as mutually agreed between the service providers, subject to compliance of prevailing regulations, directions and determinations issued by TRAI from time to time.

The charges for accessing other networks for inter-network calls shall be based on mutual agreements between the service providers conforming to the Orders/Regulations/Guidelines issued by the TRAI from time to time.

- LICENSOR shall have the right to take over the SERVICE, equipment and networks of the LICENSEE or

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revoke/terminate/suspend the LICENCE either in part or in whole of the Service area in the interest of national security or in case of emergency or war or low intensity conflict or any other eventuality in public interest as declared by the Government of India. Any specific orders or direction from the Government issued under such conditions shall be immediately applicable to the LICENSEE without loss of time and shall be strictly complied with. Further, the LICENSOR reserves the right to keep any area out of the operation zone of the service if implications of security so require. Provided any taking over or suspension of licence, issuance of an order and exclusion of an area, as described above shall neither be a ground of extension of licence period or expansion of area in different corner or reduction of duly payable fee.

Appendix II

2.1 Specimen AGR Computation Sheet:

PARTICULARS	Apr 1, xxxx to June 30, xxxx	July 1, xxxx to Sep 30, xxxx	Oct 1, xxxx to Dec 31, xxxx	Jan 1, xxxx to Mar 31, xxxx	Cumul- ative figures for the year ended Mar 31, xxxx
1. Revenue from services					
A Revenue from wireline subscribers:					
i. Rentals,					
ii. Call revenue within service area,					
iii. National Long Distance Call revenue,					
iv. International Long Distance Call revenue,					
v. Pass thru revenue for usage of other networks (give Operator-wise details),					
vi. Service tax,					
vii. Service changes,					
viii. Charges on account of any other value added services, supplementary services, etc.,					
ix. Any other income/ miscellaneous receipt from wireline subscribers					
B Revenue from WLL subscribers: (Fixed)					
i. Rentals,					

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<ul style="list-style-type: none"> ii. Call revenue within service area, iii. National Long Distance Call revenue, iv. International Long Distance Call revenue, v. Pass thru revenue for usage of other network (give Operator-wise details), vi. Service tax, vii. Service charges, viii. Charges on account of any other value added service, supplementary services, etc., ix. Any other income/ miscellaneous receipt from WLL subscribers. 					
C Revenue from WLL subscribers : (Handheld) <ul style="list-style-type: none"> i. Rentals, ii. Call revenue within service area, iii. National Long Distance Call revenue, iv. International Long Distance Call revenue, v. Pass thru revenue for usage of other network (give Operator-wise details), vi. Service tax, vii. Service charges, viii. Charges on account 					

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of any other value added service, supplementary services, etc., ix. Any other income/ miscellaneous receipt from WLL subscribers.					
D. Revenue from Mobile Services: D1. Post paid options: <ul style="list-style-type: none"> i. Rentals, ii. Activation Charges, iii. Airtime Revenue, iv. Pass through charges, v. Service Tax, vi. Roaming charges, vii. Service charges, viii. Charges on account of any other value added services, supplementary services, etc., ix. Any other income/ miscellaneous receipt from post paid options. D2. Pre-paid options: <ul style="list-style-type: none"> i. Sale of pre-paid SIM cards including full value of all components charged therein ii. Any other income/miscellaneous receipt from pre-paid options D3. i. Revenue from Mobile Community phone service including full					

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<p>value of all components charged therein</p> <p>ii. Any other income/ miscellaneous receipt from Mobile Community phone service</p>					
<p>E. Revenue from Voice Mail/ any other value added service</p> <p>1. Income from trading activity (all exclusive of sales tax)</p> <p>i. Sale of handsets</p> <p>ii. Sale of accessories, including simcards etc.</p> <p>iii. Any other income/ miscellaneous receipt from trading activity</p>					
<p>2. Revenue from roaming</p> <p>i. Roaming facility revenue from own subscribers</p> <p>ii. Roaming revenue from own subscriber visiting other networks including STD/ ISD/ pass thru charges for transmission of incoming call during roaming</p> <p>iii. Roaming Commission earned</p> <p>iv. Roaming revenue on account of visiting subscribers from other networks</p> <p>v. Service Tax if not included above</p>					

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vi. Any other income/ miscellaneous receipt from roaming					
3. Income from investments i. Interest income ii. Dividend income iii. Any other miscellaneous receipt from investments					
4. Non-refundable deposits from subscribers					
5. Revenue from franchisee/ resellers including all commissions and discounts etc. excluding the revenues already included in IA&IB					
6. Revenue from sharing/ leasing of infrastructure					
7. Revenue from sale/ lease of bandwidth, links, R&G cases, turnkey projects etc.					
8. Revenue from other OPERATORS on account of pass through call charges					
9. Revenue from other OPERATORS on account of provisioning of inter connection					

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10. Miscellaneous revenue					
AA GROSS REVENUE OF THE LICENSEE COMPANY: (Add 1 to 10)					
B. DEDUCT: 1. Charges actually paid to other service provider(s) (operator- wise) 2. Roaming revenues actually paid to other CMSPs and GMPCS service providers (operator-wise) 3. Service Tax paid to the Government 4. Sales Tax paid to the Government					
BB TOTAL DEDUCTIBLE REVENUE (1+2+3+4)					
CC ADJUSTED GROSS REVENUE (AA-BB) REVENUE SHARE @ --- % OF ADJUSTED GROSS REVENUE					

**Group
CEO**

2.2 Format of Auditor's Report on Statement of Revenue and Licence Fee as prescribed under relevant Regulations:

To

The Board of Directors

.....

.....

We have examined the attached Statement of Revenue and Licence Fee of(the name of the operators) for the quarter(s) ending _____. We have also examined the reconciliation of the cumulative figures for the quarter(s) ending _____ appearing in the Statement of Revenue and Licence Fee of the company with the figures appearing in the profit and loss account of the company for the year ended _____ which was audited by us. We understand that the aforesaid statement(s) (and the reconciliation) is /are to be furnished to the Central Government for assessment of the Licence fee payable by the company to the Government, in terms of the Licence agreement No.....signed between the company and the Department of Telecommunications.

We report that:

1. We have obtained all the information and explanations which to the best of our knowledge and belief were necessary for the purposes of our audit.
2. In our view, the company has an adequate internal control system in relation to revenues which is commensurate with its size and the nature of its business. The system, in our opinion, provides reasonable assurance that there is no unrecorded revenue and that all revenue is recorded in the proper amount and in the proper period.

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3. No amounts payable in respect of sales tax, service tax or PSTN/toll/roaming charges were outstanding at the last day of the quarter(s) for a period of more than two months from the date they became payable, except for the following:.....
4. In our opinion and to the best of our knowledge and belief and according to the explanations given to us, the Statement has been prepared in accordance with the norms/guidelines contained in the said Licence agreement in this behalf and gives a true and fair view of the revenue and Licence fee payable for the period computed on the basis of the aforesaid guidelines except for the following:

(Signature)

* Strike off wherever not applicable.

Appendix III

Glossary

1G	Gigabit Ethernet.
2G	Second Generation (digital) mobile phones.
2.5G	2G phones with improved bit rates for data (HSCSD, EDGE, GPRS).
3G	Third Generation mobile phones.
10G	10G Ethernet (IEEE802.3ae).
2B1Q	Encoding 4 bits as 1 quat. A modulation scheme in which successive pairs of user information data bits are mapped into one of four symbols.
4B3T	Encoding 4 bits as 3 tribits.
AAL	ATM Adaptation Layer. The layer in ATM that adapts the higher layer information to a format suitable for placing in cells.
AAL1-5	ATM Adaptation Layer 1-5. The terminology used to identify the five alternatives for ATM adaptation.
ACR	Absolute Category Rating. Another name for MOS.
Access	All facilities and related services needed to support information transfer to or from an information source to some network's transport service.
Access Signalling	Signalling between a telephone/terminal and local exchange.

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ACD	<p>Automatic Call Distribution.</p> <p>A system designed to evenly distribute heavy incoming traffic among agents or answering positions.</p>
ADC	<p>American Digital Cellular.</p> <p>Another name for D-AMPS.</p>
Address	<p>A means of identifying a device on a network. Each technology has its own addressing system.</p>
Admission Control	<p>A network which does not accept new calls or packets unless it knows it has the capacity to handle them. Such a network will not experience congestion.</p>
ADPCM	<p>Adaptive Differential Pulse Code Modulation.</p> <p>An improvement on pure DPCM by each end predicting the next value, and only transmitting the difference between predicted and actual values. It allows good quality voice to be transmitted at 32kbit/s.</p>
ADSL	<p>Asymmetric Digital Subscriber Line.</p> <p>Modems attached to a twisted pair copper wiring – allows for fast traffic in one direction and slower return path.</p>
AES	<p>Advanced Encryption Standard.</p> <p>A single key encryption designed for E-Commerce.</p>
A-Law	<p>The European PCM method.</p>
ACELP	<p>Algebraic CELP.</p> <p>Instead of sending the code number identifying the curve, it transmits the algebraic coefficients of the curve. It requires less processing, but does require a floating-point processor. This is more suitable for PCs as they always have a floating-point processor today.</p>
ADM	<p>Add/Drop Multiplexor.</p> <p>A multiplexor that allows one channel to be removed (dropped) and another added in its place so traffic can join and leave a multiplexed link part way along it.</p>

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Air Interface	The specification of communications between a mobile and the base station.
AM	Amplitude Modulation. A method of carrying analogue data over an analogue circuit by varying the amplitude of a carrier.
Amplify	A device that increases the strength of the signal. Unfortunately it also amplifies noise, and introduces extra noise thus distorting the signal.
AMPS	Advanced Mobile Phone Service. American analogue system.
Analogue	The signal is encoded as a constantly varying line state making errors extremely difficult to detect.
ANSI	American National Standards Institute.
AO	Always On. A mobile service where data can be sent or received without setting up a call first.
AOA	Angle of Arrival. Using a directional receiver at a base station to locate the direction of a mobile.
AO/DI	Always On Dynamic ISDN. An ISDN D channel service which is always available.
ASCII	American Standard Code for Information Interchange – the conventional method of storing characters on a computer or transmitting them over a network. There are 128 ASCII characters of which 95 are printable (upper and lower case letters, digits, punctuation) and the rest are control characters (including carriage return, line feed, tab, bell).
ASP	Advanced Speech Processing. Technique for converting voice into digital signals.

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Assured Forwarding	An IP Differentiated Service giving 4 priority levels, each with 3 drop preferences, but no guarantees.
Asynchronous	There is no time relationship between two events.
ATM	Asynchronous Transfer Mode. A packet switched technology for broadband networks with voice, data or video transported as 53-byte cells.
ATMF	ATM Forum.
Attenuation	The decrease in signal strength with distance.
Authentication	Positively identifying the other party.
Availability	The percentage of time a system is available, usually in excess of 99.99%.
B2B	Business to Business E-Commerce.
B2C	Business to Consumer E-Commerce.
Bandwidth	The information carrying capacity of a channel. Analogue channels are measured by the frequency range (maximum minus minimum) and digital channels in bit/s.
Base Station	A radio/microwave transmitter receiver.
Basic Rate	An ISDN interface providing two B channels.
Baud	The number of changes of state per second on a medium.
B Channel	The 64k ISDN channel carrying 64k voice or data.
Best Effort	The network does its best, but makes no guarantees. Usually a cheap and simple approach.
B-ICI	Broadband - Inter Carrier Interface. Interface between public ATM networks.
Billing	Converting the CDR into prices.

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B-ISDN	<p>Broadband ISDN.</p> <p>An ISDN network that does not have a fixed channel size. Today is almost a synonym for ATM except B-ISDN refers to the service and ATM to the technology.</p>
Bit	<p>Binary Digit - has two mathematical values (0 and 1), two logical values (true and false), and two physical values (on/off/ high/low, present/absent etc.).</p>
Blocking	<p>A telephone exchange which cannot process calls from all subscribers simultaneous - anyone attempting to make calls when the exchange is blocked will get a busy sign. A router or switch which cannot process data on all ports at the maximum rate. When it becomes congested data will be delayed or discarded.</p>
Bluetooth	<p>A short range (10 metre) low speed data/voice network for home use.</p>
BOM	<p>Beginning Of Message.</p> <p>Used in cell relay and ATM to identify the beginning of segmented data in cells. (see also COM and EOM).</p>
BPS	<p>Bits Per Second.</p> <p>The rate at which bits are transmitted over a communications path is expressed as BPS, but the term bit/s is recommended for clarity.</p>
Braggs Grating	<p>An optical device that reflects a single wavelength in a DWDM system.</p>
Broadband	<p>A network on which a number of independent, simultaneous data network flows are multiplexed onto each cable.</p>
Broadcast	<p>A transmission from one device to all devices.</p>
BSI	<p>British Standards Institute.</p>
Byte	<p>A term used by computer engineers to refer to 8 bits.</p>
Call Agent	<p>Device controlling media gateways.</p>

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Carrier	A tone generated by a modem that carries analogue or digital data using modulation.
CBDS	Connectionless Broadband Data Service. The ETSI term for their cell relay standards.
CBR	Constant Bit Rate. Used to describe applications in ATM such as voice and video which are very sensitive to variable delay in transit.
CBX	Computerised Branch Exchange. Name used by some manufacturers for their processor-controlled PABXs.
CCIS	Common Channel Interoffice Signalling. Signalling method used between computer controlled switching machines. Also known as CCS 7, CCITT#7, and SS-7.
CCITT	Consultative Committee for International Telegraph & Telephone. A committee which deals with standards development in telecommunications. This name has been replaced with ITU-T.
CCS	Centum Call Seconds. Traffic capacity measurement in increments of 100 seconds, 1/36 th of an Erlang.
CDMA	Code Division Multiple Access. A means of multiple access where each pair of devices chooses specific codes to represent 0 and 1, which different to the other codes in use. The signal is spread over a large range of frequencies shared by other transmissions.
CDMAOne	American second generation mobile network using narrowband CDMA.
CDMA2000	3rd generation version of CDMAOne.

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CDR	Call Detail Record. The output from charging.
Cell	A fixed size packet. The area that can receive transmissions from a base station.
Cell Relay	A packet switched network using cells, standardised as ATM.
Cellular	A radio/microwave system where the transmission power is kept low to reduce the range of the transmission, allowing the same frequencies to be used in other non-adjacent cells.
CELP	Code Excited LPC. An improvement on pure LPC by measuring the difference between PCM and LPC, plotting the error as a curve, looking the curve up in a book of standard curves, and transmitting the curve number (code). It takes a lot of processing and introduces a significant delay but gives very good quality at 8kbit/s.
Centralized Routing	Routing performed by a routing centre, usually based upon the network loading as well as the physical configuration.
CEPT	European Conference of Post and Telecommunications Originally responsible for European standards.
CEPT 30	The European 2M E1 system named after the 30 voice channels.
C/FM	Cable/Facilities Management System. Software application developed by IBM which manages the twisted pair cabling of voice and data communications.
CGI	Common Gateway Interface. A standard interface between a web server and an application.

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Character	A printable character or a control character normally is encoded in 8 bits so it often refers (informally) to a byte or octet.
CHAP	Challenge Handshake Authentication Protocol. A means of sending dynamically encrypted passwords.
Charging	Collection of data for future billing.
CICS	Customer Information Control System. An IBM telecommunications program supporting telecommunications applications.
CIR	Committed Information Rate. The almost guaranteed speed supported by a frame relay network for a PVC (Permanent Virtual Circuit).
CIT	Computer Integrated Telephony. An interface between DEC computers and PABX control computers for application integration of voice and data systems. Now more commonly known as CTI (Computer Telephony Integration).
Class 5	A local switch and its controller.
CLEC	Competitive Local Exchange Carrier.
CLI	Caller Line Identification. A method of transmitting the number of the caller to the receiver.
CMIP	Common Management Information Protocol.
CMOS	Complementary Metal Oxide Semiconductor. A fast cheap semiconductor memory. It is used in PCs to store the basic software necessary to start up the system.

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CO	<p>Central Office</p> <p>Primarily used in the U.S.A. Refers to a local switching system that connects lines to lines and lines to trunks. Other terms that are synonymous include Local Exchange, Public Exchange, End Office, Wire Centre, Class 5 Office.</p>
Co-ax	<p>Co-axially cable - a type of cable that can carry digital data at high bit rates or high bandwidth analogue signals over long distances (500MHz for 5 km) with little noise. Replaced by optical fibre in telephony, but still used for television or where analogue must be used.</p>
Coder	<p>A device which codes analogue into digital, and decodes the digital back into analogue.</p>
Coding	<p>Translating an analogue signal into a digital signal.</p>
Co-location	<p>Allowing other operators to put equipment inside an exchange.</p>
Congestion	<p>Overloading a network with traffic.</p>
Congestion Control	<p>A mechanism for avoiding or reducing congestion - discarding data is common on data networks, admission control on voice networks.</p>
COM	<p>Continuation Of Message.</p> <p>Used in cell relay and ATM to identify the continuation of segmented data in cells. (see also BOM and EOM).</p>
Connectionless	<p>A network where packets contain the destination address, and no connection is set up. The classical example is the postal service.</p> <p>LANs are connectionless, as is the Internet.</p>
Connection Orientated	<p>A network where a connection must be set up first. The classical example is the telephone network. X.25, Frame Relay, ATM and MPLS are connection orientated.</p>

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COO	Cell of Origin. Identifying which cell contains a mobile.
Corporate Number	A number identifying a company instead of its location.
CoS	Class of Service. Processing data according to its type - often used to distinguish voice and computer data traffic.
CP	Communications Processor. A statistical multiplexor with switching capability.
CPE	Customer Premises Equipment. A term used to describe any telecommunications equipment located on a subscriber's (customer's) premises.
CPS	Carrier Pre-Selection. Being able to select the carrier for a particular type of call without having to dial a special number to identify the carrier.
CPU	Central Processing Unit. Main processor for computers.
CRC	Cyclic Redundancy Checking. Part of transmission message that checks the frame for correctness.
Cross charging	Money paid to another PTO for its part in transmitting voice or data.
Cross Connect	A device taking a channel from one ring and adding it to another. Physically it is two ADMs connected back to back.
CSMA	Carrier Sense Multiple Access. Listen to see if anyone else is transmitting.

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CSMA/CA	Carrier Sense Multiple Access with Collision Avoidance CSMA, but uses a scheme for avoiding collisions. There are many different algorithms. Used on wireless networks where collision detection does not work.
CSMA/CD	Carrier Sense Multiple Access with Collision Detection. CSMA, but detects collisions, and retransmits. Used by Ethernet.
CSMA/CR	Carrier Sense Multiple Access with Collision Resolution. CSMA, but detects collisions and allows the highest priority device to continue. Used on the ISDN D channel.
CSN	Circuit Switched Network - a network where an end-to-end circuit is created to carry the signal. Network resources are dedicated to the call.
CSPDN	Circuit Switched Public Data Network. A DATEX-L type network, providing switched digital data only service.
CSU	Channel Service Unit. A function built into DCEs to support physical management to/from the network see also DSU.
CT1	Cordless Telephone 1st Generation. A generic term.
CT2	Cordless Telephone 2nd Generation. A system developed in the UK, but a heroic failure.
CTI	Computer Telephony Integration. A generic term for the integration computers and PABX control computers for application integration of voice and data systems.
CUG	Closed User Group A service on a public network which restricts data to the members of the group.

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CVSD	<p>Continuous Variable Slope Delta.</p> <p>Form of Delta Modulation which minimises the tracking error of the samples relative to the original waveform.</p>
D-AMPS	<p>Digital AMPS.</p> <p>Second generation American mobile network.</p>
Dark fibre	<p>Fibre that has been installed, but is not being used. It may refer to fibre leased from a PTO using the customer's optical transmitting/receiving equipment rather than the PTOs equipment.</p>
DASS	<p>Digital Access Signalling System.</p> <p>A common channel signalling system for use between PABXs and network local exchanges developed by GPO/BT, but being replaced by Q.931.</p>
dB	<p>Decibel One tenth of a Bell. A Bell is a ratio expressed as a logarithm to the base 10. Thus the ratio A/B is $10\log(A/B)$ dB. For example the ratio 2/1 is 3dB. It is used extensively in electronics and optics to measure attenuation, amplification etc.</p>
DCE	<p>Data Communications Equipment) OR (Data Circuit-Terminating Equipment) A device that receives the output from a terminal and reformats it to be compatible with the data communications line.</p>
D Channel	<p>The ISDN channel carrying signalling and optional low speed user data.</p>
DCS	<p>Digital Cross-Connect System.</p> <p>An internal interface that acts as a central point for cross-connecting, rearranging, patching, and testing digital equipment and facilities.</p>
DCS	<p>Digital Communication System.</p> <p>Digital mobile network based on GSM, but at a frequency of 1.8GHz in Europe and 1.9GHz in America</p>

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DDCMP	Digital Data Communications Message Protocol. Type of link protocol developed by Digital Equipment Corporation. Made obsolete with DECnet Phase V.
DDI	Direct Dial In. A feature that permits incoming calls to stations served by a private branch exchange or centrex to be dialled directly.
Decoding	Extracting an analogue signal from digital data.
DECT	Digitally Enhanced (Digital European) Cordless Telephone. Used domestically, and also in wireless PBXs.
DES	Digital Encryption Standard. The standard single key encryption algorithm (40, 56 and 128 bit keys are common, as is a triple encryption) that is easily implemented in hardware.
Demodulation	Extracting the data from the carrier, a task performed by a receiving modem.
DiffServ	Differentiated Service. A redefinition of the Type of Service field in an IP packet, used to improve the Quality of Service.
Digital	The signal is encoded using a finite number of line states allowing errors to be virtually eliminated provided the noise is below the threshold.
Diverse Routing	Using two different leased lines between two destinations so that if one is broken, the other will still be useable.
DHCP	Dynamic Host Configuration Facility. A TCP/IP protocol for assigning IP addresses from a central server.
Dibit	A symbol with 4 values representing two bits.

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DIM	Drop/Insert Multiplexor. Another name for an ADM.
Direct Routing	Another name for Step by Step routing.
DLCI	Data Link Connection Identifier. The Virtual Circuit identifier used in Frame Relay networks.
DM	Delta Modulation. Form of digitising speech where each sample generates a single bit.
DMI	Digital Multiplexed Interface. Technique using T1 carrier facilities between a PABX and a host.
DPCM	Differential PCM - transmits the difference between two PCM values – usually generates 32kbit/s.
DPSK	Differential Phase Shift Keying. A method of transmitting digital data over an analogue circuit by changing the phase of a carrier - a practical implementation of PSK.
DPNSS	Digital Private Network Signalling System. Used for signalling between PABXs in a private network.
DQDB	Distributed Queue Dual Bus. A Metro Area Network access protocol defined by the IEEE as 802.6, and used with SMDS.
Drop	Terminating a mobile call because of problems.
Drop	Discard a packet.
Drop Preference	A means of indicating which packets should be dropped in the event of congestion.
DS	Directory Services.

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DSL	Digital Subscriber Loop. A group of method of transmitting data a high rates (128k to 52M) over the local loop.
DSSS	Direct Sequence Spread Spectrum. A weak signal spread over a wide frequency range.
DSU	Data Service Unit. The term used to describe a digital DCE, also known as a line driver. (see also CSU).
DTE	Data Terminal Equipment. A device that is used with a computer system for data input and output.
DTMF	Dual Tone Multifrequency. Generic term for pushbutton or touch-tone dialling.
Duplex	Being able to transmit in both directions simultaneous. Sometimes referred to as Full Duplex.
DWDM	Dense WDM. Using 16 or more wavelengths (40, 80 and 120 are typical) at bit rates or 2.5G, 10G, or in the near future 40G each.
DXI	Data Exchange Interface. Used in ATM and frame relay standards to define how a terminal e.g. a router connects at the physical level to a DCE.
Dynamic Routing	In telephony, routing performed by a routing centre, where a call can be re-routed without terminating the call.
E	Exa (one million million million).
E1, E2 - E5	Unofficial names for methods of transmitting digital data in the telephone network. Often used to refer to leased lines.

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EAOIG	European AO/DI Interest Group.
EC	Echo Cancelling. Involves the addition of circuitry to cancel out any echo in the received signal of transmission.
ECC	Elliptic Curve Cryptography. A public key encryption algorithm.
Echo	A signal received by a transmitter from its own transmissions. Although not normally a problem in simplex and half duplex systems, it complicates full duplex systems as the received signal at one end will include echos from its own transmissions.
ECMA	European Computer Manufacturers Association. An association of European manufacturers to develop, and publish standards on for electronic apparatus.
EDFA	Erbium Doped Fibre Amplifier. A 10 metre length of Erbium doped fibre that amplifiers the signal by extracting energy from a constant beam from a pump laser.
EDGE	Enhanced Data Rates for Global (GSM) Evolution. Data rates higher than voice bandwidth over mobile phone networks, achieved by using special modulation methods.
EDI	Electronic Data Interchange. A standard approach to information interchange between open systems.
Encryption	Encoding the data in such a way that only the intended receiver(s) can read it.
EMS	Extended Message Service. An extension of SMS allowing for email type attachments.

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EOM	<p>End Of Message.</p> <p>Used in cell relay and ATM to identify the end of segmented data in cells. (see also BOM and COM)</p>
EOTD	<p>Enhanced Observed Time Difference.</p> <p>Locating a mobile by the difference in arrival time at multiple base stations.</p>
EPABX	<p>Electronic Private Automatic Branch Exchange.</p> <p>Private Automatic Branch Exchange in which switching is accomplished by the flow of electrons through solid state devices rather than by electromechanical means.</p>
EPSS	<p>Experimental Packet Switch Stream.</p> <p>A UK experimental network implemented prior to X.25.</p>
Erlang	<p>A measure of traffic intensity - the fraction of time that a system is in use. A 1 hour call in a 1 hour period is 1 Erlang which is equal to 36 ccs.</p>
Erlangs Formula	<p>There are two. The first is an equation which given the number of simultaneous connections and the number of available circuits, gives the probability of the system being blocked and a busy signal returned. The second applies to systems where instead of returning a busy signal, calls are queued until there is spare capacity.</p>
Error	<p>The difference between the received signal and the transmitted signal which is not due to attenuation.</p>
ES-IS	<p>End System - Intermediate System.</p> <p>An OSI routing protocol between end systems and intermediate systems, e.g. routers.</p>
ETACS	<p>Extended TACS - UK analogue mobile telephony.</p>
Ethernet	<p>Ether Network.</p> <p>The most popular LAN developed by Xerox from 1972, later manufactured with the help of Digital and Intel. It runs at speeds of 10 and 100M, and 1 and 10Gbit/s.</p>

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ETS	Electronic Tandem Switching. Private network service that provides customers with a uniform numbering plan and call-routing features.
ETSI	European Telecommunications Standards Institute. Responsible for European standards.
Exchange	Refers to both the building and the equipment used to set up telephone calls.
Expedited Forwarding	An IP Differentiated Service guaranteeing a minimum packet rate.
Extranet	A company's semi-secure internet containing publicly available servers.
f	Femto (one thousandth millionth millionth).
FCAPS	Fault, Configuration, Accounting, Performance and Security Management.
FDDI	Fiber Distributed Data Interface. An ANSI / ISO LAN recommendation using token passing at 100 Mbps.
FDM	Frequency Division Multiplexing. Method of multiplexing more than one channel on a medium by assigning each channel its own frequency.
FDMA	Frequency Division Multiple Access. Similar to Frequency Division Multiplexing. The two devices agree on a frequency to use which is different to the other frequencies being used.
FDUX	Full Duplex. Transmission of data or voice in both directions simultaneously.
FECN	Foreword Explicit Congestion Notification. Used in frame relay networks to flow control a transmitting device from the destination device (see also BECN & DE).

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FEP	Front End Processor. A front end computer primarily used with mainframes. An example is the IBM 3745.
FFOL	FDDI Follow On LAN. A generic term used to describe the box that interfaces a terminal (DTE) to a telephone line. The DCE can either be a modem or a line driver.
Firewall	A device which controls access into an intranet.
Fixed	A device that is static with respect to the network. Links can be wireline or wireless.
FM	Frequency Modulation. A method of carrying analogue data over an analogue circuit by varying the frequency of a carrier.
Forwarding	Another term for routing.
FSK	Frequency Shift Keying. A method of carrying digital data over an analogue circuit by using different frequencies.
F/R	Frame Relay. A packet switched network designed for data transfer between LANs (see X.25 and ATM).
FRAD	Frame Relay Assembler/Disassembler. Device which interfaces into a frame relay network.
Frame	Another name for a packet. Frequency Hopping Frequently changing frequency to avoid interference from other devices, and to improve security.
FTP	File Transfer Protocol. An Internet standard for the transfer of files.
Full Duplex	Transmission in both directions simultaneously - correctly called just Duplex.

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G	Giga (one thousand million).
G.711	The standard codec used on the PSTN.
G.729	The most common vocoder.
G.732	The European 2M E1 system.
G.733	The American 1.5 DS1 system.
Gate Keeper	Device between a PABX and a router designed to prevent the LAN becoming overloaded with voice traffic.
Gateway	A device interfacing two completely different systems.
Gateway Decomposition	Splitting conventional gateways into call agents and media gateways.
GEO	<p>Geosynchronous Earth Orbit.</p> <p>A satellite orbit where the satellites appear to be stationary. The orbit is 23,400 miles or 36,000 km. The resulting long time delays make it unsuitable for telephony.</p>
Geographic Address	An address which identifies the location of a device and so allows calls or data to be routed to it.
GIB	<p>Gateway Information Base.</p> <p>A database of the gateways to the PSTN available for the use by other domains.</p>
GLC	<p>Gateway Location Protocol.</p> <p>A protocol to find a gateway in the GIB.</p>
GMPC	<p>Global Mobile Personal Communications.</p> <p>Mobile communications using satellites.</p>
GPRS	<p>General Packet Radio System.</p> <p>A means of sending data over a radio packet network. It gives an always on shared capacity.</p>
GPS	Global Positioning by Satellite.

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GSM	Global System for Mobile communications. European standard for digital mobile cellular networks.
Guaranteed Delivery	A network that guarantees that the data will be delivered as sent with no errors.
Guiding	Adjusting the cost of a call to a customers plan.
H.225	The ITU IP Signalling protocol based on Q.931.
H.320, 323, 324	ITU recommendations for video conferencing over ISDN, PSN and POTS.
Half Duplex	Transmission in both directions, but only in one direction at a time.
Handover	The processor of transferring a mobile from one base station to another, or one MSC to another.
H Channels	High bit rate ISDN channels intended for video traffic, but rarely implemented.
HCS	Hierarchical Cell Structure. A cell within a cell typically providing greater capacity within a limited area.
HDSL	High Rate Digital Subscriber Loop. Modem technology for transmitting T1/E1 data over a twisted pair cable with out the need for repeaters.
HDUX	Half Duplex. Transmission of data or voice in either direction but not simultaneously.
HEC	Header Error Control. Used to detect bit errors in an ATM cell header.
Hertz	One cycle per second - used in analogue systems.
HiperLAN	A developing ETSI standard for a wireless LAN.
HIPPI	High Performance Parallel Interface. A high speed metallic interface originally developed by the Los Alamos Laboratory, it specifies either a 800 Mbps or 1600 Mbps point to point parallel interface.

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HomeRF	A low speed data network for the home.
HSCSD	High Speed Circuit Switch Data. High data rates over mobile networks by combining voice circuits.
HSSI	High Speed Serial Interface. An interface using a 50 pin SCSI 2 type cable, operating between 300 Kbps to 52 Mbps.
HTML	Hypertext Markup Language. The coding language used to create WWW pages.
HTTP	Hypertext Transmission Protocol. The protocol used to access world wide web (WWW) pages.
IC	Integrated Circuit. A "chip" or piece of silicon containing an electrical circuit and components, especially transistors.
ICMP	Internet Control Message Protocol. Used in the Internet to identify problems in the network.
IDF	Inter-Distribution Frame. Also known as an intermediate distribution frame, it is a wiring center used to connect floor distribution (horizontal) wiring with house cabling (vertical).
IDN	Integrated Digital Network. Networks comprised of digital data transmission and telephone traffic.
IEEE	Institute of Electronic and Electrical Engineers. An American organisation not to be confused with the British IEE.
IEEE802	The IEEE committee responsible for standardising LANs.
IEEE802.1p	The IEEE standard defining how priority can be implemented on switched LANs.
IEEE802.3	The IEEE subcommittee responsible for Ethernet.

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IEEE802.11	The IEEE subcommittee responsible for wireless LANs.
IEEE802.17	The IEEE subcommittee responsible for Resilient Packet rings.
IIS	Internet Integrated Service. A “real-time multimedia” service using RSVP.
ILEC	Incumbent Local Exchange Carrier.
IMT-2000	A hope for a single standard for the 3rd generation mobile network, but will be at least three incompatible systems. A service rather than a technology.
Imode	Japanese equivalent to WAP, but uses compact HTML.
Information	In telephony, the words being spoken.
Internet	An internet is a network of networks linked by routers. It uses LAN, WAN and MAN networks.
Intranet	A companies secure internet.
IOTP	Internet Open Trading Protocol. An E-commerce protocol supporting SET.
IP	Internet Protocol. The layer 3 protocol used in the Internet and private networks, as part of the TCP/IP suite of protocols.
ISDN	Integrated Services Digital Network. An integrated digital network which provides integrated access of voice, data, and low quality video using circuit switched technology (64k capacity).
ISDL	ISDN Digital Subscriber Loop. Carries 128k data over the local loop - similar to two ISDN B channels but over a longer distance (10km rather than 5 km).

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IN	<p>Intelligent Network.</p> <p>A network which is designed to allow the centralised creation, development, testing, installation and monitoring of a new service.</p>
International	<p>A trunk between two countries or exchange at the end of the trunk.</p>
Interconnection	<p>A trunk between two PTOs or exchange at the end of the trunk.</p>
Invoicing	<p>Combining the billing information with other charges and discounts to create a customers invoice.</p>
IP VPN	<p>IP Virtual Private Network.</p> <p>Additional security provided by an ISP to give secure communications over the ISPs internet. It is a combination of authentication, encryption and often MPLS.</p>
IS-95	<p>Another name for CDMAOne.</p>
IS-136	<p>Another name for D-AMPS.</p>
ISDT	<p>Integrated Services Digital Terminal.</p> <p>Digital telephone set designed by GPT for use on its iSDX PABX.</p>
ISO	<p>International Standards Organisation.</p> <p>A non-treaty organisation that develops telecommunications standards based in Geneva, Switzerland.</p>
ISP	<p>Internet Service Provider.</p>
ITAD	<p>Internet Telephony Administration Domain.</p> <p>The equivalent of a PTO in Internet telephony.</p>
ITU	<p>International Telecommunications Union.</p> <p>A United Nations sponsored standards organisation.</p>
ITU-TSS	<p>International Telecommunications Union – Telecommunications Standardisation Sector The new name for the CCITT, generally referred to as ITU-T.</p>

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IVDT	Integrated Voice/Data Terminal. Computer terminal capable of handling both voice and data application.
Jitter	A variation in data rate or in packet or cell arrival times.
k	Kilo - 1000 (communications).
K	1024 (computing).
LAN	Local Area Network. Network owned and used by a single organisation providing full connectivity between devices.
LAP-B	Link Access Procedure – Balanced. The version of HDLC protocol used on X.25 networks.
LAP-D	Link Access Procedure D-Channel. The version of HDLC protocol used on the ISDN D channel.
LAP-F	Link Access Procedure – Frame. The version of HDLC protocol used by frame relay.
LAP-M	Link Access Procedure-Modem. An HDLC type protocol used between two V.42 compliant modems.
LASER	Light Amplification by Stimulated Emission of Radiation. Light source used to transmit information over fibre optic system.
LATA	Local Exchange and Transport Area. Incumbent operator in the USA.
Latency	Time taken to cross a network.
LCGN	Logical Channel Group Number. Part of the 12 bit logical channel number, usually identifying a specific switching node on a packet network.

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LCN	Logical Channel Number. The PVC/SVC circuit identifier in an X.25 network.
Leased Line	A permanent connection across the PSTN which is normally paid for by a rental regardless of use. It may be used for cost or security purposes.
LED	Light Emitting Diode. Light source used to transmit information over fibre optic system.
LEO	Low Earth Orbit. A low orbit where non-directional antenna can be used.
LIM	Line Interface Module. A non-blocking port package which resides in the Ericsson MD110.
LLC	Logical Link Control. The functions performed by Layer 2 of Local Area Networks.
LLU	Local Loop Unbundling. Allowing other operators to use the local loop.
LMDS	Local Multipoint Distribution Services - another name for WLL typically using high frequencies so the transmission distance is limited by the atmosphere (water and oxygen).
Local Exchange	A telephone exchange used to switch calls from subscribers.
Local Loop	Twisted pair copper telephone line from subscriber to the local exchange. Loops may differ in distance and diameter depending on the network.
Local Office	American term for a local exchange.
Location Register	A table at an MSC containing the location (cells) of mobiles known to it. Normally there is a Home Location Register of devices which are registered with that MSC, and a Visitor Location Register of mobiles active but not registered.

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Location Services	Services which rely on knowing the location of a mobile.
Loop start	Picking up the handset closes a switch allowing a current to flow and so signals to the exchange that the user wants to make a call, or is answering an incoming call.
LPC	Linear Predictive Coding. Uses a mathematical model of the human mouth, and transmits how the sounds were generated rather than the sounds themselves. It results in robotic quality, but the bit rate can be as low as 1.8kbit/s.
m	Milli - one thousandth.
M	Mega - one million (communications).
M	$1024 \times 1024 = 1,048,576$ (computing).
MAC	Medium Access Control. Usually refers to the protocols used in Local Area Networks.
MAN	Metro Area Network. A network designed to offer interconnection service to a small geographic area such as a city. Currently offered for data networking.
Mark	The name of the symbol representing a binary one.
MD5	Message Digest 5. A standard for a one way encryption.
Media Gateway	A device converting from one coding system to another.
Mediation Device	A device in a TMN network which converts data from one form to another.
MEGACO	Media Gateway Control. Model of modern IP telephony using call agents and media gateways.

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MEM	Micro Electro-Mechanical. Used to refer to the mechanism inside an optical router where very small mirrors reflect the beams of light.
MEO	Middle Earth Orbit. An orbit between LEO and GEO.
MF	Multifrequency. Signalling used between PABXs or exchanges using tones on same path as is used for voice.
MGCP	Media Gateway Control Protocol. Protocol between call agents and media gateways.
Micron	One millionth of a metre.
Microwaves	An unofficial term used for frequencies from 1 to 100 GHz or wave lengths of 3 cm down to .03 mm. Sub-millimetre wavelengths are only starting to be used.
MMF	Multimode Fibre. A large diameter (50 or 62.5 micron core) optical fibre which transmits multiple modes or beams of light. Although relatively cheap it suffers from multimode dispersion which limits its length to a few km. It is used in LANs for cheapness.
MNS	Managed Network Services. A VPN which offers significant additional services.
Mobile	A device which moves in relation to the network. This implies a wireless link.
Modem	Stands for "Modulator-Demodulator". Converts digital data into a form suitable for transmission over the analogue medium.
Modulation	A method of carrying analogue data over an analogue circuit by modifying a property of a carrier signal (amplitude, frequency and/or phase), a task performed by a transmitting modem.

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MOS	<p>Mean Opinion Score.</p> <p>A method of quantifying the quality of coding systems based on a value between 1 (unusable) and 5 (perfect). A perfect analogue line has the value 4, and 64k PCM 4.1. Any value over 3.5 is good enough for telephony.</p>
MPEG	<p>Motion Picture Expert Group.</p> <p>An organisation which has developed an algorithm for digitizing motion pictures.</p>
MPLS	<p>Multi Protocol Label Switching.</p> <p>A form of packet switching used on the Internet which while giving the appearance of conventional routing, uses packet switching to improve both performance and security.</p>
MS	<p>Mobile Station – the GSM subscriber unit.</p>
MSC	<p>Mobile Switching Centre.</p> <p>The equivalent of an exchange in a mobile network, but it must also handle device location.</p>
MTP	<p>Message Transfer Part.</p> <p>The signalling network protocol in SS7.</p>
Mu	<p>Micro - one millionth.</p>
Mu-Law	<p>The American PCM encoding system.</p>
Multicast	<p>A transfer from one device to many (but not necessarily all) devices.</p>
Multiple Access	<p>A form of multiplexing where there is no multiplexor - each device obeys rules so that its transmissions can be distinguished from other terminals' transmissions. The common methods include FDMA.</p>
TDMA, CDMA, and CSMA. Multiplex	<p>A transmission of many logical connections along one physical connection.</p>

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MUX	<p>Multiplexor.</p> <p>Equipment for combining a number of individual channels into a common frequency band or into a common bit stream for transmission.</p>
MVS	<p>Multiple Virtual Storage.</p> <p>An operating system developed by IBM for use on some of its mainframes.</p>
n	<p>Nano (one thousandth millionth).</p>
NAU	<p>Network Addressable Unit.</p> <p>A unique network address in an IBM SNA network.</p>
NDIS	<p>Network Driver Interface Specification.</p> <p>A device driver developed by Microsoft and 3Com, used by Windows, LAN Manager and Banyan Vines, isolates layer 3 from layer variations.</p>
NE	<p>Network Element.</p> <p>A component managed by a TMN system.</p>
NFS	<p>Network File System.</p> <p>A protocol developed by Sun Microsystems to support file transfers transparently to the user, i.e. hides the difference between local and remote file location.</p>
Nibble	<p>Half a byte - 4 bits.</p>
N-ISDN	<p>Narrowband ISDN.</p> <p>An ISDN based on fixed bit rate channels (normally 64k or multiples thereof).</p>
NMF	<p>Network Management Forum.</p>
NMS	<p>Nordic Mobile System.</p> <p>First European analogue mobile network.</p>
NNI	<p>Network Node Interface.</p> <p>The electrical interface in SONET / SDH.</p>

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NNI	Network to Network Interface. The standard for switch to switch protocol in frame relay networks.
Noise	That which causes errors in the signal. Noise can be external (from other systems), or internal (from within the system - echos, amplification, quantitisation).
Non-blocking	A telephone exchange on which all subscribers can make calls simultaneous, or a router or switch which can process data at the maximum rate on all ports simultaneous. Such a device will not become congested.
NT	Network Termination. Functions associated with physical and electromagnetic termination of the ISDN.
NTA	Norwegian Telecommunications Administration.
NTU	Network Terminating Unit. Device which can be used as DCE to interface with V.24, V.35. or X.21.
Number Portability	The ability to keep the same number when changing to another PTO.
OADM	Optical Add/Drop Multiplexor.
Octet	Communication engineer's term for 8 bits.
Office	American term for a public exchange.
Olympic service	A simplified form of Assured Forwarding with only 4 options instead of 12.
Open Wires	Term used for straight (non-twisted) wires that used to be strung along telegraph poles.
Optical Router	A router that routes beams of light. It takes a relatively long time (msecs) to change the route.
Optical Switch	A switch that switches beams of light at high speeds. The term is frequently misused for an optical router.

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OS	Operator Service.
OS	Operational System.
OSS	Operational Support System.
OSI	Open Systems Interconnection. A standard set of protocols for exchanging information between independent systems developed by the International Standards Organisation (ISO).
OSPF	Open Shortest Path First. A routing protocol used by routers.
P	Peta (one thousand million million).
p	Pico (one millionth millionth).
PABX	Private Automatic Branch Exchange. Private automatic switching system which services an organization and is usually located on the customer's premises.
Packet	A block of data with control information such as source and destination addresses, or circuit identifiers.
PAD	Packet Assembler/Disassembler. Device which interfaces into an X.25 network.
Pan European	A network that connects several European countries.
PAP	Password Authentication Protocol. A means of sending passwords (in clear text).
PAM	Pulse Amplitude Modulation A method of carrying an analogue signal by sampling it at regular intervals and transmitting a pulse whose amplitude represents the value of the sample.
PANS	Pretty Amazing Network Services. A network offering more services than POTS.

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PBX	Private Branch Exchange - American term for PABX.
PCI	Protocol Control Information. An OSI term to describe the header added to the data by an ' N ' layer.
PCI	Peripheral Component Interconnect. An Intel developed local bus for personal computers.
PCM	Pulse Code Modulation. Method of converting a varying analogue signal into a digital signal by sampling at regular intervals and transmitting the value of the sample. It usually implies 64k bit/s voice.
PCN	Personal Communication Network (GSM 1800).
PDC	Personal Digital System. Japanese second generation mobile network.
PDH	Plesiochronous Digital Hierarchy. The access network TDM system (E1 to E3 in Europe, and DS1 to DS3) in America. Devices have their own derived clocks and so bit rates are only approximately the same.
PDN	Public Data Network. Public network designed exclusively for data transmission which is physically separate from the voice network, although it may share transmission facilities.
PDN	Private Data Network. A privately owned network that uses the same technologies as public data networks.
PDH	Plesiochronous Digital Hierarchy. The traditional digital telephony network where clock speeds are approximate. Now used as an access network to SDH.

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PDS	Premise Distribution System. System of organised wiring and related components developed by A.T.&T.
PDU	Protocol Data Unit. An OSI term for a data unit passed to an N-1 layer for processing.
Personal Number	A telephone number identifying a person rather than a telephone.
PHS	Personal Handy Phone System. Japanese mobile network.
PIN	Positive-Intrinsic-Negative. Basic receiver that detects light and outputs an electric current in fibre optic transmission.
PING	Packet Internet Groper. A program used by Internet hosts to test reachability of destinations.
PMD	Polarisation Mode Dispersion. A problem encountered when using older optical fibre at bit rates over 2.5G, due to different polarisation modes having different velocities.
Port	Interface on a device.
POTS	Plain Old Telephone Service. The basic telephone system.
PPP	Pretty Good Privacy. A public key encryption algorithm.
Primary Rate	An ISDN interface providing 30 B channels in Europe and 23 B channels in America.
PSE	Packet Switch Exchange.

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PSN	<p>Packet Switched Network.</p> <p>A network where the information is put into packets. Each packet has an identifier that allows packet switches to switch the packets along a pre-established route to the destination. Network resources are not dedicated to specific circuits, and it is more efficient than circuit switching for data. Typical examples include X.25, Frame Relay, ATM, and MPLS.</p>
Protocol	<p>Set of rules for communications. These are of two types. Procedural – the order in which things are done, and Syntactical - the formats and structures.</p>
PSK	<p>Phase Shift Keying.</p> <p>Sending digital data over an analogue circuit by changing the phase of the carrier - in practice DPSK is used.</p>
PSTN	<p>Public Switched Telephone Network.</p> <p>Portion of the total network that provides the capability for interconnecting homes or offices.</p>
PTT	<p>Post Telegraph & Telephone.</p> <p>Used to refer to a public monopoly (e.g. The General Post Office in the UK prior to 1980).</p>
PTO	<p>Public Telephony Operator.</p> <p>Pulse Dialling A rotary dial telephone opened and closed contacts thus causing short breaks in the current. Each digit was represented by a different number of breaks 9 zero by 10 breaks).</p>
PVC	<p>Permanent Virtual Circuit.</p> <p>A permanent connection between two end systems on a packet switched network (see also SVC).</p>
Q Interface	<p>A standard TMN interface - a Q3 or a Qx interface.</p>
Q3	<p>The interface between an OS and a device in a TMN network.</p>
Qx	<p>The interface between a mediation device and another device in a TMN network.</p>

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Q.931	The ISDN signalling protocol.
Q Adapter	A TMN device which interfaces to non-TMN devices.
QAM	<p>Quadrature Amplitude Modulation.</p> <p>Sending digital data over an analogue circuit by changing both amplitude and phase of a carrier. The name comes from the first system that encoded 4 bits per baud. Today this would be called 4QAM as today we have 8QAM, 16QAM etc., the number representing the number of bits per baud. These usually have unacceptably high error rates so are combined with TCM.</p>
QoS	<p>Quality Of Service.</p> <p>A specification of the quality of service of a network connection. For data it may be sequential or guaranteed delivery, for voice and video it is normally latency and jitter.</p>
Quality	In telephony the degree to which the person talking can be identified by the sound of their voice.
Quantisation noise	The error induced in a PCM system due to values being measured to at the nearest integer value.
Quat	A quadbit - a symbol which has 16 possible values representing 4 bits.
Queuing	Theory A branch of mathematics that gives the average delay based up the utilisation of a system (measured in Erlangs).
Raman Amplification	Amplifying the signal using the Raman effect where energy from one beam is transferred to another beam in the same fibre. It has the advantage over EDFAs that it does not require special fibre and it works over a much greater range of wavelengths.
RAS	<p>Registration, Administration and Status.</p> <p>An H.323 protocol (part of H.225) between a terminal and a gate keeper.</p>

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Rating	Converting a CDR into a price by looking up costs in a table or using an algorithm.
RC	Routing Centre.
Real Time	An application where minimal time delay is critical.
Repeater	A device which receives distorted digital signals and transmits a regenerated signal, thus removing any noise.
RIP	Routing Information Protocol. A protocol used to exchange routing information amongst a set of computers.
Ringin	Current An alternating current designed to make an electro-mechanical bell on the telephone ring.
RJ-11	The 6 pin plug used for UK telephones.
RJ-45	The 8 pin plug used for LANs, and ISDN.
Roaming	Using a mobile on another operators network.
Route	The path followed or to be followed across a network.
Routing Centre	The location where routing decisions are made.
RPR	Resilient Packet Rings. A low cost alternative to SDH/SONET rings.
RSA	Rivest, Sharmir and Aldeman. A public key encryption algorithm.
RSVP	Resource Reservation Protocol. Used to reserve capacity within IP routers.
RTCP	Real Time Control Protocol. Used to control RTP.
RTP	Real Time Protocol. Used to carry voice and video.

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SA	Signal Attenuation. A method of locating a mobile by signal strength.
SASL	Simple Authentication Security Layer. A protocol for authentication.
SCE	Service Creation Environment. The part of an intelligent network where new services are created and tested.
SCP	Signalling Control Point. The controlling part of a SS7 network.
SCCP	Signalling Connection Control Part. The connection across a SS7 network
SCPP	Smart Card Payment Protocol A method of securing credit card information.
SCSI	Small Computer System Interface. A popular parallel interface between personal computers and disk drives. Standard on Macintosh computers, optional on others.
SDCU	Satellite Delay Compensation Unit. Device used over satellite link to increase throughput efficiency.
SDH	Synchronous Digital Hierarchy. The TDM system used in the core network at speeds of 155 and 622M, 2.5 and 10Gbit/s. All devices are controlled by a single clock so bit rates are exactly the same. The network is constructed in rings for increased availability, and allowance has been made for network management traffic. The numbering system is based on multiples of 155M.
SDSL	Symmetric Digital Subscriber Loop. A method of transmitting data over the local loop which provides for the same data rate in both directions.

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SDP	<p>Service Data Point.</p> <p>The part of an intelligent network where all the data for a service is held, plus CDRs.</p>
SDP	<p>Session Description Protocol.</p> <p>Used in conjunction with SIP, it gives information regarding the type of session and the equipment used.</p>
Sequential Delivery	<p>A network that guarantees that data will be delivered in the correct order however it does not necessarily mean that the data has not been corrupted.</p>
Service code	<p>A telephone number that indicates a type of service (typically call cost) as opposed to a geographical number. The best known is the American 1-800 which has been adopted in most countries (in the UK it is 0800).</p>
SET	<p>Secure Electronic Transaction.</p> <p>A method of securing credit card information so that the store does not have access to it.</p>
Shift Keying	<p>Sending digital data over an analogue connection using modulation.</p>
Signal	<p>An electrical voltage or current, or a light beam carrying data.</p>
Signalling	<p>The process of call set -up and call clear-down (plus other status messages) on a telephony network. The term is rarely used on data networks.</p>
Signalling Protocol	<p>Signalling using messages instead of tones, currents and voltages.</p>
Signalling Network	<p>A network optimised for signalling traffic.</p>
SIM	<p>Subscriber Interface Module.</p> <p>A GSM smart-card holding the subscribers information.</p>

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Simplex	Transmission in one direction only.
SIP	Session Initiation Protocol. An Internet user-user signalling protocol used to set up sessions.
Sizing	Calculating the capacity to be provided to give an acceptable service. It is the application of Erlang's formula.
Slot	The location of a voice sample in a TDM frame.
SMF	Single Mode Fibre. The core is only 8.3 microns which only allows one beam of light so it does not suffer from multimode dispersion, and the distance is typically limited by attenuation (at speeds up to 2.5G). Used in WANs, but is expensive.
SMS	Service Management System. The part of an intelligent network where services are installed, configured and monitored.
SMS	Short Message Service. 160 character GSM message.
SNMP	Simple Network Management Protocol.
States	The values of a digital system (normally 1 and 0).
SONET	Synchronous Optical Network. The American equivalent of SDH, the main difference being that SDH supports a 51Mbit/s channel, and the number refers to multiples of that value.
SP	Signalling Point. The part of an exchange which handles the signalling.
Space	The name of the symbol representing a binary zero.
SPAG	Standards Promotion and Application Group. A European association of Information Technology organizations whose goal is to further the realisation of open systems.

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SPC	<p>Stored Program Controller.</p> <p>The specialised computer controlling a telephone exchange.</p>
SS7	<p>Signalling System 7.</p> <p>A standard model for modern digital signalling within the telephony network.</p>
SSAC	<p>Signalling System Alternating Current.</p> <p>Used for Inter-city distances via tones over talk circuits.</p>
SSL	<p>Secure Sockets Layer.</p> <p>The standard technique for IP authentication of client, and encryption of data.</p>
SSP	<p>Service Switching Point.</p> <p>An exchange which can communicate with a SCP.</p>
STATDM	<p>Statistical Time Division Multiplexer.</p> <p>Similar to TDM except that total bit rate is assigned dynamically rather than with time slots. The bits or characters only occupy bandwidth as needed.</p>
State	<p>The physical encoding of a symbol.</p>
STD	<p>Subscriber Trunk Dialling.</p> <p>The system allowing UK subscribers to make long distance calls (outside the area of the local trunk exchange).</p>
Step by Step Routing	<p>The early form of routing telephone calls where one exchange would route it on to the next until the destination was reached.</p>
STM	<p>Synchronous Transport Module.</p> <p>Used in SDH to identify a specific payload size, e.g. STM-1 = 155.52 Mbps.</p>
STS	<p>Synchronous Transport Signal.</p> <p>Used in SONET to identify a specific payload size, e.g. STS-1 = 51.84 Mbps.</p>

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Subscriber	In a telephone network it normally refers to a telephone rather than a person.
SVC	Switched Virtual Circuit. A connection set up and cleared down between two end systems on a packet switched network.
Switch	The equipment within an exchange which switches data from an input to an output.
Symbol	The representation of a digital value on a physical medium.
Synchronous	There is a time relationship between two events.
System X	The first UK digital telephone system.
T	Tera (one million million).
T1, T2, T3, T4	Standard methods of sending digital data over twisted pair in America.
TA	Terminal Adapter. Equipment to connect non ISDN compatible equipment (such as an analogue telephone or a computer) to an ISDN network.
TACS	Total Access Communication System. First UK analogue mobile network.
Tag Switching	A form of packet switching developed by Cisco and standardised as MPLS.
TAT	Transatlantic. Term used to refer to the cables. TAT8 was the first fibre.
TAXI	Transparent Asynchronous Transceiver/ Receiver Interface. A 100 or 140 Mbps interface using AMD's TAXI chip, used as an initial User Network Interface (UNI) for ATM. Its layer 1 physical line signalling is the same as FDDI (4B5B).

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TCM	<p>Trellis Code Modulation.</p> <p>A method of correcting errors on high speed modems. The name comes from the signal's appearance on an oscilloscope - it looks like a trellis gate.</p>
TCP	<p>Transmission Control Protocol.</p> <p>Used in the Internet as a layer 4 protocol giving reliable delivery of data.</p>
TDM	<p>Time Division Multiplexing.</p> <p>A method of serving multiple channels over a common transmission path via discrete time intervals.</p>
TDMA	<p>Time Division Multiple Access.</p> <p>Similar to TDM, but there is no multiplexor.</p>
TD-SCMA	<p>Time Division - Synchronous CDMA.</p> <p>Chinese 3rd generation mobile network.</p>
TE	<p>Terminal Equipment.</p> <p>Equipment such as digital telephones, data terminal equipment, and integrated work stations that provide functions necessary to interface to an ISDN.</p>
Telegraph	<p>A network capable of sending text messages. Mechanical telegraph used flags or semaphores, optical telegraph uses lights, electrical telegraph uses wires, and wireless telegraph uses radio. It is complicated to send and receive messages so specialist operators are normally required.</p>
Telephone	<p>An analogue device containing little more than microphone, loudspeaker, amplifiers and a bell.</p>
Teleprinter	<p>A printer that prints data received from a connection or paper tape.</p> <p>Sometimes called a teletype.</p>
Telex	<p>Teleprinter Exchange - uses a feature similar to telephone exchanges to create a true telegraph network. It also implies that specialist staff are not required in the sense that simple keyboards are used for input, and the received messages are automatically printed or displayed. It works at a speed of 50, 110 or 2400 bit/s with 5 bits per character so is limited to upper case letters, digits and a few punctuation signs.</p>

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Terminal	The digital equivalent of a telephone - often has more features, and can do more than set up clear down calls. Used for ISDN and mobile networks. Most PBX use proprietary terminals.
TETRA	Terrestrial Trunked Radio. The European standard for digital radio/telephone.
Tetrapol	A proprietary alternative to TETRA.
TLS	Transport Layer Security. A method of encrypting internet data developed from SSL.
TMN	Telecommunications Management Network. A network management system used by the telephone industry to manage their internal networks consisting of 5 layers.
TOA	Time of Arrival. Method of determining the location of a mobile by the time at which a signal arrives.
Tone dialling	Each key produces two tones which are used by the telephone exchange to detect the button pressed. The system allows for 16 buttons. The tones are also sent across the network once a call has been made so the buttons can also be used for user-user signalling.
ToS	Type of Service. Processing data according to its type - often used to distinguish voice and computer data traffic.
Traffic	Telephony term referring to voice as opposed to signalling.
Traffic Intensity	The number of calls and the time they last measured in Erlangs or ccs.
Transcoder	A device which changes from one coding system to another (usually changing the bit rate).
Tribit	A symbol with 3 possible values, mathematically -1, 0 and +1.

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Trunk	A connection between two exchanges that carries many calls. A trunk consists of two physical connections, each connection carrying traffic in one direction only.
Trunk Exchange	A central exchange used to switch calls from local exchanges.
TTY	Teletype Equipment. Data transmission terminal used in time sharing, dial-up applications.
Twisted pair	A pair of wires twisted together to enhance transmission qualities, especially to reduce noise.
UART	Universal Asynchronous Receiver Transmitter. A chip used in serial communications boards to interface terminals to modems.
UDP	User Datagram Protocol. Used on the Internet for applications not requiring the overheads of TCP. Used especially for real time application.
UMTS	Universal Mobile Telecommunications Service. This uses the term Universal in its narrower sense of Europe and Japan.
UNE	Unbundled Network Elements.
UNI	User Network Interface. A broad term that describes the necessary protocols to support communications between user equipment and a network interface.
Unicast	A transmission from one device to just one other device.
Unicode	A universal coding system for all the worlds major languages. It is compatible with ASCII, and is being widely used on the World Wide Web.

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UP	User Part. The SS7 application protocols.
URL	Uniform Resource Locator. A combination of protocol, DNS name and file path used to identify resources on the World Wide Web.
User Signalling	Signalling between a telephone/terminal and local exchange.
User-user Signalling	End-to-end signalling across the network.
UTRAN	UMTS Terrestrial Radio Access Network.
UWC-136	Third generation version of IS-186.
VCI	Virtual Channel Identifier. Used in the ATM cell header to uniquely identify a virtual circuit over an ATM network.
VDSL	Very High Rate Digital Subscriber Loop. A method of transmitting very high data rates over very short local loops (approximately 50 Mbit/s for 300 metres).
VF	Voice Frequency. An analogue voice signal which modulates a higher frequency carrier wave.
Vocoder	A coder that is designed specifically for voice, and which will not work with other types of signal such as modem traffic.
VoDSL	Voice over DSL.
Voice Gateway	An interface between VoIP and the PSTN.
VoIP	Voice Over IP.
VPI	Virtual Path Identifier. Used in the ATM cell header to uniquely identify a group of virtual circuits over an ATM network.

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VPN	<p>Virtual Private Network.</p> <p>A service offered by a PTO to a company that appears to be a private network with the features that a private network has that are not present on a public network.</p>
VTAM	<p>Virtual Telecommunications Access Method.</p> <p>The primary access method used by IBM in SNA networks.</p>
WAN	<p>Wide Area Network.</p> <p>The public network provided by a country's public telephone operator.</p>
WAP	<p>Wireless Application Protocol.</p> <p>Equivalent to HTTP used on mobile networks.</p>
W-CDMA	<p>Wideband CDMA.</p>
WDM	<p>Wave Division Multiplexing.</p> <p>Using typical 4 wavelengths (colours), each carrying 2.5G giving 10G in all.</p>
Wireless	<p>A link that does not have a physical connection. It is typically microwave, radio, infra red or visible light.</p>
Wireline	<p>A link that does have a physical connection, typically electric cable or optical fibre.</p>
WLL	<p>Wireless Local Loop.</p> <p>A directional radio system (using high frequency microwaves) as an alternative to a wired local loop.</p>
WML	<p>Wireless Markup Language.</p> <p>Equivalent to HTML optimised for text over the World Wide web.</p>
Word	<p>Basic unit processed by a computer - typically 32 bits, but the next generation of computers will use 64 bit words.</p>
WWW	<p>World Wide Web.</p> <p>A resource on the internet.</p>

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X.21	A circuit switched data network standardised in 1972 and used extensively in Scandinavia.
X.25	A packet switched data network designed for low speed reliable data transfers, standardised in 1976 (see frame relay and ATM).
XML	Extensible Markup Language. A meta language for data.

3

**Technical Guide on
Audit in Hotel Industry**

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Foreword

The Hotel Industry comprises a major part of the Tourism industry. Historically viewed as an industry providing a luxury service valuable to the economy, only as a foreign exchange earner, the hotel industry today contributes directly to employment, employing around 0.15 million people in India, and indirectly facilitates tourism and commerce. The Hotel Industry has grown leaps and bounds after the Asiad games held in India in 1982 and the subsequent partial liberalization of the Indian economy. The Commonwealth Games hosted by India in 2010 have given a greater push to the growth of the hotel industry. The hotel industry has also got a fillip from the entry of low cost airlines and the open skies policy.

With increasing number of hotels in the country and their penetrative reach in each and every part of the country, the responsibility of their effective and timely audit lies with the Chartered Accountants. I am happy to note that the Auditing and Assurance Standards Board of the Institute of Chartered Accountants of India has come out with a Technical Guide on Audit in Hotel Industry, written by an eminent expert. The Technical Guide is designed to help the members and other readers, have a thorough understanding of the peculiarities involved in the operations and audit of hotel industry.

At this juncture, I wish to place on record, the efforts of CA. Abhijit Bandyopadhyay, Chairman, Auditing and Assurance Standards Board for his unstinted endeavours to help the members in their day to day audit assignments through such industry specific audit guides as well as awareness programmes and training workshops on Standards on Audit that were conducted this year.

I am sure that this Technical Guide would be immensely useful and highly appreciated by the members as well as other interested readers.

February 8, 2011
New Delhi

CA. Amarjit Chopra
President, ICAI

Preface

The Hotel Industry in India is set to grow at the rate of 15% a year. This figure skyrocketed in 2010, when Commonwealth Games were hosted by Delhi. Already, more than 50 international budget hotel chains have moved into India to stake their turf. Therefore, with opportunities galore, the future scenario of the Indian hotel industry looks brighter than ever before.

In order to sustain the success of an entrepreneurship, timely, relevant and reliable financial information complemented by an independent audit is indispensable, the hotel industry being no exception. The prime objective of the Auditing and Assurance Standards Board in bringing out industry specific audit guides is to help the members understand and address the issues peculiar to the and affecting the audit in a particular industry appropriately.

Accordingly, this Technical Guide on Audit in Hotel Industry provides an insight not only into the general functioning of hotels, but also the risk areas as well as methods of accounting and auditing peculiar to them. It discusses in detail the peculiarities associated with the important items on the financial statements of a hotel, such as, revenue from different streams and activities and receivables, expenditure on aspects such as food and beverage costs, commissions, maintenance costs, rentals, payroll costs, etc., and other issues such as property, plant and equipment, guest royalty reward programmes, etc., The appendices to the Guide contain sample checklists for audit of revenue and a sample audit programmes for the benefit of the members.

At this juncture, I wish to express my heartfelt gratitude to CA. S Narasimhan, Chennai for sparing time out of his pressing professional and personal preoccupations for preparing this Technical Guide. I am also thankful to CA. T. V. Balasubramanian for his assistance in developing the Guide. My sincere thanks are also due to CA. Amarjit Chopra, President, ICAI as well as CA. G Ramaswamy, Vice President, ICAI whose vision, guidance and support I have been privileged to receive in the activities of the Board.

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Many thanks are also due to my Council colleagues at the Board, viz., S/Shri Rajkumar S Adukia, Vice Chairman, Sumantra Guha, P Rajendra Kumar, Jayant P Gokhale, Jaydeep N Shah, Sanjeev Maheshwari, S Santhanakrishnan, J Venkateswaralu, Pankaj Tyagee, Anuj Goyal and the Central Government nominees, Shri Prithvi Haldea and Smt. Usha Shankar and also to the co-opted members at the Board, viz., K. Rajasekhar, Ganesh Balakrishnan, Samir Shah, Harinderjit Singh and T.V. Balasubramanian, for their dedication and support in charting the work plan of the Board and bringing it to fruition. I also wish to place on record my thanks to the special invitees to the Board, viz., Nilesh S. Vikamsey, Sanjay Vasudeva, Bhavani Balasubramanian, Amit Roy, R. Narayanaswamy, Prof. Vipul and Jaideep Bhargava who have taken time out of their far more pressing commitments to devote time to the activities of the Board.

I am confident that this Technical Guide would be well received by the members and other interested readers.

February 8, 2011
Kolkata

CA. Abhijit Bandyopadhyay
Chairman
Auditing and Assurance Standards Board

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Part 1

Framework of Hotel Industry

Hotel Industry in India

Understanding Hotel Industry

1.1 Hotel industry is foremost among various industries that reflect the economic activity in an economy. It mirrors true social, cultural and economic growth and maturity of a country. The Hotel industry is directly related to the Travel and Tourism industry.

1.2 India is a very vast country with geographical diversity, ranging from snowcapped mountains to deserts to vast coastlines, complemented by rich culture and heritage, fairs and festivals, monumental attractions, etc. For sheer diversity, no other tourist destination probably comes close to India. Therefore, there is a tremendous potential for growth of tourism industry in India.

1.3 The earlier setbacks in global tourism have strengthened the Department of Tourism's resolve to promote India's tourism through aggressive marketing strategies through its campaign 'Incredible India'. The 'marketing mantra' for the Department of Tourism is to position India as a global brand to take advantage of the burgeoning global travel and trade and the vast untapped potential of India as a tourist destination.

1.4 In 2009, the domestic market in India recorded 650 million travellers as compared to only about 5 million international travelers, indicating the dominance of domestic travel in the country. The foreign tourist arrival during the period January-October 2010 was 4.32 million with a growth rate of 9.9 per cent.

1.5 India is fortunate to have a domestic market that supports the growth of the travel industry even when the world economy is experiencing a downturn. However, domestic travel has probably never been given its due. Even today, it is the statistics on the foreign travellers that garner attention; though, it is the less

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represented domestic segment that forms the major component of revenue generated by the Indian travel industry.

1.6 The domestic demand for hotels in India has historically been higher than the demand from foreigners. Though a large portion of domestic demand originates from commercial activity, an increasing number of Indians are taking annual holidays, both within the country and overseas. Many States within India such as Kerala, Rajasthan, Goa have started focusing their efforts on the Indian traveller.

1.7 The current count of hotel rooms in India is 130,000, and the country is expected to require an additional 50,000 rooms over the next two to three years, according to World Travel and Tourism Committee (WTCC) estimates.

1.8 The World Travel and Tourism Council (WTTC) has predicted that India has the potential to become the number one tourist destination in the world with the demand growing at 10.1 per cent per annum and will receive 25 million tourists by the year 2015.

1.9 Other than hotels, there are lots of standalone restaurants which are also contributing to economic activity and there are branded chains of restaurants which are claiming prominence across India. Similarly, standalone SPA, medical tourism, etc., are driving the demand and need for expansion of hotel room requirements.

Factors Affecting Hotel Industry

1.10 There are various factors which affect the growth of the Hotel industry, viz., economic, political, competition, substitutes, strength of suppliers and of course employees.

Economic Factors

1.11 Various key economic factors like interest rates, taxation changes, economic growth, inflation and exchange rates affect the Hotel industry as much as any other business. However, even global recession which has even though not affected India much had major impact in hotels as foreign tourist arrival dropped

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considerably. Hence, economic circumstances of not only India but global economic factors also affect the industry performance. This phenomenon has been witnessed even in the past like during the 1997 Asian economic crisis.

Political Factors

1.12 Political stability in the country is considered important for the growth of any industry in the country. The political stability is even more necessary for the growth of Hotel industry. In the past Afghan war, Mumbai terror attacks, etc., have forced foreign countries to bring in travel adversaries which poorly affected the Hotel industry.

Competition

1.13 Competition drives both the supply of the rooms and also creates demand for rooms through advertisements by competitors. Whereas competition leads to reduction in prices in the short run, it also leads to improvement in quality of service / product and also bring in healthier impact in the Industry by forcing players to reposition the brand / quality of service in the long run.

Substitutes

1.14 Of late due, to ever raising room rates especially in five star Hotels category, lots of substitutes have emerged to cater to travellers who spend considerable amounts on Hotel stays. For instance, video conferencing has obviated the need for businessmen to travel long distances, stay in hotels and have face-to-face meetings. Similarly, most corporates have started using own guesthouses / shared service apartments resulting in reduction in the Hotel capacity.

Strength of Suppliers

1.15 The existence of reliable sources that could provide timely and high quality goods and services at competitive rates, is a very important factor for growth of the Hotel industry. The existence of such sources is of even greater necessity for purchase of perishable goods that need to be procured on a daily basis. In the

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scenario where outsourcing of certain services (like back of the house cleaning services, Kitchen Stewarding) is gaining wider acceptance for the purpose of converting fixed overheads into variable overheads, the strength of suppliers in terms of their ability to provide consistently timely services, assumes great significance.

Employees

1.16 Employees are always considered as the key asset in a service-oriented industry. The quality and competence of employees, not only of those who interact directly with the guests but also of those who provide support services, are critical to the success of a hotel. Ever increasing employee cost also results in reduction in manpower. Hotels in India in the past had operated with an average of 2, and in some cases, 3 employees per room as compared to the international benchmark of 1.5 or less employees per room.

Peculiar Features of the Hotel Industry

1.17 There are a number of special features that set the Hotel industry apart from other service industries. These factors are briefly discussed hereinafter.

Fixed Supply of Rooms

1.18 The number of rooms available in a hotel remains fixed and there is no scope for flexibility in the same. The hotelier cannot increase/decrease the number of rooms available with increase/decrease in demand, unlike in a manufacturing industry where a reduction in the production is possible in response to rising / falling demand. Another constraint in case of the hotel industry is that there is very little scope for putting the rooms to alternative use for generating revenue.

Perishability of Hotel services

1.19 The services of Hotel are immediately perishable as these cannot be stored for future use. For example, if a room remains vacant on a particular day, revenue for that day is lost immediately

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and it cannot be made up in future. Similarly, if restaurant tables are not occupied it is a lost business opportunity.

Controls on Leakage of Revenue

1.20 The existence of appropriate controls for preventing leakage of revenue assumes great significance in case of a hotel for the reason that it generates revenue through a number of operating departments. The existence of appropriate controls is more important in the case of resident guests who have access to virtually all the facilities offered by a hotel. In most of the services, person offering service interacts with a guest and expected to bill for service rendered. It's called moments of truth.

1.21 To prevent any possible leakage of revenue, a number of hotels in India are automating their billing systems for telephones, food and beverages that get linked directly to guest ledgers by interfacing point-of-sale billing to Property Management System (PMS). Despite the automation, a hotel is exposed to certain types of leakage of revenue. The control issues in case of a hotel have been more elaborately dealt in subsequent Chapter.

Seasonality Factor

1.22 The seasonality factor that affects the hotel industry is of more dynamic nature are compared to the other industries. Besides climate and weather factors, hotels have also to contend with the weekdays, weekends as well as monthly 'seasonality' factors. Consequently, a hotel has to devise suitable packages and resort to innovative pricing to overcome this problem. (For instance in Goa and Kerala, monsoon packages are offered at cheaper rates to attract local tourist / corporate travellers for conferences, etc.)

Service Charges

1.23 The Hotel industry is one of those industries that levy a service charge on the billed amount. These charges are generally levied on food and beverage bills. Service charges are treated differently by different Hotels. While some use it to distribute to the staff as part of labour cost and some for hiring temporary staff for

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functions, or for breakage of Crockery / Cutlery and Glassware, etc.

High Fixed Cost

1.24 The proportion of fixed costs to the total costs is normally higher in case of a hotel. This means that a hotel has to incur certain costs whether or not it has generated any revenue. The need to reduce the proportion of fixed costs has resulted in an increasing trend towards outsourcing. For example, many hotels in India get their laundry done through external agencies. Many of the housekeeping functions, which comprise a chunk of the fixed costs, are also being outsourced. Abroad, sub-letting of bars and restaurants and even the entire food and beverage function is already in vogue.

Contribution Factor on Revenue from Rooms

1.25 Revenue from rooms is one of the few revenue streams that have lowest variable costs and, consequently, provide the highest contribution. The incremental costs on letting out of a room are generally the cost of washing the linen and replenishing the guest amenities like toiletries.

Night / Income Audit

1.26 The term night audit is widely prevalent in the hotel industry. The term refers to the procedure under which various revenues are checked at night, i.e., after the end of the 'normal' business hours. Night audit is a control procedure which is carried out to ensure that revenues for the day, as also cash / credit card collections, have been correctly recorded, so that records are updated and ready by the next morning. As most of the hotels now use PMS, the need for night audit has been shifted to more of income audit done during day time. PMS has ensured that there is an automatic balancing of revenue posting, cashier closing and guest posting. Hence, of late, night date change (for running procedure of posting room revenue in PMS) is done by the front office operating team and income audit is done next day during the day time.

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Time Sharing Arrangements

1.27 Time-sharing is a relatively new concept that offers the right to use, for a set interval each year, the facilities in a designated hotel/resort, wherein the purchaser pays an initial fixed amount to acquire the timeshare product and then pays an annual contribution known as maintenance or management fee.

High Capital Investment

1.28 Hotel industry involves high amount of investment in fixed assets, primarily land. Typically, nearly 90% of the net worth of a hotel is invested in fixed assets. Further, the gestation period for hotels is generally longer as compared to other industries.

Laws / Statutes Applicable to Hotel Industry

1.29 Apart from the common laws that are generally applicable to any business entity, such as the Income-tax Act, 1961, the Companies Act, 1956 (if the entity owning the hotel is a company), and the labour laws, the following statutes require specific mention as being applicable to the hotel industry:

Details of the Law	Subject	Levy on
Luxury Tax Acts	State Act	For levy of tax on luxury provided in the hotel.
Prevention of Food Adulteration Act, 1954* Food Safety & Standards Act, 2006 Prevention of Food Adulteration Rules, 2010	Central Act	For maintenance of hygiene and quality of food.
Central Excise Act, 1944	Central Act	Excise duty on pastries and cakes.

* Getting repealed shortly

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Details of the Law	Subject	Levy on
State Excise Acts	State Act	State Excise laws for levy of excise duty on liquor& regulate sale / service of liquor.
Service Tax (levied under the Finance Act, 1994)	Central Act	For levy of service tax on banquet revenue and various other services like dry cleaning services, etc.
Shops and Establishments Act and the Catering Establishments Act (In few states)	State Act	For regulating the working of the hotels.
Value added Tax Acts	State Act	For levy of tax on sale of food and other goods.
Standards of Weights and Measures Act, 1976	Central Act	To establish standards of weights and measures.
Contract Labour (Regulation & Abolition) Act	Central Act	Controlling & regulating employing contract labour

Key Revenue Generation Activities

1.30 In a hotel, following are the typical revenue streams

Revenue stream	Basis of revenue& Tax there on
Room Revenue	<ul style="list-style-type: none"> ✓ From sales of rooms. Billing is done through PMS. ✓ Luxury tax is chargeable on room revenue. In some States it is chargeable on published rack rate and in some States it is on actual room revenue charged to guest. ✓ Luxury tax is payable on complimentary rooms as well in

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Revenue stream	Basis of revenue& Tax there on
	most States. Exemptions are given for employees of the hotel who are staying in hotel.
Retention charges – Due to cancellation / no shows	<ul style="list-style-type: none"> ✓ Collected from guest for either cancellation of a reservation or due to no-show (non-arrival upon reservation) ✓ It is not equivalent to room revenue as no room is sold but it is collected as a penalty for non-fulfilling the commitment. Hence, it can not be classified with room revenue. However, in some States, Commercial tax authorities have been claiming luxury tax on retention forcing hotels to account it as part of room revenue.
Food and Beverage (F&B) revenue from Restaurants	<ul style="list-style-type: none"> ✓ Food and Beverage sold in restaurants. Billing is done through POS (Point of sales) ✓ VAT is charged on F&B sales. ✓ Normally F&B income is charged based on food served. But it is also apportioned from a composite charge through a process called meal plan apportionment. This is explained below.
F&B Revenue from minibar	<ul style="list-style-type: none"> ✓ Most hotels keep minibar stocked with liquor, soft drinks, snacks etc. ✓ These are normally billed based on self-declaration by the Guest by filling up the form kept in minibar.

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Revenue stream	Basis of revenue& Tax there on
	<ul style="list-style-type: none"> ✓ While replenishing, minibar attendant checks consumption and bills.
F&B revenue from Banquets	<ul style="list-style-type: none"> ✓ Normally, rates offered are per cover basis (cover means per person). Rate is a composite rate for F&B and hall hire. ✓ Banquet billing is normally billed on guaranteed covers if actual cover is less than contracted. ✓ Banquet income is chargeable with VAT and also service tax, one of the few things which are being subjected to double tax in India.
Hall hire from Banquets	<ul style="list-style-type: none"> ✓ Where rate offered is not composite, then hotels can offer hall hire separately. ✓ This will also be subjected to Service tax only.
Communication revenue (Both Telephone & Internet)	<ul style="list-style-type: none"> ✓ Revenue is charged to PMS through interface from EPABX system or internet service provider system ✓ For internet alone service tax is charged ✓ In some States telephone is included for luxury tax (Like Kerala)
Car Hire income	<ul style="list-style-type: none"> ✓ Normally car rentals are facilitated by hotel through dedicated travel desk which are normally outsourced to a travel agency. ✓ Guest hires car and hire charges are

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Revenue stream	Basis of revenue& Tax there on
	normally posted to guest folio. Hotel gets its commission based on hire charges earned by agency.
Business centre revenue	<ul style="list-style-type: none"> ✓ Business centre services are generally, meeting room, fax service, photocopying services, secretarial services, etc. ✓ Revenue assurance is a challenge here as service provided is only manually tracked to billing. If manual tracking through appointment register is missed, billing will be missed.
Arcade revenues	<ul style="list-style-type: none"> ✓ Shopping space is provided at a fixed monthly income at lobby level or in any public area. ✓ At time rental is linked to billing done by them. Controls in those cases need to be exercised by ensuring that correct revenue to the Hotel.
Health club/Spa/Beauty parlour revenues	<ul style="list-style-type: none"> ✓ Health club and beauty parlour revenue is booked based on guest serviced. An appointment register is maintained for all guests who seek appointment for service. Upon service, guests are billed in POS. ✓ In some hotels, membership fees are received for use of health club (gym) by members. The fees is apportioned over a period of the membership.
Laundry revenues	<ul style="list-style-type: none"> ✓ Laundry is provided to resident guests and employees. At times, in some hotels, outsiders are also

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Revenue stream	Basis of revenue& Tax there on
	<p>allowed to use laundry service through club membership like 'Fabric care club'.</p> <ul style="list-style-type: none">✓ Billing is done in POS and master data for rates is updated upon rate revision.✓ Laundry dry cleaning services are subjected to service tax.
Housekeeping billing	<ul style="list-style-type: none">✓ Housekeeping revenue is generated out of sale of wardrobes, baby-sitting services, etc. These are very rare services.
Disposal of empties / sale of scrap	<ul style="list-style-type: none">✓ Hotels normally sell scrap through annual rate contract process. In case of project scraps, one time seller evaluation will be done considering the volume.✓ Scrap is differentiated into wet and dry scrap. Dry scrap of empties comprises empty cans, bottles (liquor, beer and water) and other containers are items, which fetch higher realization.

Possible Business Structures

Operating Arrangements

1.31 The arrangements for operating a hotel can be structured in different ways which are discussed hereinafter.

Owned Hotels

1.32 In this type of arrangement, the hotel is owned and managed by the same entity. The land on which the property is

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situated can be either owned or leased. There can be certain variations in the manner of ownership of hotels, such as a joint venture where, for example, one of the parties contributes the land and the other party provides finance as well as technical expertise.

Managed Hotel

1.33 Under such arrangements, there is a clear separation of ownership from its management. The day-to-day operations of the hotel are managed by an enterprise, which specializes in the management of hotels and is not the owner of the hotel. The enterprise generally receives a management fee for management services provided by it.

Leased / Licensed Hotels

1.34 In such type of arrangements, hotels that are owned by others are taken on lease by an enterprise operating a hotel chain for an annual lease rent or license fee. The rent/fee can be either a lumpsum amount or a combination of minimum guaranteed fees and additional fees paid as a fixed percentage of revenue or profit.

Alliances – Ownership and Franchise Affiliation

1.35 Under such arrangements, the owners of hotel make a contract with another enterprise running a chain of well-known hotels for the use of name and reservation system. The hotels may also align with various other partners for services such as, reservation system, on-site car rentals and frequent stay/flier programme. Any such alliances are designed to help both the parties through referrals and cross-selling.

Types of Hotels

1.36 An overview of different classification of hotels are given below:

Hotel Classification in India

1.37 With the aim of providing contemporary standards of facilities and services available in the hotels, the Ministry of

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Tourism, Government of India has formulated a voluntary scheme for classification of operational hotels which will be applicable to the following categories:

- **Star Category Hotels:** - 5 Star Deluxe, 5 Star, 4 Star, 3 Star, 2 Star and 1 Star
- **Heritage Category Hotels:** - Heritage Grand, Heritage Classic and Heritage Basic

1.38 The Hotel and Restaurant Approval and Classification Committee (HRACC) inspects and assesses the hotels based on the facilities and services offered.

Hotel Segments

1.39 The Hotel industry can be classified into various market segments on the basis of spending ability of the individual traveler and on the basis of entitlement in the case of traveler representing an organization. Market segments are important for better revenue management in a Hotel. It allows the Hotels to target and market to a variety of consumer groups with different behavior with an offer that matches their needs and budget level.

1.40 The Hotel market segmentation helps to identify the purpose of the trip: either business or leisure. The price does not decide the market segmentation. Clear distinction must also be achieved between individual and group business.

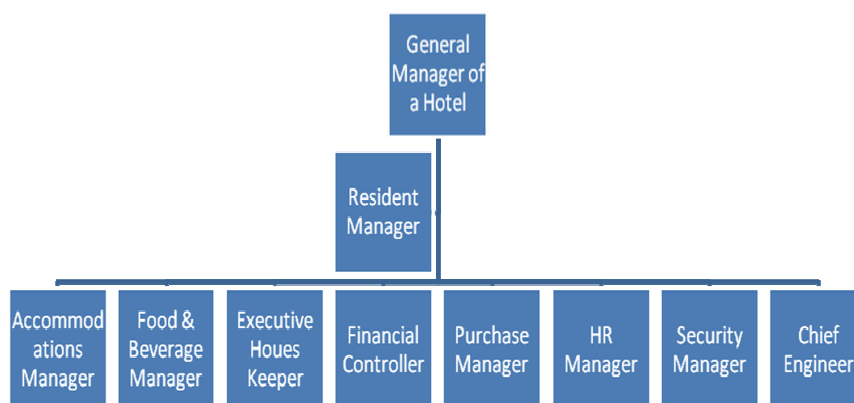
1.41 Major segments practiced in industry are Corporates, leisure, groups, events, conferences, airline crew / layovers, etc.

Classification of Brand

1.42 Of late hotels in India is also looking for branding and trying to associate itself with various brands. Branding helps in positioning the hotel in a particular segment and also get revenues in that level. Also, internationally same group may have multiple brands for various segments like Luxury, upper upscale, budget, no-frills hotels, etc.

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Hotel Organisation Structure



Scope and Objective of the Technical Guide

1.43 The main purpose of this Guide is to provide an insight into the general functioning of hotels, the technical aspects peculiar to the industry and its unique accounting methods which would be helpful in the conduct of audit of a hotel.

1.44 Since the size, functioning and nature of business may vary materially from hotel to hotel, the Guide cannot cover all the intricacies that may be involved in all practical situations. The various principles, enunciated in this Guide, would, therefore, require appropriate modifications/adjustments depending on the size, functioning and nature of the business of the hotel under consideration. It should also to be noted that only specific aspects which are unique to the Hotel industry are dealt with and normal aspects like audit of the Sundry Creditors / Accounts payable, etc., are not covered in this Technical Guide.

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1.45 It needs to be noted that globally, the Hotel industry practices Uniform System of Accounts for Lodging Industry (USALI) which is a uniform chart of accounts owned by Hotel Association of New York City which is part of American Hotel & Lodging Association (AH&LA). This document has, however, not been adopted by the Hotel Industry in India which still follows accounting based on natural head of accounts. (For instances in USALI expenditures are accounted based on revenue department – Salaries & wages are accounted as S&W – rooms division, S&W – F&B, S&W – Sales & Marketing, S&W – Admin, etc.)

Part 2

Accounting Features

Special Features of Hotel Industry

2.1 The technical and operational aspects of a hotel can be discussed under the following broad heads:

- (a) Rooms
- (b) Food & Beverages (including purchases)
- (c) Foreign Exchange Compliance
- (d) Marketing Department

Rooms

2.2 Rooms generally constitute the biggest source of revenue for a hotel. Approximately, 50 to 65% of the gross revenue of a hotel comes from room rent which of course could vary depending on the city and hotel configuration of banquet business. Normally, contribution from this source of revenue is more than 70% due to the low variable costs. The various operations relating to rooms normally are Reservations including revenue management, Front Office including Concierge, House keeping.

Revenue Management

Pricing of Rooms

2.3 Room rent generally makes a major contribution to the overall profitability of the hotel and, therefore, performance statistics of rooms are considered as indicators of the success of the entire hotel business. Keeping in view the importance of the room rent to the overall profitability of a hotel, pricing of the rooms is required to be done in a manner that overall revenue can be maximized by optimizing average room rate and average occupancy.

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2.4 **Average room rent (ARR)** and average occupancy are two of the key indicators for measuring the performance of the rooms department. Average room rent could be arrived at by dividing the total room revenue for a given period by the number of room nights actually sold during that period. It is also sometimes referred to as Average Daily Rate (ADR). Average occupancy is determined by dividing the total room nights sold during a given period by the room nights available during that period.

2.5 **Revenue Per Available Room (RevPar)** is being used of late to compare the revenue between hotels. RevPar is computed by dividing Room revenue by number of rooms available for sale. RevPar is nothing but ADR multiplied by occupancy percentage.

2.6 Care is exercised while offering discounts on the standard room rate since there are chances that it might create a precedent that may bind the hotel to lower rates in future. While pricing the rooms, rates offered by the competitors are also required to be considered so that misperception about the segment in which hotel is operating may be avoided.

Barter Arrangements

2.7 Hotels are often presented with offers for goods and services on a barter arrangement. These include “rooms for airline tickets”, “Beverages for the attendant publicity”, “event sponsorship for free invitations” and so on. Whilst many barter arrangements appear extremely attractive and in the hotel’s interest, they have implications from the standpoint of legality, sales tax, income tax, accounting disclosure and the Company’s stated accounting policies. Barter arrangements are also difficult to monitor and keep track of.

2.8 Normally, hotels are expected to get arrangements approved by corporate (where it is a corporate run hotel) for monetary and taxation impact. Ideal accounting system is to account both given and taken services to be valued and accounted and taxes like VAT and service tax if any payable must

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be paid. It may be noted that barter arrangement is as good as normal sale except that consideration is received in kind.

Reservations

2.9 Normally, in most hotels revenue management and reservations are under same person or in some hotels reservations is an exclusive department either under front office or under Sales department.

2.10 Sources of reservations may be direct inquiries from the guests or through other diverse sources such as travel agents, reservation networks (in the case of an enterprise operating a chain of hotels), Global distribution systems (GDS), etc. Now days, reservations are expected to flow into the hotel along with guest details including positive identity proof. This has become a security requirement to ensure that undesirable elements are identified and appropriately dealt.

2.11 Normally, the reservation department is expected to manage rates as well which are offered in PMS through occupancy maintenance. Various categories of rates that are used are national / global contracted rates, territory sales contracted rates, Airline crew rate, layover rate (use for airline passenger, provided by Airline), best available rate (BAR), etc. Sources of these rates can be decided by various levels of decision making process in an organisation.

Front Office Operations

Filling of Registration Card

2.12 For each guest, a registration card is made at the front office normally printed out from PMS. The registration card generally records the name and address of the guest, the nationality, passport number (in case of a foreign national), rate to be charged, billing instruction, the arrival date and time, as also the expected departure date and time. The registration card is required to be signed by the guest and either by duty manager or even Front Office Manager of the hotel (based on company

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practice). The arrival of customer is also recorded through check-in in the guest folio in PMS.

Unauthorised Occupancy of Room

2.13 Biggest risk in any hotel is letting room without showing check in into the PMS. Unauthorised occupancy can be detected through two checks, namely room discrepancy report and key checks.

- **Housekeeper's Occupancy Report (HOR):** The reports on the rooms occupied are based on guest counts carried out by the housekeeping staff. Normally, such counts are carried out twice a day; once in the morning while cleaning the room and once in the evening, while making the bed (evening turn down service). HOR is generated at least once a day. In addition to occupancy status, this report will also include number of guests (Single/Double etc.), rooms with scanty Baggage. This report is to ensure that:
 - there is no unauthorized letting out of a room by the Front Office; and
 - the guest has not checked out without settling the bill (for the purpose, due cognisance is taken of the Scanty Baggage Report).
- The housekeeping report, so prepared, is sent to the Front Office where discrepancies, if any, are reconciled. FO ensures that the HOR is cross-checked with front office occupancy data (as per PMS), and a Room Discrepancy Report (RDR) prepared. (This can be done in PMS itself). All discrepancies per the RDR are verified by the Duty Manager, and follow-up action taken to resolve such differences and documented. Hotel's night/day audit procedure verifies that RDR has been prepared, differences resolved, action recorded and reports signed off by the Duty Manager.
- **Key checks** - Key counting at night by authorized person other than FO personnel for keys in front office for all

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unoccupied rooms has to be done. Where it is an electronically controlled card (like Ving card) if card making is not integrated with PMS then a dump of keys made as per card system is to be compared with occupancy as per PMS and differences to be investigated and acted upon. Alternatively, authorised person opens unoccupied rooms as per PMS to see whether the room is actually vacant.

Complimentary Rooms / House Use Rooms

2.14 In the course of conducting its business, hotels often have to give out guest rooms on a complimentary / house use basis. House use rooms are defined as those rooms which are given on a no-charge basis to hotel / company executives when on official tour, as well as no-charge rooms used from time to time by the hotel / company's business associates visiting on the Hotel's official business. Even manager on duty (MOD) is provided with a room for overnight stay as he is officiating at night as Head of the hotel.

2.15 All these have appropriate authorisation as per the corporate policy. What all needs to be given as complimentary is also normally fixed like room, food, soft beverage, local calls, official long distance calls and laundry. Normally, liquor, smokes, long distance calls, spa / beauty club usage are not permitted.

2.16 Complimentary rooms can be classified as under which are normally approved as per corporate policy:

- Given to tour leaders for group and conference bookings as per the terms of the written agreements entered into by the various Sales & Marketing offices directly by FO as per terms.
- Others, including FAM (familiarization) tours, visits by travel writers, business partners, etc.

2.17 Normally, in some States (like Tamilnadu, Andhra Pradesh, etc.) Luxury tax is payable on complimentary rooms. Hence, there is additional cost while offering complimentary rooms in those States.

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Upgrades

2.18 Normally, rooms are allotted based on category of room for which room is booked. However, higher category of room can be allotted due to various reasons like requested room category not available, guest patronage, profile of the guest, etc. Whenever upgrade is given, it must be authorised by appropriate person as per the corporate policy.

2.19 Luxury Tax has to be applied in cases of room upgrades. In States where Luxury Tax is applicable on published tariff and not on room rates actually charged, the differential of Luxury Tax is normally billed to the guest. However, in case the upgrade takes place because a room of the booked category was not available, and not at the instance of the guest, then such cost has to be borne by the hotel.

Early check in / Late check out

2.20 In most of the hotels, the check-out time is 12.00 noon and a day is assumed to be complete for charging room rent at 12.00 noon irrespective of the arrival time. In view of this, guests arriving in the hotel in the evening and checking out on the next day morning are charged full day's room rent. Concessions are, however, made for guests checking out after 12.00 noon; usually no extra charge is levied for the first couple of hours based on the corporate policy. Otherwise a fixed percentage of daily rate is charged. Similar concessions are also granted to guests checking in before noon, which is called as early check in. Normally, all late checkout or early check in charges waivers are authorised by appropriate person to ensure that there is no revenue leakage.

Check out process

2.21 When a guest checks out, i.e., settles the bill, the guest folio is closed and the room is declared vacant in PMS. Immediately, after closing the guest folio, a message is sent to housekeeping department indicating that the room is vacant. This intimation enables the housekeeping department to take charge of the room, clean and rearrange the room and keep it ready for the next guest. The guest usually settles the bill by making immediate

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payment and credit is granted, normally, only to the guests having a contractual arrangement with the hotel.

Day use

2.22 When a guest checks in for few hours' use and not staying over night, such room occupancy is called day use. It is important to keep tab over day use rooms as rate to be charged is much less than rack rate or even BAR. Also, as check out happens before day end (at night time when date change), room rent needs to be manually posted, else day use room may become unbilled.

Allowances

2.23 When a guest complains about any service or claims that some charges were made to him by mistake, the Hotel may grant certain waivers to the customer for unsatisfactory services or eliminates the charges in question for the satisfaction of the customer. Credits made to guests' account on account of these aspects are called allowances. Most allowances granted to guests are on account of disputed telephone charges, adjustments for overcharges, compensation for damage to clothes given to laundry, and adjustments for unsatisfactory service. These are normally approved through appropriate processes. Billing corrections (for incorrect rate applied) are normally done through adjustments / negative postings as it is not a waiver.

Bills on Hold

2.24 When a guest leaves the hotel without settling the bills, either in part or in full, front office has no option but to keep the Bills on hold. These amounts are required to be transferred immediately from guest ledger to the City Ledger, i.e., Debtors ledger so as to facilitate prompt follow-up action. This situation could arise due to any of the following two reasons:

- (i) ***Late Charges:*** These are the charges for which details have been received at the Front Office after the relevant guest has departed after settling his other dues. Such charges are not posted to the guest folio, but are posted

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directly to the City Ledger, if it can be included in the original bills for recovery.

- (ii) **Skip:** Such a situation takes place when a guest, not enjoying credit facilities, has departed without settling his bill. 'Skipping' is invariably a pre-determined act on the part of a guest. Such cases should be transferred immediately from the guest ledger to the City Ledger and handed over to the legal department of the hotel for initiating necessary action for recovery. To avoid such a situation, most of the hotels collect an advance from walk-in guests at the time of reservation.

Concierge (otherwise called as bell desk)

2.25 The bell-desk is managed by a bell captain supported by bell-boys, porters and elevator operators and doormen. The bell-boys escort the newly arrived guests to their rooms, carry their baggage, deliver mail, faxes and messages, and perform such other services for guests which are not specifically assigned to other employees.

Scanty Baggage Report

2.26 The Scanty Baggage Report, as the name suggests, is a report meant to keep track of guests having very small baggage. The purpose of this report is to reduce possibility of their checking out without settling the bill. The tendency of checking out without settling the bill and leaving their baggage has been found in the case of walk-in guests, who come to the hotel for the first time. The realizable value of baggage left behind by such guests, who are known as skippers, is generally very less. The report is prepared on daily basis by the bell desk based on noting made whilst handling guest baggage. The report is forwarded to the Front Office, which may make relaxations for regular and known guests carrying scanty baggage.

Night Audit

2.27 The practice of night audit is very widely prevalent in the hotel industry and is normally considered as a major tool in

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prevention of leakage of revenue. Functions of Night auditors include

- Checking guests' accounts and usually taking charge from the front office billing clerk around midnight.
- Compare vouchers with sales summaries to ensure completeness and tally the same before income accounting.
- Sometimes posting vouchers in guest folios.
- Checking the cash receipts and the allowance credits.
- Making sure that if there has been change in the room of an existing guest, the same has been recorded on the guest folio and that the folio has been transferred in the file to the new room number.
- Checking whether room rent has been charged correctly

2.28 However, need for such activities have been reduced due to integrated computerisation. Most of the hotels have dispensed with night audit and at night time date change in PMS is done by the front office personnel themselves. Charges are normally posted to the guest folio immediately at the point of sale and from POS to PMS. The night auditor is, consequently, relieved from the burden of manual posting. Nevertheless, the role of night audit has become that of day audit as a revenue assurance exercise. A detailed checklist which can be adopted for revenue assurance is given in **Appendix 1**.

Cash Float

2.29 Each cashier, wherever located, generally holds a minimum cash balance, which is normally referred to as cash float or house bank. The largest amount of the float is usually held by the general cashier in the accounts department whereas the next largest amount is usually held by the front office cashier. The front office cashier uses his float for purchasing foreign currencies, including travelers cheques from foreign guests and for making payments on behalf of guests. The front office cashier hands over all cash (as well as cheques and foreign currencies) collections

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eventually to the general cashier, who in turn deposits the same in the bank.

Paid-Outs

2.30 Paid-outs refer to the payments made by the Front Office on behalf of guests. Guests, who, for example, may not be carrying ready cash with them, may request the Front Office to make payments on their behalf, such as hire charges of a taxi. Further, the guest may also request for buying certain items from market for which payment would be made by the Front Office. Any such payments made on behalf of a guest is charged immediately to the guest folio so that the risk of late charges might be avoided.

Meal Plan Apportionment

2.31 Hotels fix the rates to be charged from resident guests either as per American Plan (AP) or as per European Plan. Under the AP, a composite price, comprising room rent for the day and price of three meals is charged, whereas under the European Plan a separate charge is made for room rent and food. Some other hotels fix their charges on the basis of Modified American Plan which is a variant of the American Plan. Under this plan, hotels charge a composite price for room rent, breakfast and dinner for the day.

2.32 In case the hotel is following the American Plan or the Modified American Plan (MAP) for fixation of charges, it is required to apportion the composite amount charged, into room rent and charges for food, on equitable and reasonable basis applied consistently. The amount identified as room rent would be treated as income of Rooms Department whereas the amount received for food supplied to the guest would be treated as revenue of food and Beverages Department.

2.33 Most of the hotels follow the practice of issuing food coupons to the guests registered under the AP and the MAP. The guests are expected to present these coupons at the restaurant against which they are served their meals. The coupons presented at the restaurant are handed over to the front office,

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which identifies the coupons that have expired unutilized. The value of unutilized coupons should be credited to a separate account. However, now days, plan details are entered as package element in PMS that flows into POS as well. In computerised environment, package element can be automated which distributes the income between rooms & F&B.

2.34 There are States like Goa where Luxury Tax (LT) is payable on actual basis and hence, they split F&B and room as per package offered and pay VAT and LT accordingly. However, in States like Tamil Nadu, Delhi, Andhra Pradesh, etc., where LT is payable on Rack Rate, it is difficult to segregate F&B component and pay VAT separately as LT itself is on higher side due to the inability of hotel to sell at rack rate. Hence, in these States many companies do not apportion meal plan. However, in MIS reporting such hotels do account apportioned income.

Arcade Revenue

2.35 As it is controlled by the front office, normally, arcade revenue is a fixed monthly rental. However, at times it is also linked to revenue billed by such shops. In such cases, the hotel should ensure that adequate control exists to keep track of the shop income.

Food and Beverages

2.36 Food and Beverages (F&B) are generally considered as the second largest source of revenue for a hotel and generally contributes 30% – 32% of the gross revenue. The F&B department typically comprises the following sections:

- Kitchen
- Banqueting
- Restaurant(s)
- Bar(s)
- Room service
- Stewarding, and
- Stores

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2.37 The profitability of the F&B department depends on the combination of two factors, i.e., gross margin (selling price minus cost) and volume. On the one hand, volumes are never fully within the control of the hotel and on the other hand, selling prices are normally fixed in a manner so as to be competitive with the other hotels in the same segment operating in the vicinity. Therefore, profitability of F&B department can be increased mainly by controlling F&B costs. The various technical aspects relating to the F&B department are discussed hereinafter.

Kitchen

2.38 Kitchen is the heart of the F&B operation because food is prepared in entirety in the kitchen and supplied to the various outlets. With the increasing emphasis on the control of food costs, it would not be an exaggeration to state that the success or failure of the F&B department is dependent on the kitchen. A hotel may have more than one kitchen, depending on the size of the hotel and number of outlets. The kitchen is under the charge of the head chef, who reports to the F&B Manager. In a large hotel having speciality outlets, the head chef is usually supported by *sous* chefs, who are the second in command after the head chef and / or are in charge of the kitchen of their respective outlets.

Components of Food Preparation

2.39 The raw material used for food preparation can be categorized under the following two broad heads:

- (a) Perishables, and
- (b) Provisions

2.40 Perishables are those items that do not have any shelf life; for example, vegetables, fruits, milk, fish and meat. Consequently, such items are required to be purchased on a daily basis. Provisions, on the other hand, have a shelf-life, and can, therefore, be stocked and procured at periodic intervals.

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Control over Raw Material Cost

2.41 As already mentioned, the profitability of the F&B department, to a great extent, depends on the control of the raw material costs, since it is the only major variable cost. Labour cost, which is the next major head of expenditure in the kitchen, is a fixed cost. Perishables constitute a major component of the raw material cost, not only by virtue of the sheer physical composition of the total quantity required, but also because of the tendency for wastage. The key to controlling food costs, therefore, lies in exercising control over the purchase of perishables. The various methods usually employed by hotels to control the raw material costs are discussed hereinafter.

Purchase of Raw Materials – Annual Rate Contracts

2.42 Annual rate contracts are a typical feature of hotel purchases. Such contracts generally cover all perishable goods and some provisions. Under such arrangements, the supplier agrees to supply raw materials to the hotel at a fixed price. Therefore, the annual rate contracts have the impact of fixing the price at which various items of raw material can be purchased. The annual rate contracts are generally finalized by a Purchase Committee comprising the representatives of the purchase department, accounts department and administration department. The contracts may either specify the rate and the overall quantity of a particular item to be purchased during the year, or, alternatively, specify only the rate. In most of the cases, more than one supplier is identified for each item to ensure regular supply of the item. Further, the contracts generally contain a provision to the effect that in the event of any short supply, purchases would be made in the open market and the incremental costs, if any, would be charged to the supplier's account.

Ordering for Perishables and Provisions

2.43 The perishables (Vegetables, fruits, Meat, Fish & Poultry (MFP) items, Dairy products) are ordered on the previous day of its intended usage. As they are stored in the deep freezers, MFP

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items at times are procured twice or thrice a week. Orders for provisions, on the other hand, are placed on a periodical basis.

Basis of Ordering

2.44 The Purchasing Department places the order for perishables/provisions on the basis of requisition received from the head chef. Where a hotel has more than one kitchen, requisitions are sent by the *sous* chefs to the head chef, who consolidates the requisitions and sends a copy of the same to the Purchase Department. The chef generally relies on his past experience and trend while preparing the requisition slip. Many chefs also take into account other factors such as popularity charts, be it for different days of the week, or for particular times of the year while preparing the requisition. Banquet functions and conferences, with their pre-decided menus, generally provide a degree of accuracy to the ordering process. While preparing the requisition, it is recognized that the ordering of perishables could affect the cost to a great extent due to the fact that their shelf life is very limited.

Receipt, Storage and Issue of Raw Materials

2.45 All perishables received are normally sent directly to the kitchen without routing them through the stores department. The various items of perishables received are inspected by the head chef, or in his absence, by the *sous* chef. Rejections, if any, are usually made immediately. After checking, the perishables are sent straightaway to the kitchens requiring them. All perishables purchased on a particular day are normally charged to consumption for that day, whereas provisions are taken into stores and are treated as consumed on the day these are issued for use in the kitchen. All receipts, whether perishables or provisions, are normally recorded in a Daily Receipts Register which becomes the basis for recording of receipt of provisions at the stores and for payment of suppliers' bills.

Food Preparation and Serving of Food

2.46 The various aspects involved in the preparation and serving of food are discussed hereinafter.

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2.47 Menu engineering: Is an interdisciplinary field of study devoted to the deliberate and strategic construction of menus. It is also commonly referred to as Menu Psychology. In general, the term menu engineering is used within the hotel industry. Typically the goal of menu engineering is to maximize a firm's profitability by subconsciously encouraging customers to buy what you want them to buy, and discouraging purchase of items you don't want them to buy.

2.48 Fields of study which contribute most to menu engineering include:

- Psychology (perception, attention, emotion/effect)
- Managerial Accounting (contribution margin and unit cost analysis)
- Marketing & Strategy (pricing, promotion)

2.49 Standard Recipes: Standardisation of recipes is the integral part of menu costing and involves balancing of two delicate and crucial aspects – the taste and the cost. Once the balance has been achieved, it becomes a powerful tool for controlling food costs and even plays a very important part in the determination of the quantity of raw materials to be ordered. The hotels generally maintain an elaborate database on popularity charts of various dishes which is often used to estimate the expected business for the next day. The standard recipe, therefore, helps in making better estimate of the raw material requirements on the basis of the expected business.

2.50 Portion Control: The process of determining the standard quantity to be served per dish is known as Portion Control. Such a practice facilitates in optimizing the number of dishes that can be served out of a given quantity of an item and ensuring customer satisfaction. Any arbitrary increase/decrease in the quantity of dish would result in a loss in revenue to the hotel/dissatisfaction to the customer. While determining the standard quantity per dish, due consideration should be given on striking a balance between the price of the dish and the minimum standard quantity that must be served.

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2.51 Menu Costing: Menu costing involves determination of the cost of the standard recipes based on current prices. Such costing would also be helpful in ensuring that selling prices of various recipes are arrived at only after including the gross profit at a certain rate.

2.52 Wastage Report: At the end of each day, left-over food, which would not be useful for the next day, is thrown away and known as wastage. The cost of the wastage is determined and included in the Wastage Report. The Wastage Report is usually considered as an indicator of the efficiency of the kitchen in terms of food preparation.

Banqueting

2.53 Revenue from the banqueting activities generally constitutes significant component of the total F&B revenue. Banqueting activities include hosting of weddings, parties, seminars, conferences and such other functions. The size of a banquet could vary from as low as 25 people to more than 2000 people. Large hotels generally have a range of banquet halls/rooms that can cater to crowds of varying sizes. The services provided by the banquet departments may include foods, sound system, audio visual equipment, decoration, hall, etc., depending on the requirements of the customer. Nowadays, outdoor catering and letting out of a part of the hotel premises for film shooting has also become a part of the banqueting activity. Generally, the hotel itself supplies food and beverages to the banquet functions whereas, for other services, it may tie-up with the outside parties with a view to reduce fixed overheads. In the banquet function, the major source of revenue is considered to be sale of food and beverages. There are certain typical features of the banqueting activities, which are discussed below. Banquet functions are contracted through a document called *Function Prospectus* which details the services to be provided along with menu for the function. Banquet is one activity which normally attract both VAT and the service tax. Liquor is served in banquets normally by the hotel itself and billed. However, if guest is permitted to bring in liquor, "corkage", which is a service charge

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for serving liquor brought by the guest, is charged at nominal rates. Corkage is accounted as income.

Guaranteed PAX (Persons) and Expected PAX (Persons)

2.54 Hotels make charge for the food consumed at a banquet function on the basis of number of plates used. It is a common practice in hotels to require the customer to specify the number of plates expected to be consumed, based on which the customer is also required to guarantee minimum number of plates to be consumed in the function. Such a practice provides basis to the kitchen for food preparation and ensures minimum level of revenue for the hotel, even if the actual plates used are lower than the guaranteed number of plates.

Plate Count

2.55 As stated earlier, the food cost is charged to a banquet function on the basis of number of plates used and therefore, plate count constitutes a very important aspect of the billing process. The plate count, in some cases, may become a subject matter of dispute, particularly in large functions such as weddings. Hotels have recognized the plate count as a critical control risk area from the point of view of possible revenue leakage, since the possibility of understatement of the number of plates used by the banqueting department in connivance with the customer cannot be ruled out. To avoid such a situation, some hotels have instituted a system wherein, if the guaranteed plate level is beyond a specified threshold, representative(s) from the accounts department and/or the F&B Controller's office are required to be present during the function to vouch for the plate count.

Outdoor Catering

2.56 Hotels also serve food for functions to be held outside the hotel. Food is prepared and transported to the location. Billing controls like plate count as indicated in banquets are applicable.

Restaurant

2.57 Restaurant in a hotel is meant for resident guests (i.e. guests staying in the hotel) as well as for non-resident guests.

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Large hotels generally also maintain a coffee shop, which is open for 24 hours, as well as speciality restaurants that offer specific types of food; for example, Italian, Japanese, Chinese, Continental, Mediterranean, Thai, Moghlai, etc. The typical procedure in any restaurant is that the guest arrives, places the order, consumes the food and settles the bill. The technicalities involved in the various procedures of the restaurant are discussed hereinafter.

Pricing of Off-Menu Items (Open food)

2.58 The regular guests, sometimes, may order a dish that is not listed on the menu card. In order not to disappoint such guests, the requests are usually entertained. In such situations, the restaurant manager, in consultation with the head chef or the *sous* chef of the restaurant, as the case may be, fixes the price to be charged. A similar problem also arises at the bar, where wine, which is normally sold by the bottle, has been requested in the glass or where a particular cocktail drink, which is not normally served at the bar, has been ordered. The manager of the bar fixes the selling price in such situations. It may have to be kept in mind that an item which is in menu can also be billed as open food and billed at rates other than that at which it should be billed.

Cancellation of Bills (void bills)

2.59 Cancellation of bills usually takes place either on account of error in the billing due to the order having been wrongly taken down, or because the customer, on the grounds of quality, rejects the dish. The cancellation of bills represents a control risk in terms of unauthorized or fraudulent cancellation of bills after cash has been collected. To avoid such a situation, the hotels follow a procedure according to which cancellation of bills is required to be approved by the restaurant manager. After cancellation, bills are duly defaced on the bill book and are considered in the serial control of bills. It is also ensured that if food is prepared and then order is cancelled, then chef at the outlet should also approve.

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Reprints of Bills

2.60 At times in POS, reprints become necessary due to bill stationery getting smudged or printer error. It is also possible that credit customers may ask for bill copies at the time of settlement which might be months after the actual bill date. The reprints of cash settled bills are prone to be misused and hence in case of every reprint of checks, copies of the original as well as the reprinted check should be preserved and reasons recorded by the Restaurant in charge.

Bar

2.61 A bar is an exclusive section of the hotel where wines, spirits, beers and smokes (Cigars) are sold. While wines and beers are generally sold only in bottles, spirits are also sold in pegs. A small peg measures 30 ml and a large peg measures 60 ml. The bar is managed by a barman who is responsible not only for issuing bottles of wine and beer, pouring alcoholic drinks and mixing cocktails, but also for maintaining proper stocks thereof. The technicalities involved in the operations relating to the bar, are discussed below.

Maintenance of Excise Records for Alcoholic Beverages

2.62 The bar stores are required to maintain proper excise records in respect of imported as well as Indian Made Foreign Liquor (IMFL) in order to ensure that only duty paid liquor is sold. An excise officer as nominated by the company should be present at the liquor stores of the hotel at all times and should record receipt and issue of liquor immediately in the stock register maintained at the store. In the stock register, a separate account should be maintained for each brand of liquor. The excise records may also serve as a cross-check for ascertaining the sales tax liability on sale of liquor.

2.63 As a critical liquor control, a hotel normally has a process of reconciliation sales as per POS and consumption arrived as per books. (Opening stock + receipts from stores to outlet – closing physical stock should tally with sales as per POS).

Mixing of Drinks for Cocktails

2.64 Cocktail refers to the combination of one or more of alcoholic and non-alcoholic beverages in specified measures.

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The preparation of cocktail involves a great deal of expertise on the part of the person preparing the drinks. Cocktails also give the bartender an opportunity of manipulating the composition of the cocktail by pouring in less quantity of the more expensive drinks and more quantity of the less expensive drinks. The resultant surplus of expensive drinks is called 'overage' and is a benefit to the hotel. However, in such a case, the possibility of the bartender selling surplus liquor, without raising bills and pocketing the cash, cannot be ruled out.

Physical Verification at the Bar

2.65 Physical Verification at the bar represents one of the prime control mechanisms on bar inventory. Inventory of bar is generally taken by the bartenders at the end of each shift and at the beginning of the morning shift. The hotels usually follow a policy of recovering shortages, if any, from the bartender without giving him credit for any excesses.

Happy Hour Billing and Discounts

2.66 The concept of "Happy hours" is that the hotel identifies few hours of a day during which the drinks are sold at a discounted rate. There can be variations to this concept such as some hotels may have "one for one" offer where in for every bottle sold, there is a complimentary bottle offered. This offer would normally be valid only for consumption of beers.

2.67 The rate master has to be updated with happy hour rate and POS must be configured in such a manner that the happy hour rates are picked only during the designated happy hours. Also in case of "one for one" offer, there needs to be reconciliation between actual bottles sold and offered complimentary so that there is no leakage of revenue.

2.68 Also the hotel may decide to give discounts to a particular class of customers such as "crew" at a fixed percentage. All discounts have to be authorised by the outlet manager and the reasons for the same has to be indicated on the face of the bill and it has to be ensured that such discounts are given only to customers belonging to that category.

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2.69 Also, there is a normal practice in bar to provide complimentary soda or snack items. Such complementary items have to be tracked and the cost of it has to be monitored so that there is no pilferage.

Room Service

2.70 Unlike restaurants and bars within a hotel that cater to resident guests as well as the non-resident guests, room service caters exclusively to the needs of the resident guests. As the name suggests, the department/section is responsible for serving food and beverages to the guests in the room. In large hotels, room service usually remains operative for 24 hours without any break. All room service bills are debited to the folio of the guest after obtaining guest signatures on the same.

Minibar Income

2.71 Minibar consists of miniature liquor, beer, soft drinks, juices, snacks, etc., kept in room for consumption of guest. A list along with prices of those items placed in minibar is kept in room. Guests are expected to indicate items consumed to facilitate billing. Also, minibar attendant will visit every room daily to replenish the stocks through which billing is done. At times sale posted is disputed by guest at the time of check out. Most hotels practice waiver if guest disputes any minibar charge.

Stewarding

2.72 The stewarding department of the hotel is responsible for maintaining stocks of cutlery and crockery of the various outlets and for banquets. Depending on the size of the hotel, the stewarding department could either be common to all outlets or could be dedicated to an outlet or a group of outlets.

2.73 The stock of cutlery and crockery is maintained at the stewarding department on imprest system. Under the system the quantity under circulation is determined and issues are made from the main stores to stewarding department. In this regard, it is important to note that crockery and cutlery are usually accounted for as consumed at the time of their issue from the main stores,

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notwithstanding the fact that these items may be in use for long durations (particularly in the case of cutlery, including silverware). Proper stock registers are required to be maintained for various items of cutlery and crockery on account of the constant movement of these items between the stewarding department and the various outlets. Periodic physical verification of the stewarding stocks is carried out and comparison of physical count is made with the records so as to calculate shortages, if any. Shortages generally arise on account of breakage, pilferage and due to crockery and cutlery ending-up in the garbage bin. However, first time purchase of Crockery & Cutlery in a new hotel is capitalised and amortised over the estimated life.

In Circulation Inventory - Inventory of Housekeeping Department

2.74 Linen normally constitutes a major portion of the housekeeping inventory. Many hotels follow a system known as par stocks system for maintaining the inventory of linen. Under this system, four sets of each item of linen are maintained for each room, i.e., one in the room, second at laundry, third in housekeeping store and fourth in main stores. In the normal course, the inventory circulates between room, laundry and housekeeping stores. The items in main stores are being maintained to take care of any possible exigency. The system is considered helpful in monitoring and controlling consumption/use of linen. The accounting treatment is similar to cutlery and crockery stock.

Guest Amenities

2.75 In guest rooms, amenities like toiletries, guest stationary, water, complimentary beverages like tea, coffee, etc., are placed in the room. Mostly, these are handled through the Housekeeping department. Consumption is accounted once these items are issued from stores to the Housekeeping pantry. There are incirculation inventory kept in guest amenities these are however not valued as value of inventory in room will not be material enough to impact inventory value. Many of the hotels also have the practice of placing fruit baskets/chocolates or wine (For VVIP

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guests and normally called as “gratis” bar) in the room on complimentary basis. These are issued from the kitchen/stores to the in room service/ housekeeping department and accounted as consumption except that liquor and wine are accounted only on consumption in Gratis bar. However, in the case of Gratis bar, if the guest does not consume the wine / liquor, then it is taken to the main bar for usage. The treatment in excise register has to be carefully seen so that there is not mis-statement in respect of this.

Foreign Exchange Compliance

2.76 Hotels are generally authorized to deal in foreign exchange as a ‘restricted money-changer’ especially for accepting foreign currency/ traveller’s cheques. The authorization is subject to conditions laid down in this regard and remains valid for a limited period only and the hotel gets renewed after that period. The hotel is required to issue encashment certificates to the travellers in respect of foreign currency/traveller’s cheques purchased and submit a report to the Authorised Dealers regarding encashment of foreign currency on a monthly basis.

Sales Department

2.77 The sales department of a hotel is responsible for selling the hotel services and building its brand image, by the use of innovative strategies. These strategies may include, amongst others, devising off-season packages, holding food festivals, booking of conferences and sponsoring social events. The hotel industry is a seasonal industry in which highs and lows in business volumes during specified periods of the year can be predicted. It is the responsibility of the marketing department to sell the hotel services in a manner that the maximum occupancy is achieved during the off season also to beat the trend. Each hotel usually has its own sales department, but in a hotel chain, the sales departments of various properties complement each other in procuring business. With the constant pressure to perform and achieve targets, the marketing department may, for example, out of desperation, book conferences at ridiculously low rate, that do not yield any profits to the hotel or recommend credits that may eventually become doubtful of recovery.

Part 3

Audit Approach and Procedures

Audit of Hotel Industry

Initial Aspects

3.1 While auditing the financial statements of a hotel, an auditor should ensure that all Standards on Auditing (SAs) are adhered to like any other audits.

3.2 Though specific requirements of these Standards on Audit (SAs) have not been articulated in this document as they apply uniformly for all audits, some critical objectives an auditor should adhere are given below.

- Obtain preliminary knowledge of industry, nature of business ownership, management & operations, and decide whether the level of knowledge of business is adequate to perform the audit.
- SA 300, “Planning an Audit of Financial Statements” requires an auditor to establish an overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan.
- SA 315, “Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment” requires an auditor to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels, through understanding the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement. This will help the auditor to reduce the risk of material misstatement to an acceptably low level.
- SA 330, “The Auditor's Responses to Assessed Risks” deals with nature, timing and extent of planned further audit procedures at the assertion level.

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- Any other planned audit procedures that are required to be carried out so that engagement is in compliance with SAs.
- Audit process has to be divided into risk assessment, risk response and reporting^{*}.

Organisation Structure of a Hotel

3.3 For determining appropriate accounting and audit procedures to be adopted in case of a hotel, it would be useful to have knowledge of its various operational details. This Chapter contains a broad overview of organizational structure of a hotel and deals with the various technical and operational aspects of the hotel industry.

3.4 The departments of a hotel may be divided into two categories, viz., revenue generating and non-revenue generating. Major revenue generating departments of a hotel include rooms and food and beverages. Minor operating departments include laundry, health club, barber shop, etc. The non-revenue generating departments include the accounts, Purchases, Stores, Housekeeping, Concierge, Security and the Engineering department. Notwithstanding the departmentalization, the departments are required to work in tandem with each other for satisfying the requirements of majority of guests. For example, when a conference is held, the services are provided by the rooms department as also by the food and beverages department and other minor departments, such as health club and leisure facilities.

Need for Information Technology Experts in Audit

3.5 It has to be noted that modern day hotel operations are completely computerised with

- Property management softwares (PMS like PMS, Opera, Amadeus, Springer-miller, IDS etc) for room management,
- Point of sales softwares for F&B and other revenues (POS like Micros, Infogenesis, Shawman, etc.) and back office softwares.

^{*} Attention of the readers is drawn to the Implementation Guide to Risk-based Audit of Financial Statements, published by the Institute.

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- There are hotel industry ERPs like SIMhotel (SAP), Opera, IDS which are integrated, all-encompassing systems which cover from front desk to back office accounting.

3.6 Many interfaced solutions are implemented by various companies. Hence, revenue assurance to cost control needs to be audited through the system than around the system.

3.7 The audit team may therefore need to include IT expert(s) who can understand the data model of applications and application level controls to ensure that any risk in the financial reporting are adequately taken care of in audit planning.

3.8 It is imperative for the auditor to ensure that from the perspective of the financial statements that these systems generate, capture and provide complete, accurate, valid and timely information for financial reporting.

3.9 Generally, IT experts may be called up to work keeping in mind the scope of the financial audit with specific reference to following:

- Information Technology General Controls (ITGC) for identifying key risks in IT, gathering & documenting information about IT systems and controls along with related risks, determining financial reporting significant IT systems and scoping the work over ITGC.
- Evaluating and validating automated application controls and also end user computing.
- Testing integrity of the system generated data and reports used in key manual controls.
- Revenue assurance controls / POS controls.
- Data analysis using CAAT for identifying exceptions in controls.

3.10 While planning the audit, involvement of IT experts should be considered keeping in mind:

- The testing plan and resource allocation for ITGC, automated application level controls, automated accounting procedures, revenue assurance controls, etc.

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- IT related issues and risks that should be given particular attention.
- Documentation and reporting of control weaknesses identified.

Risk Assessment and Internal Controls

Audit Risk

3.11 Audit Risk consists of two key elements namely:

- Inherent and control risk that the financial statements may contain material misstatement.
- Detection and engagement risk that the auditor will not detect such a misstatement.

3.12 To ensure that audit risk is kept at an acceptably low level and auditor should:

- Assess the risk of material misstatement; and
- Limit non-detection risk which can be achieved by performing procedures that respond to the assessed risks at the financial statement, class of transaction, account balance, disclosure and assertion level.

Components of Audit Risk

- **Inherent Risk** – This refers to susceptibility of an assertion to a misstatement that could be material. (Both individually and aggregate with other misstatements). It is assessed both at financial statement level and at assertion level. These are business and other risks that arise in entities objectives, nature of operations, industry, and regulatory environment in which it operates and its size and complexities. Risk of material misstatement may vary based on nature of account balance or class of transactions
- **Control Risk** - It's a risk that the entity's internal control system does not prevent, or detect and correct on timely basis, a misstatement that could material. (Both individually and aggregate with other misstatements). Entity should identify and assess its business & other risks and respond by designing and implementing proper

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internal controls. Entity level controls are for all assertions but activity level control is for specific assertion. Some control risks always exist and accepted by entity but auditors are expected to understand the entity's internal control and perform audit procedures to assess risks of material misstatement at assertion level.

- **Detection Risk** - This refers to auditor's inability to detect a misstatement that exists in an assertion that could be material (both individually and aggregate). Acceptable level of detection risk for a given level of audit risk bears an inverse relationship to the risk of material misstatements at the assertion level. Hence, auditor should focus on the audit procedure on those areas where risk of misstatements is high.

3.13 The audit team can optimize the time to be spent in an audit by focusing on risk assessment which might reduce or eliminate audit work in low risk areas.

3.14 Effective risk assessment process requires all members of the engagement team be involved and team to meet regularly and talk (between hotels as well if a company has multiple hotels) to share insights such as to:

- discuss and decide over all audit strategy, detailed audit plan, audit procedures to be designed & employed to detect any fraud (Team planning meetings).
- discuss implication of findings, discuss fraud risk and need for further audit procedure requirement (Team debriefing meetings).

Risk Assessment

Need for Risk Assessment

3.15 The auditor should record risks relevant to assertions as well as the related control activities which respond to the risk. The auditor must test controls where the risk is such wherefor the substantive procedures alone will not provide sufficient assurance or where the risk assessment includes an expectation that the control is operating. In addition, if the auditor wishes to test

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controls to reduce substantive testing for efficiency purposes then the auditor must test controls.

3.16 Audit procedures should be responsive to the risks identified. Risk assessment and control may be documented as below.

- A brief summary of risk and related controls including whether risk is significant or one where substantive procedures alone are insufficient.
- These are documented for assertion risk indicating.
- Existence/ occurrence, rights / obligations, completeness, accuracy, valuation and presentation and disclosure.
- Also assessing risks for its magnitude of risk and likelihood of risk to occur.
- Whether control testing is required or not? Cross reference to control activities evaluation and testing form.
- Control testing conclusion and impact on substantive audit procedures.(consider need to revise planned substantive procedures if testing unsatisfactory)
- Substantive audit procedure number if any carried out.

3.17 The substantive procedures program should contain tests which reduce the risk of material misstatement of the financial statements to an acceptable level taking into account the risks and the controls testing as documented above.

3.18 Substantive procedures should be performed for all material areas and risks identified as significant. Tests should be designed such as are responsive to the assessed level of risk.

3.19 When the approach to significant risks consists only of substantive procedures these may be tests of detail only or a combination of tests of detail and substantive analytical procedures.

3.20 When substantive procedures are performed at an interim date the auditor may perform further substantive procedures or substantive procedures combined with tests of control to cover the

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remaining period so that there is a reasonable basis for extending the audit conclusions from the interim date to the period date.

3.21 When auditing accounting estimates, the auditor may use one or more of the following procedures to conclude on the reasonableness of the estimate:

- Review and test the process used by management to develop the estimate
- Use an independent estimate for comparison with that prepared by management
- Review of subsequent events which provide audit evidence of the reasonableness of the estimate made

3.22 In Hotel industry, following are an illustrative list of key risks which persists and may require greater audit focus.

Revenue Related Risks

3.23 These include:

- Non-recognition of room revenue by providing unauthorized occupancy of rooms without showing check-in in PMS.
- Incorrect rate charged / package used due to which revenue is short collected in case of rooms / in POS.
- Providing room on complimentary or as house use when rooms are not to be provided so but charged.
- Unauthorised waiver of a fully or portion of charges leading to loss of revenue in any name (like discounts / voids / allowances, etc.)
- Incorrect revenue accounting in General Ledger due to interface issues from PMS to Financial accounting systems.
- Non recognition of actual cash settlement made by accounting it as a settlement by other mode thereby leading to fraud risk.

Expenditure Related Risks

3.24 The risks related to expenditure include:

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- Non- recognition of provision for cost incurred but bills not received (for services or good received for which vendor bills not received).
- Non-recognition of time period cost especially like municipal property taxes, liquor licenses cost, license fee for hotel premises in a managed hotel, etc.
- Incorrect recognition license fees payable to owners or management fees payable to managing company.
- Possibility of mismatch between the expenditure incurred and the payment made may be due to non-adherence to bill wise payment accounting.

Fixed Assets Related Risks

3.25 Following are some examples of fixed assets related risks:

- Incorrect capitalisation of refurbishment or renovation expenditure without decapitalizing original asset from books.
- Capital item wrongly charged to revenue or otherwise.
- Incorrect classification of asset leading to incorrect depreciation as well.
- Delay in capitalisation / incorrect date of capitalisation.

Information Technology Application Level Controls

3.26 ITGC review is generally performed to obtain audit comfort over the financial statement assertions in the financial statements. Since the comfort is required on financial statements assertions, greater audit focus is needed on the financially significant applications.

3.27 In the hotel industry PMS, POS, Back office systems including financial books are significant applications.

3.28 The audit should document the link between key ITGC and key automated application controls and interfaces, key automated accounting procedure and system generated reports used in key manual controls or in generating journal entries. ITGC has to be

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conducted over computer operations, access to programs and data, change management and program development.

3.29 Control weaknesses in ITGC would impact the financial statement assertions. In view of such weaknesses it would be difficult for the auditor to place reliance on the automated application controls. However each and every weakness observed should be discussed in terms of its potential impact on audit, the materiality of the exception, the compensating controls and mitigating factors, if any and further audit procedures required in that area. All these should be clearly documented in audit work papers.

Financial Reporting Controls (Including end user computing)

3.30 A critical check that is required for financial reporting control is to ensure that all income from subsystems viz., PMS or POS are flowing to financial reporting system (back office systems). Most of the hotels have interfaced or even integrated system to facilitate free flow of revenue information. However, the auditor has to ensure that there exists a process to ensure completeness of income accounted.

3.31 Similarly, hotel should ideally ensure that accounting of all transactions other than revenue is done on real time and there is an inventory module integrated with the financial module. Alternatively, there must be a process to match GL system with subsystems at all levels.

3.32 Most hotels generate financial reporting pack through spread sheet softwares. Hence, there must be adequate control over end user computing of generation of financial statements. End user computing control should include version controls, integrity check for last trial balance and maintenance of log of changes.

Revenue Assurance Controls

3.33 Primarily, in a hotel revenue assurance controls happen in both Room Revenue & F&B Revenue. Revenue assurance

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controls gets ensured on a daily basis by night / day audit process. A detailed checklist as given in **Appendix 1** ensures that revenue assurance risks are covered.

3.34 As part of control evolution, auditors may use sample document given in **Appendix 1** with modification based on the features and automated controls exist in PMS, POS and General Ledger.

Audit Plan for Control Evaluation

3.35 The auditor would need to develop a detailed audit plan indicating the control objective, various activities and validation procedure to test controls. The results of the validation procedure should be documented and observations if any should be discussed with the management to obtain their comments as well as identify any mitigating controls that the auditor would need to test to obtain comfort over the area. An indicative audit program is given in **Appendix 3**. An illustrative audit plan indicating control objective, activities performed and validation procedure is given below:

3.36 In Room revenue, Front office allowancing and adjustments

Risk	Classification (High / Medium / Low)	Control	Control classification (Critical/ essential/ desirable)
Allowances may be passed which are <ul style="list-style-type: none">• Unauthorised• Not posted appropriately in PMS	H	• All allowances are directly posted in the PMS.	E
		• Allowances for crew are based on the contracted all inclusive rates.	E

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		<ul style="list-style-type: none"> Balance transfers to other rooms are done manually, i.e. credit in one room folio and debit in another. 	E
		<ul style="list-style-type: none"> Guest disputes less than INR 1,000 can be allowed by the Front Office Staff, however Allowances greater than INR 1,000 need the Duty Manager's approval. 	E
		<ul style="list-style-type: none"> 'Posting adjustment report' is generated at the end of each day, which is reviewed by the Duty Manager. 	C
		<ul style="list-style-type: none"> This report is cross checked by the FOM next morning and sent back to finance. 	C

Data Analysis

3.37 Data analysis is done using CAAT tools to facilitate evaluation of controls. Most of the revenue assurance checks can be done using data extracted from PMS / POS and GL. Audit through CAAT will help in identifying the exceptions better with

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root cause for exceptions. This will ensure that any systemic pattern for exception is established and can be rectified. Typically, following reports are useful for running CAAT based exceptions identification.

3.38 From PMS:

- Journal by department code report (consist of daily postings)
- Guest in house report (list of guest who are in house at the end of the day)
- Departures of the day report
- User log which consist of all user activity.

3.39 From POS:

- KOT - Billing reconciliation report
- Voids report
- Discounts report
- Complimentary report (including non-chargeable KOT – NCKOT)
- Item sales summary
- Bill print audit to check on delay in settlement

Fraud Risk Control

3.40 Hotels have potential fraud risk which needs to be extensively covered by the auditor for fraud risk management policies of the hotel. An illustrative checklist is given in **Appendix 4**.

Audit of Revenue and Receivable

Background of Revenue and Receivable

3.41 As seen in the previous Chapter, revenue stream in a hotel is primarily from Rooms and F&B. All others are minor revenue streams. Normally, more than 50% of the business is done either on cash or credit card. Credit customers are from airline, travel agents, corporates, Government departments and very rarely individuals. Hence, credit offering in hotels itself is a specific activity treated as not ordinary. Hotels have a list of credit

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customers for whom credit is offered. If any other guest requires credit, an ad hoc credit authorization process has to be adhered. Usually the credit department is responsible for collections, but may also take help of the Sales and the front office. If there are any dispute with the guest at later stage due to some billing errors etc, credit department will do a back office allowance. (Similar to front office allowance but done post check out of the guest) However, if it is anything other than billing errors, then normally doubtful debts provisioning norms of the company should be adopted.

3.42 Credit department is also responsible for credit card reconciliation for ensuring that daily batch closing and credit received from bank for credit card collections are same (after adjusting for credit card commission).

Various Streams of Revenue, Its Controls and Audit Considerations

Room Revenue

3.43 Hotels use property management software to maintain, allot, bill guests for room related services. Rooms are sold based on reservation that flows into the hotel either directly or through reservations networks. Critical internal control relating to rooms that must exist are given below:

- Rates that are updated in the PMS are either done centrally by Central reservation network or if done in PMS are reviewed and signed off by the Reservation Manager.
- All ad hoc rates / discounts offered on contracted rate or on BAR based reservations are being reviewed by reservations of the day report and signed off by Revenue Manager.
- For all guest checked in, the Duty Manager, at the end of the shift, should ensure that registration card duly filled up with all required fields are made and signed off by guest.
- Rates offered are reviewed and signed off by FOM through rate variance report.

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- Duty manager reviews rooms occupied at the time of night date change and ensures that all rooms have been charged.
- All manual postings are reviewed and signed off by the Duty Manager.
- All allowances made are signed off with reasons at the end of the shift by Duty Manager. FOM generates a report on daily basis and signs off after reviewing the allowances with reasons.
- All negative postings and adjustments of the day are reviewed and signed off by FOM.
- Upgrades of the day report is generated and approvals as per corporate policy is ensured and signed off by FOM and GM.
- Paid outs are reviewed to ensure that all paid outs have been acknowledged by guest and also signed off by the Duty Manager.
- Review splits and transfers between folio to ensure that these have been done only between related guests (of same company or group).
- Income audit ensures that cash receipts, EDC batch closing and city ledger settlements are tallying with daily PMS trial balance of guest ledgers.
- Complimentary and house use rooms are listed and reviewed for authorization on a daily basis.
- All waivers of retention for cancellations / no shows /charges for late check outs / early check ins are all documented and signed off.
- Income audit ensures that income as per PMS flows into GL and accounting happens correctly.

Food and Beverage Revenue (Including Banquet Revenue)

- Finance through F&B Control department ensures that menu rates are appropriately approved as per levels of authority of the hotel.

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- Menu approved are updated in menu master of the POS and there are no mistakes.
- F&B Manager reviews open food items (off menu items) along with item modified report and ensures price offered is reasonable and in line with policy and comparable with similar item.
- F&B Manager ensures that POS level exceptions are reviewed and signed off like void KOTs, void bills, NCKOT (complimentary food), entertainment bills, discounts and missing KOTs if any.
- Where due to some POS system failure, manual KOTs are used, serial continuity of KOTs and its link to billing should be ensured at the end of the shift.
- F&B Manager ensures that daily reprint reports are taken and reprinted checks are enclosed along with reasons documented.
- F&B Manager ensure that guest tracking sheets are maintained for coffee shop where buffet is offered and guests are escorted to table and marked in tracking sheets. These sheets are mapped to bills generated at the end of every shift.
- F&B Manager also reviews delay in opening tables, settlement of bills in POS and ensure that outlet incharge documents reasons for such delays.
- F&B controls ensure that liquor sold and NCKOTs (including happy hour billing and gratis bar consumed) are reconciled with consumption arrived by opening stock, plus receipts from stores adjusted for physical closing stock.
- F&B control ensures that liquor is stored and sold only in earmarked areas and keep a tab on excess liquor if any gets generated due to overage.
- Similar reconciliation and controls are exercised in minibar as well.
- Cash turn in procedure of ensuring cash collected and credit card EDC batch closing summary are tallied with chance sheet (summary from POS) and deposited in front office or to accounts.

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In case of banquets:

- There is a process to ensure that all functions are backed by function prospectus (FP) and a contract.
- Advance is collected for all functions as per corporate policy and any deviations are documented and approved by appropriate authority in FP itself.
- On function date, F&B service shall ensure that banquet challan is prepared documenting all services offered and signed off by guest.
- Banquet billing is done based on banquet challan to ensure that there is no dispute on billing at later date.
- Liquor drawn from main stores for a function is tracked and unsold is returned and balance is matched with sales as per banquet challan.

Other Revenues like Laundry, Telephone, Internet etc.

- Finance through income audit ensures that menu rates are appropriately approved as per levels of authority of the company.
- Menu approved are updated in menu master of the POS and there are no mistakes.
- All POS controls to the extent applicable for F&B will be applied.

Accounting Considerations (special natures)

3.44 Only special feature one needs to keep in mind when auditing hotels are meal plan accounting. All other aspects are normal. In case of guest staying in on last day of financial period, room revenue is accrued in the books till last night and is kept as guest ledger balance. Guest ledger balance is transferred to city ledger or settled by cash or credit card upon check out.

Audit of Expenditures (Special Emphasis on Hotel Industry Specific)

Room Related Expenditures including Travel Agent Commission

3.45 Room related expenditures are primarily travel agent commission, upselling commission, complimentary airport transfer cost, guest amenities, TV channel subscriptions, new paper and magazines, florist. Some rare expenses like guest damage and book out cost could also be incurred.

3.46 Travel agent's commission is normally accounted on accrual basis based on agent profile attached with reservation. Hotels needs to put in process to check whether the profiles attached are proper and process of accrual based on guest check ins. Auditor must ensure that there is a process to ensure that:

- Commission is not being paid to a non-existent / dummy travel agent.
- Commission is not being paid to travel agents who are not eligible to receive them.
- Claims made by the travel agent for commission for bookings not materialised are not paid.
- Commission paid to the agent not as per the company defined rates structure or non-commissionable rates are identified.
- Unauthorised higher commission is not paid.
- Erroneous calculation being made at the time of commission payment is corrected.

3.47 *Upselling Commission*: "Upselling" is an activity by which the guests are persuaded to book for higher category room than what they have actually booked for. This can happen at the time of reservation or at the time when the guest actually arrives. The former is normally very difficult to track as there cannot be any documentary proof to suggest that the potential guest asked for a lower category of room and he was persuaded to take a higher category of room unless the reservation is confirmed through

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email correspondence. But the latter case of the upselling by the front office personnel can be easily identified by the seeing the difference in room category at the time of reservation and at the time of check in. The reservation and front office personnel are encouraged to upsell by giving an incentive in the form of commission as a percentage of the differential revenue earned on account of such upsell. However, the auditor should ensure that , all “upsells” are being authorized so that it is not misused. The difference between an upgrade and upsell is that in case of upgrade cost is borne by the company and in upsell additional revenue is earned.

3.48 *Complimentary Airport Transfers* – Hotels provide complimentary transfers for certain category of the guest rooms. In those cases, hotels may hire cars from external service providers which need to be accounted as expenditure. An auditor should ensure that there is a process to map front office check in's to travels bills for car hire. Hotels should ensure that this is done before payment.

3.49 *Guest Amenities* – Auditor should ensure that the hotel has a process for accounting guest amenities consumption based on issues from stores to housekeeping. A comparison of cost of amenities per occupied room indicates average cost over a period.

All other expenses are time period based on supply of goods / services. Like any other audit, an auditor shall ensure that they are accrued properly and processes exist for the same.

3.50 *Guest Damage* compensation occurs very rarely but is even based. Hence, chances of omitting to accrue in the books are high. Auditor can review the system of review of guest complaint system by the hotel and see whether any of them will result in possible damage claim and evaluate need for provisioning.

3.51 *Book out Cost*- Book out cost is the cost incurred in accommodating a guest in another hotel. This situation may arise due to over booking, which at times is practiced by hotels to manage last minute cancellations and ensure full occupancy. In these cases, auditor should ensure that there is a process to ensure certification of such expenditure and accrual process exists.

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Food and Beverage Cost and Its Controls

3.52 Food and beverage cost primarily consist of perishables, groceries, crockery/cutlery/glassware / silverware (CGS), kitchen requisites (incl cleaning supplies), fuel (cooking / natural gas) and banquet sundry expenses including audio / video hire.

3.53 Almost all expenses other than banquet sundry expenses are normally controlled through material management system.

3.54 Primarily, normal audit checks that are required to be done for material issues are to be carried out in case of hotel also. In hotels, daily food cost report is prepared considering direct material issued (perishables and groceries). Ideally, audit should also ensure that there is a process of reconciling daily cost report to monthly financials.

3.55 In case of CGS, as explained elsewhere before issues of these items from stores are normally accounted as consumption. Stock in Kitchen Stewarding is considered as a memorandum record for monitoring breakage / loss of CGS. Auditor also needs to check whether breakage is as per the norms established by the hotel.

Purchase

3.56 Various control procedures are adopted in the area of purchase should primarily aim at minimizing risk of incurring excess expenditure that may take place due to entering into contracts at rates that are not competitive or making purchases in spite of existing stock being adequate or receiving goods that are not upto the specifications. The basic requirements of a good internal control system in the area of purchases are discussed herein after.

Annual Rate Contracts

3.57 The following aspects should be kept in mind with regard to internal control on annual rate contracts entered into by the hotels for purchase of various items:

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- Such contracts should be entered into by the Purchase Committee having Purchase Manager, Chief Accountant and Administration Manager as its members.
- There should be proper documentation of the minutes of negotiations and short listed parties based on the comparative chart.
- In case the contract has been awarded to the vendor whose quote is not the lowest, the reasons for doing the same should be properly documented.
- A list of approved suppliers should be maintained and periodic review thereof should be made.
- Level of authority for raising and approval of purchase orders should be predetermined.
- Proper control over serial numbering of purchase orders should be maintained.

Formalised Indenting System

3.58 There should be a formalized indenting system having the following features:

- Authority level for raising indent on the stores department should be clearly defined in the user department.
- Proper control over the serial numbering of indents should be maintained.

Monitoring of Stock Levels

3.59 For ensuring proper monitoring of stock levels and avoiding purchase of excessive stocks, the following measures are required to be taken:

- Reorder level, maximum order quantity and maximum and minimum stock levels should be defined clearly prescribed for each item of inventory.
- Stock records should be maintained properly and updated on regular basis.

Receipts of Materials

3.60 The following precautions are required to be taken at the time of receipt of materials in store/kitchen:

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- Proper inspection of the material received should be done by a responsible person at the time of receipt
- Proper control should be exercised on preparation of goods received note and serial number should be maintained thereon.

3.61 *Cooking Gas* – Auditor should ensure that there is a process of controlling gas cylinders receipt / consumption / return of empties. In case of pipeline supplies, hotel should have process of monitoring meters used to keep track of consumption.

3.62 *Banquet Sundries* – Banquet Sundries consist of cost incurred on decoration, seating arrangements, stage, audio / video arrangements, public address system, floral arrangement, etc. Normally, all these are identified with a particular function and are linked to Function Prospectus. Hence, the auditor needs to ensure that all expenses for a function is accrued and accounted based on Function Prospectus.

Other Maintenance Costs and Its Controls

3.63 Engineering department controls all maintenance costs. An audit of these costs should ensure that there is a process to ensure that all services rendered have been provided for in the books whether bills for such services are received or not. Typically, in a hotel, utilities like electricity bills, diesel / furnace oil used for genset, boiler (for generating steam / hot water) are all monitored and maintained by engineering department. These bills are also certified by engineering department. The auditor must ensure that all these are accounted based on processes establish to ensure that time period based billings are accrued and where services are received, it is accrued upon receipt of service.

Rentals

3.64 Rental expenses payable by hotel for the owners of the hotel are governed by the agreements. Audit should ensure that all the terms and conditions of the agreement have been complied and rent provision is made in books as per the same. Care should be taken if the rent payable is a percentage of gross revenue or gross operating profit as all items to be considered for payment has been considered correctly.

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Payroll Costs

3.65 Like any other audit, payroll cost should be audited to check whether there adequate processes exist to ensure that time period costs are accrued in the books and there is no risk of any misstatement of account balances and class of transactions.

Incirculation Inventory

3.66 As explained elsewhere, incirculation inventory of linen, CGS etc, should be audited to ensure that all those items which are issued from stores have been accounted as consumption. There are risks of some hotels taking some stock as 'To be returned' and use some CGS items for some functions and return. Such practices should be prohibited and consumption should be accounted once it is issued from stores.

Audit of Other Aspects

Audit of Property, Plant and Equipment

3.67 Audit of fixed assets should be done as in any other industry. However, as hotel requires renovation / refurbishment every 4-5 years, there is major cost incurred for maintaining the quality. This amount is mostly capitalised by identifying the earlier cost and de-capitalising the same. Also, typically hotel fixed assets are broadly categorized as:

Land
Lease hold Land
Building
Owned Building Hotel
Plant &Machinery and Electrical installation
P&M General
P&M Less than Rs. 5000
P&M HVAC
P&M refrigeration
P&M electrical Equipment
P&M Sanitary & Plumbing

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P&M Elevators &Escalators
P&M AV equipment
P&M Generators & Boilers
P&M Water Systems
P&M EDP& Computers
P&M Kitchen equipment
P&M House keeping equipment
P&M Special equipment
P&M Fire fighting equipments
P&M sports &fitness equipment
Electrical fittings & Installation
Furniture, fixtures and office equipments
F&F Hotels
F&F Decorations &Artefacts
F&F Hotel Carpets
F&F Offices
F&F lower than 5000
office equipment

3.68 Normally all tangible assets are depreciated based on useful life. However, most hotel companies adopt depreciation rates as per Schedule XIV of the Companies Act, 1956.

3.69 Attention is drawn to a head called F&F decorations & artefacts. All painting & artefacts purchased should be capitalised as furniture and fixtures. Key controls in terms of these items are given below:

- The paintings and artefacts classified under the head 'furniture and fittings' are separately identified and memorandum account (a separate logbook is maintained which gives details of all paintings purchased, the date of acquisition, the name of the artists and the value at which it was purchased) is maintained for review of such artefacts.

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- MIS tracking is done for paintings having high values, to determine its actual realizable value.
- In case of sale / disposal of paintings, revaluation is done in order to arrive at the realizable value.
- Unit reviews on a periodic basis to verify the paintings and art works.
- Any differences on such verification are reported to the General Manager with a copy to Financial Controller for necessary action.
- The Financial Controller reviews the discrepancy report, and the follow up action is taken.
- The conditions of the paintings are regularly monitored, especially, where the values are proportionately higher.
- The paintings and artefacts are codified giving details of name of painter and date of acquisition.
- Special locks and hooks are used to secure the paintings.
- The unit adequately insures paintings and art works.

3.70 Other intangible assets would include scientific or technical knowledge, design and implementation of new processes or systems, licenses, intellectual property, patents, copyrights, customer lists, mortgage servicing rights, fishing licenses, import quotas, franchises, customer or supplier relationships, customer loyalty, market share and marketing rights or any other asset which qualifies for recognition as an intangible asset as per the provisions stated in AS – 26 stated above. The cost of the intangible asset is recognized in Balance Sheet and amortised.

3.71 Software to be capitalized are large application level software like PMS / POS etc., or operating systems like Oracle. All generalized software like windows OS, MS Office tools, etc., should be charged off in the year of purchase. Amortization should be based on estimated user life. Such estimation is, therefore, made on a prudent basis. Accordingly, it is considered appropriate to amortize software over a period not exceeding six years. However, audit committee of respective company can decide on the amortization policy.

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Audit of Guest Loyalty Reward Programme/ Redemptions

3.72 Hotels introduce their own loyalty program to attract guest and encourage them to earn points so that they can redeem the same against their free stay or some gift items. Points accrue based on the amount spent by the guest. Normally, points at the financial closing date are accrued in the books of the various entities based on accrual pattern. Value of accrual is determined based past trend of redemption and value of redemption per point.

3.73 Hitherto, the cost of such royalty programs are accrued in the books at period end based on number of points outstanding in member's account at redeemable cost. However, based on Ind AS / IFRS such royalty program points should be accrued and adjusted against sales and not accrued as expenditure separately.

3.74 International Financial Reporting Interpretations Committee (IFRIC) 13 discusses Customer Loyalty Programmes. According to Para 5 of IFRIC 13, the consideration received or receivable is to be allocated between award credits and other components of sale. Para 6 states that consideration to be allocated to award credits will be based on their fair value. This fair value as stated in Para 6 is to be recognized as a liability until the awards credits are redeemed in exchange for awards.

3.75 When the award credits are redeemed the following amount is to be recognized as revenue:

$$\frac{\text{Total award credits redeemed}}{\text{Total number expected to be redeemed}} \times \text{previously recognized liability}$$

3.76 As auditors one has ensure that accrual and redemption processes are robust to ensure that there are no unauthorized accrual and also unauthorized redemption. There are fraud risks if the program is not closely monitored and controls are in place.

Appendix 1

Revenue Assurance Checklist

Risk No.	Risk Description	Control Framework / Checks to be carried out
1.	ROOM REVENUE	
1.1.	Room charge not charged but rooms let out	<p>Check whether room revenue has been charged for all rooms occupied during the day. This check is to be carried out by checking the spool report "Journal for the day" from PMS. The check should specifically cover the following:</p> <ul style="list-style-type: none"> • All the Guest In House at the time of night audit • All the guests who have checked out during the day
1.2.	Room charge not charged but rooms let out – special cases	<p>Wherever the room revenue has not been charged for occupied rooms, check whether they fall in the following category</p> <ul style="list-style-type: none"> • Complimentary • House Guest • Late Check-out • Early Check-In • Day use guest • In the case of complimentary and house guest rooms check whether necessary approvals in accordance with Corporate circular exist and they appear in the Complimentary report printed and circulated to GM / FOM. • In the case of Late checkouts <ul style="list-style-type: none"> ○ Whether half day / full day charge levied is in accordance with the

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Risk No.	Risk Description	Control Framework / Checks to be carried out
		<p>late check-out policy of the Hotel</p> <ul style="list-style-type: none"> ○ Whether the waiver of half day / full day charges is in accordance with the late check-out policy of the Hotel ○ If it is not in accordance with the policy, check whether the same has been duly documented and approved in accordance with corporate Circular. • In the case of early check-ins (after the night audit and before noon) <ul style="list-style-type: none"> ○ Whether half day / full day charge levied is in accordance with the policy of the Hotel. ○ Whether the waiver of half day / full day charge is in accordance with the early check-in policy of the Hotel. ○ If it is not in accordance with the policy, check whether the same has been duly documented and approved. • In the case of Day use guest <ul style="list-style-type: none"> ○ Check whether room revenue has been charged for all day use guests ○ Whether the waiver of half day / full day charges has been duly documented and approved.
1.3.	Check-in without reg. Card or	<ul style="list-style-type: none"> • Review Registration cards for their completeness • Check whether Room Discrepancy

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Risk No.	Risk Description	Control Framework / Checks to be carried out
	improper reg. Card – control over unauthorised use of rooms.	<p>Report has been prepared and documentation for resolving the discrepancies.</p> <ul style="list-style-type: none"> • Check whether Key checks have been carried out by the authorised person and documented.
1.4.	Incorrect rates charged leading to loss of revenue	<ul style="list-style-type: none"> • Rate Variance Report – Approvals in accordance with Corporate circulars for adhoc rates • Check the rates charged, especially adhoc rates / rates based on BAR with appropriate approvals. • Upgrade report – Approvals in accordance with Corporate circulars.
1.5.	Check outs not billed and not settled	<p>For all check-outs during the day, check whether bills have been raised and duly settled in PMS either as</p> <ul style="list-style-type: none"> • Credit card settlement • City Ledger settlement • Cash settlement
1.6.	Credit card settlement not properly done	<p>Credit card settlements</p> <ul style="list-style-type: none"> ▪ For all bills settled by Credit card as per PMS, availability of credit card charge slips should be verified. ▪ For all bills settled by Credit card as per POS Chance sheet, availability of credit card charge slips should be verified. ▪ Credit card charge slips should also be matched with the EDC summary sheet for the day

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Risk No.	Risk Description	Control Framework / Checks to be carried out
1.7.	City ledger settlement without billing instruction.	City Ledger settlements <ul style="list-style-type: none"> • Check whether for all bill settlement to city ledger, there is billing instruction or the party is a credit listed party • Check for guest signature in the case of Credit customers. • Ensure that all City ledger settlements have been duly posted to CITY LEDGER and the control totals matched.
1.8.	Cash Settlement not accounted in cash book or paid outs not charged	<ul style="list-style-type: none"> • Tally the cash settlements with the cash summary and the cash book / scroll • Check all Paid Outs as per PMS report with the Paid out slips and check for guest acknowledgement and Duty Manager approval.
1.9.	Forex Settlements – wrong rates applied for charging / settlement	<ul style="list-style-type: none"> • Check whether correct foreign exchange rates have been updated in the system and check whether TT rates are applied for billing and TC / CN rates are applied for settlement. • Verify all Foreign exchange encashment certificates. Ensure serial continuity, filling up of all relevant details and signature of the guest and authorised signatory.
1.10.	Checkouts without settlement of bills but keeping bills open	<ul style="list-style-type: none"> • Ensure that all the bills received from Front desk are final bills and not Information bills • Review payment masters (PM) with reasons, ensure that they are properly approved by Front office Management

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Risk No.	Risk Description	Control Framework / Checks to be carried out
		<p>and are not kept pending.</p> <ul style="list-style-type: none"> • Review bills on hold and ensure that they are transferred as per corporate policy to city ledger • Check bills are periodically (not later than a fortnight) raised for long stayers • Review Guest In House balances and High Balances Report. Specifically look for abnormal balances and amounts pending in PM accounts.
1.11.	Charges being unauthorised allowed	<ul style="list-style-type: none"> • Check Front office allowances are as per PMS report with its base documents, reasons and the approval of the same. • In case of Diplomats where taxes are not charged, check with the relevant supporting documents applicable to the respective state laws. • Review and confirm the correctness of Manual Postings in PMS. • Review Lost postings account and take corrective action to identify the correct guest name.
1.12.	User using software options to not charging or billing the guest.	<p>Review User logs to identify exceptional and unusual events logged by the system. Special emphasis to be given to the usage of the following options:</p> <ul style="list-style-type: none"> • Deletions, • Transfers, • Moves, • Modifications and • Splits

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Risk No.	Risk Description	Control Framework / Checks to be carried out
1.13.	Over all revenue control and tally	<ul style="list-style-type: none"> • Review PMS Trial Balance and ensure it tallies • Review and ensure the correctness of Daily Business Report
1.14.	Room Rate Master Maintenance – Rate codes wrongly updated	<p>Master Maintenance audit</p> <ul style="list-style-type: none"> • Check all rate code amendments in the rate master. • Check creation of new department codes in PMS, necessary approvals for such creation and the correctness of the flow of data from the new department code in PMS to ARCL.

Risk No.	Risk Description	Control Framework / Checks to be carried out
2.	FRONT OFFICE CASH	
2.1.	IOUs controls – not approved / not settled	<ul style="list-style-type: none"> • Check IOU's with vouchers and approval by FOM / DM. • Ideally IOUs should be discouraged.
2.2.	Cash Turn not receipted	<ul style="list-style-type: none"> • Check cash turn in procedure and tally cash receipts from all the outlets with cash settlement reports from POS, PMS and Front Office cashbook, • Check all cash Receipts with PMS and Manual cash book. • Check for serial continuity of receipts.

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Risk No.	Risk Description	Control Framework / Checks to be carried out
		Cancelled receipts should have the reason for cancellation and approval by FOM / DM.
2.3.	Physical cash not verified	<ul style="list-style-type: none"> • Physically verify cash and tally with book balance and document denominations and fact of verification done. • Physically verify Foreign Exchange with Forex encashment certificates and TC/Cash with PMS and manual / PMS cashbook. • Check whether there is process of physical verification of cash / forex at the time of shift change and denominations are recorded in the cash book / shift handover book.

Risk No.	Risk Description	Control Framework / Checks to be carried out
3.	OTHER REVENUE CONTROLS	
3.1.	Non-charging / non-billing services provided.	<ul style="list-style-type: none"> • Check all the bills with the sales summaries received from the outlets (Pastry shops, Beauty Parlour, Laundry, Business Centre, Boat Income, etc.) • Check all settlement modes and cross check with respective controls Viz., <ul style="list-style-type: none"> ○ Batch slip for EDC machine in case of credit card,

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Risk No.	Risk Description	Control Framework / Checks to be carried out
		<ul style="list-style-type: none"> ○ Billing instruction for city ledger and ○ Cash summary for cash sales. • In the case of Manual bills ensure serial number continuity of bills and ensure it is duly posted in PMS. • Check telephone charges as per telephone system matches with the charge in PMS

Risk No.	Risk Description	Control Framework / Checks to be carried out
4.	F&B REVENUE	
4.1.	POS controls – serial continuity of the bills settled.	<ul style="list-style-type: none"> • Check whether sales as per Chance Sheet from Point Of Sales tallies with entries posted in PMS. • Check whether all bills have been received from all the outlets for the sales made during the day. • Check the void bills report and ensure that the original void bills are physically available and the same have been approved by the Restaurant Manager / F&B Manager and counter Chef. • Check the Reprint bills report and ensure that the original bill and the reprinted bill are physically available and the same has been approved by the Restaurant Manager / F&B Manager

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Risk No.	Risk Description	Control Framework / Checks to be carried out
		<ul style="list-style-type: none"> • Check whether there are any open bills, if yes, approval and the reasons for the same.
4.2.	POS controls – non-billing of food and beverage served or short billing.	<ul style="list-style-type: none"> • Check whether duly approved entertainment slips as per corporate policy are available for the complimentaries / entertainments • Check whether all EDM bills have been appropriately approved. • Check whether Gift vouchers / share holders coupon attached to the food bills are duly defaced • Check F&B discounts and its authorisation. Check whether discount coupons are defaced
4.3.	Wrong appropriation of income between F&B / room revenue	<ul style="list-style-type: none"> • Check whether Meal plan credits and taxes have been correctly given in all cases as per corporate circular.
4.4.	Rate master wrong updation	<ul style="list-style-type: none"> • Check restaurant rate code amendments with menu card and edit list from system.

Risk No.	Risk Description	Control Framework / Checks to be carried out
5.	BANQUET REVENUE	

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Risk No.	Risk Description	Control Framework / Checks to be carried out
5.1.	Rates – unauthorised discounts / terms	<ul style="list-style-type: none"> • Check whether banquet contract as envisaged in Corporate Circular is entered into. • Check whether the rates fixed are as per Corporate Circular on optimising revenue and necessary approvals have been taken with regard to discounts. • Check whether the contract terms on advances, credit extensions have been adhered. • Check whether the PAN number has been obtained for all bills over Rs.25000 if settlement is going to be in cash.
5.2.	Billing for quantity less than what has been guaranteed	<ul style="list-style-type: none"> • Cross check the Function Prospectus (FP) with the Banquet challans and check the correctness of billing. • Check whether all corrections / modifications in the FP / Banquet challans have been duly approved by the Banquet supervisor and the guest. • Any changes in Guaranteed Pax (covers) have been duly approved by Banquet Sales Manager and F&B Manager.
5.3.	Incomplete billing	<ul style="list-style-type: none"> • Check whether bills have been raised for all the banquets for the day and they are supported by Banquet challans duly signed by the guests.

Appendix 2

F&B Cost Related Risks and Controls

Risk	Control
Non verification of liquor stock on daily basis	Item to item reconciliation is conducted by the F&B Cost Controller on a daily basis for entire liquor inventory of outlet and minibar.
	F&B Cost Controller reconciles sales as per POS with the consumption arrived at from the liquor inventory (Opening stock plus requests less closing stock) for all outlets and minibar. Discrepancies are reported to the Outlet Manager.
	Excess liquor found is booked in the Liquor inventory by the F&B Controller.
	For shortage in liquor, reasons for the same are obtained from the Outlet Manager.
	In case of shortage of liquor from spoilage or breakage, spoilage / breakage report duly signed by the Outlet Manager and F&B Manager is obtained. In case of breakage, the broken bottle neck is obtained from the outlet.
	In case of shortage, if the reasons cannot be clarified by the Outlet Manager, the shortage is debited to Outlet at Sale price of the liquor.
	F&B Controller compares the physical stock with book stock as per FLR register on daily basis.
	Random density checks are carried out by F&B Controller to ensure that the liquor is not diluted.

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Monthly physical verification of stores inventory not conducted.	Month end verification done by F&B Controller for entire food and liquor inventory in stores and is compared with the MMS. Discrepancies are reconciled with the Storekeeper.
	In case the discrepancy cannot be reconciled, the report is sent to the Finance Controller (FC).
	Expired stocks and non / slow moving stocks are also identified in such monthly verifications.
	Stores initiates action on such expired / slow moving / non moving stocks.
Cost consumption report not generated / monitored	Food consumption- Food cost is debited to the outlet based on the requisition raised by outlet and food issued by the kitchen to outlet on daily basis.
	- Daily food cost report is generated by F&B Cost Controller for review by the Financial Controller.
	Liquor / tobacco consumption - Liquor cost is treated as circulating inventory and is charged based on the consumption of the outlet (arrived at as Opening stock plus requisition less closing stock) on monthly basis.
	The cost of consumption less the Non-chargeable KOT (at cost) equals the Net cost, which is compared with Sales posted in FIDELIO to arrive at Cost percentage.
No system of reporting on costs	Following reports are generated on a monthly basis by the Cost Controller for MIS and review by GM / F&B Manager / FC:
	• RM Cost to F&B Sales (%) (Excl complimentary)
	• Food Cost % to Food Sales (Excl Complimentary)
	• 'Soft Drink Cost % to Soft Drink Sales (Excl Complimentary)

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	<ul style="list-style-type: none"> • Liquor Cost % to Liquor Sales (Excl Complimentary)
	<ul style="list-style-type: none"> • 'Smoke Cost % to Smoke Sales (Excl Complimentary)
	<ul style="list-style-type: none"> • Complimentary Cost (Guest+ Staff) % to F&B sale
	<ul style="list-style-type: none"> • Complimentary Cost (Guest) % to F&B sale
	<ul style="list-style-type: none"> • Complimentary Cost (Staff) % to F&B sale
	<ul style="list-style-type: none"> • Average Cover per day
	<ul style="list-style-type: none"> • Average Check per cover
	<ul style="list-style-type: none"> • Outlet wise
	<ul style="list-style-type: none"> ○ Income
	<ul style="list-style-type: none"> ○ Resident, Non-resident and Total covers
	<ul style="list-style-type: none"> ○ Covers per day
	<ul style="list-style-type: none"> ○ Average check

Liquor Inventory Controls

Risk	Control
Purchases of Non Moving Liquor brands	There may be a need to stock all the brands even if they are non-moving. However, the stock levels for the same need to be prescribed and monitored. Reorder levels also need to be fixed at minimum for non moving brands.
	Fresh orders to be placed after considering the existing inventory levels.
	In case of non-moving and slow moving, the ageing needs to be regularly reviewed.

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Risk	Control
Purchase of imported liquor by paying duty and not under the EXIM policy as per the Hotel's policy	Procedure for import of liquor is communicated by corporate purchase to all the units.
	Foreign liquor for all the units under the luxury division is imported under a single license. Corporate purchase forwards the license copy to unit purchase.
	P.O is authorised by the FC and GM of the unit.
	In case due to certain emergencies imported liquor has to be purchased by payment of duty, approval of GM and Materials Head needs to be taken before placing the order.
Issue of liquor from the main store to the outlet without valid approvals leading to contravention of excise laws and misappropriation of liquor.	Outlets raise requisition duly authorised by outlet managers to Foreign Liquor (FL) store room for their imported liquor requirement.
	All issues from the FL store room are supported with FL 9 form duly authorised by the excise inspector.
No independent, appropriate inventory counts being carried out	Physical verification of Liquor inventory in the liquor store is done on a monthly basis with the stock as per excise register.
	Liquor inventory stock count is done in the presence of F&B cost controller

Appendix 3

Sample Audit Programme Checklist

Client : _____ Schedule No: _____

Audit Period : _____ Date: _____

Audit of Fixed Assets

Audit Objectives

1. Fixed assets recorded in books are actually in existence owned by the entity and are used in operations,
2. No unrecorded fixed asset is in existence.
3. Fixed assets sold, abandoned, or otherwise disposed off have been eliminated from the financial statements. Fixed assets, retired from active use and held for disposal, have been stated at the lower of their net book value and net realisable value are shown separately in the financial statements.
4. Subsequent amounts spent on existing fixed assets have been capitalized only in a case where it increases the future benefits in the asset beyond its previously assessed standard of performance, for example, where it increases the capacity.
5. Valuation of fixed assets is appropriate keeping in view the generally accepted accounting principles and these principles have been consistently applied.
6. All the assets obtained on finance lease, on or after 1st April 2000 are recognized as assets in the financial statements as per accounting standard 19, leases, issued by the ICAI. Operating lease rentals have been appropriately charged as an expense over the life of the lease.
7. Any impairment in the value of fixed assets has been appropriately recognised in the financial statements.

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Audit Procedures

1. Trace and verify opening balances of fixed assets from previous year audited financial statements.
2. Review significant expenditure related to fixed assets incurred during the year to ensure that the expenditure resulting in increase in capacity of existing fixed assets as also expenditure incurred on purchase of new fixed assets have been properly capitalized.
3. Obtain a list of fixed assets disposed off during the period and verify computation of profits/loss, if any, on the same on sample basis.
4. Verify the items of fixed assets, retired from active use and held for disposal, have been stated at the lower of their net book value and net realisable value and are shown separately in the financial statements. Also verify that any expected loss has been recognized immediately in the statement of profit and loss.
5. Ensure that depreciation on fixed assets has been charged at the rates which are not lower than the rates prescribed and applicable statute, if any, to the enterprise, Eg: Rates prescribed in schedule XIV to the Companies Act, 1956, would be relevant to the companies registered under the Act.
6. In case depreciation on fixed assets has been charged at rates higher than those prescribed in the applicable statute on the grounds of lower useful life, the report of the technical expert must be verified.
7. Perform analytical review procedures on computation of depreciation on major fixed assets as also on useful life of the assets.
8. Verify that the fixed assets register has been duly maintained and updated on regular basis. Further, various balances appearing in the fixed asset register should be reconciled with the books of accounts.

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9. Physical Verification of various fixed assets should be carried out and discrepancies noticed, if any, should be properly analyzed and reconciled.

Profit and Loss Account

Audit Objectives

1. All the items of revenue and expenses have been properly recorded and recognised.
2. Proper adjustments have been made for expenses accrued/outstanding at the year end and for the prepaid expenses.
3. Proper adjustments have been made for income accrued at the year end and for the income received in advance.
4. Adequate provision has been created for expected uncollectible portion of debtors and the individual items have been charged off on becoming uncollectible.
5. Recognition, measurement and disclosure requirements laid down in various pronouncements of the Institute of the Chartered Accountants of India have been duly complied with.

Audit Procedures

Sales and Purchase Accounting

1. Perform walk-through tests to examine the system of accounting and internal control with regard to sales and purchases.
2. Identify and test controls on which reliance is to be placed.
3. In case accounting and/or internal control system has undergone a change during the year, re-perform tests as stated in (1) and (2) above to the extent required and document the same.
4. Apply necessary tests on the systems and controls, designed to prevent errors and frauds, to obtain the desired level of confidence. In case the desired level of confidence cannot be obtained by applying these tests, its

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impact on the accounts and audit must be ascertained and the auditor should consider applying the additional tests.

Analytical Review of Profit & Loss Account

1. Determine significant variances for major heads of revenue and expenditure *vis-à-vis* the budget figures and the corresponding figures for the previous year.
2. Identify unusual items of revenue and expenditure in the profit and loss account.
3. Ascertain/obtain reasons from the management for such variances and unusual items and these reasons should be properly documented.
4. Obtain corroborative evidence for management's explanations of significant matters.

Analytical Review of Individual Items

1. Compare monthly room rent revenue with the budgeted amount and with the revenue for the corresponding month of the previous year/period.
2. Compare monthly room rent revenue with the revenue computed on the basis of industry trends and occupancy rates for the month.
3. Carry out a global check on the room rent revenue by considering industry occupancy rates (particularly in that market segment) and the room rates charged by the hotel.
4. Obtain necessary information and explanations from the management for major variances, if any, and ensure that all information and explanations for variances are consistent with the relevant available information.
5. Compare and analyse monthly relationship of food and beverages revenue with room rent revenue besides comparing actual food and beverage revenue with budgeted revenue and revenue for the corresponding month in previous year.
6. Verify reasonableness of banqueting income by comparing the same with the income for the corresponding previous

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period and the budgeted income. Any material variances should be properly analysed and investigated.

7. Assess reasonableness of interest received and interest paid by comparing the same with interest computed on the average balance outstanding and applicable rates of interest. Further, ensure on test basis that interest has been received and paid at rates contracted and computation of interest should also be checked on sample basis.

Payroll

Audit Objectives

1. Amounts outstanding at the year-end as also the amounts paid in advance have been recorded and properly adjusted in the financial statements for the period.
2. Amounts recorded as payroll expenses accurately represent the value of services received by the entity.
3. Allocation of various expenses to assets, expenses and other accounts has been done correctly on reasonable and equitable basis and applied consistently.
4. Accounting principles applied to various employee benefit cost including health care, pension and other post retirement benefit costs are appropriate keeping in view various pronouncements of the Institute of Chartered Accountants of India such as Accounting Standard (AS-15), Accounting for Retirement Benefits in the financial statements of the employers. It should also be ensured that accounting principles have been appropriately disclosed in the notes to the financial statements.

Audit Procedures

Accounting system and Internal Control

1. Perform walk-through test to examine the accounting system and internal control with regard to payroll.
2. Identify and test controls on which reliance is to be placed.

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3. In case of accounting and/or internal control system has undergone a change during the year, re-perform tests as stated in (1) and (2) above to the extent required and document the same.
4. Apply necessary tests on the systems and controls, designed to prevent errors and frauds, to obtain the desired level of confidence. In case desired level of confidence cannot be obtained by applying these tests, the impact on the accounts and audit must be ascertained and the auditor should consider applying the additional tests.
5. Examine and review the segregation of duties with in the payroll department and the EDP department.
6. Carry out analytical review of payroll costs using key performance indicators.
7. Make comparison of current year payroll costs with the budgeted costs as also with the cost for the previous year.
8. Apply trend analysis on payroll costs incurred and benefit received by the department.
9. Compute a ratio of profit as a percentage of payroll costs for each department and compare the same with prior years as also with industry standards.
10. Obtain necessary information and explanation from the management for major variances, if any, noticed at steps 7 to 9 and ensure that all the information and explanations for variances are consistent with the relevant available information.
11. Check the relevant documents relating to fresh appointments and for resignations.
12. Review payroll sheets to identify unusual items and significant variances and obtain explanations from the management for such unusual items and variances.

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13. Analyse relationship between casual labour cost and monthly occupancy rate, compare the same with previous year figures and industry standards and obtain explanation from management for significant variances.
14. Verify that timely payment of payroll related statutory dues such as tax deducted at source, provident fund, ESIC, etc., has been made.
15. Review the correctness of various calculations done by actuaries with regard to retirement benefit and ascertain reasonableness of assumptions used.
16. Examine the following documents for their relevance to the period under audit:
 - Contracts with unions
 - Other employment contracts
 - Employee benefit plans
 - Post retirement benefits

Stock Verification

1. Obtain a copy of the stocktaking instructions to ensure that these instructions are adequate from the control viewpoint and also ensure that these instructions have been duly complied with.
2. Identify all stock locations to ensure the coverage of all locations in the stocktaking process.
3. Identify important items from the stock sheets and physically verify them. Discrepancies notice, if any, should be properly documented.
4. Select certain items of inventory on random basis and ensure that these appear properly in the stock sheets.
5. Identify important items of inventory from the stock ledger and confirm their balances in the stock sheets.

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6. Select certain items of inventory from the stock sheets (other than those covered referred in 5 above) and trace their balances in the stock ledger.
7. Ensure that the stock sheets are referenced/numbered in a manner which ensures their completeness.
8. Obtain details of cut-off procedures used on inventories from all documents pertaining to movement of stocks.
9. Identify any damaged or slow/non-moving stock, as also stocks in excess of current requirements.

Stock Valuation

1. Ensure that the principles relating to valuation of inventories stated in Accounting Standard (AS) 2, Valuation of Inventories, issued by the Institute of the Chartered Accountants of India, have been duly complied with.
2. Verify that the principles relating to valuation of inventories have been followed consistently from year to year, i.e., the valuation principles followed in the current year are the same as those followed in previous year.
3. Independently determine lower of net realizable value and cost for certain important items of inventory and ensure that their valuation is correct.
4. Carry out an analytical review on the value of stock by comparing the same with the budgeted value as also with the value of inventories at the end of the previous year.
5. In case significant variances are found in the valuation of inventories, category-wise analytical review must be carried out and reasons for variances in value of each category must be ascertained from the management and properly documented.

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6. Verify that appropriate provision has been created on damaged or slow/non-moving stock, as also on stocks in excess of current requirements.

Debtors

1. Examine the relevant records to ensure validity, accuracy and recoverability of debtor balances.
2. The balances of debtors shown in the schedules must be tallied with those shown in the ledger accounts. Further, the total of schedules must be tallied with the control account of debtors as appearing in the ledger accounts. Any differences in this regard should be clearly examined and analysed.
3. In case of significant debtors, the correspondence and other documentary evidence must also be verified to ensure their validity and accuracy.
4. For larger balances, subsequent realizations might also be verified.
5. Bad debts written off or excessive discounts or unusual allowances should be verified from the relevant correspondence.
6. Review city ledger and front office reconciliation for the year and investigate any unusual or significant items in the reconciliation.
7. Ensure that year-end charges made to guests have been adjusted for credit notes/allowances given in the next accounting year.
8. Examine credit balances in Sundry Debtors Account and after verifying correctness thereof ensure that these are grouped under creditors.
9. Obtain explanations from the management with regard to doubtful debts and verify the same with the corroborative

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evidence available. Further, it should be ensured that provision for doubtful debts is adequate.

10. Obtain an aging analysis of guest balances to identify old debts in respect of which provision has not been made, check all correspondence in relation thereto, and obtain explanations from the management before deciding upon whether a provision ought to be made
11. Assess the effectiveness of credit control; the measures taken to ensure credit-worthiness of the significant debtor groups such as corporates, travel agents and long-staying guests before extending credits.

Creditors

1. Ensure that all perishables / other stocks received till last day of the financial period have been accrued in the books for materials received for which bills not received.
2. Such cut off procedure should ensure that physical verification is done after taking last document references.

Appendix 4

Fraud Risk Checklist

Fraudulent Financial Reporting	
Tone at the Top Pertains to management's abilities, pressures, style and attitude relating to internal control and the financial reporting process.	1. Pressures <ul style="list-style-type: none">• Bonuses A significant portion of management or staff's compensation is represented by bonuses (or other incentives), the value of which is contingent upon the entity achieving unduly aggressive targets for operating results, financial position, or cash flow.• Forecasts Management commits to financial institutions, creditors and other third parties to achieving what appear to be unduly aggressive or clearly unrealistic forecasts.• Tax reduction Management has an interest in pursuing inappropriate means to minimize reported earnings for tax-motivated reasons.

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	<p>2. Opportunities</p> <ul style="list-style-type: none"> • Management's attitudes <p>Failure by management to display/communicate an appropriate attitude regarding internal control and the financial reporting process such as:</p> <ul style="list-style-type: none"> ◦ Management does not effectively communicate and support the entity's values or ethics or Management communicates inappropriate values or ethics; ◦ Management is dominated by a single person or a small group without the compensating internal control such as effective oversight by those charged with governance; ◦ Management does not monitor significant internal control procedures adequately;
	<ul style="list-style-type: none"> ◦ Management fails to correct known material weaknesses in internal control on a timely basis; ◦ Management sets unduly aggressive financial targets and expectations for operating personnel; ◦ Management displays a significant disregard for regulatory authorities; and ◦ Management continues to employ ineffective accounting and/or information technology staff. <ul style="list-style-type: none"> • Turnover <p>There is a high turnover of management,</p>

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	<p>legal counsel or board members.</p> <ul style="list-style-type: none"> • Management/auditor relationships <p>There is a strained relationship between management and the current/ predecessor auditor such as:</p> <ul style="list-style-type: none"> ◦ Frequent disputes on accounting, auditing, or reporting matters; ◦ Unreasonable demands on the auditor, including unreasonable time constraints regarding the completion of the audit or the issuance of the auditor's report; ◦ Formal or informal restrictions on the auditor that inappropriately limit the auditor's access to people or information or limit the auditor's ability to communicate effectively with those charged with governance; and ◦ Domineering management behaviour in dealing with the auditor, especially involving attempts to influence the scope of the auditor's work. <ul style="list-style-type: none"> • Corporate governance structure <p>The corporate governance structure is weak or ineffective as evidenced by inexperience or lacking members, members who are not independent of management or where little attention is being paid to financial reporting matters and accounting and internal control systems.</p>
Industry Conditions	<ul style="list-style-type: none"> • New compliance requirements <p>New accounting, statutory, or regulatory</p>

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<p>Pertains to the economic and regulatory environment in which the entity operates.</p>	<p>requirements that could impair the financial stability or profitability of the entity.</p> <ul style="list-style-type: none"> • Operational challenges <p>A high degree of competition or market saturation, accompanied by declining margins.</p> <ul style="list-style-type: none"> • Industry trends <ul style="list-style-type: none"> ◦ A declining industry with increasing business failures and significant declines in customer demand; and ◦ Rapid changes in the industry, such as high vulnerability to rapidly changing technology or rapid product obsolescence.
<p>Operating Characteristics and Financial Stability</p> <p>Pertains to the nature and complexity of the entity and its transactions, the entity's financial condition, and its profitability.</p>	<ul style="list-style-type: none"> • Cash flows <ul style="list-style-type: none"> ◦ Inability to generate cash flows from operations while reporting earnings and earnings growth; and ◦ Significant pressure to obtain additional capital necessary to stay competitive, considering the financial position of the entity (including a need for funds to finance major research and development or capital expenditures). • Estimates <ul style="list-style-type: none"> ◦ Assets, liabilities, revenues or expenses based on significant estimates that involve unusually subjective judgments or uncertainties; and ◦ Estimates subject to significant change in the near term that may have a

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	<p>financially disruptive effect on the entity (such as collectibility of accounts receivable, valuation of inventory, timing of revenue recognition, or a significant deferral of costs).</p> <ul style="list-style-type: none"> • Related parties <ul style="list-style-type: none"> ◦ Significant related-party transactions which are not in the ordinary course of business; and ◦ Significant related-party transactions which are not audited or are audited by another firm. • Complexity <ul style="list-style-type: none"> ◦ Significant, unusual or highly complex transactions (especially those close to year end) that pose difficult questions concerning substance over form; ◦ Significant bank accounts or subsidiary operations in tax-haven jurisdictions for which there appears to be no clear business justification;
	<p>Reporting</p> <ul style="list-style-type: none"> ◦ An overly complex organizational structure involving numerous or unusual legal entities, managerial lines of authority; or contractual arrangements without apparent business purpose; and ◦ Difficulty in determining the organization or person (or persons) controlling the entity. <ul style="list-style-type: none"> • Growth/profitability

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	<p>Unusually rapid growth or profitability, especially compared with that of other companies in the same industry.</p> <ul style="list-style-type: none"> • Dependencies/vulnerabilities <ul style="list-style-type: none"> ◦ Especially vulnerable to changes in interest rates; ◦ Unusually high dependence on debt, a marginal ability to meet debt repayment requirements, or debt covenants that are difficult to maintain; ◦ Unrealistically aggressive sales or profitability incentive programs; ◦ A threat of imminent bankruptcy, foreclosure; or hostile takeover; ◦ Adverse consequences on significant pending transactions (such as a business combination or contract award) if poor financial results are reported; and ◦ A poor or deteriorating financial position when management has personally guaranteed significant debts of the entity.
Misappropriation of Assets	
Susceptibility of Assets to Theft	<ul style="list-style-type: none"> • Large amounts of cash on hand or processed; • Inventory characteristics, such as small size combined with high value and high demand; • Easily convertible assets, such as bearer bonds, diamonds, or computer chips; and

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	<ul style="list-style-type: none">• Fixed asset characteristics, such as small size combined with marketability and lack of ownership identification.
Absence of Internal Control	<ul style="list-style-type: none">• Lack of appropriate management oversight (for example, inadequate supervision or inadequate monitoring of remote locations);• Lack of procedures to screen job applicants for positions where employees have access to assets susceptible to misappropriation;• Inadequate record keeping for assets susceptible to misappropriation;• Lack of an appropriate segregation of duties or independent checks;• Lack of an appropriate system of authorization and approval of transactions (for example, in purchasing);• Poor physical safeguards over cash, investments, inventory or fixed assets;• Lack of timely and appropriate documentation for transactions (for example, credits for merchandise returns); and• Lack of mandatory vacations for employees performing key internal control functions.

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Technical Guide on Audit in Automobile Industry

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Foreword

The Automobile industry in India is the ninth largest in the world and is currently growing at a pace of around 18% per annum. Due to low cost of labour, India has become a hot destination for a number of global auto players. According to reports, car sales in January, 2011 witnessed a growth of 32% which is the highest ever witnessed by the auto industry and has come on the back of economic growth, reduced interest rates and better money supply in the system.

Audit of such a rapidly growing industry involves many audit peculiarities which can be addressed through an Industry specific audit guide. Hence, it is heartening to note that the Auditing and Assurance Standards Board of the Institute of Chartered Accountants of India has come out with a Technical Guide on Audit in Automobile Industry, which has been authored by senior members of the profession. I am also glad to note that the guide formulated in an easy to understand language contains detailed and in depth guidance on the various intricacies involved in audit of automobile companies.

I wish to place my appreciation to CA. Abhijit Bandyopadhyay, Chairman, Auditing and Assurance Standards Board in his vigorous efforts of spreading awareness regarding Standards on Auditing and helping the members with such useful industry specific guides.

I am extremely confident that this Technical Guide would help the members and other readers understand the auditing aspects of the automobile industry.

New Delhi
June 21, 2011

CA. G. Ramaswamy
President, ICAI

Preface

One of the major industrial sectors in India is the automobile sector. India manufactures over 11 million vehicles and exports about 1.5 million every year. Subsequent to liberalisation, the automobile sector has been aptly described as the sunrise sector of the Indian economy as this sector has witnessed tremendous growth. The Indian automobile industry is currently going through a phase of rapid change and high growth. A number of our members are engaged in various capacities in the automobile sector. As statutory auditors, our members have played an important role in ensuring the credibility of the financial information being sent out to the various stakeholders in the financial reporting process.

Every industry has certain peculiarities, industry practices, customs and usages which, in addition to the Accounting Standards define and shape its internal controls, including its financial reporting processes and ultimately, the preparation and presentation of its financial statements. Adequate knowledge of the client and the peculiarities, practices, etc., of the industry in which it operates is therefore an indispensable for an auditor to properly plan and execute an audit that also meets quality standards and provides a value add to the client. With this perspective in mind, the Auditing and Assurance Standards Board brings out industry specific audit guides. This Technical Guide on Audit in Automobile Industry is one such Guide in the series.

This Technical Guide on Audit in Automobile Industry comprehensively covers its important aspects, growth and background, the regulatory environment, main revenue streams, special considerations relating to fixed assets and inventories, peculiarities associated with other assets, loans and advances, current liabilities and provisions, including product warranties in automobile industry and the related audit procedures for each of the aforementioned items of financial statements. The Guide has been authored by eminent experts in the field of audit in the automobile industry.

Technical Guide on Audit in Automobile Industry

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At this juncture, I wish to express my sincere thanks to CA. G Ramaswamy, President, ICAI as well as CA. Jaydeep N. Shah, Vice President, ICAI whose vision, guidance and support I have been privileged to receive in the activities of the Board.

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I am confident that this Technical Guide will help auditors perform high quality and efficient audits in the automobile industry.

Kolkata
June 10, 2011

CA. Abhijit Bandyopadhyay
Chairman,
Auditing & Assurance Standards Board

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Chapter 1

Introduction

Industry Overview

1.1 The Indian automotive industry after de-licensing in July, 1991 has demonstrated sustained growth as a result of increased competitiveness and relaxed restrictions. From 2003-04 to 2009-2010, passenger vehicle sales in India have grown at a CAGR of 13.7%; this growth is unlikely to stop in the coming decade. The total vehicle sales in that period grew by 10.3%. (*Source: Siam November 2010*)

1.2 There are two distinct sets of players in the Indian auto industry: automobile component manufacturers and the vehicle manufacturers, which are also referred to as Original Equipment Manufacturers (OEMs). While the former is engaged in manufacturing parts, components, bodies and chassis involved in automobile manufacturing, the latter is engaged in assembling of all these components into an automobile.

1.3 The Indian automotive component manufacturing sector consists of 500 firms in the organised sector and around 31,000 enterprises in the unorganised sector. In the domestic market, the firms in this sector supply components to vehicle manufacturers, other component suppliers, state transport undertakings, defence establishments, railways and even replacement market. A variety of components are exported to OEMs abroad and after-markets worldwide.

1.4 The automobile manufacturing sector, which involves assembling the automobile components, comprises two-wheelers, three-wheelers, four-wheelers, passenger cars, light commercial vehicles (LCVs), heavy trucks and buses/coaches. In India, mopeds, scooters and motorcycles constitute the two-wheeler industry. In 2009-10, the Indian auto sector had produced over 10.5 million two wheelers and 1.9 million passenger cars. (*Source: CIER Industry Statistic*)

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1.5 India is a global major in the two-wheeler industry producing motorcycles, scooters and mopeds principally of engine capacities below 200 cc. It is the second largest producer of two-wheelers in the world. The two-wheeler industry in India has grown at a compounded annual growth rate of more than 10 per cent (in number) during the last five years and has also witnessed a shift in the demand mix, with sales of motorcycles showing an increasing trend. Indian two wheelers comply with some of the most stringent emission and fuel efficiency standards worldwide.

1.6 The automotive industry is a volume driven industry and certain critical mass is a pre-requisite for attracting the much needed investment in Research and Development (R&D) and New Product Design and Development. R&D investment is needed for innovations which is the life-line for achieving and retaining the competitiveness in the industry. This competitiveness in turn depends on the capacity and the speed of the industry to innovate and upgrade. The most important indices of competitiveness are productivity of both labour and capital.

1.7 The automotive sector with its deep backward linkages (such as metals like steel, aluminium, copper etc., plastic, paint, glass, electronics, capital equipment, trucking, warehousing and logistics) and forward linkages (including dealership retails, credit and financing, logistics, advertising, repair and maintenance, petroleum products, gas stations, insurance, service parts) has been recognized and identified at different forums (Development Council of Automobile and Allied Industries, Planning Commission, National Manufacturing Competitiveness Council and Investment Commission etc.) as a sector with a very high potential to increase the share of manufacturing in GDP, exports and employment. The sector is also seen as a multiplier of industrial growth.

1.8 India with its rapidly growing middle class with an increasing purchasing power, market oriented stable economy, availability of trained manpower at competitive cost, fairly well developed credit and financing facilities and local availability of almost all the raw materials at a competitive cost has emerged as

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one of the favourite investment destinations for automotive manufacturers. The rapid improvement in infrastructure including road, port, power and world class facilities for testing, certification and homologation, coupled with enabling government policies to promote fair competition make Indian automotive industry more competitive in world. These advantages need to be leveraged in a manner to attain the twin objectives of ensuring availability of best quality product at lowest cost to the consumers on one hand and developing and assimilating the latest technology in the industry on the other. The Government recognizes its role as a catalyst and facilitator to encourage companies to move to higher level of competitive performance. The Government wants to create a policy environment which will encourage growth, promote domestic competition, stimulate innovation and help companies gain competitive advantage.

1.9 The auto industry has grown in clusters of interconnected companies which are linked by commonalities and complementarities. The major clusters are in and around Manesar in the North, Pune in the West, Chennai in the South, Jamshedpur-Kolkata in the East and Indore in Central India. The Department of Heavy Industries is envisaging in the Eleventh Five-Year Plan period to create a National Level Specialized Education and Training Institute for the automotive sector and to enhance the transportation, communication and export infrastructure facilities through concerned Ministries in and around these clusters.

1.10 The industry being highly capital intensive, has entry barriers for smaller players. Even the existing global auto majors are realigning their production bases - coming closer to the scene of action in Asia-Pacific region, mainly in China, India and Thailand. Besides the above, the constant pressure for cost reduction on original equipment manufacturers (OEMs) is compelling them to outsource more and more components from low cost countries. The changing scenario has opened up opportunities for the Indian automotive industry.

Evolution and Policy Framework Surrounding the Indian Automotive Sector

1.11 While the genesis of the Indian automotive industry can be traced to the 1940s, distinct growth decades started in the 1970s. Between 1970 and 1984 cars were considered a luxury product; manufacturing was licensed, expansion was restricted; there were quantitative restrictions on imports and a tariff structure designed to restrict the market. The market was dominated by six manufacturers - Telco (now Tata Motors), Ashok Leyland, Mahindra & Mahindra, Hindustan Motors, Premier Automobiles and Bajaj Auto.

1.12 The decade of 1985 to 1995 saw the entry of Maruti Udyog in the passenger car segment and Japanese manufacturers in the two wheelers and light commercial vehicle segments. Economic liberalization, which started in 1991, led to the delicensing of the passenger car segment in 1993 though quantitative restrictions on imports continued. This decade witnessed the emergence of Hero Honda as a major player in the two wheeler segment and Maruti Udyog as the market leader in the passenger car segment.

1.13 Between 1995 and 2000 several international players entered the market. Advanced technology was introduced to meet competitive pressures and adhere to environmental and safety norms. Automobile companies started investing in service networks to support maintenance of on-road vehicles. Auto financing started emerging as an important driver for demand.

1.14 Starting in 2000, several landmark policy changes like removal of quantitative restrictions and 100 percent foreign direct investment (FDI) through automatic route were introduced. The import of technology for technology upgradation on royalty payment of 5% without any duration limit and lump sum payment of USD 2 million is also now allowed under automatic route in this sector. These changes have led to dramatically increased competition from imported vehicles, including second hand or pre-owned vehicles. Indigenously developed (Made in India) vehicles were introduced in the domestic market and exports were given a

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thrust. Auto companies started collaboration with financial firms to provide auto financing and insurance services to customers. Manufacturers also introduced systems to improve capacity utilization and adopted quality and environmental management systems. In 2003, the Core-group on Automotive R&D (CAR) was set up to identify priority areas for automotive R&D in India.

1.15 Though there remain relatively high tariffs on imports of vehicles and components, the tariffs on the import of components and cars in completely built units (CBUs), and/or completely knocked down units (CKDs), are expected to be reduced in the future in line with India's obligations under the World Trade Organization agreement.

1.16 The automotive industry in India is now working in terms of the dynamics of an open market. Many joint ventures have been set up in India with foreign collaboration, both technical and financial with leading global manufacturers. Also a very large number of joint ventures have been set up in the auto-components sector and the pace is expected to pick up even further. The Government of India is keen to provide a suitable economic and business environment conducive to the success of the established and prospective foreign partnership ventures.

Constituents of the Automotive Industry

1.17 The automotive industry is a highly diversified sector that comprises of manufacturers, suppliers, dealers, retailers, original equipment manufacturers or OEMs, aftermarket parts manufacturers, automotive engineers, motor mechanics, auto electricians, spray painters or body repairers, fuel producers, environmental and transport safety groups, and trade unions.

1.18 The automobile and automotive parts and components manufacturers constitute a major chunk of automotive industry not only in India but throughout the world. The automotive component industry manufactures a wide range of parts including castings, forgings, finished, semi-finished components, assemblies, and subassemblies for all types of vehicles produced in India.

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1.19 While the OEMs are at the top of the auto supply chain, it should be noted that there are a few OEMs in India which supply some components to other OEMs in India or abroad. Most of the Indian OEMs are members of the Society of Indian Automobile Manufacturers (SIAM), while most of the Tier-1 auto component manufacturers are members of the Automobile Component Manufacturers' Association (ACMA). All of them are in the organised sector and supply directly to the OEMs in India and abroad or to Tier-1 players abroad.

1.20 Tier-2 and Tier-3 auto-component manufacturers are relatively smaller players. Though some of the Tier-2 players are in the organised sector, most of them are in the unorganised sector. Tier-3 manufacturers include all auto-component suppliers in the unorganised sector, including some Own Account Manufacturing Enterprises (OAMEs) that operate with one working owner and his family members, wherein manufacturing involves use of a single machine such as the lathe.

1.21 Auto-component manufacturers cater not only to the OEMs, but also to the after-sales market. In the recent years, there has been a rapid transformation in the character of the automotive aftermarket, as a fast maturing organised, skill-intensive and knowledge driven activity. Hence, the auto industry in India possesses a very diverse and complex structure, in terms of scale, nature of operation, market structure, etc. While output, emoluments and Gross Value-Added (GVA) have been growing in both the automobile and auto-component industries, employment is on the rise in the latter and it is declining in the former.

1.22 The unorganised sector consists of enterprises that are not registered under certain sections of the Factories Act. The unorganised auto sector in India has grown in terms of number of enterprises, employment, output, capital, capital intensity and labour productivity. However, capital productivity has fallen considerably in this sector.

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Evolution of the Auto Component Sector in India

1.23 In 1953, the Tariff Commission in its report to the Government had stressed the need for a balanced and integrated development of the automotive industry by promoting the emergence of a strong auto-component sector. As a result of this recommendation, the leading entrepreneurs were invited by the Government to establish an auto- component manufacturing industry.

1.24 In the pre-1985 era, the auto component sector was a protected market with high import tariffs. The market was oriented primarily towards supply of components to domestic manufacturers.

1.25 In the 1980s, encouraged by the establishment of many Japanese OEMs in the passenger car, two-wheeler and LCV industry in the country, a number of Indian companies entered into joint ventures with Japanese companies and exports also commenced.

1.26 The Phased Manufacturing Programme (PMP) introduced in the Indian automotive sector in the 1980s for localization had laid the foundation for the development of the auto component industry. This programme enabled the auto-component industry to modernize its technology, improve quality and to imbibe good manufacturing and shop-floor practices and to transform itself into a highly capable sector of the industry, while at the same time contribute to localizing the component base. In 1990s global OEMs and Tier 1 suppliers started operations in India. This paved the way for a large number of new joint ventures in the component industry with European and American component manufacturers and gave the Indian component industry an all-round expertise to manufacture components for Japanese, European as well as American vehicles. After the PMP programme came to an end in 1991, the Government introduced the Memorandum of Understanding (MOU) system that continued to place emphasis on the aspect of localization of components. With support from this policy, the component industry developed further capability to

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manufacture the new breed of auto-components required for the new generation vehicles.

1.27 The Indian automobile ancillary sector has thus transformed itself from a low-volume, highly fragmented one into a competitive industry, backed by competitive strengths, technology and transition up the value chain. Today, the auto component industry is one of the fastest growing segments of Indian manufacturing due to its capability to manufacture the entire range of auto parts and rapidly increase its capacity base. As stated above, the Indian automotive component industry can be divided into the organized and the unorganized segments. While the forte of the organized sector is the high valued added precision engineering products, the presence of a large unorganized sector is characteristic especially of the lower value-added segments of the industry.

1.28 The ACMA-McKinsey Vision 2015 document forecasts the potential for the Indian auto component industry to be US\$ 40-45 billion by 2015. Today vehicle manufacturers outsource more and more components rather than manufacturing them in-house. Investments and exports in this segment are witnessing continuous growth. Global automobile manufactures see India as a manufacturing hub for auto components and are rapidly ramping up the value of components they source from India due to:

- the cost competitiveness in terms of labour and raw material.
- its established manufacturing base.
- fine quality of components manufactured in India.

Whenever required, OEMs supported component manufacturers through equity participation, technical collaboration, etc.

The U.S. and European markets account for 28% each of the total exports from the Indian auto component companies. More than 70% of the exports go to the OEMs and Tier I suppliers and only 30% to the global aftermarket, indicating the high level of maturity

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in quality and technology that has been achieved by the component industry.

1.29 On the quality and productivity front, the auto component industry maintained its leadership with more than 95% companies being certified as per the ISO 9000 system standards and more than 70% of the companies certified as per the ISO/TS 16949 standards. It has also the distinction of having the maximum number of 11 Deming award winning companies.

Capacity Utilisation

1.30 Most automobile assemblers in India produce less than their installed capacity. This is because of various reasons. First, capacity utilisation is totally demand dependent. Secondly, some of these firms intentionally keep their installed capacity higher than what is required to let it serve as a buffer capacity to cater for growth and demand uncertainty. Thirdly, the production is flexible and gets adjusted based on market forecasts. Firms that have faced bottlenecks in production capacity have increased their capacities either by increasing number of production shifts or by establishing new plants.

1.31 However, the situation is different and diverse for the auto-component firms. In about 60 per cent of the auto-component firms, actual production is higher than installed capacity. In general, this problem is tackled by going for sub-contracting and outsourcing. Some firms are capable of increasing their capacities, with the lag time of less than six months. A few other firms have started establishing new capacities, while others have joined hands with foreign firms for higher and better capacities, mainly through acquisitions.

1.32 Around 20 per cent report underutilisation of their existing installed capacities due to varied reasons: lack of demand, machinery maintenance schedules, technical defects in machineries and demand uncertainty. Of these, lack of demand appears to reflect the fact that these firms are not competitive enough to derive advantages from growing automobile market.

Growth Drivers in the Automotive Industry

1.33 Rising per capita income and the changing demographic distribution are conducive for growth. India has the highest proportion of population below 35 years, 70%, (potential buyers), which means that 130 million people were added to the working population between 2003 and 2009. The trends indicate that small and medium cars would remain dominant and a shift towards high end cars is expected at a faster rate. The Sports Utility Vehicles (SUV) market is expected to develop rapidly in future. Higher disposable incomes coupled with availability of easy finance options have driven the passenger vehicle segment.

1.34 In the commercial vehicle segment, increased investment in road infrastructure and availability of cheaper finance has led to a growth in multi-axle vehicles. This is expected to be followed by a shift to tractor-trailer combinations on account of operating economics of higher power-to-weight ratio vehicles. Growth in the demand for pick-up trucks has coincided with the growth in multi-axle vehicles. The next growth driver for LCVs is expected to be the introduction of lighter pick-ups.

1.35 The two wheeler segment growth is led by rapid urbanization and resultant rise in demand from semi-urban and rural areas, increasing income levels, wider product range available to customers, and easy finance options.

1.36 The growth in tractor industry is linked with the growth in agricultural output and exports to neighbouring countries.

1.37 Auto component industry growth is directly linked to the growth of automobile industry since more than 65% sales is to the OEMs. However, in recent years, component exports are becoming an important growth driver and it is expected to assume greater importance in future.

1.38 The following are the key growth drivers for the automobile industry:

- Rising industrial and agricultural output.

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- Rising per capita income.
- Favourable demographic distribution with rising working population and middle class Urbanisation.
- Increasing disposable incomes in rural agri-sector.
- Availability of a variety of vehicle models meeting diverse needs and preferences.
- Greater affordability of vehicles.
- Easy finance schemes.
- Favourable government policies.
- Robust production.

Export Trends

1.39 Compared to domestic sales, vehicle exports have grown at the rate of 39% CAGR over the last five years, led by exports of passenger cars at 57% and two wheeler exports at 35%. Last year however, overall exports registered a growth of around 28%. In value terms, exports crossed USD 2 billion. The key destinations are the SAARC countries, European Union (Germany, UK, Belgium, the Netherlands and Italy), Middle East and North America. Maruti Udyog, Tata Motors and Hyundai Motor India are key exporters for passenger cars; Mahindra & Mahindra and Tata Motors for light commercial vehicles, medium and heavy commercial vehicles, Mahindra & Mahindra for Multi Utility Vehicles (MUVs), Bajaj Auto for two and three wheelers and Mahindra & Mahindra and TAFE for tractors. A 3% growth in global demand is anticipated over the next five years and it will be led by Asia (mainly by China, India and ASEAN). Also global auto companies are increasingly sourcing components and vehicles from low cost countries. The outsourcing pie is slowly extending to services like engineering design and other business processes. India is well positioned to take advantage of the outsourcing opportunities.

Recent Policy Initiatives

National Automotive Testing and R&D Infrastructure Project (NATRIP)

1.40 To put the Indian automotive industry on the global map, the National Automotive Testing and R&D Infrastructure Project (NATRIP) at the total cost of Rs. 1,718 crores has been initiated.

This project principally aims to:

- create critically needed automotive testing infrastructure to enable the government in ushering in global vehicular safety, emission and performance standard,
- deepen manufacturing in India, promote larger value addition and performance standards and facilitates convergence of India's strength and IT and electronics with automotive engineering,
- enhance India's abysmally low global outreach in this sector by debottlenecking exports, and
- provide basic product testing, validation and development infrastructure so that Indian automotive sector would not face any export obstacle in the foreign market.

The Automotive Mission Plan (2006-2016)

1.41 In order to develop and realize the growth potential of the automotive sector both at domestic and global level, and to optimize its contribution to the national economy, the Department of Heavy Industries drew up a 10 year Mission Plan for the development of Indian automotive sector and creation of global hub.

1.42 The Automotive Mission Plan (AMP) 2006-2016, aims at doubling the contribution of automotive sector in GDP by taking the turnover to USD 145 billion and providing additional employment to 25 million people by 2016 with special emphasis on export of small cars, MUVs, two and three wheelers and auto components.

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1.43 Implementing AMP 2006-2016 would need an incremental investment in the order of USD 35-40 billion in the Indian auto industry from 2006 to 2016. It is anticipated that the bulk of this investment will come from expansion of capacities by existing manufacturers operating in India and remaining from global multinational corporations (MNCs) seeking to make India their manufacturing base. Competition for attracting investments in India would come from countries such as China and Thailand.

1.44 The future challenges for the Indian automobile industry in achieving the targets defined in the Automotive Mission Plan would primarily consist of developing a supply base in terms of technical and human capabilities, achieving economies of scale and lowering manufacturing costs, overcoming infrastructural bottlenecks, while at the same time stimulating domestic demand and exploiting export and international business opportunities.

1.45 Interventions envisaged for the successful implementation of this Plan are required at two levels - Industry and the Government. The Government would play a key enabling role in facilitating infrastructure creation, promote the country's capabilities, create a favourable and predictable business environment, attract investments and promote R&D.

1.46 The role of Industry will primarily be in designing and manufacturing products of world-class quality standards, establishing cost competitiveness, improving productivity of both labour and capital, achieving scale and R & D enhancing capabilities and showcasing India's products in potential markets.

Competitiveness in Manufacturing

1.47 The share of the manufacturing sector (within the Industry sector) has shown only a marginal improvement in the last decade. It is known that stagnation of manufacturing as a proportion of GDP has adverse impact on employment generation. Therefore it is imperative to boost manufacturing given the huge anticipated increase in the workforce over the next 15 years.

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1.48 As observed by the National Manufacturing Competitiveness Council in its national manufacturing strategy, the challenges faced by Indian manufacturers raise important questions for both Industry and Government “.... this calls for ‘breakthrough’ and bold thinking on the part of all stakeholders. Only bold aspirations can enable India benefit from emerging opportunities in the manufacturing sector”.

1.49 The productivity in the automotive industry in India is substantially higher than other sectors and it has a huge potential for further improvement, which in turn will pull up the competitiveness of entire manufacturing sector. Hence, it becomes imperative to identify factors that make manufacturing in India un-competitive and address these and improve our competitiveness.

1.50 The National Manufacturing Competitiveness Commission’s National Manufacturing Strategy lists the following factors impacting manufacturing competitiveness:

- (i) Higher import duties including inverted duty structure on raw materials.
- (ii) Higher incidence of indirect taxes.
- (iii) Sub-optimal levels of operations.
- (iv) Lower operational efficiencies and higher transaction costs.
- (v) Lower labour productivity and higher cost of capital.
- (vi) Inadequate infrastructure.

1.51 In a survey of corporates, the following factors were ranked on the basis of the responses:

- (i) Flexibility in labour laws.
- (ii) Scale of operations.
- (iii) Cost of capital.
- (iv) Cost, availability and quality of raw materials.
- (v) Technology gap with international levels.

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- (vi) Power costs.
- (vii) Cost of compliance to government regulations.
- (viii) Quality of transport infrastructure.

1.52 The key factors that contribute to competitiveness of a country or a location can be summarized as shown in the table below.

Efficiency factor	Labour Productivity cost Labour Flexibility Capital efficiency / other production factors
Resource Availability	Quality Manpower Infrastructure Raw Materials
Ability to attract investment	Economic Policies and Stability Incentives
Proximity to Markets	Domestic / Exports Auto clusters

1.53 In a study commissioned by SIAM, ICRA Advisory Services evaluated the Indian and Chinese economies from an automotive manufacturing perspective. A cost comparison study between Indian and Chinese automotive manufacturing companies reveals that the cost of manufacture of a passenger vehicle in China is 23% lower than in India with the principal difference owing to higher taxes and their cascading impact in India. Higher labour productivity and lower infrastructural costs make China more competitive. The study also revealed that since design and engineering capabilities in India have not been as strong there would be a disadvantage of 30% higher costs for products manufactured in India. While some of the above issues like scale of operations and labour productivity are industry or

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company related, others are identified for improvement and strengthening by the Government.

Prescriptions for Industry in the National Manufacturing Strategy

1.54 The National Manufacturing Strategy has indicated that Industry would not only need to think big in terms of scale but also need to:

- (i) Invest in R&D and technology.
- (ii) Have a continuing commitment for skills development and education.
- (iii) Benchmark their performance against best in the industry.
- (iv) Adopt best manufacturing practices and production techniques.
- (v) Deliver on globally acceptable quality levels.

1.55 In light of the above scenario and goal of making India a hub for small cars, MUVs, two and three wheelers, tractors and components, it becomes essential to focus on the automotive sector and develop a policy specific to the sector which addresses all the constraints. Investment in R&D for technology development will become one of the most important aspects of future strength of this industry. Given India's strength in having the skill sets required to promote technological development, the industry needs to invest in research and development to increase innovative breakthroughs for vehicle design as well as in manufacturing technology and incentivisation of such investments will be needed on the part of the Government.

Demand Creation, Brand Building and Infrastructure

1.56 In order to raise the contribution of the automotive industry to GDP, there has to be a focus both on the domestic market as well as exports. Domestically the focus should be on developing

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and selling appropriate products for the large population of the country. These products could include cost effective small carriers, strong, rugged, low cost vehicle for the rural market, motorbikes and small, safe four wheelers for family transport. For exports, the focus should be on new geographies for growth beyond traditional markets.

Enhancing Exports

1.57 Export opportunities for four wheelers lie primarily in the small car segment as Indian companies have gained expertise in manufacturing vehicles in this segment and enjoy an advantage over other low cost countries. India should capitalize on this expertise and target becoming a manufacturing hub for A/B class vehicles. This is already being leveraged by OEMs like Hyundai with Santro, Suzuki with Maruti 800/Alto and Tata Motors with Indica. The exports in respect of MUVs, three wheelers and two-wheeler are expected to become substantial in the coming years. Export of other vehicle categories is largely driven by strategies of individual companies. Incentivising the exports, encouraging development of domestic competitiveness, establishing 'Made-in-India' brand are some of the initiatives required to promote International business.

Environment and Safety Regulations

1.58 Emission norms came into force with the Idle Emission Norms in 1984. Mass Emission Norms were introduced in 1991 for petrol vehicles and in 1992 for diesel vehicles. These norms have been progressively made stringent and India has followed the European emission standards and test procedures. Environmental concerns led to India narrowing the gap with Euro norms at a rapid pace and currently BS-II or Euro II equivalent norms are in force throughout the country and BS-III or Euro-III norms in eleven cities. Two wheelers which play the unique role of family vehicles in India comply with stringent emission norms while at the same time satisfactorily meeting the Indian customer demand for fuel

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efficiency. Idle emission norms applicable to in-use vehicles have also been tightened. The need is for an appropriate in-use vehicle management policy. Also, a long term emission roadmap needs to be developed. Alternative fuels like Hydrogen and bio fuels need to be promoted to ensure sustainability of the industry over the long term.

Human Resource Development

1.59 Employment is always a major factor when measuring the significance of any economic activity. The automotive industry, on account of its backward and forward linkages, is a significant generator of employment - both direct and indirect. While direct employment is by way of workers engaged in the production of automobiles and auto components, indirect employment is generated in feeder and supplier industries to the automotive industry, such as the vehicle financing and insurance industry, vehicle repair, service and maintenance outfits, automobile and auto component dealers and retailers, vehicle drivers and cleaners, tyre industry, amongst others. Thus steps are needed to ensure that demand — supply gap, both quantitative and qualitative, in terms of human resources, does not arise.

1.60 The need of engineering and managerial manpower is being met by Indian Institutes of Technology (IITs) and Indian Institutes of Management (IIMs). The setting up of a specialized institute for this industry will add to the competitiveness of the industry. The institute, besides developing as a repository of knowledge in the field, will also take up market research and analysis within and outside the country. The Investment Commission has also identified this input as a requirement for the industry. The adoption of existing training institutes by OEMs and setting up of new training institutes by them will be promoted.

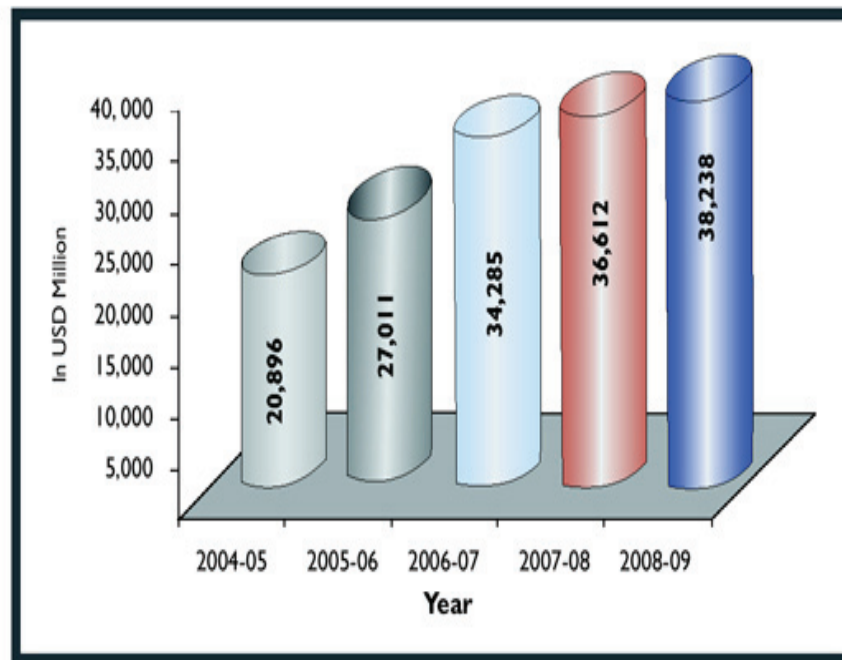
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Statistical Data

Gross Turnover

Gross Turnover of the Automobile Industry in India	
Year	In USD Million
2004-05	20,896
2005-06	27,011
2006-07	34,285
2007-08	36,612
2008-09	38,238

GROSS TURNOVER OF THE AUTOMOBILE INDUSTRY IN INDIA
2004-05 TO 2008-09



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Installed Capacity

Installed Capacity	In Millions
Four Wheelers	3.88
Two & Three wheelers	14.31
Engines	0.49

Production Trends

Automobile Production Trends (Number of Vehicles)							
Category	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11
Passenger Vehicles	1,209,876	1,309,300	1,545,223	1,777,583	1,838,593	2,357,411	2,987,296
Commercial Vehicles	353,703	391,083	519,982	549,006	416,870	567,556	752,735
Three Wheelers	374,445	434,423	556,126	500,660	497,020	619,194	799,553
Two Wheelers	6,529,829	7,608,697	8,466,666	8,026,681	8,419,792	10,512,903	13,376,451
Grand Total	8,467,853	9,743,503	11,087,997	10,853,930	11,172,275	14,057,064	17,916,035

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Domestic sales Trends

Automobile Domestic Sales Trends (Number of vehicles)							
Category	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11
Passenger Vehicles	1,061,572	1,143,076	1,379,979	1,549,882	1,552,703	1,951,333	2,520,421
Commercial Vehicles	318,430	351,041	467,765	490,494	384,194	532,721	676,408
Three Wheelers	307,862	359,920	403,910	364,781	349,727	440,392	526,022
Two Wheelers	6,209,765	7,052,391	7,872,334	7,249,278	7,437,619	9,370,951	11,790,305
Grand Total	7,897,629	8,906,428	10,123,988	9,654,435	9,724,243	12,295,397	15,513,156

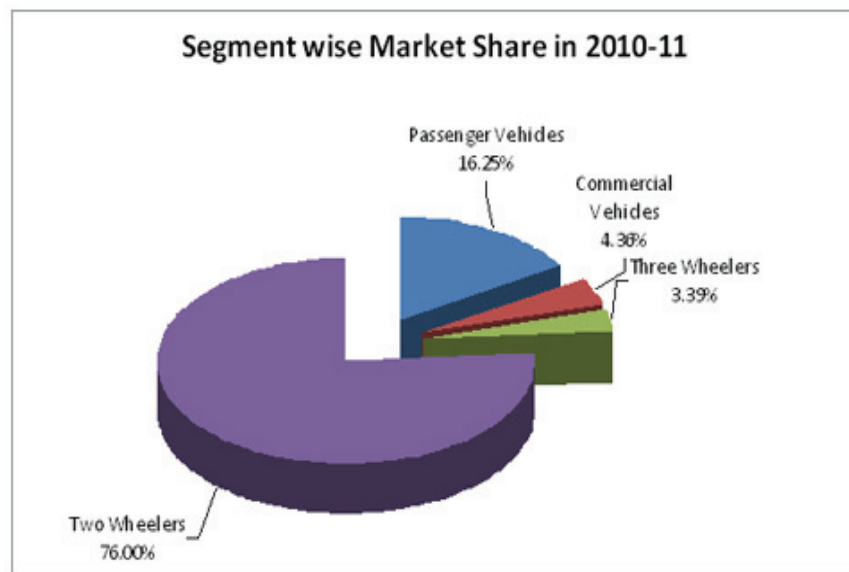
Export Trends

Automobile Exports Trends (Number of Vehicles)							
Category	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11
Passenger Vehicles	166,402	175,572	198,452	218,401	335,729	446,145	453,479
Commercial Vehicles	29,940	40,600	49,537	58,994	42,625	45,009	76,297
Three Wheelers	66,795	76,881	143,896	141,225	148,066	173,214	269,967
Two Wheelers	366,407	513,169	619,644	819,713	1,004,174	1,140,058	1,539,590

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Domestic Market Share

Domestic Market Share for 2010-11 (percentage)	
Passenger Vehicles	16.25
Commercial Vehicles	4.36
Three Wheelers	3.39
Two Wheelers	76



(Source for Statistics: SIAM)

Chapter 2

Regulatory Environment

2.1 The Indian auto industry is harmonizing both safety and emission regulations with International Standards for sustained growth of the industry, combating environmental issues and becoming a global export hub.

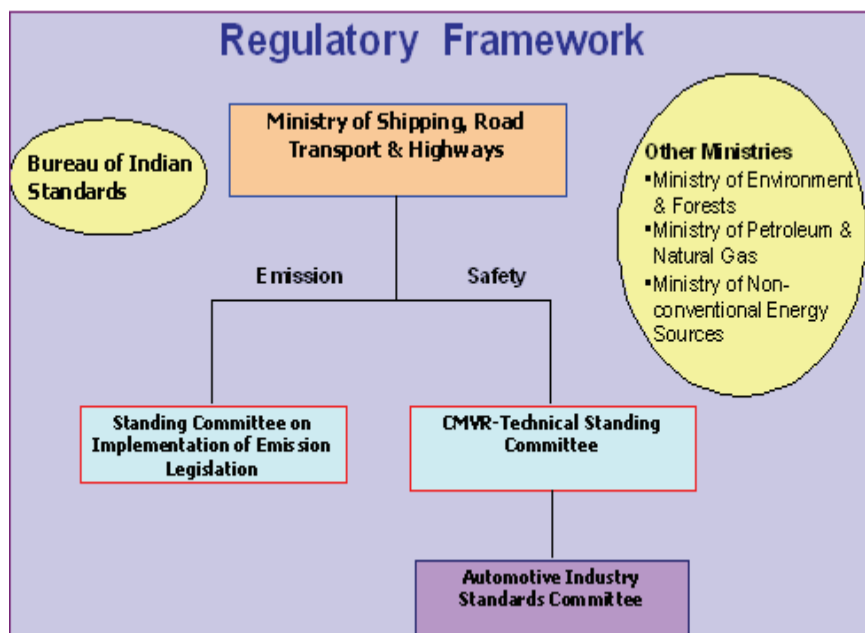
2.2 India has a well-established regulatory framework under the Ministry of Shipping, Road Transport and Highways in which the Society of Indian Automobile Manufacturers (SIAM) plays a very important role. SIAM is the apex Industry body representing 46 leading vehicle and vehicular engine manufacturers in India.

2.3 All the stake holders are part of the regulation formulation setup. The Ministry issues the notifications under the Motor Vehicles Act, 1988 and Central Motor Vehicle Rules, 1989.

Regulatory Framework

2.4 In India, the rules and regulations related to driving license, registration of motor vehicles, control of traffic, construction and maintenance of motor vehicles etc are governed by the Motor Vehicles Act 1988 (MVA) and the Central Motor Vehicles Rules 1989 (CMVR). The Ministry of Shipping, Road Transport and Highways (MoSRT&H) acts as a nodal agency for formulation and implementation of various provisions of the Motor Vehicles Act and CMVR.

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2.5 In order to involve all stake holders in regulation formulation, MoSRT&H has constituted two Committees to deliberate and advise Ministry on issues relating to Safety and Emission Regulations, namely –

I. CMVR- Technical Standing Committee (CMVR-TSC)

2.6 This Committee advises MoSRT&H on various technical aspects related to CMVR. This Committee has representatives from various organisations namely; Ministry of Heavy Industries and Public Enterprises (MoHI&PE), MoSRT&H, Bureau Indian Standards (BIS), Testing Agencies such as Automotive Research of India (ARAI), Vehicle Research Development and Establishment (VRDE), Central Institute of Road Transport (CIRT), industry representatives from Society of Indian Automobile Manufacturers (SIAM), Automotive Component Manufacturers Association (ACMA) and Tractor Manufacturers Association (TMA) and representatives from State Transport Departments. Major functions of the Committee are:

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- To provide technical clarification and interpretation of the Central Motor Vehicles Rules having technical bearing, to MoRT&H, as and when so desired.
- To recommend to the Government the international/ foreign standards which can be used in lieu of standards notified under the CMVR and permit use of components/parts/assemblies complying with such standards.
- To make recommendations on any other technical issues which have direct relevance in implementation of the CMVR.
- To make recommendations on the new safety standards of various components for notification and implementation under CMVR.
- To make recommendations on lead time for implementation of such safety standards.
- To recommend amendment of CMVR having technical bearing keeping in view of Changes in automobile technologies.

2.7 CMVR-TSC is assisted by another Committee called the ***Automobile Industry Standards Committee (AISC)*** having members from various stakeholders in drafting the technical standards related to safety. The major functions of the Committee are as follows:

- Preparation of new standards for automotive items related to safety.
- To review and recommend amendments to the existing standards.
- Recommend adoption of such standards to CMVR Technical Standing Committee.
- Recommend commissioning of testing facilities at appropriate stages.
- Recommend the necessary funding of such facilities to the CMVR Technical Standing Committee, and

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- Advise CMVR Technical Standing Committee on any other issues referred to it.

2.8 The National Standards for Automotive Industry are prepared by Bureau of Indian Standards (BIS). The standards formulated by AISC are also converted into Indian Standards by BIS. The standards formulated by both BIS and AISC are considered by CMVR-TSC for implementation.

II. Standing Committee on Implementation of Emission Legislation (SCOE)

2.9 This Committee deliberates the issues related to implementation of emission regulation. Major functions of this Committee are –

- To discuss the future emission norms.
- To recommend norms for in-use vehicles to MoSRT&H.
- To finalise the test procedures and the implementation strategy for emission norms.
- Advise MoSRT&H on any issue relating to implementation of emission regulations.

2.10 Based on the recommendations from CMVR-TSC and SCOE, MoSRT&H issues notification for necessary amendments / modifications in the in Central Motor Vehicle Rules.

2.11 In addition, the other Ministries like Ministry of Environment & Forest (MoEF), Ministry of Petroleum & Natural Gas (MoPNG) and Ministry of Non-conventional Energy Sources are also involved in formulation of regulations relating to Emissions, Noise, Fuels and Alternative Fuel vehicles.

Automobile Research Association of India (ARAI)

2.12 ARAI is a co-operative industrial research association established by the automotive industry with the Ministry of Industries, Government of India. ARAI is the nodal center for research and development in the automotive field and is committed to provide research and development, testing, certification and calibration support for developing safe, reliable

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and eco-friendly vehicles / components and harmonize Indian automotive standards to global standards. A certificate from ARAI is a pre-requisite before any new vehicle model is permitted to ply on the roads.

2.13 The main activities of the ARAI are:

- Carry out sponsored Research and Development projects for the industry / Government of India / national and international agencies.
- Certification of vehicles and components as a notified agency as per the Central Motor Vehicle Rules.
- Formulation of automotive standards.
- Participation in national and international forums in the automotive technology and related fields.
- Carry out own Research Projects in automotive technology.

Vehicular Safety Standards and Regulations

2.14 Environmental imperatives and safety requirements are two critical issues facing the automotive industry, worldwide. Indian Automobile Industry in the last decade has made significant progress on the environmental front by adopting stringent emission standards, and is progressively aligning technically with international safety standards.

2.15 CMVR came into force from 1989 and serious enforcement of regulations came into effect. Chapter V of the CMVR, 1989 deals with construction, equipment and maintenance of vehicles and in addition to rules governing emission limits, there are several rules in this chapter requiring motor vehicles to comply with safety regulations.

2.16 Vehicles being manufactured in the country have to comply with relevant Indian Standards (IS) and Automotive Industry standards (AIS). Indian Standards (IS) have been issued since the late 1960s and these standards for Automotive Components were based on EEC/ISO/DIN/BSAU/FMVSS etc at that time.

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2.17 Regulations are reviewed periodically by the Technical standing Committee on MCVR (CMVR-TSC).

2.18 States also have their State Motor Vehicle Rules.

2.19 Since 2000 ECE Regulations have been used as basis for Indian regulations and since 2003, increased efforts are being made to technically align with ECE. Variance from ECE exists on formatting phraseology and administration related issues.

Harmonisation

2.20 At present vehicles sold in a country have to meet the regulations and standards of that country. This requires approvals or approval of a vehicle and / or its components according to the procedure of the Government of that country. With the globalisation of the automobile industry, vehicle and vehicle parts are being internationally traded these days. The existence of separate regulations and approvals procedures in different countries requires design modifications, added tests and repetitive approvals.

2.21 To address this situation and to assist the global trade of automobiles and their components, efforts are being made to have harmonised vehicle regulations worldwide. The major role in this direction is being played by Working Party (WP) 29 under United Nations Economic Commission for Europe (UNECE).

2.22 WP.29 was established on 6th June 1952 as Working Party 29 and is presently known as the World Forum for Harmonisation of Vehicle Regulations under the Inland Transport Committee of the United Nations Economic Commission for Europe. The objective of the WP.29 is to initiate and pursue actions aiming the harmonisation or development of technical regulations, which may be accepted worldwide. These regulations are directed at improving vehicle safety, protecting the environment, promoting energy efficiency and anti-theft performance, providing uniform conditions for periodical technical inspections and strengthening economic relations world-wide.

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2.23 WP.29 administers two UNECE Agreements on harmonisation of vehicular regulations, namely -

1. UNECE 1958 Agreement Concerning the Adoption of Uniform Technical Prescriptions for Wheeled Vehicle, Equipment and Parts Which Can be Fitted and / or be Used on Wheeled Vehicles and the Conditions for Reciprocal Recognition of Approvals Granted on the Basis of These Prescriptions.

This Agreement was made under UNECE with an objective of establishing uniform technical prescriptions for vehicles and their components relating to safety, environment, energy and anti-theft requirements. The Agreement aims to promote the harmonisation of vehicle regulations and the mutual recognition of type approvals amongst Contracting Parties to the Agreement. The Agreement in its original form allowed participation of only UNECE members. It was revised in 1995 to promote non-European participation.

2. UNECE 1998 Agreement Concerning the Establishing of Global Technical Regulations for Wheeled Vehicles, Equipment and Parts Which Can be Fitted and /or be Use on Wheeled Vehicles.

The 1998 Agreement runs parallel to the 1958 Agreement and establishes a process through which countries from all regions of the world can jointly develop Global Technical Regulations (GTRs) for vehicles and their components.

2.24 The aim of the Agreement is to promote participation of various countries in the formulation of Global Technical Regulations, but, contrary to the 1958 Agreement, no provisions are given regarding the acceptance of mutual recognition of approvals.

2.25 The regulations being formulated under this Agreement are known as *Global Technical Regulations*.

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2.26 India is gradually harmonising its automotive standards with global norms, giving due cognizance to the prevailing national concerns. The Union Cabinet also approved the constitution of a National Level Standing Committee to deal with issues pertaining to WP.29.

2.27 Earnest efforts are underway for a meaningful participation in the deliberations of WP.29 and its subsidiary bodies. Experts from India have been regularly participating in sessions of WP.29 and its subsidiary bodies. The government is currently in the process of taking a decision regarding joining one or both of the 1958 / 1998 Agreements.

Emission Norms

2.28 The automobile industry has to address the following issues at all the stages of vehicle manufacture:

- Environmental Imperatives.
- Safety Requirements.
- Competitive Pressures, and
- Customer Expectations.

2.29 There is a strong interlinking amongst all these forces of change, influencing the automobile industry. These have to be addressed consistently and strategically to ensure competitiveness.

2.30 Since pollution is caused by various sources, it requires an integrated, multidisciplinary approach. The different sources of pollution have to be addressed simultaneously in order to stall widespread damage.

2.31 Parameters determining emissions from vehicles:

- Vehicular Technology.
- Fuel Quality.
- Inspection and Maintenance of In-Use Vehicles.
- Road and Traffic Management.

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2.32 While each one of the four factors mentioned above have direct environmental implications, the vehicle and fuel systems have to be addressed as a whole and jointly optimised in order to achieve significant reduction in emission.

Vehicular Technology

History of Emission Norms in India

2.33 The significant environmental implications of vehicles cannot be denied. The need to reduce vehicular pollution has led to emission control through regulations in conjunction with increasingly environment-friendly technologies.

2.34 The first Indian emission regulations were idle emission limits which became effective in 1989. These idle emission regulations were soon replaced by mass emission limits for both petrol (1991) and diesel (1992) vehicles, which were gradually tightened during the 1990s. Since the year 2000, India started adopting European emission and fuel regulations for four-wheeled light-duty and for heavy-dc. Indian own emission regulations still apply to two- and three-wheeled vehicles.

2.35 Bharat Stage emissions standards are emissions standards instituted by the Government of India that regulate the output of air pollutants (such as nitrogen oxides, carbon monoxide, hydrocarbons, particulate matter, soot, and, where applicable, sulfur oxides) by internal combustion engine powered equipment, including motor vehicles, or other air polluting facilities or equipment. In many cases they are similar to European emissions standards.

2.36 Since India embarked on a formal emission control regime only in 1991, there is a gap in comparison with technologies available in the USA or Europe. Currently, we are behind Euro norms by a few years, however, a beginning has been made, and emission norms are being aligned with Euro standards and vehicular technology is being accordingly upgraded. Vehicle manufactures are also working towards bridging the gap between Euro standards and Indian emission norms.

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Overview of the Emission Norms in India

- 1991 - Idle CO Limits for Gasoline Vehicles and Free Acceleration Smoke for Diesel Vehicles, Mass Emission Norms for Gasoline Vehicles.
- 1992 - Mass Emission Norms for Diesel Vehicles.
- 1996 - Revision of Mass Emission Norms for Gasoline and Diesel Vehicles, mandatory fitment of Catalytic Converter for Cars in Metros on Unleaded Gasoline.
- 1998 - Cold Start Norms Introduced.
- 2000 - India 2000 (Equivalent to Euro I) Norms, Modified IDC (Indian Driving Cycle), Bharat Stage II Norms for Delhi.
- 2001 - Bharat Stage II (Equivalent to Euro II) Norms for All Metros, Emission Norms for CNG and LPG Vehicles.
- 2003 - Bharat Stage II (Equivalent to Euro II) Norms for 13 major cities.
- 2005 - From 1 April Bharat Stage III (Equivalent to Euro III) Norms for 13 major cities.
- 2010 - Bharat Stage III Emission Norms for 4-wheelers for entire country whereas Bharat Stage - IV (Equivalent to Euro IV) for 13 major cities. Bharat Stage IV also has norms on OBD. (similar to Euro III but diluted)

(Source: ECMA)

Emission Testing in India

2.37 In India, the idle emission test has been introduced since mid-eighties. Only CO was tested (% Vol) from gasoline cars and vehicle had to meet a limit of 3.0% for passing the test. The idle CO emission checking process is a world-wide accepted quick and easy method to indicate if the vehicles emission control is within the acceptable performance requirement. A vehicle with improper combustion is in most cases likely to fail the idle CO test. Thus the vehicle could be advised to go to a workshop for suitable maintenance.

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2.38 This process has been in force for about 20 years in the country. Euro II emission-technology norms were first introduced in certain cities from April 1, 2000, as a result of which most of the vehicles were equipped with a three-way catalytic converter and a closed loop feedback system. It is very critical that the air/fuel ratio in these vehicles is maintained at the stoichiometric levels. This would ensure that the catalytic converters efficiency for converting all the three pollutants, carbon monoxide, hydrocarbons, and oxides of nitrogen is the highest.

2.39 It is well accepted by automobile companies that while for carburetted cars, simple idle test can identify malfunctioning systems, the same does not hold for cars, which are equipped with catalysts. Modern cars equipped with electronic fuel injection and ignition systems and three-way catalysts may have defects — such as defective sensors and degraded catalyst efficiency — that may not show up in idle tests. Thus given the inherent disadvantages of the idle tests, the first step should be to move towards an improved system which would mandate measurement of all the four gases and the lambda for catalyst-equipped cars at high idle (accelerated driving speeds).

2.40 Lambda is a dimensionless value representative of the burning efficiency of an engine in terms of the air/fuel ratio in the exhaust gases and determined with a referenced standardized formula. Lambda represents actual to stoichiometric air/fuel ratio.

2.41 Lambda measurement is absolutely critical, as the new generation vehicles fitted with catalytic converters requires that the lambda be maintained within its range. Lambda measurement checks the performance of the fuel air mixture preparation system. For a well-tuned/maintained vehicle lambda value should be 1 ± 0.03 in the range 0.97 to 1.03 as per international norms/practices. Any value beyond this range indicates faulty mixture preparation or poor performance of mixture preparation system. If the value were not in the specified lambda range, it would also result in sub optimal performance of the catalytic converter. For catalyst-equipped cars, a lambda test may be

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coupled with an idle/fast idle test in order to check the performance of the mixture preparation system.

Fuel Technology

2.42 Fuel quality plays a very important role in meeting the stringent emission regulation.

2.43 The fuel specifications of gasoline and diesel have been aligned with the Corresponding European Fuel Specifications for meeting the Euro II, Euro III and Euro IV emission norms.

2.44 There is a need for a holistic approach so that upgradation in engine technology can be optimised for maximum environmental benefits.

Inspection and Maintenance (I&M) of In-use Vehicles

2.45 At any point of time, new vehicles comprise only 8% of the total vehicle population. In India currently only commercial vehicles are required to undergo periodic fitness certification. The renewal period for fitness certification in general is 2 years for new commercial vehicles and every 1-year for old vehicles. For private vehicles no mandatory periodic fitness check is required in India but there exist a system of re-registration of private vehicles after 15 years of initial registration or 1st registration. Thus, after 15 years a private vehicle has to go for fitness to get re-registered which remains valid for the next five years Pollution Under Control (PUC) is the existing system of periodic I&M in India which is a mandatory requirement for all categories of on-road vehicles including two wheelers. Under this system a PUC certificate is issued for a vehicle upon conformity to emissions based on idle test for Gasoline vehicles and free acceleration smoke test for diesel vehicles.

2.46 In most countries that have been able to control vehicular pollution to a substantial extent, Inspection and Maintenance of all categories of vehicles have been one of the chief tools used. Developing countries in the South East Asian region, which till a few years back had severe air pollution problem have introduced an I&M system and also effective traffic management

Chapter 3

Revenue

3.1 Revenue accounting in the automotive industry is a complex process and requires considerable level of professional judgment.

Revenue in the automotive industry consists of the following:

- a) Revenue from sales of goods and sales of services.
- b) Revenue from customer financing.

A. Revenue from sales of goods and sales of services

3.2 Sales consist of the following:

- Sales of goods;
- Sales of services;
- Royalty income;
- Commission income; and
- Maintenance and service contracts.

B. Revenue from financing, leasing, etc.

3.3 Revenue from financing/leasing consists of the revenue generated from financing/leasing facilities given to the dealers or ultimate users either directly by the manufacturer or by a financing Company. It includes the following:

- Interest income on financing to dealers;
- Interest income on installment credit granted to ultimate users;
- Interest income from finance leases;
- Rental income from operating leases; and

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- Amortization of subsidies received from the manufacturers on low-rate financing to ultimate users in the case of financing companies only.

This Guide deals with the audit of the above mentioned types of revenue covered under Accounting Standard (AS) 9, Revenue Recognition, as well as Accounting Standard (AS) 19, Leases notified under the Companies (Accounting Standard) Rules, 2006.

Point of Recognition of Revenue

3.4 As stated in AS 9 regarding the sales of goods, performance should be regarded as being achieved when the following conditions have been fulfilled:

- (i) The seller of goods has transferred the property in the goods or all significant risks and rewards of ownership to the buyer for a price and seller retains no effective controls associated with ownership of the goods transferred; and
- (ii) No significant uncertainty exists regarding the amount of the consideration that will be derived from the sale of the goods.

3.5 Revenue should be recognized when the above mentioned conditions related to the performance are satisfied provided that at the time of performance it is reasonable to expect the ultimate collection. If at the time of raising of any claim, it is unreasonable to expect the ultimate collection, recognition of revenue should be deferred.

3.6 In the case of rendering of services, performance should be regarded as achieved when no uncertainty exists regarding the amount of the consideration that will be derived from rendering that service.

3.7 Sales in the automotive industry can be further categorized as follows:

1. Direct Sales by Manufacturer to the ultimate customer.
2. Sales to Dealers by the Company.

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3. Sales to institutional parties.

4. Export sales.

3.8 While auditing the revenue booked by the manufacturer, it is essential to review the terms of the agreement entered into between the buyer and the seller and the time when revenue is booked.

3.9 The auditor has to ensure that at the time of booking the revenue, as required by AS 9, all the significant risks and rewards related to the goods sold have been transferred to the buyer, which may not necessarily coincide with the transfer of property in the goods. It should be ensured that the sale is not in the nature of consignment sales or stock transfer.

3.10 In an automotive industry, sales volumes are usually fixed for the sales team and are closely monitored by the higher management. This, in turn, leads to an inherent risk of sales being booked or goods being dumped at the dealers' premises (forced sales) without adequate purchase orders. It is imperative for the auditor to obtain the copies of the agreement entered between the dealer and the Company in order to ensure the point of time at which all the significant risks and rewards have actually been transferred. If the agreement is silent about transfer of significant risks and rewards, the auditor should use his professional judgment to ensure that the revenue is accounted for appropriately. Further, the sales return should be tested and ensured that these do not related to dumped (forced) sales which are getting reversed in the next period. If that be the case, it should be ensured that the original sale is reversed. There might also be cases where sales are booked and the delivery of the vehicles has not been made as of the cut-off date. In case, where the sales are booked but the delivery has not been made as of the cut-off date, the auditor should obtain confirmations from the dealers confirming the passing of risks and rewards of the vehicles. The important conditions which should be considered in determining whether the significant risks and rewards have been transferred or not are listed as follows:

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- a) Who bears the future price risk.
- b) Who bears the risk in case the goods are damaged subsequently, including obsolescence.
- c) Who bears the credit risk.

Institutional Sales

3.11 Institutional sales in the automotive industry mainly comprise of Government rate contracts and sales to military and para-military forces, Public Transport Agencies, Police and other Government departments. The contracts are characterized by a fixed price for specific models, stringent inspection procedures of agencies designated by Government and adherence to stringent time schedule. Liquidated damages are imposed if the seller fails to meet the deadline. Sometimes Government departments even require certain specifications suitable to their own needs like for example, in the case of sales to the Military, the vehicles are different than those used for the general civic society.

3.12 The nature of the institutional sales, described above, gives rise to following inherent risks:

- a) Contract becoming onerous in case the cost of production increases and the agreed rates, usually of long term in nature, are lower than the actual cost.
- b) Inventory obsolescence as large number of items are required to be kept for specific models.
- c) Inappropriate booking of revenue which should be done only after the inspection formalities are over and as per the terms of the contracts.
- d) Unaccounted liquidated damages or retention money. Receivables from Government agencies need a thorough scrutiny in order to ensure that there are no unaccounted liquidated damages or retention money deducted by these departments. Retention money is very often deducted by these agencies for future warranties and services.

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Export Sales

3.13 In case of export sales, the time of booking the revenue is very important as it is based on the terms mentioned in the agreements entered into for export sales such as sales to be ex-factory or free on board or delivery at client location including the testing to be done at the buyer's end. To mitigate the risk inherent in these areas, the sale agreements should be studied in detail and the audit should be conducted having regard to the substance of the transactions.

Incentives, Discount Schemes and Other Marketing Schemes to Dealers and Customers

3.14 Another important aspect of the automotive industry is various kinds of marketing schemes offered by the manufacturers from time to time.

The various types of incentives and discount schemes offered by the seller are listed as follows:

1. Rebates including volume discount.
2. Cash discounts.
3. Free gift items.
4. Free insurance.
5. Loyalty bonus.
6. Free after sales services, etc.

3.15 Computation of the value of the incentive and discount schemes should be checked while auditing.

3.16 The incentives/discount schemes can be classified into two types. They are stated as follows along with their accounting treatment:

- a) **Schemes which are computed on the basis of sales value** – These should be grouped under rebates and deducted directly from the total sales amount. For example, if a customer has made bulk purchases entailing

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to a volume discount, bonus or other similar incentives, this should be treated as a reduction in the sales value (i.e. a rebate), even if it is processed separately from the regular invoicing.

- b) Schemes which are not computed on the basis of sales value** – These should be included in selling expenses. For example, incentives not related to the scope of the purchase and have other measures, such as certain advertising undertakings.

Distinction between Rebates, Volume Discounts and Re-Imbursement of Selling Expenses

3.17 The main distinction between rebate and volume discount is that while rebates are based on the sales value, volume discount is based on the quantities of goods sold. Whether a discount or rebate should be netted off against revenue depends on the nature of the discount rather than whether the amounts are determined based on sales value. Broadly, if the nature of the discount/rebate is towards adjustment of price, the same needs to be adjusted against revenue. However, if the nature is such that it is towards sale incentives or commission or sale promotion reimbursements of certain expenses incurred by dealers such as on advertising etc., the same should be grouped as a sale promotion expense. The treatment given for these types of discounts/commissions etc. for the purpose of excise duty/tax deduction at source etc. can also be evaluated and corroborated to ensure that the treatment of such items is given on a consistent basis.

3.18 The auditor should ensure that all the schemes are properly authorized and there are adequate internal controls for monitoring the accounting and issuance of credit notes in respect of these schemes. At the reporting date the auditor should ensure that an appropriate accrual has been made in the books of account for incentive schemes.

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3.19 The auditor should obtain the list of all the schemes floated during the year and ensure that the client has an appropriate log of all these schemes. Often the accrual for such discounts/rebates/re-imbursements etc. requires estimation by the Company. The auditor should understand the process followed by the Company in arriving at the estimates and the assumptions used in arriving at these estimates while testing the accrual for these incentives/re-imbursements.

3.20 The auditor should also ensure that there are no special preferences given to any particular dealer in any of the scheme and the schemes are common for the dealers. However, the scheme may differ from region to region and product to product based on market dynamics but should be common for the dealers serving the region or a product. Key performance criteria for availing benefits under such schemes must be clearly stipulated in the scheme and it must be verified that dealers to whom these benefits are allowed, have met all the conditions as required by the scheme.

3.21 The auditor should ensure that the entity has maintained proper segregation of duties so that persons approving the credit notes for these schemes are not from the marketing department but are from the finance/accounting department.

Cash Discount

3.22 While auditing the sales, the auditor should ensure that the cash discounts given by the seller are not deducted from the total sales amount but are included under other operating expenses. Further, the auditor should check that the discount has been allowed on the basis of the actual cash received from the customers and not on any other parameters like sale value or volume/quantity. If the latter is the case, then the discount should be considered as any other rebate and should be deducted from the total sales value.

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Illustration for accounting and computation of schemes

A Company has offered following schemes to its dealers:

- a. Annual target @1% of total sales value if more than 100% of sales target is achieved.
- b. Free gifts including automotive accessories given at the time of sales.
- c. Cash discount on payment within 2 weeks.
- d. Reimbursement to the dealer for free insurance provided to ultimate customer, and
- e. Free after sales services for a period of 1 year to the ultimate customer.

The Company needs to create a provision for expense against all these schemes as and when the sale is incurred on the basis of their nature.

As per the guidance given above, expense related to annual target scheme needs to be deducted from revenue and expenses related to other schemes should be booked under selling expenses. Further, in case of schemes for which the Company has identified the value at the time of sales and has shown these charges separately in the invoice, these should be taken directly to liabilities.

Basis of computation of scheme value

Target rebate: Based on the performance of the dealers in current year and in prior years, e.g. in the prior three years, 90%, 80% and 70% dealers have achieved the sales more than target. So, on an average of last three years, 80% dealers have achieved more than the target. If the Company has to compute the target rebate for any interim date, estimated sales value of those dealers who are likely to exceed targets during the current year should be considered for computation of target rebate expense which should be deducted from revenue.

Free gift including automotive accessories: Actual cost of

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these materials should be booked as expense immediately when the sale is incurred.

Cash discount: It should be booked on the basis of actual cash received from the customer or the past experience of receipt of payments from that customer should be analyzed for booking of expense on an estimated basis.

Free insurance: Actual/estimated expenses to be borne by the Company for free insurance should be booked.

After sales services: On the basis of actual/estimated cost to be reimbursed by the Company to the dealers after considering the percentage of claims received in the prior years. Further, as stated above, if the value of services is known at the time of sales, then the amount should be deducted from the revenue and should be taken directly to the liabilities as deferred revenue.

Note: Wherever estimates are made, the same should be tried up when the actuals are known.

3.23 In addition, sometimes companies float schemes such as festive schemes for the ultimate customers. Companies agree to bear the scheme cost on the stock lying with the dealers on the day of announcement of the scheme. In such circumstances, the auditor should ensure that if the dealers have some stock lying at their premises related to the sales made by the Company before the announcement date, then provision has been made in the books of the Company for the expense against such sales.

Annual Maintenance Contracts

3.24 Annual maintenance contracts are after sales services provided to customers to cover the future maintenance of products sold.

3.25 Revenue from annual maintenance contracts should be deferred and recognized as income on a straight-line basis over the contract period except where empirical data is available which indicates that the costs of performing services under the contract

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are incurred other than on a straight-line basis. In such cases, revenue should be recognized over the contract period in proportion to the costs expected to be incurred in performing services under the contract.

Extended Warranty

3.26 An extended warranty sometimes called a service agreement, a service contract, or a maintenance agreement is a prolonged warranty offered to consumers to cover products under specific conditions for an agreed period and/or content in addition to the standard contractual warranty. For e.g. an extended warranty scheme may cover a period (say one year or 2 years) beyond the free warranty service period. In the automobile industry, an extended warranty generally covers all mechanical and electrical failures and labour for these repairs. An extended warranty may be sold as a part of the original sale of product or as a separately priced extended warranty contract.

3.27 Revenue from extended warranty maintenance contracts should be deferred and amortized to income on a straight-line basis over the extended warranty contract period except where sufficient past evidence is available which indicates that the cost of performing service under the contract is incurred other than on a straight-line basis. Therefore where the extended warranty is for a period of two years beyond the free warranty service period, the extended warranty amount collected should be recognized as income over two years after completion of the free warranty period.

3.28 If, however, the costs incurred or to be incurred to service the extended warranty contract cannot be measured reliably, revenue is not recognized. This criterion flows from the matching principle. Therefore, warranty costs should be estimated and accrued. If such costs cannot be estimated reliably, revenue is deferred until the amount of such expenses can be more reliably estimated or have been incurred. In these circumstances, any consideration already received from the sale of the extended warranty is recognized as a liability.

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3.29 As per the requirements of AS – 29 Provision, Contingent Liabilities and Contingent Assets, loss on an onerous extended warranty contract should be recognized immediately if the future expected cost of providing services under such contract exceeds the revenue.

Illustration

A Company has charged Rs. 100,000 for extended warranty provided to a customer for a period of 10 months of free after sales service which covered labour expense only. As per the guidance given above, Rs.10,000 per month should be taken to income every month on the time/straight-line basis during the extended warranty contract period.

Further, as per past experiences, if the Company believes that the cost to be incurred against extended warranty contract will be Rs. 120,000, then the loss of Rs. 20,000 should be provided for in the books immediately and revenue of Rs. 10,000 and cost of Rs.10,000 (or at actuals, whichever is higher) should be booked every month.

3.30 The auditor should obtain a schedule of all such extended warranty schemes given by an entity during the year and ensure that both revenue and costs pertaining to such schemes have been properly booked.

Low-rate/ Subsidized Financing to Ultimate Users

3.31 Subsidies granted by automobile companies to finance companies to facilitate wholly or partially for low-rate financing arrangements granted to ultimate users are basically discounts granted to ultimate users. More automobile companies are starting to offer incentives on leasing to the ultimate users. Such leasing incentives are called lease subvention. Such expenses should be provided for and should be treated as sales rebates in the financial statements.

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Factoring Fees

3.32 Factoring fees mainly include servicing costs and finance costs.

3.33 In case of factoring arrangements where the receivables are retained in the balance sheet, the finance or interest cost portion of the factoring fee should be included under “Interest expenses”. The service costs portion of factoring fees should be accounted for as “Selling expenses”.

3.34 The auditor should ensure that the entity maintains a proper record of such arrangements. The auditor should ensure that a schedule is prepared by the entity for all such arrangements and ensure that the service costs and finance costs are accrued and accounted properly.

Used Products Traded-in for New Products

3.35 In cases where a used product is traded as a part of the payment for the sale of a new product, the product which is traded-in should be recorded in inventories using its market value as the cost of inventory. The difference between this market value along with any other amount received or receivable and the purchase price offered to the customer should be reported as a rebate in the selling price of the new product sold. If a subsequent decrease in the market value of the product traded-in happens, the decrease should be reported as a loss in the value of inventories, in accordance with Accounting Standard – 2 “Valuation of Inventories.

3.36 The auditor while carrying out audit procedures should ensure that there is proper documentation for assessing the market value of traded-in products.

Barter Transactions

3.37 Transactions under barter system normally entitle a Company receiving products not related to its operations as payment, in full or in part, for the goods which are sold.

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3.38 When goods or services are exchanged for dissimilar goods or services, a transaction that generates revenue has taken place and revenue is recognized. The revenue is measured at the fair value of the goods or services received, adjusted for any cash payments made by either the buyer or the seller. If the fair value of the goods or services received cannot be measured reliably, revenue is recognized at the fair value of the goods or services given up, adjusted for any cash payments made or received.

3.39 For all barter transactions, the auditor should obtain a list of such contracts and ensure that there is a proper authorization for such products. The auditor should also ensure that there is a proper system for valuation of such products. At the reporting date, the auditor should evaluate that all such contracts have been duly considered in the accounts, wherever necessary.

Residual Value Commitments

Definition

3.40 A transaction which legally constitutes a sale, i.e. the risk and reward of the product is shifted to the customer, but the seller gives a commitment to the buyer for some value in future of the used product through a contract. The residual value commitment may be made to various parties including ultimate customer, dealer, to a customer financing company etc.

Examples

3.41 Followings are examples of various types of residual value commitments:

- a. **Buy-back agreements:** The customer has the option to resell the used product to the seller at a stipulated future date. The price for re-sale is agreed upon at the time of sale.
- b. **Multiple buy-back agreements:** Similar to an agreement mentioned above, with the difference that the buyer may choose between several dates in the future to resell the used product to the seller.

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- c. **Trade-back agreements:** This agreement is also similar to buy-back agreement with the difference that the buyer has to accept a new product to exercise his option to re-sell the product.

3.42 Minimum value guarantees agreements: These have a right vested with the customer to get the compensation from the seller in case the value received at the time of disposal of the used products is lower than a certain price determined initially at the time of the sale. The difference between a buy back agreement and this agreement is that in these arrangements, the customer is responsible for the disposal of the used products.

3.43 Return Rate: While making the agreements for residual value commitments, the seller generally retains a risk for the future price levels of the used products. The risk is actualized if:

- the customer exercises the option to re-sell the used product (in case of buy back agreements), and
- the customer has the right to receive a fixed compensation at the time of disposal of the used product (in case of minimum value guarantees agreements).

3.44 Basically, this return rate measures as to what extent this type of risk had been realized in the past. The return rate is a percentage and may be calculated by applying following formula:

$$\frac{\text{Number of products with realized risk}}{\text{Number of products with expired risk}} = \text{Return rate (\%)}$$

Number of products with expired risk covers all the products sold in the same period with an expired residual value agreements commitment, irrespective of whether any risk has been realized or not.

Sales Recognition with Residual Value Agreements

3.45 Sales of products which are combined with residual value commitments (buy-back contracts in future) or may be recognized

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as sales at full value or may be accounted for as an “operating lease”.

3.46 The auditor should verify the terms and conditions of residual value agreements to ascertain if the seller has transferred all the significant risks and rewards of ownership to the buyer (As per the requirements of AS – 9). If the significant risks and rewards are transferred, sales should be recognized immediately. In a scenario where legal title has been transferred but the seller has retained all the significant risks and rewards, the transaction is in the nature of an operating lease and should not be recognized as sales.

3.47 Transactions involving residual value commitments should be recognized as sales if any of the criteria given below are fulfilled:

A. *Value of residual commitment is not significant as compared to the initial sales price of the product:*

3.48 Normally, if the residual value commitment covers less than 10% of the sales price of the product, the transaction should be accounted for as a sale. E.g. If a vehicle's sales price is Rs. 5,000 and the customer can resell the same for Rs. 400, the initial transaction should be accounted for as sales.

3.49 For the purpose of the above calculation, the residual value commitment should be discounted to the present value using the discount rate the lessee would incur to borrow over a similar term, and with a similar security, the funds necessary to purchase the asset.

B. *A separate agreement, independent from the original sales contract has been entered into for the residual value commitment.*

3.50 Example: A finished good is sold to a dealer. After that a customer financing Company enters into a contract with the end customer. The initial sales transaction should be recognized as sales if it is independent from the second transaction. A contract shall be treated as an independent contract if:

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- A separate contract is entered between the entity and the dealer without any residual value commitments,
- Subsequently, a separate financing contract is entered between the end customer and a customer financing Company. The customer has other financing options different from the customer financing Company and has no binding limitations in making this decision.

C. A contract in the nature of trade back

3.51 Sales transactions which are combined with trade-back arrangements should be recognize as sales.

3.52 If none of the above conditions are fulfilled, the transaction should be recognized as an operating lease. This recognition is further illustrated in the box given in the following page:

Illustration for operating lease (All amounts in Rs.)

Assumptions:

A product is sold to a customer. In connection with this sale, a buy-back contract is entered with the customer. This transaction does not fulfill the conditions as mentioned as per the guidance to be recognized as a sales transaction and, hence, would be covered through operating lease.

Price	5,000 (fully paid at sale)
Product cost	4,250
Residual value commitment (buy-back value)	2,750 (after three years)
Initially estimated net realizable value	2,600 (after three years)
Price ultimately realized on sale of used product	2,625

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Accounting:

Statement of profit and loss	At Sale	First Year	Second Year	Third Year	Used Vehicle Sale**
Lease Income	-	750	750	750	-
Sale of used product	-	-	-	-	2625
Lease income/ Net sales	-	750	750	750	2625
Depreciation	-	(550)	(550)	(550)	-
Cost of used product	-	-	-	-	2600
Gross income	-	200	200	200	25
Balance Sheet:*					
Assets:					
Assets under operating lease	4,250	(550)	(550)	(3,150)	-
Inventory	(4250)	-	-	2,600	(2,600)
Cash	5,000	-	-	(2,750)	2,625
Liabilities:					
Shareholders' equity	-	200	200	200	25
Deferred Leasing income	2,250	(750)	(750)	(750)	-
Residual value liability	2,750	-	-	(2,750)	-
Operating Cash flow	5,000	-	-	(2,750)	2,625

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* The amounts reflect the change of balance sheet values during the different periods

** Assuming that the customer utilizes the buy-back option.

Leasing income: The difference between the initial sales price and the buy-back value is accrued over the agreement period and accounted for as leasing income. The amount of leasing income credited to the statement of profit and loss should be debited to deferred leasing income.

Illustration of operating lease

Depreciation: The difference between the product cost and the estimated net realizable value of the product at the end of the commitment period (Agreement) is depreciated over a straight-line basis. For the debit to depreciation there should be a corresponding credit against the value of assets under operating leases.

Accounting at the expiry of a contract if the product is not repurchased:

If, at the end of the commitment period, the customer decides to utilize the buy-back option, the product is reclassified as inventory and the sale of the used product is recorded as a regular sales transaction.

If, at the end of the commitment period, the customer decides not to utilize the buy-back option, the “Residual value liability” should be reversed and recognized as “Net Sales” (i.e. 550 in the example). Simultaneously, the remaining balance of “Assets under operating leases” should be reversed and recognized as “Cost of Sales” (i.e. 520 in the example).

Accordingly, these postings would result in an additional gross profit of 30 being recognized in the income statement. Operating cash flow is not affected under this scenario.

Residual Value Losses

Definitions

Residual Risk

3.53 Residual risk is the possibility that the amount the seller obtains from returned vehicles will be less than the estimate of the expected residual value for the vehicle.

Residual Value Losses

3.54 Residual value losses are the future expected losses on the sale of used products that are returned from the buyer under a residual value commitment agreement.

3.55 The expected residual value is usually evaluated by recent auction values, return volumes for leased vehicles, industry-wide used vehicle prices, marketing incentive plans, and vehicle quality data.

Net Realizable Value (NRV)

3.56 NRV is the estimated selling price in the ordinary course of business less costs of reconditioning and costs that must be incurred in order to make the sale.

Calculation of Residual Value Losses

3.57 $[\text{Residual value commitment less Net realizable value (NRV) of used products on the date of the return (as defined above)}] \times [\text{Expected future rate of return}]$

3.58 Calculation of NRV and the residual value commitment should, if possible, be made on a “product by product” basis. However, if it is not possible, then the group of products sold with residual value commitments must be divided in subgroups of products with similar characteristics (similar model, market, customer, type of use etc.) and the calculation of NRV and residual value commitments should be made for each subgroup

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separately. The impact of the expected future rate of return should generally be posted on a collective basis for each subgroup.

Recognition of Residual Value Losses

3.59 Residual value losses should be recognized when they are probable and can be measured reliably.

3.60 Residual value losses for some products (or a group of products) should not be set off with the residual value gain of other products (or a group of products). In case of trade-back contracts, it is not permissible to offset the calculated residual value losses with the expected future gross income on new product sales.

Recognition of Residual Value Losses at the Time of the Initial Sale

3.61 If at the time of the initial sales transaction, the Company granted the customer a residual commitment which is higher than the NRV of the used product at that time, this residual value loss should be reported as a reduction in the gross income of the transaction.

3.62 While applying the “operating lease model”, such a residual value loss will result in a higher periodical depreciation during the contract period, as explained in the box given below:

Additional residual value losses under the operating lease model (All amounts in Rs.)

Assumptions:

Same assumptions as in the above ‘Illustration of operating lease’, with the difference that at the end of the first year, an updated estimate indicates that the net realizable value of the used product after three years will amount to 2150, i.e. 450 lower than the initially estimated amount.

Price	5,000 (fully paid at sale)
Product cost	4,250

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Residual value commitment (buy-back value)	2,750 (after three years)				
Initially estimated net realizable value	2,600 (after three years)				
Estimated net realizable value at end of first year	2,150 (after three years)				
Price ultimately realized on sale of used product	2,150				
Statement of profit and loss	At Sale	First Year	Second Year	Third Year	Used Vehicle Sale***
Leasing Income	-	750	750	750	-
Sale of used product	-	-	-	-	2,150
Leasing income/	-	750	750	750	2,150
Net Sales					
Depreciation (= SCS)	-	(550)	(550)	(550)	-
Additional Depreciation (= Variance)*	-	-	(200)	(200)	-
Write-down (= Variance)*	-	(50)	-	-	-
Cost of used product	-	-	-	-	(2,150)
Gross Income	-	150	-	-	-
Balance Sheet:**					
Assets:					
Assets under operating	4,250	(600)	(750)	(2,900)	-

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lease					
Inventory	(4,250)	-	-	2,150	(2,150)
Cash	5,000	-	-	(2,750)	2,150
Liabilities:					
Shareholders' equity	-	150	-	-	-
Deferred Leasing income	2,250	(750)	(750)	(750)	-
Residual value liability	2,750	-	-	(2,750)	-
* Revaluation of residual value provision					
** The amounts reflect the change of the balance sheet values during different periods.					
*** Assuming that the customer utilizes the buy-back agreement.					
Comment					
The initially calculated residual value loss of 150 (2600-2750) is accounted for as depreciation allocated over the commitment period. Out of the additional residual value loss of 450 (2150-2600), because the initially estimated net realizable value was optimistic, a write-down of 50 needs to be accounted for immediately at the end of the first year as this part of the residual value loss is not covered by unrecognized gross profit on the transaction.					
The remaining part of the additional residual value loss is accounted for as additional depreciation allocated over the remaining commitment period, i.e. 200 per year during the second and third year.					

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Improvement of Market Conditions

3.63 Where the residual value losses recognized during an earlier period are no longer probable due to improvements in the market conditions, the depreciation, write-downs or provisions made for these losses should be reversed. While applying the “operating lease model”, reversal of depreciation should be allocated over the remaining contract period.

Expected future residual value gains should not be recognized until they are realized.

Sales in Foreign Currencies

3.64 Sales denominated in foreign currencies should be translated using the historical exchange rate on the date of the transaction (as stated in AS – 11). The auditor needs to verify that exchange fluctuation on export debtors has been appropriately accounted.

3.65 If the sale is hedged in accordance with the accounting principles stated in AS 30, and if the criteria for cash flow hedging are satisfied, the effective portion of the gain or loss will initially be recognized in equity and subsequently recycled to the statement of profit and loss in accordance with AS 30. The ineffective portion of the gain or loss will directly be taken to the statement of profit and loss.

3.66 The export sales are eligible for the exports benefits in the form of DEPB licenses / Duty Draw back. The Company should recognize the export incentives at the time of booking of sales provided it is reasonable to expect ultimate collection. In case there is any doubt for the recovery of these incentives, these should be provided for. Also see Chapter 8.

Revenue from Financing/Leasing

Interest Income on Installment Credit Granted to Dealers or Ultimate Customers

3.67 Interest income on installment is recognized on an accrual basis using the effective interest method.

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Interest Income on Finance Leases

3.68 All the significant risks and rewards of ownership are transferred by the lessor to the lessee under a finance lease. Lease rentals receivable from the lessee are separated into repayments of principal amount and interest income.

3.69 The income allocation is based on a pattern reflecting a constant rate of return on the lessor's outstanding net investment.

3.70 The difference between the total rent received and the interest, as computed above, should reduce the net investment in order to reflect the outstanding amount receivable.

Rental Income from Operating Leases

3.71 Rental income from an operating lease should be recognized on a straight-line basis over the lease term, unless another systematic basis is more representative of the time pattern of the earning process of the lease.

Sales Return

3.72 For some companies, sales return forms a major part of the transactions. The sales returns may be due to the following reasons:

1. Technical default.
2. Delivery of goods to dealers without valid purchase order.
3. Mistake in delivery documents, like invoice or challans.

3.73 While checking the revenue, the auditors should ensure that sales return of goods subsequent to the reporting dates pertaining to the reasons 1 and 2 above should be adjusted from the revenue. However, with respect to the reason 3, no adjustment is required to be made.

Illustrative Audit Procedures

Identifying and Assessing the Risk of Material Misstatement

3.74 There are various approaches an auditor may use to identify risk at the assertion level for classes of transactions, account balances, and disclosures. One way might be to think about the ways a class of transactions, account balance, or disclosure might be misstated by considering “what can go wrong” for each material class of transactions, account balance, and disclosure. Another way is to consider what particular concerns one has about each assertion in addition to the risk of misstatement described by the assertion itself.

3.75 The auditor should assess each identified risk to determine whether it is a significant risk. This is intended to be a judgment decision based on the auditor’s cumulative knowledge of the entity.

3.76 When Information Technology (IT) is used to initiate, record, process, or report transactions or other financial data for inclusion in the financial statements, the systems and programs may include controls related to the corresponding assertions for material accounts or that may be critical to the effective functioning of manual controls that depend on IT. In such a scenario, the involvement of an IT specialist should be assessed.

3.77 The auditor will need to identify the risk of material misstatement in the financial statements and develop the audit plan accordingly. When the auditor has determined that a significant risk exists, the auditor will have to obtain an understanding of the entity’s controls, including control activities, relevant to that risk.

3.78 Hence, these audit procedures will vary according to the given situation.

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Sales

Material Classes of Transactions, Account Balances and Disclosures	Assertions		Audit Procedures
Sales		A	System update
		1	Update and document the understanding of the controls and the accounting system through a review of the system notes in the planning section.
		B	Review of sales contracts Review sales contracts/ agreements including side agreements to identify the terms of the sales and summarize the important terms and conditions of these contracts.
		C	Recording accuracy
	Accuracy, Completeness	1	Obtain/prepare a schedule of sales. Test the total and reconciliation of the total to: <ul style="list-style-type: none"> • Debtors ledger containing bill wise detail of each party. • Profit & Loss Account. • Compare and reconcile the sale quantity and value with the details filed by the Company in its statutory return such as Excise/VAT etc. • Compare the list of customers with the list of

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			<p>dealers/customers as per the Marketing system/other sources to ensure the existence of the customer. Also send periodical confirmation of balances to major customers to ensure existence of customers and the terms of sales.</p> <ul style="list-style-type: none"> Obtain a list of all price revisions made during the year from the sales team of the Company and check whether those have been considered appropriately in the books of account.
		D	Review of balances
	Occurrence	1	<p>Review the pattern of sales by month for the year to latest practicable date with corresponding pattern shown in the budget and in the previous years. Also compare the growth trend with the industry trend. Investigate any significant variations in pattern, particularly:</p>
	Cut Off		<ul style="list-style-type: none"> variations in the periods before and after the year end which may indicate a deliberate acceleration of invoicing and revenue recognition.
	Completeness		<ul style="list-style-type: none"> reduced sales in the months which may indicate omissions of sales.
	Accuracy,	2	Review sales accounts with

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	Classification		significant debit balances and check for any misstatements. Investigate for any unusual entries if they pertain prior to year-end.
	Accuracy, Classification	3	Investigate any journal entries recorded in the general ledger or subsidiary ledger and other adjustments made in the preparation of the financial statements at the year end and test the appropriateness of such entries.
		E	Test propriety of revenue recognition policies and procedures – Sales
	Accuracy, Classification	1	Understand the impact of significant accounting policies and compliance with applicable accounting pronouncements on sales balances.
	Accuracy, Classification	2	Determine that the accounting policies and methods for revenue recognition are appropriate and are applied consistently.
	Occurrence		<ul style="list-style-type: none"> Verify that delivery has occurred or services have been rendered.
	Accuracy, Occurrence		<ul style="list-style-type: none"> Delivery generally is not considered to have occurred unless the customer has taken title and assumed the risks and rewards of ownership of the products specified in the customer's

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			purchase order or sales agreement. After the delivery of a product or performance of a service, if uncertainty exists about customer acceptance, revenue should not be recognized until acceptance occurs.
	Accuracy		<ul style="list-style-type: none"> • Collectability of the revenue is reasonably assured.
	Completeness, Classification, Occurrence		<ul style="list-style-type: none"> • If any of the following are excluded from recorded revenues, determine that the exclusion is appropriate in relation to the economic substance of the transactions:
			* Consignment sales.
			* Sales with recourse.
			* Other deliveries of goods or performances of services without sales being recorded.
			* Bulk sales orders with multiple shipping dates.
			* Deferred revenues.
			* Installment sales.
	Occurrence, Accuracy, Classification	3	Make a selection of revenues recorded in the general ledger and verify that revenue was

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			appropriately recognized.
	Classification, Occurrence	4	Design and perform appropriate procedures to understand and test significant revenue streams that are not converted to cash in a relatively short period of time (e.g. 60 to 90 days). Revenue streams not converted to cash in a relatively short period of item may be generated on the basis of contractual obligations and/or may be contingent on particular events occurring. In designing and performing procedures, consider matters related to revenue recognition such as the following:
			<ul style="list-style-type: none"> • The nature of the specific transactions.
			<ul style="list-style-type: none"> • Who bears the risk in the transaction.
			<ul style="list-style-type: none"> • Payment terms.
			<ul style="list-style-type: none"> • The nature of any related contingencies.
	Classification	5	Whether an entity should report revenue based on (a) the gross amount billed to a customer because it has earned revenue from the sale of the goods or services or (b) the net amount retained (that is, the amount billed to the customer less the amount paid to a supplier) because it has earned a commission or fee. In assessing whether

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			revenue should be reported gross with separate display of cost of sales to arrive at gross profit or on a net basis, consider whether the entity:
			<ul style="list-style-type: none"> • Acts as a principal in the transaction.
			<ul style="list-style-type: none"> • Takes title to the products.
			<ul style="list-style-type: none"> • Has risks and rewards of ownership, such as the risk of loss for collection, delivery, or returns, and
			<ul style="list-style-type: none"> • Acts as an agent or broker (including performing services, in substance, as an agent or broker) with compensation on a commission or fee basis.
		6	<p>Additional audit procedures to establish delivery:</p> <ul style="list-style-type: none"> • Test the proof of delivery of vehicles to the customers/proof of handing over the vehicles to the carrier depending on the terms of sale. • Test the shipping/customs clearance documents and compare the same with the timing of revenue recognition in the books of account. • Where the documents

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			available with the Company do not provide sufficient evidence of transfer of risks and rewards to recognize sales, obtain confirmations from customers confirming their acceptance of the risks and rewards.
		7	Evaluate results of the tests.
		F	Test sales balances
	Occurrence, Completeness, Accuracy	1	Perform substantive analytical procedures to test sales balances. Consider developing an expectation of sales during the year:
			<ul style="list-style-type: none"> Historical and current year trends in sales and sales returns.
			<ul style="list-style-type: none"> Historical and current year trends in cost of sales and gross margins.
			<ul style="list-style-type: none"> Historical and current year shipments (or hours of service) and pricing.
			<ul style="list-style-type: none"> Sales to largest customers.
			<ul style="list-style-type: none"> Industry statistics.
			<ul style="list-style-type: none"> Changes in the business in the current year affecting the pricing or sales mix.
	Classification, Occurrence,	2	Consider disaggregating the data used to build the

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	Completeness		expectations and the recorded sales balances at a level of detail sufficient to enable obtaining the desired level of assurance based on a comparison of the amounts. Consider the following means of disaggregation:
			<ul style="list-style-type: none"> • By period.
			<ul style="list-style-type: none"> • By account, product line, or both.
			<ul style="list-style-type: none"> • By division or location.
	Accuracy	3	Determine that the data used to make an independent estimate is independent and reliable and if information produced by the client is being used, obtain audit evidence about the accuracy and completeness of the data.
	Accuracy	4	In assessing the reliability of the data gathered, consider the source of the data and the conditions under which it was gathered.
	-	5	Determine the threshold – the amount that represents the maximum needed to identify a significant difference between the expectation and the recorded sales amounts that is acceptable without further investigation.
	-	6	Compare the expectation to the recorded balance and identify any differences. For any difference that is more

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			than the threshold, obtain, quantify, and corroborate explanations for the difference by performing further analysis or inquiry and examining supporting documents. Explanation needs to be initially sought for the full amount of the difference, not just that part that exceeds the threshold.
	Accuracy, Completeness, Occurrence	7	We also consider investigating the following:
			<ul style="list-style-type: none"> Any unusual pattern in the differences.
			<ul style="list-style-type: none"> Whether the differences between the actual and budgeted amounts are so close that it could imply that management has manipulated either or both items. Use professional skepticism to evaluate whether the considerations give rise to any specific or pervasive risk as a result of fraud.
		8	Determine whether there are unusual relationships involving year-end revenue and income. Consider whether the following conditions exist:
	Cut Off		<ul style="list-style-type: none"> Uncharacteristically large amounts of income being reported in the last one or two weeks of the reporting period from unusual

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			transactions.
	Classification		<ul style="list-style-type: none"> Income that is inconsistent with trends in cash flow from operations.
	Classification	9	Perform tests of details of sales transactions. As debits to cost of sales are recorded concurrently with credits to sales, make a selection of debits to cost of sales:
	Occurrence		<ul style="list-style-type: none"> Trace the item to a sales invoice and final sales contract, if applicable.
	Accuracy		<ul style="list-style-type: none"> Agree the sales invoice prices to a price list.
	Accuracy		<ul style="list-style-type: none"> Verify additions and extensions on the invoice.
	Cut Off		<ul style="list-style-type: none"> Review shipping records or evidence of service performance to determine that the sale was recorded in the correct period, based on the terms of the sales agreement.
	Completeness		<ul style="list-style-type: none"> Trace the sales invoice amount to a sales journal.
	Completeness		<ul style="list-style-type: none"> Trace the sales journal total to the general ledger.
	Occurrence, Accuracy	10	Make a selection of items from other independent source documents corresponding to revenue

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			transactions (e.g. shipping records):
	Completeness		<ul style="list-style-type: none"> Test the numerical sequence of the source documents, if numerically controlled, or otherwise test the completeness of the records.
	Completeness		<ul style="list-style-type: none"> Trace the item to a sales invoice and final sales contract, if applicable.
	Accuracy		<ul style="list-style-type: none"> Agree the sales invoice prices to a price list.
	Accuracy		<ul style="list-style-type: none"> Verify additions and extensions on the invoice.
	Cut Off	11	Review shipping records or evidence of service performance to determine that the sale was recorded in the contract period, based on the terms of the sales agreement:
	Completeness		<ul style="list-style-type: none"> Trace the sales invoice amount to a sales journal.
	Completeness		<ul style="list-style-type: none"> Trace the sales journal to the general ledger.
		12	Evaluate results of the tests.
		G	Test sales returns
	Completeness, Accuracy, Cut Off, Occurrence	1	Make a selection of recorded sales returns:

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			<ul style="list-style-type: none"> Trace selected sales returns to credit notes. Trace credit notes to receiving documents and original sales invoices, and to customer correspondence, if any. Ensure that credit is given for proper amount and returned inventory is properly valued. Determine that the credit notes were recorded in the correct period.
		2	Evaluate results of the tests.
		H	Test early cut-off of sales
	Cut Off	1	Make a selection of records representing shipments or services that occurred in the five (5) days period prior to year end:
			<ul style="list-style-type: none"> Trace selected shipping records to sales invoices and final sales contracts, if applicable. Determine that sales were recorded in the correct period.
	Cut Off	2	Make a selection of recorded sales invoices in the five (5) days period after year end:
			<ul style="list-style-type: none"> Trace selected sales invoices to shipping records. Determine that the transactions were recorded in the correct period.

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		3	Evaluate results of the tests.
		I	Test late cut-off of credit notes
	Cut Off	1	Make of selection of customer returns in the fifteen (15) days period after year end:
			<ul style="list-style-type: none"> Determine that the credit notes (debits to sales or sales returns accounts) were recorded in the correct period.
	Cut Off	2	Make a selection of recorded credit notes in the five (5) days period prior to year end:
			<ul style="list-style-type: none"> Trace the credit notes to receiving records and determine that they were recorded in the correct period. Ensure that credit is given for proper amount and returned inventory is properly valued.
	Cut Off, Accuracy	3	Make a selection of miscellaneous debits to sales recorded in the fifteen (15) days period prior to year end:
			<ul style="list-style-type: none"> Trace the debits to supporting documents and determine that they were recorded in the correct period.
		4	Evaluate results of the tests.

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		J	Roll forward test for sales tested prior to year end
	-	1	This test is to be performed where we have performed detail testing of sales on an interim date. The following procedures have to be performed for the period from the interim date to the balance sheet date.
	Completeness, Occurrence, Accuracy	2	Perform substantive analytical procedures to test the sales balance at the year-end. Consider using the following data, as applicable, to develop an expectation of the receivables balance at the year-end:
			<ul style="list-style-type: none"> Monthly amounts of sales and sales returns in the intervening period from the interim testing date to the balance sheet date compared to such monthly amounts in prior years and in the current year prior to the interim testing date.
			<ul style="list-style-type: none"> Monthly amounts of costs of sales and gross margins in the intervening period from the interim testing date to the balance sheet date compared to such monthly amounts in prior years and in the current year prior to the interim testing date.
			<ul style="list-style-type: none"> Monthly amounts to

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			historical and current year shipments (or hours of service) and pricing from the interim testing date to the balance sheet date compared to such monthly amounts in prior years and in the current year prior to the interim testing date.
	-	3	Determine the threshold – the amount that represents the maximum needed to identify a significant difference between the expectation and the recorded year end sales balance that is acceptable without further investigation.
	-	4	Compare the expectation to the recorded balance and identify any differences. For any difference that is more than the threshold, obtain, quantify, and corroborate explanations for the difference by performing further analysis or inquiry and examining supporting documents. Explanation needs to be initially sought for the full amount of the difference, not just that part that exceeds the threshold.
		5	We also consider investigating the following:
	Accuracy, Completeness, Classification		<ul style="list-style-type: none"> Any unusual pattern in the differences.
			<ul style="list-style-type: none"> Whether the differences between the actual and

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			budgeted amounts are so close that it could imply that management has manipulated either or both items. Use professional skepticism to evaluate whether the considerations give rise to any specific or pervasive risk as a result of fraud.
		6	Test transactions during the intervening period between the interim testing date and year end:
	Completeness		<ul style="list-style-type: none"> Obtain a reconciliation of the sales balance to the year-end balance and agree sales total to sales journals.
	Accuracy, Occurrence		<ul style="list-style-type: none"> Examine supporting documents to verify other significant entries.
		7	Make a selection of entries in sales journal in the intervening period between the interim testing date and year-end:
	Accuracy		<ul style="list-style-type: none"> Trace the selected entries to sales invoices and shipping records.
	Accuracy		<ul style="list-style-type: none"> Agree the sales invoice prices to a price list.
	Accuracy		<ul style="list-style-type: none"> Verify additions and extensions on the invoices.
	Cut Off		<ul style="list-style-type: none"> Determine that the sales were recorded in the

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			correct period.
		8	Evaluate results of the tests.
		K	Test amortization of deferred income balances
	Classification, Accuracy	1	For selected deferred income balances, obtain an understanding of the nature of the deferred income, determine that the period of amortization is appropriate and test the entity's calculation of the release into income.
		L	Test foreign currency sales
	Completeness, Occurrence	1	Inquire and consider other available evidence, if any, to identify foreign customers with whom sales transactions were in foreign currency.
	Accuracy	2	Agree the closing rate(s) used to published records and test the translation calculation.
	Classification, Accuracy	3	Determine the impact of foreign currency hedging contracts, if any, on the recorded balance of foreign currency receivables.
	Accuracy, Classification	4	Trace currency translation adjustments to the general ledger.
		M	Test presentation of sales
	Classification, Understandability,	1	Understand the impact of significant accounting policies and compliance with

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	Valuation, Accuracy		applicable accounting pronouncements on receivables.
	Completeness Classification & Understand-ability Classification & Understand-ability Classification & Understand-ability Classification & Understand-ability, Accuracy & Valuation, Classification & Understand-ability	2	<p>Determine that amounts presented as sales and receivables are properly recorded, classified and/or disclosed as required by the Revised Schedule VI of the Companies Act:</p> <ul style="list-style-type: none"> • Total turnover, that is, the aggregate amount for which sales are affected by the entity. • Revenue should be shown under the following heads: <ul style="list-style-type: none"> • sale of products; • sale of services; • other operating revenues; <p>Less:</p> <ul style="list-style-type: none"> • Excise duty. • Excise duty should be shown as deduction from turnover. Excise duty related to increase/decrease in inventory should be shown in profit and loss account. • In case of companies rendering or supplying services, the gross income derived from services rendered or supplied. • Earnings in foreign exchange from export of goods calculated on

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			<p>F.O.B. basis.</p> <ul style="list-style-type: none"> Check that scrap/waste sales are disclosed under miscellaneous income and not considered as part of sales.
	Completeness	3	<p>Obtain from the management the information identifying all known related parties, account balances and transactions, and test the information for completeness:</p>
	Occurrence and rights & obligations		<ul style="list-style-type: none"> Review the accounts of parties mentioned in section 301 of the Companies Act, 1956 in the sales ledger and check if sales recorded to such parties aggregate during the year to Rs.500,000 or more.
	Accuracy & Valuation		<ul style="list-style-type: none"> For such parties, make a selection of sales and test reasonableness by agreeing sales prices to similar sales from other parties and to available price lists.
		4	<p>Determine that the amounts related to the items listed below are properly recorded, classified, and/or disclosed:</p>
	Classification & Understandability, Accuracy &		<ul style="list-style-type: none"> Sales to related parties.

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	Valuation		
	Classification & Understandability, Accuracy & Valuation		<ul style="list-style-type: none"> Sales to consolidated companies, with particular attention to inter-entity profit elimination.
	Classification & Understandability, Accuracy & Valuation	5	<ul style="list-style-type: none"> Non-trade sales. <p>Review the sale agreements to ensure that the price does not include any other component such as extended warranty fees etc., in which case such portion of the price should be recognized appropriately and disclosed separately and not as part of sales.</p>
		N	Conclusion
	-	1	Document the results of the audit procedures performed, the significant points considered in arriving at the conclusion, and a brief statement of the conclusion itself.
	-	2	<p>Consider including the following when documenting the conclusion:</p> <ul style="list-style-type: none"> A description of the risks associated with the account balance and how these risks were addressed in the substantive testing. The relevant potential errors and control objectives for each account balance or disclosure being tested. The substantive

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			<p>procedures performed or a cross-reference to where the substantive procedures are performed, including identification of both direct and indirect tests for the related potential errors.</p> <ul style="list-style-type: none">• The results of substantive tests, including misstatements identified, and how such results support the conclusion on the potential errors for each account balance or disclosure.• The tests of controls we performed or a cross reference to where the tests of controls performed are documented.• The results of the tests of controls, including deficiencies identified, and how such results support the conclusion as to whether we have obtained control reliance for the potential errors for each account balance or disclosure.
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Chapter 4

Fixed Assets

4.1 In the automotive industry, fixed assets mainly comprise of land, buildings, plant and machinery, tools, moulds, computers, furniture and fixtures, vehicles, assets taken under finance lease and intangible assets such as technical know how, software etc. Assets such as tools, moulds and technical know-how are usually specific to a particular product model and are peculiar to this industry.

Classes of Assets

4.2

- A. Buildings:** Buildings consist of facilities or constructions and service units such as heating installations, tunnels and tanks for heating fuel.
- B. Plant and machinery:** The items under plant and machinery are generally categorized as follows:
- Assembly Lines.
 - Paint Shop.
 - Press Shop.
 - General Engineering.

Plant and machinery constitute a major part of the asset block of an automotive Company. They are mostly high-value items which can be either manufactured specifically to the Company's need or purchased by the Company. The asset register is generally maintained according to the product models as it helps in the impairment analysis. Other assets which are not specific to the automobile models are maintained by the Company as a whole.

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- C. Tools:** Tools represent the manufacturing aids, such as dyes, fixtures, and machine heads, which are attached to or are used in conjunction with fixed manufacturing facilities. Tools may be type-bound or general. A type-bound tool is specific to a particular product or product line. They are designed or acquired for the production of new products or models, and their utility generally ceases with the discontinuation or modification of such products or models. When the product is phased out, the tool specific to that product is also scrapped. Therefore, it is imperative that the records for various tools, dyes, jigs and fixtures are kept model-wise so that they are depreciated correctly or impaired if the corresponding model is impaired. Tools can be readily relocated.
- D. Moulds:** In addition to moulds directly used by the Company, the Company also owns/finances moulds in the case of out-sourced products. Such moulds though owned/financed by the Company are usually kept in the custody of an outside supplier. These moulds are either purchased or manufactured by the Company and are shipped to the supplier. The supplier can also purchase or manufacture these moulds. The supplier (first tier supplier) may also further ship these moulds to its sub-contractor (second tier supplier).
- E. Intangible assets:** This mainly includes the technical know-how expenditure and has been discussed in the succeeding pages.

Moulds

4.3 The accounting of moulds would differ according to the arrangement related to the custody of the moulds with the supplier. Very often, the Company finances the moulds for the suppliers. To check the accuracy, the auditor should ensure that the accounting has been done as per the agreement.

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Illustrations

- 1) *Moulds manufactured and owned by the supplier and cost of production charged to the Company on cost per piece basis:*

Background

X Auto Limited, a manufacturer of car model – Alpha, regularly purchases components from its Vendor Y. To manufacture these components, Y has manufactured/purchased certain moulds according to the specifications given by X. These moulds are owned by Y and are used only for manufacturing the components of Alpha for X. The price arrangement between X and Y is such that the cost of production of these moulds would be recovered from X on cost per piece basis.

Solution

Y should capitalize these moulds and depreciate them over their useful lives/per piece basis on the basis of total estimated production of components. X should treat the proportionate cost of moulds included in the rate charged per piece by Y as a part of the purchase cost of the component.

The Company should keep the quantitative details of such moulds as they are developed by the suppliers on behalf of the Company.

Audit procedures

- The terms of the agreement between the Company and the supplier should be reviewed thoroughly by the auditor in order to check as to who bears the significant risks and rewards of the ownership of the moulds and that the agreement does not contain any financing or leasing element related to the moulds developed by the supplier.
- The rates charged per piece should be reviewed or re-calculated and it should be ensured that the Company has proper controls in place related to its costing system.

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- 2) *Moulds manufactured and owned by the supplier and cost of production charged from the Company on cost per piece basis with a commitment to purchase a specified minimum quantity:*

Background

Using the same facts as given in Illustration 1, X has a commitment to purchase minimum 10,000 items every year and the cost per piece of the mould is Rs. 10 per unit. In the year 20XX, X purchased only 7,000 items.

Solution

In case the normal off-take is $>$ or $=$ 10,000 items, then in the year in which the off-take is only 7000 items, mould cost of Rs. 10 each per piece would be treated as a part of the purchase cost of components and should be expensed off when the components are consumed.

Balance Rs. 30,000 (cost of the remaining 3,000 items at Rs. 10 per piece) should be expensed off immediately.

In case where the normal off-take is 7,000 units, the whole amount of Rs. 100,000 should be inventorized and should be expensed off when components are consumed.

Audit procedures

In addition to the procedures listed in Illustration 1, the auditor should, at each cut-off date ensure that the provision has been made adequately for the committed amount in the books of account.

Based on the planned off take establish the normal cost which should get inventorized or charged off.

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3) *Moulds manufactured and owned by the Company and shipped to the supplier:*

Very often an automotive Company, in order to maintain strict quality procedures, manufactures moulds and then sends them to the supplier.

Background

X Auto Limited, a manufacturer of car model – Alpha, regularly purchases components from its Vendor Y. To manufacture these components, X has manufactured/purchased certain moulds and has given them to Y.

Solution

X should capitalize these moulds and depreciate them over their useful lives/per piece basis on the basis of total estimated production of components.

Y should maintain the records of such moulds as it holds them on behalf of X.

X should also maintain the records of such moulds kept by Y on its behalf.

Audit procedures

- The auditor should ensure that the moulds are valued appropriately and recorded in the fixed assets register correctly.
- Physical verification of these moulds should be carried out at regular intervals and confirmations should be obtained from the supplier regarding the moulds present in his premises.
- Depreciation should be charged off on the basis of the useful lives of these moulds/per piece basis.

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4) *Moulds manufactured by the supplier and financed by the Company:*

Background

X Auto Limited, a manufacturer of car model – Alpha, regularly purchases components from its Vendor Y. To manufacture these components, Y has manufactured/purchased certain moulds according to the specifications given by X. Further, X has financed the cost of such moulds and charges interest @ 9% p.a.

These moulds are owned by Y and are used only for manufacturing the components of Alpha for X. The price arrangement between X and Y is such that the cost of these moulds would be recovered from X on cost per piece basis.

Solution

Y should capitalize these moulds and depreciate them over their useful lives/per piece basis on the basis of total estimated production of components.

The finance given to Y by X should be classified as a loan and interest should be accounted for as an income on accrual basis in the books of X.

X should treat the proportionate cost of moulds included in the rate charged per piece by Y as a part of the purchase cost of the component and should expense off the same when the component is consumed.

Audit procedures

- The auditor should evaluate whether the financing agreement is covered under the purview of AS 19 – Leases and the accounting should be done accordingly.
- The auditor should review the terms of the contract to check if the loan given by the Company to the supplier is backed by a deed of hypothecation.
- The auditor should check whether the loan given is recoverable or not. If not, it is in the nature of an advance i.e.

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given as an adjustment to the price of the mould, in which case it should be amortized in proportion to the pieces received from the vendor.

- The auditor should ensure that the loan is appropriately classified as secured or unsecured.

5) *Moulds manufactured by the Company and subsequently sold to the supplier:*

In this case, revenue should be recognized when these moulds are sold by the Company to the supplier as per the criteria stated in AS 9 – Revenue Recognition.

Background

A Auto Limited, manufactures certain moulds for selling them to its component supplier, B. B regularly purchases these moulds from A. The risks and rewards are transferred to B on its purchase.

Solution

A should treat these moulds as inventory since they are produced for sale in the ordinary course of business. Revenue should be recognized once these moulds are sold.

B should treat these moulds as the cost of purchase of the moulds and should capitalize them depending on their nature.

Audit procedures

- The auditor should ensure that the revenue is recognized on the sale of these moulds in accordance with AS 9 – Revenue Recognition.
- The auditor should also check that, at each reporting date, such moulds are not capitalized but are treated as inventory.

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- 6) *The sales agreement provides for the partial recovery of the cost of moulds from the vendors:*

Here, the unrecovered portion of the cost should be depreciated.

Background

A Auto Limited, regularly manufacture moulds for its vendor B. The price arrangement between A and B is such that a portion of the cost of these moulds is charged directly to B. These moulds are owned by A.

Solution

A should capitalize the portion of the mould cost which is not recovered from B and depreciate it over the useful life/per piece basis on the basis of total estimated production of components.

- 7) *Accounting for the cost of moulds manufactured by the vendor of the components:*

Background

A Auto Limited, regularly purchases moulds used in its manufacturing process from its vendors and as per the contract with its vendors, A is owner of these moulds on “as is where is” basis. These vendors regularly submit the status report of these moulds and transfer them to A once the moulds are completed.

Solution

At the end of each period, A should calculate the amount of these moulds, treat them as Capital work-in-progress (CWIP) and provide for the corresponding liabilities. Assuming that there are only two moulds, their status as at the period end is as follows –

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Particulars	Total cost of moulds Rs.	Percentage completed at the period end	CWIP Rs.
Mould K	100,000	20%	20,000
Mould L	200,000	40%	80,000

Hence, the mould cost is accounted as CWIP and a corresponding liability of Rs.100,000 is created in the books of A. Once the manufacture of the mould is completed, its cost is capitalized.

Other Concepts Related to Tools and Moulds

Control Issues Specific to Tools

4.4 It is difficult to track some of the tools as individual assets. This may be due to the tools being too small to mark, highly mobile or in the custody of outside vendors. However, if possible and practical, a system of control over the tools should be maintained by the management so that (1) acquisitions and disposals of tools are executed in accordance with management's authority and (2) accountability over the tools is maintained.

The auditor should review such system to ensure proper recording of the tools in the financial records.

4.5 A high percentage of special tools/moulds owned by the Company could be in the custody of the suppliers(both outside and allied).The management should obtain confirmation letters from such suppliers regarding the possession of tools on regular intervals. Confirmation letters are an important mechanism in ensuring control over special tools. Once the production is over, a vendor may still be required to retain the tool in order to create replacement parts. In this case, it is recommended that an annual confirmation is taken from the supplier. The confirmation letter serves to confirm the physical

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location of the tool which may be required for certain tax or other governmental reporting.

4.6 Confirmation letters may include the following:

- i) Description of tools or any other information which will assist the Company in identifying the special tools/moulds.
- ii) Request for confirmation that the supplier still has the special tools.
- iii) Request for explanation if the supplier does not have the special tools.
- iv) Request for the confirmation of the physical location of the tools.
- v) Request for the status of the tools (active, idle, scrapped etc.).

4.7 The management should reconcile the differences, if any, between the confirmation letters received and the book records. If required, an adjustment entry should be passed by the management in the financial records. The auditor should review such confirmations and ensure that the financial records are true and fair.

Depreciation of Tools

4.8 Tool costs may be depreciated over the number of years of their useful lives or a number of production units. Depreciation over a number of production units generally results in a more constant charge to each unit, particularly when production extends over a number of years and annual production volume varies. Depreciation over a period of years may achieve substantially the same result when the life of the tool or product is relatively short and when the production volume is reasonably constant. The method which assigns the same depreciation charge to each unit produced should be considered. The management should regularly review the useful lives of assets at the end of each period/year.

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4.9 If the tools are specific to a particular model of the product, they are generally used during the useful life of the product manufactured and their utility ceases when the manufacturing process is over. The general policy is to depreciate the cost of such tools over the useful life of the product and they are impaired when the life of the product is over. Management is responsible for determining the useful lives of a product for depreciation purposes. Depreciation should begin as soon as the production starts.

4.10 The auditor should verify the classification of the fixed assets to ensure that the tools are depreciated/impaired correctly. The management should maintain adequate records to substantiate the costs accumulated with regard to the specific tools. The records should be in conformity with the general ledger. The auditor may rely on the technical personnel certificate in case of a new model of the vehicle and should corroborate with the past experience of other models.

Intangible Assets - Technical Know-how Expenditure

4.11 Companies usually pay one time technical know-how fee i.e. Intellectual Property Rights (IPR) fee to the owner of IPRs for a new model of the vehicle launched in India. Usually the owner of IPR is a group Company, a parent Company or an outside party such as a Joint Venture.

4.12 The amount paid as IPR fees usually meets the conditions of an intangible asset as stated in AS 26 – Intangible Assets. It should be noted that the research costs embedded in the agreements related to the technical know-how fees should be expensed off. However, when the research costs are incurred for the development purposes, they should be capitalized if all the conditions as per AS 26 are met.

4.13 While some development activities may result in an asset with physical substance, the physical element is secondary to its intangible component i.e. the knowledge embodied in it. Where development relates to an intangible asset, the cost of the assets

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can be capitalized only if it is considered probable that the future economic benefits attributable to the asset will flow to the enterprise and the costs can be measured reliably. Consequently, the degree of certainty about the success of the product being launched is also a key element.

Illustration

Background

X Auto Limited, has paid technical know how fee of USD 100 million for the IPR of newly launched car model Alpha held by Z Auto Limited.

The issue faced by X Auto Limited is whether X should capitalize the same as an intangible asset or expense it off.

Solution

X should capitalize USD 100 million as intangible assets if, and only if, all the conditions given in AS 26 are fulfilled, which include the following:

- (a) the technical feasibility of completing the product for which know-how is sought for so that it will be available for use or sale;
- (b) X's intention to complete the intangible asset and use or sell it: Following should be considered under this:
 - i) X's ability to use or sell the intangible asset;
 - ii) Whether the intangible asset will generate the probable future economic benefits. Among other things, X should demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset;
 - iii) the availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset; and

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- (c) X's ability to reliably measure the expenditure attributable to the intangible asset during its development.

If the above conditions are not fulfilled, the fees should be expensed off immediately.

Audit procedures

- The auditor should ensure that all the requirements of AS 26 have been complied with as stated above.
- The auditor should obtain a copy of the agreements and ensure that the amount paid is not for the research activities, training activities, marketing activities but are towards the development of the products.
- It should be ensured that the Company has all the requisite approvals and that the Company has control over usage of the intangible asset.
- The auditor should check that the intangible asset is correctly amortized.

Depreciation of Fixed Assets

4.14 Most automotive companies depreciate the fixed assets over their estimated useful life. A Company should follow Schedule XIV of the Companies Act, 1956 for depreciation. If the estimated useful life of an asset is shorter than the useful life determined using the Schedule XIV rate, depreciation on the shorter useful life should be provided and a note explaining the depreciation policy should be given in the financials of the Company.

4.15 The auditor should ensure that the rate adopted by the Company for depreciation is a correct measure of the wearing out, consumption or other loss of value of a depreciable asset arising from use, efflux of time or obsolescence through technology and market changes.

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Other Procedures for Auditing Fixed Assets

4.16 While conducting the audit of fixed assets, an auditor is primarily concerned with testing the recording, cut-off procedures, existence and valuation of fixed assets.

4.17 The auditor has to comment on the following given under the Companies (Auditor's Report) Order, 2003 (CARO) issued by the Central Government in terms of Section 227 (4A) of the Companies Act, 1956 –

- Whether the Company is maintaining proper records showing all the particulars, including quantitative details and location of the fixed assets.
- Whether these assets have been physically verified by the management at reasonable intervals; whether any material discrepancies were identified during such verification and if so, whether they have been properly dealt with in the books of accounts.
- If a substantial part of the fixed assets have been disposed of during the year, whether it has affected the going concern of the Company.

4.18 The auditor has also to comment on whether there is an adequate internal procedure commensurate with the size of the Company and nature of its business, for the purchase of fixed assets and whether there is a continuing failure to correct major weakness in internal controls.

Internal Control System for Fixed Assets

4.19 Management should monitor the compliance with all significant policies concerning the fixed assets. Exceptions to the fixed assets policies and procedures should be noted and raised to the appropriate levels within the Company and resolved in a timely manner. Internal control system for fixed assets will involve the following checks and inquiries:

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Acquisition of Fixed Assets

4.20 To ensure that the fixed assets were actually acquired by the Company and recorded correctly, changes in the fixed assets register and/or in the master file should be made on the basis of authorized source documents and approved by the management or other authorized personnel who are not involved in recording the changes. Asset acquisitions and related financing agreements should be reviewed by management (including consideration of the capital expenditure budget) before being authorized. Requests to change the fixed assets register and/or master file data should be submitted in a proper form and processed timely so that the fixed asset acquisitions are recorded in the appropriate period. The fixed assets register and/or master file data should be periodically reviewed by the management for accuracy and reconciled to the corresponding general ledger accounts. Any reconciling items should be identified and addressed in a timely manner.

Depreciation of Fixed Assets

4.21 Depreciation rates and methods of calculation should be reviewed periodically to ensure that the depreciation charges are reasonable and in accordance with generally accepted accounting principles. Where manufacturing is done in shifts, the depreciation rates for shift operations should be applied. The auditor should verify that the calculations of the extra depreciation for double shift working and for triple shift working are made separately in the proportion which the number of days for which the concern worked double shift or triple shift, as the case may be, bears to the normal number of working days during the year.

4.22 Standard programmed algorithms should be used to calculate the depreciation charge accurately. Depreciation charges should be reviewed by the management, including the consideration of recording such charges in the appropriate accounting period.

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Disposal of Fixed Assets

4.23 To ensure that the fixed assets disposed represent actual disposals made, changes in the fixed assets register and/or in the master file should be made on the basis of authorized source documents and approved by the management or other authorized personnel who are not involved in recording the changes. Requests to change the fixed assets register and/or master file data should be submitted in a proper form and processed timely so that the fixed asset disposals are recorded in the appropriate period. The fixed assets register and/or master file data should be periodically reviewed by the management for accuracy and reconciled to the corresponding general ledger accounts. Any reconciling items should be identified and addressed in a timely manner.

Managing Fixed Assets

4.24 To ensure that the fixed assets records are accurately maintained, asset maintenance schedules should be prepared, updated, and monitored by the management at regular intervals. Activity per the asset maintenance schedule should be reconciled to the asset maintenance history register regularly.

4.25 Fixed assets should be located in an appropriate and secured area where access is restricted to the authorized personnel only. There should be proper security arrangements at the premises. Appropriate safety measures such as fire alarm systems, burglar alarms should be in place.

4.26 Adequate insurance cover should be obtained for the fixed assets. Regular annual maintenance contracts should be entered into for their maintenance.

4.27 Management should physically verify the fixed assets and reconcile the same to the fixed assets register. The interval at which such verification is to be conducted should also be determined by the management. Discrepancies, if any, noted during the physical verification should be appropriately dealt with.

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4.28 It is essential to ensure that the financial information is appropriately presented, and all information necessary for the fair presentation and compliance with the professional standards or legal requirements is disclosed. To achieve this objective, fixed assets staff should be appropriately trained. They should be able to classify the assets properly, identify a finance lease or an operating lease etc.

Maintaining a Fixed Assets Register and/or a Master File

4.29 Only authorized personnel should be allowed to access the master tables in the fixed assets register. Any changes in the fixed assets register and/or the master file should be made on the basis of authorized source documents to ensure that they were recorded accurately and in time. The fixed assets register and/or the master file data should be periodically reviewed by the management for accuracy and reconciled to the corresponding general ledger accounts. Any reconciling items identified should be addressed in a timely manner.

Assets Transferred

4.30 Sometimes, fixed assets like furniture, office equipments, etc. are transferred from one office to another. The auditor should examine whether the accumulated depreciation in respect of such assets is also transferred. It may be noted that the consolidated accounts of the Company would not be affected by such transfers. However, the expenses which are related to the capital items but are in the nature of operating expense e.g. expenses incurred in the course of removing existing items of plant and equipment or rearranging plant layouts should be expensed off as and when incurred.

Assets Lying with Third Parties

4.31 Sometimes, fixed assets like moulds and tools are often lying with the subcontractors/ suppliers from whom the Company purchases components. The Company should maintain a list of all such items separately and also have a program for periodical physical verification of such items. The Company should also have procedure of obtaining periodic

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confirmation from the sub- contractors/ suppliers stating the location / description/ quantity and the physical condition of the Company's assets held by them.

General Audit Procedures

4.32 The auditor should verify the opening balance of fixed assets with reference to the schedule of fixed assets, the ledger or the fixed assets register. The auditor should also examine whether the balances as per the fixed assets register reconcile with the ledger and the financial statements.

4.33 As per AS 10, Accounting for Fixed Assets, the cost of an item of fixed asset comprises of its purchase price, including import duties and other non-refundable taxes or levies and any directly attributable cost of bringing the asset to its working condition for its intended use. Trade discounts and rebates are deducted in arriving at the purchase price. Site preparation costs, initial delivery and handling costs, installation costs and professional fees are some examples of directly attributable costs. Administration and other general overhead expenses are usually excluded from the cost of fixed assets, unless they are specifically attributable to the construction project or to the acquisition of a fixed asset or bringing it to its working condition.

4.34 Substantive procedures for audit of fixed assets may include the following inquiries and verifications:

A. Acquisition of New Fixed Assets

4.35 Acquisition of new fixed assets should be verified by the auditor with reference to authorisation, quotations, vendor bills, title deeds, record of payment, etc.

B. Self-Constructed Fixed Assets/ New Projects

4.36 One common feature in automobile companies is the usage of internally manufactured vehicles for the purposes of the Company's own use. Similarly, automobile companies also capitalize vehicles for testing purposes internally.

4.37 The cost of such self- constructed fixed assets is

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measured at the production cost of the asset, which consists of the raw materials and consumables used, plus other costs incurred (including appropriate overheads) that are directly attributable to the production of the asset. Self-constructed fixed assets should be verified by the auditor with reference to the authorisation and documents such as contractors' bills, work order records and record of payments. The auditor should also verify that only directly attributable costs have been capitalized. Administrative and general overhead costs are not a component of the cost of the asset because they cannot be directly attributed to the acquisition of the asset or bringing the asset to its working condition.

4.38 The auditor should verify the methodology followed for identification of costs to be capitalized and perform procedures to validate the same. Further, the auditor should ensure that the Company maintains adequate records of such vehicles capitalized and the useful lives considered for depreciation of these vehicles are appropriate considering the purpose for which these are being used.

4.39 In the automotive industry, where a new vehicle line is set up or a new car/engine plant is set up i.e. where a project is under construction, it should be verified that it is shown in the financials under a separate heading, e.g., 'Project under construction'. Capital advances should be shown under the head 'Long term Loans and Advances' as per the requirements of the Revised Schedule VI.

4.40 In a new project, it is likely that the Company employees are used for more than one project and that there is an overlap between the construction and maintenance activities. These factors create ambiguity in identifying the costs of construction. The auditor should ensure that capital projects are clearly identified and appropriate controls are put in place to ensure that the right costs are charged to these projects. A time recording system may help in clearly identifying the time spent on construction activities and maintenance activities. If the Company

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does not have a time recording system, the auditor should review the assumptions for allocating expenses to different projects.

4.41 The auditor should also review the capital budget prepared by the management for the fixed assets. Total costs capitalized under the project should be compared with the budget. The auditor should obtain explanations for significant variations noted.

4.42 If there is a system of creating purchase orders for every project – separate car-line wise, the auditor should ensure that all purchase orders under the project that is capitalized are closed. This will provide an assurance about completeness of the costs to be capitalized. If certain purchase orders are not closed for want of final invoices from the suppliers or contractors, it may be necessary to make capitalizations based on estimates.

C. Installation Fees

4.43 Since plant and machinery forms a large portion of the fixed assets in automobile companies, it is common for such companies to incur costs towards installation/related fees pertaining to the main plant and machinery. The auditor should identify such cases of fees by going through the purchase order/other relevant document for purchase of plant and machinery and ensure that the same are accounted for appropriately at the time of capitalization of the assets. If such fees are towards bringing the assets to the present condition and location, the same may be capitalized as part of the cost of such plant and machinery. In cases where the conditions for capitalization are not met, the same should be charged off to the profit and loss account in the appropriate period.

D. Capital work in Progress(CWIP)

4.44 The auditor should also review items under CWIP. If it includes any costs relating to a project that has been capitalized, inquiries with the management are necessary. The auditor should verify the certificate from the technical department or engineers, which confirms that the fixed assets are available for use.

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4.45 An aging analysis of items included in CWIP will highlight expenses which have not been capitalized for a considerable period. The auditor should make inquiries with the management for such delays and evaluate whether the CWIP should be tested for impairment.

4.46 The expenses under CWIP should be reviewed to determine whether any revenue items are debited under that head.

E. Revaluation

4.47 Where the plant and machinery (or any other fixed assets) are re-valued, the auditor should examine the basis of revaluation. The auditor should also examine whether the treatment of resultant revaluation surplus or deficit is in accordance with AS 10 -Accounting for Fixed Assets. The auditor should also check the impairment, if any, by applying the principles laid down in AS 28 - Impairment of Assets in such cases.

F. Exchange

4.48 An exchange of fixed assets is accounted for by reference to the fair market value of the asset given or the fair market value of the asset acquired, if that is more clearly evident. An exchange of similar fixed assets should not result in any gain/loss. Any assets acquired in such an exchange are recorded at the carrying value of the net book value of the assets given up. In all the above cases, adjustment should be made for any balancing receipt or payment of cash or other consideration.

G. Intangible Assets

4.49 Companies may carry amounts of goodwill, technical know-how fees (as explained above) and other intangible assets on their balance sheets. The depreciable amount of an intangible asset should be allocated on a systematic basis over the best estimate of its useful life. For technical know-how fees, the amortization should be in line with the period of usage after

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considering other factors such as life of model and its obsolescence and abandonment. For e.g., if technical know-how is obtained for a specific product whose useful life is only 5 years, the technical know how should be also be amortized over a period of 5 years. If the production of the model is abandoned/discontinued before the expected 5 year period, then the balance carrying value needs to be written off in the period of such abandonment/ dis-continuance. The auditor should verify whether the Company has evaluated at each balance sheet date the amortization period and the amortization method. Adjustments made to the estimated life should also be verified.

4.50 In automotive companies, fixed assets may also include computer hardware and software. Computer hardware qualifies the definition of a 'fixed asset' as given in AS 10, "Accounting for Fixed Assets" (viz. "an asset held with the intention of being used for the purpose of producing or providing goods or services and is not held for sale in the normal course of business"). Systems software that are essential for the functioning of the hardware (e.g., operating system) can be considered an integral part of the related hardware. Applications software is an intangible asset that is identified separately from the hardware and should be accounted for as per AS 26, "Intangible Assets".

4.51 The auditor should examine whether the accounting treatment of the expenditure on computer hardware and software is in consonance with their nature as described above. The expenditure on acquisition and installation of hardware (as also on any systems software considered to be an integral part of the related hardware) should be capitalized in accordance with the principles laid down in AS10, Accounting for Fixed Assets, and depreciated over the useful life of the hardware. Expenditure on applications software, whether acquired from outside or developed in-house, would be capitalized if criteria specified in AS 26, Intangible Assets are met, and amortized over its useful life. However, in estimating the useful life of applications software, the rapid pace of changes in software as

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also the need for periodic modification/ upgradation of software to cater to changes in nature of transactions, information needs etc. need special consideration.

4.52 As far as expenditure during the stage of in-house development of software is concerned, the same needs to be accounted for in accordance with AS-26 Intangible Assets, according to which expenditure incurred during the research phase should not be capitalized as part of cost of intangibles. While capitalising the development phase expenditure, due consideration should be given to the requirements of the said Standard. Hardware and software are susceptible to faster rate of technical obsolescence. Hence, the auditor must take into consideration this fact while assessing the computation of provision for depreciation/amortization for such assets.

H. Depreciation and Useful Lives

Depreciation

4.53 Fixed assets are generally capitalized and depreciated when they are available for use. Available for use indicates that the asset is in the location and condition necessary for it to be capable of operating in the manner that management intends.

4.54 As per AS 6, Depreciation Accounting, depreciation is a measure of the wearing out, consumption or other loss of value of a depreciable asset arising from use, efflux of time or obsolescence through technology and market changes.

4.55 Accordingly, even if the fixed asset has not been put to use for production, it should be depreciated from the date it is available for use, since the factors of efflux of time and technological obsolescence cannot be ignored. The date of commercial launch is often considered as the "available for use" date. Commercial launch is not a defined term but is usually interpreted as the date when the engineers certify that testing has been completed and the fixed asset is capable of providing commercial production. Also, evidences in the form of RTO Certificates/ other regulatory confirmations available to prove

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the launch of the product may be considered for corroborating the capitalization date.

4.56 The auditor should ensure that certificates from technical departments and other RTO and regulatory confirmations are available on record for all such major capitalizations.

Useful lives

4.57 Companies generally depreciate their fixed assets at rates specified in Schedule XIV of the Companies Act, 1956. Automotive companies work in an environment of rapidly changing technology. Companies should therefore evaluate whether depreciation charge based on Schedule XIV rates will represent an adequate depreciation charge.

4.58 If the useful lives are shorter than those envisaged under the Companies Act, the assets should be depreciated over the shorter life. The auditor should ensure that the rate adopted by the Company for depreciation is a correct measure of the wearing out, consumption or other loss of value of a depreciable asset arising from use, efflux of time or obsolescence through technology and market changes.

4.59 Due to continuous modifications and upgrades in vehicle models, the possibility of obsolescence is very high in this industry. The auditor needs to obtain a clear understanding of the product profile of the companies being audited. Whenever it comes to the notice of the auditor that a specific model is no more in vogue and is being phased out, suitable adjustments need to be made to the value of such model specific fixed assets carried in the books of account.

4.60 The estimate of useful life of a fixed asset should be reviewed by the management at least at each financial year end. If the estimates differ from the previous estimates, the un-depreciated cost should be written off to the statement of profit and loss over the revised remaining useful life (accelerated depreciation).

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4.61 Where the change in asset life is significant, this may indicate that immediate impairment rather than a revision to the onward depreciation rate is necessary.

I. Impairment

4.62 AS 28 Impairment of Assets and Technical Guide on Estimation of Future Cash Flows and Discount Rates for the purposes of AS 28 issued by the Institute of Chartered Accountants of India should be referred for impairment testing. In the automotive industry, impairment testing is generally carried out on vehicles model wise as each vehicle model is a cash generating unit.

4.63 The auditor should ensure that wherever there are indicators of impairment, impairment testing is carried out by the Company.

Impairment Indicators

4.64 Companies must assess at each balance sheet date whether there is any indication that an asset may be impaired. External factors and evidence from internal reporting may provide indicators that an asset may be impaired. Management should consider both general and automotive industry-specific factors, including:

- adverse trends in performance indicators such as reduction in sales, reduction in market share, the number of customers, increase in cost of production of the vehicles;
- plant's operating or maintenance expenditure significantly in excess of original budget;
- significant shortfall of revenues compared to budget or prior periods;
- technological developments that may reduce the economic performance of the assets (i.e. the technology related to the production becomes obsolete);
- impact of changes in regulation and deregulation; and

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- increase in market interest rates.

4.65 As per AS 26, Intangible Assets, a tangible asset that is not yet available for use and an intangible asset that is amortized over a period exceeding 10 years from the date when the asset is available for use should be tested for impairment, even if there is no indication of impairment for that asset.

Cash Generating Units

4.66 A Company must determine whether the assets should be tested separately for impairment or as part of a cash generating unit (CGU). CGUs are the smallest group of assets, which includes the assets under review, which generates cash inflows that are largely independent from the cash flows from other assets or groups of assets.

4.67 The independence of cash flows will be indicated by the way management monitors the activities, for example by product lines or locations. A Company needs to consider if the vehicle line can be treated as a single CGU or complete factory would be a single CGU. Generally a vehicle line is treated as a single CGU.

4.68 The auditor needs to evaluate the assumptions in detail and should have reasonable and supportable basis for the management assumptions.

Calculating a CGU's Recoverable Amount

4.69 An asset's carrying value should not be greater than its recoverable amount, which is the higher of its value in use or net selling price. The CGU's recoverable amount must be calculated and compared with its net book value.

4.70 The Company's assumption would include volumes projections over the life of vehicle model, sales price per vehicle and cost per vehicle over the life of the model. Generally, companies launch new models at a low price and increase the price once the model sale increases. Further, over the years, cost per vehicle decreases due to localization of parts.

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4.71 The auditor needs to evaluate the assumptions in detail and ensure that there is a reasonable and supportable basis for the management's assumptions.

Forecast Horizon

4.72 Value in use is the net present value of the future cash flows expected to be generated from the CGU. Cash flow projections should be based on reasonable and supportable assumptions that represent management's best estimate of the range of economic conditions that will exist over the remaining useful lives of the assets or the CGU.

4.73 In the automotive industry, assessing life of the vehicle model is very complex. A model may run for 10 years and another model may not run for a complete year. Hence, the auditor needs to evaluate management assumptions in details. In India the small cars' life is generally more than that of the big cars. The projections should be based on management's most recently approved financial budgets/forecasts and should not exceed a period of five years unless a longer period can be justified. The projections beyond this point should be extrapolated using a steady or declining growth rate, unless an increasing rate can be justified. These projections should be extrapolated over the remaining useful life of the primary asset in the CGU.

4.74 The auditor needs to evaluate the assumptions in detail and ensure that there is a reasonable and supportable basis for the management's assumptions.

Capital Expenditure

4.75 Future cash flows are estimated for the CGU in its current condition. Estimates of future cash flows should not include amounts expected to arise from improving or enhancing the CGU's current performance until the Company actually incurs capital expenditure that improves or enhances an asset in excess of its originally assessed standard of performance.

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4.76 Determining whether items of capital expenditure complete, maintain or enhance the assets is often complex. Future capital expenditure necessary to maintain or sustain an asset at its originally assessed standard of performance should be included in the value in use calculation.

4.77 Most companies have significant capital expenditure programmes in place either for the newer version of the existing model or an entirely new vehicle model. Generally CGU in these cases is considered by taking together the existing model along with the improved version thereof.

4.78 The auditor has to exercise his judgement and obtain audit evidence that the determination made by management in respect of CGU is appropriate. The auditor should ensure that the Company follows a consistent policy to determine CGU's wherever impairment testing is done.

J. Leasehold Land/ Finance Lease

4.79 In the case of leasehold premises, capitalization and amortisation of lease premium, if any, should be examined.

4.80 As per AS 19 –Leases, a finance lease is a lease that transfers substantially all the risks and rewards incident to ownership of an asset.

4.81 AS 19 states that whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than its form.

4.82 Examples of situations given in AS 19, which would normally lead to a lease being classified as a finance lease are:

- the lease transfers ownership of the asset to the lessee by the end of the lease term;
- the lessee has the option to purchase the asset at a price which is expected to be sufficiently lower than the fair value at the date the option becomes exercisable such that, at the inception of the lease, it is reasonably certain that the option will be exercised;

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- the lease term is for the major part of the economic life of the asset even if title is not transferred;
- at the inception of the lease the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset; and
- the leased asset is of a specialised nature such that only the lessee can use it without major modifications being made.

4.83 Indicators of situations which individually or in combination could also lead to a lease being classified as a finance lease are:

- if the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee;
- gains or losses from the fluctuation in the fair value of the residual fall to the lessee (for example in the form of a rent rebate equalling most of the sales proceeds at the end of the lease); and
- the lessee can continue the lease for a secondary period at a rent which is substantially lower than market rent.

Lease classification is made at the inception of the lease.

4.84 Leases which do not meet any of these criteria are to be accounted for as operating leases and require no entries to the fixed asset accounts.

4.85 The assets taken on finance lease may include certain plant and machinery, IT equipments etc.

4.86 The auditor should ensure that assets capitalized as finance lease satisfy the criteria given in AS 19 and that the accounting treatment followed is as per AS 19.

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K. Product Development

4.87 In the automotive industry, there is a requirement to introduce new models frequently. Companies incur huge expenditure on product development to remain competitive. Major kinds of expenditure would include materials, labour and overhead costs, technical know-how, testing expenses, depreciation of testing equipments, inspection costs etc. incurred while developing a new product.

4.88 In the automobile industry, product development expenditure could be categorized into the following broad heads:

- Vehicle on a totally new platform-New Generation of Vehicles.
- Variant of Existing Vehicles where model is derived from an existing platform.
- Projects which are undertaken to meet the legal requirements of either emission norms or safety.
- Enhancement: Enhanced specification and styling changes/ improvements.
- Fresh look/ Face lift of vehicles with very restricted changes to the vehicle.
- Upgrade.
- Version changes with Addition / Deletion of features to existing model.

4.89 The auditor should ensure that expenses incurred under the various categories stated above are appropriately classified as either “research” or “development” in accordance with AS 26 – Intangible Assets. The auditor should also verify that there are proper internal controls in place to identify and record these expenditures appropriately. Once the particular model is developed, the cost incurred on the same during the development phase can be capitalized in accordance with AS 26. Expenditure

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on the research phase of an internal project should be recognized as an expense when it is incurred.

L. Borrowing Costs

4.90 In respect of borrowing costs, the auditor should ensure that the borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset are capitalized as part of the cost of that asset, which would generally be in respect of a new vehicle line or a new car/engine plant set up by the Company.

4.91 The auditor should ensure that the borrowing costs are capitalized as part of the cost of a qualifying asset when it is probable that they will result in future economic benefits to the Company and the costs can be measured reliably. Other borrowing costs are recognised as an expense in the period in which it is incurred.

4.92 The auditor should ensure that the borrowing costs incurred during an extended period in which the activities necessary to prepare an asset for its intended use or sale are interrupted, is not capitalized, unless such temporary delay is a necessary part of the process of getting an asset ready for its intended use or sale.

M. Physical Verification of Fixed Assets

4.93 In respect of fixed assets, the auditor should pay particular attention to the system of recording the movements as well as other controls over fixed assets, e.g., their physical verification at periodic intervals by the management and/or by internal audit team. He should also examine whether discrepancies have been properly dealt with in the books of account and adequate provision in respect of any damaged assets has been made.

4.94 The auditor should also evaluate the reasonableness of the intervals at which management or the internal audit team physically verifies the other assets.

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N. Fiscal Benefits for Investments in Fixed Assets

4.95 Some automobile companies are eligible for getting various incentives/benefits from Government agencies for setting up their manufacturing plant at a specific location. One of the conditions normally specified for such cases is a minimum prescribed amount of investments in fixed assets. The companies also need to furnish such details of fixed assets to the agencies in order to get the eligible benefits and in certain cases cannot dispose of the assets without obtaining prior permission from the Government agencies. The auditor should review such arrangements with the Government agencies and ensure that the Company complies with the conditions prescribed in the same. The auditor should also ensure that the Company maintains the details in the specified format and also corroborate the returns/other documents filed with the Government agencies in order to ensure that the same are in line with the details as per the books of account.

Illustrative Audit Procedures

Identifying and Assessing the Risk of Material misstatement

4.96 There are various approaches an auditor may use to identify risk at the assertion level for classes of transactions, account balances, and disclosures. One way might be to think about the ways a class of transactions, account balance, or disclosure might be misstated by considering “what can go wrong” for each material class of transactions, account balance, and disclosure. Another way is to consider what particular concerns one has about each assertion in addition to the risk of misstatement described by the assertion itself.

4.97 The auditor should assess each identified risk to determine whether it is a significant risk. This is intended to be a judgment decision based on the auditor’s cumulative knowledge of the entity.

4.98 When Information Technology (IT) is used to initiate, record, process, or report transactions or other financial data for inclusion in the financial statements, the systems and programs may include controls related to the corresponding assertions for material accounts or that may be critical to the effective functioning of manual controls that depend on IT. In such a scenario, the involvement of an IT specialist should be assessed.

4.99 The auditor will need to identify the risk of material misstatement in the financial statements and develop the audit plan accordingly. When the auditor has determined that a significant risk exists, the auditor will have to obtain an understanding of the entity’s controls, including control activities, relevant to that risk.

4.100 Hence, these audit procedures will vary according to the given situation.

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Material Classes of Transactions, Account Balances and Disclosures	Assertions		Illustrative Audit Procedures (these procedures will vary according to the given situation)
Fixed Assets			
		A	System update
		1	Update and document the understanding of the controls and the accounting system through a review of the system notes.
		B	Recording accuracy
	Completeness	1	Obtain/prepare a schedule of fixed assets, showing, for each major category, the amounts of cost (or other valuation) and accumulated depreciation at the beginning and end of the year, and movements during the year. Check the totals and agree the closing balances to: <ul style="list-style-type: none"> • Trial balance. • General ledger. • Balance sheet. • Opening balances to prior year financial statements. • Depreciation charge to the profit and loss account.
	Completeness	2	Agree the original cost, accumulated depreciation and written down value as on the beginning and end of the year to the fixed assets register.
	Completeness	3	Review the fixed assets register and ensure that the necessary details are recorded for each fixed asset.
		C	Review of balances

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	Valuation & Allocation, Rights & Obligations	1	<p>Review and explain movements between the current year, prior year and budgeted amounts for:</p> <ul style="list-style-type: none"> • additions and disposals by class of asset. • repair and maintenance expenses. • depreciation charges. <p>Where amounts appear excessive or inadequate based on the knowledge of the business, investigate the reasons for the same.</p>
	Valuation & Allocation	2	Review entries in respective ledger accounts for the year and investigate unusual items.
	Valuation & Allocation	3	Review the ratio of depreciation charge for each major category of fixed assets with agreed depreciation rates and with the ratio for the previous year. Investigate any significant variations.
		D	Test property balances
	Valuation & Allocation, Rights & Obligations	1	Understand the impact of significant accounting policies and compliance with applicable accounting pronouncements on property and accumulated depreciation balances.
		2	Obtain schedules of property, plant and equipment showing beginning and ending balances, purchases, sales, and other acquisitions and disposals during the current period, as well as accumulated depreciation at the beginning and end of the period. The schedules should show property by category or type of

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			asset, with the date of purchase of each significant item and, where applicable, the sales proceeds and profit or loss on a disposal.
	Completeness		<ul style="list-style-type: none"> • Test summarization of the schedule.
	Completeness		<ul style="list-style-type: none"> • Agree beginning balance to prior year working papers.
	Completeness, Valuation & Allocation, Rights & Obligations		<ul style="list-style-type: none"> • Trace totals of property and accumulated depreciation to the general ledger and fixed assets register. Trace gain or loss on disposals to the general ledger. Trace significant reconciling items, if any, to supporting documents.
	Existence	3	Obtain from the entity, a copy of the instructions of physical verification of fixed assets.
	Existence, Valuation & Allocation	4	Determine that management has verified fixed assets during the year and discrepancies noted on such verification have been properly dealt with in the books of account.
		5	Make a selection of fixed assets from the beginning cost column and the current period purchases/ acquisitions column of the schedules and perform the following:
	Existence, Rights & Obligations		<ul style="list-style-type: none"> • Physically inspect the asset, if possible, or determine by other means that the asset is owned and still in use by the entity, and that the remaining useful life appears to be reasonable

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			in relation to its condition and estimated future use.
	Valuation & Allocation, Rights & Obligations		<ul style="list-style-type: none"> Trace the recorded costs of the selected asset to supporting documents (e.g. capital expenditure approvals and vendor invoices for purchases in the current year, the prior-year working papers for assets purchased in prior years).
	Valuation & Allocation, Rights & Obligations		<ul style="list-style-type: none"> Determine that current period additions are properly approved and include no amounts of an expense nature.
			<ul style="list-style-type: none"> Determine that the current period additions include expenses incurred only up to the date of installation.
			<ul style="list-style-type: none"> If an addition replaces an asset, determine that the asset replaced was properly treated as a disposal.
		6	Make a selection of fixed assets from the current period sales/disposal column of the schedules and perform the following:
	Valuation & Allocation, Rights & Obligations		<ul style="list-style-type: none"> Examine the documents authorizing the disposal and supporting the amounts for which the selected assets were sold (e.g. cash receipts).
	Valuation & Allocation		<ul style="list-style-type: none"> Recompute the gain or loss on disposal.
	Valuation & Allocation, Completeness	7	Perform substantive analytical procedures to test property balances. Consider using the following data, as applicable,

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			to develop expectations of property balances:
			<ul style="list-style-type: none"> • Prior year property balances.
			<ul style="list-style-type: none"> • Monthly amounts of property purchases and sales, write-offs, and gain or loss on disposals.
	Completeness	8	Determine that the data used to make independent estimates is independent and reliable and if information produced by the entity is used, obtain audit evidence about the accuracy and completeness of the data.
	Accuracy	9	If the data is not independent, separately audit the data. In assessing the reliability of the data gathered, consider the source of the data and the conditions under which it was generated.
	-	10	Determine the threshold – the amount that represents the maximum difference between the expectations and the recorded year end property balances that is acceptable without further investigation.
	-	11	Compare the expectation to the recorded balance and identify any differences. For any difference, that is more than the threshold, obtain, quantify, and corroborate explanations for the difference by performing further analysis or inquiry and examining supporting documents. Explanation needs to be initially sought for the full amount of the difference, not just that part that exceeds the

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			threshold.
			We also consider investigating the following:
	Valuation & Allocation		<ul style="list-style-type: none"> Any unusual pattern in the differences.
	Valuation & Allocation		<ul style="list-style-type: none"> Whether the differences between the actual and budgeted amounts are so close that it could imply that management has manipulated either or both items. Use professional skepticism to evaluate whether the considerations give rise to any specific or pervasive risk as a result of fraud.
	Valuation & Allocation	12	Specifically, determine that the accounting policies and procedure for capitalization of assets costing below Rs.5,000 are appropriate and are applied consistently.
	Valuation & Allocation	13	Review changes in property categories during the period and consider their reasonableness in view of prior history and current information, such as increased productivity, business plans, etc.
	Valuation & Allocation	14	Determine that events have not occurred that might lead to a reduction in the period over which an asset is being written off, or, in the extreme, lead to a total write-off of an asset (e.g. changes in production rendering some assets obsolete).
	Valuation & Allocation	15	Review the repairs and maintenance expense accounts for the period and determine whether there are

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			items which should have been capitalized.
	Valuation & Allocation	16	For assets transferred from one location to another, verify that the transfers are at book value.
	Rights & Obligations	17	Verify the register of charges and identify assets on which a charge has been created.
	Valuation & Allocation	18	Obtain the information necessary to audit the cash flow statement.
		19	Evaluate results of the tests.
		E	Test Capital Work In Progress
		1	Obtain a schedule of capital work in progress and capital advances paid showing beginning and ending balances, value of purchase orders, additions during the period, capitalization during the period and projects written off during the period. The schedules should show details by capital purchase order/work order (including those where work has not commenced), with the date of purchase order, date of advance and, where applicable, the sales proceeds and profit or loss on a disposal.
	Completeness		<ul style="list-style-type: none"> • Test summarization of the schedule.
	Valuation & Allocation		<ul style="list-style-type: none"> • Agree beginning balance to prior year working papers.
	Valuation & Allocation, Completeness		<ul style="list-style-type: none"> • Trace totals of capital work in progress and capital advance to the general ledger. Trace gain or loss on disposals

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			to the general ledger. Trace significant reconciling items, if any, to supporting documents.
	Valuation & Allocation		<ul style="list-style-type: none"> Recompute capital commitments at the year-end and verify that these are net of advances paid.
		2	Make a selection of projects from the beginning column and the current period additions column of the schedules and perform the following:
	Valuation & Allocation, Rights & Obligations		<ul style="list-style-type: none"> Trace the recorded costs of material and labour to supporting documents (e.g. capital expenditure approvals and vendor invoices for purchases in the current year, the prior-year working papers for assets purchased in prior years), evidence of receipt, labour records and rates and determine that the items have been properly included as capital assets.
	Valuation & Allocation		<ul style="list-style-type: none"> Determine that current period additions are properly approved and include no amounts of an expense nature.
	Valuation & Allocation		<ul style="list-style-type: none"> Recompute overheads (including interest capitalized) and determine that these have been properly included in the project cost.
		3	Make a selection of projects from the current period adjustment column of the schedules and perform the following:

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	Valuation & Allocation		<ul style="list-style-type: none"> On abandonment of a project, recompute the gain or loss on disposal. Examine the documents authorizing the disposal and supporting the amounts for which the selected assets were sold (e.g. cash receipts).
	Valuation & Allocation	4	Inquire of any delay in completion of a project and the likelihood of the project being abandoned.
	Valuation & Allocation, Completeness	5	Verify that fixed assets in transit and considered as capital work in progress at the year-end has been subsequently received.
	Valuation & Allocation, Completeness	6	Review the general ledger for the period after the year-end and investigate for any assets sold or scrapped after the year-end. Consider the requirement of an impairment of such assets existing at the year-end.
	Valuation & Allocation	7	For a selected period before the year end, investigate for any journal entries recorded for adjustment of fixed assets. Test the appropriateness of journal entries recorded in the general ledger or subsidiary ledger and other adjustments made in the preparation of the financial statements.
	Existence	8	Prepare, or have the client prepare, standard confirmation requests for capital advances and perform the following:
			<ul style="list-style-type: none"> Mail the confirmation requests under the auditor's control, determine that the

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			requests are properly addressed (i.e. obtain audit evidence about the accuracy and completeness of addresses provided by the client) and request that all replies be sent directly to the auditor's office.
			<ul style="list-style-type: none"> • Send second requests for non-replies. Request the client to follow up, if necessary.
			<ul style="list-style-type: none"> • Compare replies to the schedule of capital advances.
	Valuation & Allocation	9	Review capital advance accounts with significant credit balances and check for any misstatements.
			<ul style="list-style-type: none"> • Inquire into any significant disputed balances. Investigate as necessary.
	Valuation & Allocation	10	Prepare a list of advances which, in your opinion, are doubtful of recovery with reasons and discuss the same with the management.
	Valuation & Allocation	11.	Examine the documents authorizing the completion of installation and commencement of commercial production.
		12	Evaluate results of the tests.
		F	Test valuation of property
	Valuation & Allocation, Rights & Obligations	1	Understand the impact of significant accounting policies and compliance with applicable accounting pronouncements on property and accumulated depreciation balances. Specifically,

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			determine that the accounting policies and procedure for calculating and recording depreciation are appropriate and are applied consistently.
	Valuation & Allocation, Completeness	2	Perform substantive analytical procedures to test depreciation expense. Consider using the following data, as applicable, to develop an expectation of depreciation expense at the year-end:
			<ul style="list-style-type: none"> Property balances during the year and in prior years, depreciation expenses in prior years, stated depreciation lives and depreciation rates.
	Valuation & Allocation, Completeness	3	If necessary, disaggregate both the data used to build the expectations and the recorded depreciation expense at a level of detail sufficient to enable us to obtain the desired level of assurance based on a comparison of amounts. Consider using the following means by disaggregation:
			<ul style="list-style-type: none"> By category or type of asset. By period. By depreciation method. By division or location.
	Completeness	4	Determine that the data used to make independent estimates is independent and reliable and if information produced by the entity is being used, obtain audit evidence about the accuracy and completeness of the data.
	Valuation & Allocation	5	If the data is not independent, separately audit the data. In

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			assessing the reliability of the data gathered, consider the source of the data and the conditions under which it was generated.
	-	6	Determine the threshold – the amount that represents the maximum difference between the expectations and the recorded amounts that is acceptable without further investigation.
	-	7	Compare the expectation to the recorded balance and identify any differences. For any difference, that is more than the threshold, obtain, quantify, and corroborate explanations for the difference by performing further analysis or inquiry and examining supporting documents. Explanation needs to be initially sought for the full amount of the difference, not just that part that exceeds the threshold.
		8	We also consider investigating the following:
	Valuation & Allocation		<ul style="list-style-type: none"> Any unusual pattern in the differences.
	Valuation & Allocation		<ul style="list-style-type: none"> Whether the differences between the actual and budgeted amounts are so close that it could imply that management has manipulated either or both items. Use professional skepticism to evaluate whether the considerations give rise to any specific or pervasive risk as a result of fraud risks.

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		9	Make a selection of fixed assets from the schedule tested in Step D.5 and D.6 above and perform test of detail for depreciation expense.
	Valuation & Allocation		<ul style="list-style-type: none"> Recompute the current period depreciation expense amount and reconcile the beginning accumulate-ed depreciation amount to the ending amount.
	Completeness		<ul style="list-style-type: none"> Test summarization of the schedule and trace ending balances of accumulated depreciation to the general ledger.
	Valuation & Allocation		<ul style="list-style-type: none"> Inquire into other significant entries recorded in the depreciation expense account. Investigate these entries and trace them to supporting documentation.
		10	Evaluate results of the tests.
		G	Gain or loss on disposal of property
	Valuation & Allocation	1	Using the schedule obtained in Step D.6 above, test related gain or loss on disposals for the current year by performing substantive procedures as noted below:
		2	Make a selection of fixed assets from a reciprocal population to test disposals for understatement. The reciprocal population to be used is the total of property, plant and equipment from the beginning cost column and the

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			current period purchases/acquisitions columns of the schedules.
	Existence, Rights & Obligations		<ul style="list-style-type: none"> Determine that the selection is a valid asset or addition, still in use and that it is not a disposal.
	Existence, Rights & Obligations		<ul style="list-style-type: none"> For each selection, physically inspect the asset, if possible, and contact the management to corroborate that the asset is still in use by the entity. Determine that the remaining useful life appears to be reasonable in relation to its condition and estimated future use.
	Completeness		<ul style="list-style-type: none"> For the step above, inquire as to whether or not the individual is aware of any other disposals during the period under audit. If so, corroborate that the disposal is noted in the schedule obtained in Step D.6 above.
	Completeness	3	Make a selection of fixed assets from a reciprocal population to test the gain on disposal for understatement. The reciprocal population to be used should be total disposals noted on the schedule obtained in Step D.6 above.
			<ul style="list-style-type: none"> Verify that the disposal was accurately recorded in the proper period.
		4	Evaluate results of the tests. Also evaluate whether losses on disposal indicate an inadequate depreciation charge or the fact that certain

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			other assets within the class may be impaired.
		H	Roll forward test for property tested prior to year end
	Valuation & Allocation, Completeness	1	Inquire, and consider any other evidence that comes to our attention, as to any significant acquisitions or disposals in the intervening period from the interim testing date to the balance sheet date. Test any such acquisitions or disposals as in Step D.5 and D.6.
		2	Test transactions during the intervening period between the interim testing date and year end.
	Completeness		<ul style="list-style-type: none"> Obtain a reconciliation of the interim property balance to the year-end balance.
	Completeness		<ul style="list-style-type: none"> Agree purchases totals to purchases or cash disbursements journals.
	Completeness		<ul style="list-style-type: none"> Agree sales totals to sales or cash receipt journals.
	Valuation & Allocation, Rights & Obligations		<ul style="list-style-type: none"> Examine supporting documents to verify other significant entries.
	Valuation & Allocation		<ul style="list-style-type: none"> Ensure compliance with section 293 of the Companies Act in case of sale of an undertaking.
		2	Make a selection of property purchases or other acquisitions in the intervening period between the interim testing date and year-end.
	Valuation &		<ul style="list-style-type: none"> Trace to supporting

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	Allocation, Rights & Obligations		documents (e.g. capital expenditure approvals and vendor invoices).
	Valuation & Allocation		<ul style="list-style-type: none"> Determine that amounts of an expense nature are not included.
	Valuation & Allocation		<ul style="list-style-type: none"> If an addition replaces an asset, determine that the asset replaced is properly treated as a disposal.
		3	Make a selection of property sales or other disposals in the intervening period between the interim testing date and year end.
	Valuation & Allocation, Rights & Obligations		<ul style="list-style-type: none"> Examine documents authorizing the disposal and supporting the amounts for which the selected assets were sold.
	Valuation & Allocation		<ul style="list-style-type: none"> Recompute the gain or loss on disposal.
	Valuation & Allocation, Completeness	4	Perform substantive analytical procedures to test property balances at year end. Consider using the following data, as applicable, to develop expectations of property balances at year end:
			<ul style="list-style-type: none"> Prior-period property balances; monthly amounts of property purchases and sales, write offs, and gain or loss on disposals, in the intervening period from the interim testing to the balance sheet date, compared to such monthly amounts in prior years and in the current year prior to the interim

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			testing date.
		5	Determine that the data used to make independent estimates is independent and reliable and if information produced by the entity is being used, obtain audit evidence about the accuracy and completeness of the data.
	Valuation & Allocation	6	If the data is not independent, separately audit the data. In assessing the reliability of the data gathered, consider the source of the data and the conditions under which it was generated.
	-	7	Determine the threshold – the amount that represents the maximum difference between the expectations and the recorded year-end property balances that is acceptable without further investigation.
	-	8	Compare the expectation to the recorded balance and identify any differences. For any difference, irrespective of the direction of the primary test, that is more than the threshold, obtain, quantify, and corroborate explanations for the difference by performing further analysis or inquiry and examining supporting documents. Explanation needs to be initially sought for the full amount of the difference, not just that part that exceeds the threshold.
		9	We also consider investigating the following:
	Valuation & Allocation		<ul style="list-style-type: none"> Any unusual pattern in the differences.

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	Valuation & Allocation		<ul style="list-style-type: none"> Whether the differences between the actual and budgeted amounts are so close that it could imply that management has manipulated either or both items. Use professional skepticism to evaluate whether the considerations give rise to any specific or pervasive risk as a result of fraud.
		10	Evaluate results of the tests.
		I	Test Intangible Assets (Other than Goodwill)
		1	Obtain schedules of patents, copyrights, and other intangible assets, showing beginning and ending balances and acquisitions and disposals during the current period, as well as amounts written off during the period. The schedules also need to show a description of each asset, the date of acquisition, the useful life (if applicable), and the sales proceeds and profit or loss on a disposal (if applicable).
	Completeness		<ul style="list-style-type: none"> Test summarization of the schedule.
	Completeness		<ul style="list-style-type: none"> Trace year-end asset totals to the appropriate balance sheet account in the general ledger and charges for the year (i.e. amortization and/or impairment charges) to the appropriate income statement account in the general ledger.
	Valuation & Allocation		<ul style="list-style-type: none"> Verify that costs that should have been

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			expensed in current or past periods are not being carried forward.
	Valuation & Allocation		<ul style="list-style-type: none"> Verify that costs of internally developing, maintaining, or restoring intangible assets that are not specifically identifiable, or are inherent in a continuing business related to the entity as a whole have been expensed as incurred.
		2	Make a selection of intangible assets from the beginning cost column and the current year acquisitions column of the schedules.
	Valuation & Allocation, Rights & Obligations		<ul style="list-style-type: none"> For intangible assets not acquired in the current year, trace the recorded value of the selected intangible assets to supporting documents (e.g. our prior year working papers for intangible assets acquired in prior years).
	Valuation & Allocation		<ul style="list-style-type: none"> For intangible assets that were acquired individually or with a group of other assets in the current year (other than those acquired in a business combination), verify that intangible assets were recognized and measured at cost.
	Valuation & Allocation		<ul style="list-style-type: none"> Verify that selected intangible assets have not been written down and/or written off unless they became impaired.

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	Valuation & Allocation, Rights & Obligations		<ul style="list-style-type: none"> Trace additions to the appropriate authorizations or board minutes.
	Valuation & Allocation, Rights & Obligations		<ul style="list-style-type: none"> Trace additions to independent supporting evidence (e.g. copies of wireless licenses), if applicable.
		3	For those intangible assets selected in Step 2 that were disposed of during the current period:
	Valuation & Allocation, Rights & Obligations		<ul style="list-style-type: none"> Examine documents supporting the amounts for which the selected intangible assets were disposed (e.g. cash receipts).
	Valuation & Allocation		<ul style="list-style-type: none"> Recompute the gain or loss on sale.
		4	Evaluate results of the tests.
		J	Test valuation of Intangible Assets (Other than Goodwill)
	Valuation & Allocation, Rights & Obligations	1	Determine that the accounting policies and methods for intangible assets are appropriate and are applied consistently. Understand the impact of significant accounting policies and compliance with applicable accounting pronouncements on valuation of intangible assets.
	Valuation & Allocation, Rights & Obligations	2	Determine that intangible assets are being amortized over their useful lives (i.e. the period over which the asset is expected to contribute directly or indirectly to the future cash flows of the entity). If the

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			useful life exceeds 10 years, ensure that it is tested for impairment at the balance sheet date even if there is no indication of impairment. (Such testing is required for intangible assets not yet available for use also).
		3	Make a selection of the intangible assets tested in Step J.2, and perform tests of details for amortization expense.
	Valuation & Allocation		<ul style="list-style-type: none"> The method of amortization should reflect the pattern in which the economic benefits of the intangible assets are consumed or otherwise used up. If that pattern cannot be reliably determined, a straight line amortization method should be used.
	Valuation & Allocation	4	Verify that the useful life of each intangible asset that is being amortized has been evaluated at each reporting date to determine whether events and circumstances warrant a revision to the remaining period of amortization.
			<ul style="list-style-type: none"> If the intangible asset's remaining useful life has changed, determine that the remaining carrying amount is being amortized prospectively over the revised remaining useful life.
		5	Evaluate results of the tests.
		K	Test capital (finance) leases where entity is a lessee

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		1	Obtain schedules of capital (finance) leases where entity is a lessee showing beginning and ending balances and lease additions and terminations during the current period and perform the following:
	Completeness		<ul style="list-style-type: none"> • Test summarization of the schedule.
	Completeness		<ul style="list-style-type: none"> • Trace ending balances to the general ledger.
	Valuation & Allocation, Rights & Obligations		<ul style="list-style-type: none"> • Trace details to agreements.
	Valuation & Allocation		<ul style="list-style-type: none"> • Determine the propriety of capitalization for items included.
	Valuation & Allocation		<ul style="list-style-type: none"> • Determine the propriety of the depreciation methods used.
		2	Make a selection of items from the beginning balances and current period additions column of the schedule.
	Existence		<ul style="list-style-type: none"> • Physically inspect the asset, if possible, or determine that the asset exists and is in use by the entity.
	Valuation & Allocation, Rights & Obligations		<ul style="list-style-type: none"> • Trace the minimum lease payments and the period of the lease to supporting documents (e.g. lease agreements).
	Valuation & Allocation		<ul style="list-style-type: none"> • Recompute the net present value and interest amount expensed during the current period.

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	Valuation & Allocation		<ul style="list-style-type: none"> Recompute current period depreciation expense.
	Existence, Valuation & Allocation	3	Prepare, or have the entity prepare, confirmation requests for all leases at Step K.1. On the confirmation, consider including outstanding balance, installments paid, rate of interest and interest expenses.
			<ul style="list-style-type: none"> Mail the confirmation requests under the auditor's control, determine that the requests are properly addressed (i.e. obtain audit evidence about the accuracy and completeness of addresses provided by the entity) and request that all replies be sent directly to the auditor's office.
			<ul style="list-style-type: none"> Send second request for non-replies. Request the entity to follow up, if necessary.
			<ul style="list-style-type: none"> Compare replies to requests. Prepare, or have the entity prepare, reconciliation of exceptions. Trace reconciling items to supporting documents (e.g. lease agreements, bank statements) and determine that the asset, liability and interest expenses have been properly recorded.
			<ul style="list-style-type: none"> Trace non-replies to subsequent cash payments.

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			<ul style="list-style-type: none"> Inquire into any significant disputed balances. Investigate as necessary
	Completeness	4	Make inquiries of management, and consider whether evidence obtained from other audit procedures indicates the existence of additional leases.
	Valuation & Allocation	5	For those assets selected in Step K.2 that were no longer leased at the year end, determine that the lease termination was authorized and was recorded properly.
		6	Evaluate results of the tests.
		L	Test capital (finance) leases where entity is a lessor
		1	Obtain schedules of capital (finance) leases where entity is a lessor showing beginning and ending balances and lease additions and terminations during the current period and perform the following:
	Completeness		<ul style="list-style-type: none"> Test summarization of the schedule.
	Completeness, Valuation & Allocation		<ul style="list-style-type: none"> Trace the lease income to the general ledger and cash receipt records.
	Completeness	2	Make inquiries of management, and consider whether evidence obtained from other audit procedures indicates the existence of additional leases.
		3	Make a selection of items from the beginning balances and current period additions column of the schedule.
	Valuation &		<ul style="list-style-type: none"> Trace the minimum lease

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	Allocation, Rights & Obligations		payments and the period of the lease to supporting documents (e.g. lease agreements).
	Valuation & Allocation		<ul style="list-style-type: none"> Recompute the net present value and interest income during the current period.
	Valuation & Allocation		<ul style="list-style-type: none"> Recompute current period depreciation expense.
	Completeness	4	Obtain the schedule of unearned income and test the reconciliation of opening and closing balances as well as movements of the period to the general ledger.
	Existence, Valuation & Allocation	5	Prepare, or have the entity prepare, confirmation requests for all leases at Step L.1. On the confirmation, consider including outstanding balance, installments received, rate of interest and interest received.
			<ul style="list-style-type: none"> Mail the confirmation requests under the auditor's control, determine that the requests are properly addressed (i.e. obtain audit evidence about the accuracy and completeness of addresses provided by the entity) and request that all replies be sent directly to the auditor's office.
			<ul style="list-style-type: none"> Send second request for non-replies. Request the entity to follow up, if necessary.
			<ul style="list-style-type: none"> Compare replies to requests. Prepare, or

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			have the entity prepare, reconciliation of exceptions. Trace reconciling items to supporting documents (e.g. lease agreements, bank statements) and determine that the asset, liability and interest expenses have been properly recorded.
			<ul style="list-style-type: none"> Trace non-replies to subsequent cash payments.
			<ul style="list-style-type: none"> Inquire into any significant disputed balances. Investigate as necessary.
		6	Evaluate results of the tests.
		M	Test presentation of property balances and intangible balances
	Classification & Understand-ability, Accuracy & Valuation	1	Understand the impact of significant accounting policies and compliance with applicable accounting pronouncements on presentation of fixed assets.
	Classification & Understand-ability, Accuracy & Valuation, Occurrence & rights and obligations	2	<p>Determine that amounts presented as fixed assets are properly recorded, classified and/or disclosed as required by Schedule VI of the Companies Act:</p> <ul style="list-style-type: none"> Heads of assets as specified. Under each head, original cost, additions, deduction, accumulated depreciation. Where assets have been revalued: <ul style="list-style-type: none"> * each balance sheet should show the increased/ reduced

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			<p>figures with the date of revaluation.</p> <p>* each balance sheet for first five years should show the amount of increase/decrease made.</p> <ul style="list-style-type: none"> • Estimated amount of contracts remaining to be executed on capital account and not provided for. • Net book value of assets on hire purchase. • Fixed assets acquired on lease not included in schedule of fixed assets. • Future obligations in respect of leased assets. • General description of depreciation methods for major classes of property. • Total amount of depreciation charged to expense. • Property mortgaged and encumbered by indebtedness.
	Classification & Understandability, Accuracy & Valuation,	3	Determine that the following items have been properly presented in the financial statements:
			<ul style="list-style-type: none"> • All intangible assets have been aggregated and presented as a separate line item in the statement of financial position. However, that requirement does not preclude presentation of individual intangible assets as separate line

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			items.
			<ul style="list-style-type: none"> The amortization expense and impairment losses for intangible assets are presented in income statement line items within continuing operations.
	Classification & Understandability, Accuracy & Valuation,	4	Determine that the following disclosures, if applicable, have been made:
			<ul style="list-style-type: none"> Balances of significant intangible assets segregated by type. General description of amortization methods for major classes of intangible assets.
		N	Conclusion
	-	1	Document the results of the audit procedures performed, the significant points considered in arriving at the conclusion, and a brief statement of the conclusion itself.
	-	2	<p>Consider including the following when documenting the conclusion:</p> <ul style="list-style-type: none"> A description of the risks associated with the account balance and how these risks were addressed in the substantive testing. The relevant potential errors and control objectives for each account balance or disclosure being tested. The substantive

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			<p>procedures performed or a cross-reference to where the substantive procedures are performed, including identification of both direct and indirect tests for the related potential errors.</p> <ul style="list-style-type: none">• The results of the substantive tests, including misstatements identified, and how such results support the conclusion on the potential errors for each account balance or disclosure.• The tests of controls we performed or a cross reference to where the tests of controls performed are documented.• The results of the tests of controls, including deficiencies identified, and how such results support the conclusion as to whether we have obtained control reliance for the potential errors for each account balance or disclosure.
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Chapter 5

Inventories

Definition of Inventories

5.1 Inventories are defined as assets:

- a) held for sale in the ordinary course of business;
- b) in the process of production for such sale; or
- c) in the form of materials or supplies to be consumed in the production process or in the rendering of services.

5.2 While auditing inventories, the auditor should keep in mind the general rule for deciding whether an item should be treated as inventory or not, which is basically to determine the purpose for which the entity is using the item. If the purpose is any of the three alternatives mentioned above, the item should be treated as inventory. Particular care is required in the case of moulds, the treatment of which can vary according to the arrangement with the supplier. For instance, where the mould belonging to the supplier of an original car manufacturer is used for the manufacture and supply of components, it is capitalized in the books of the supplier. However where, the supplier manufactures and sells the mould to the original car manufacturer, but retains possession on behalf of the original car manufacturer so as to manufacture and supply components, the mould is treated as inventory by the supplier till it is sold to the original car manufacturer at which time the original car manufacturer will capitalize the same in their books. The auditor should ensure that all arrangements in this respect are checked with correspondences and agreements in this respect.

Specific Items

5.3 This section deals with some specific items which are important in relation to the automotive industry.

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- 1) **Consumable supplies:** Consumable supplies are divided into two major parts:
 - a) ***Production supplies:*** Production supplies are used in the production process- they are also known as indirect materials. Production supplies may consist of, fuel, gas, propellants, oil, grease and grinding materials, supplies used in the commercial area such as in the workshop of a dealer, etc. The auditor should ensure that production supplies should be treated as inventories unless they are of insignificant value, in which case they should be expensed off immediately. The auditor should ensure that there are adequate internal controls and procedures in respect of the procurement of these items and proper records are kept for these inventories.
 - b) ***Other supplies:*** Other supplies are used for product development, product instructions, printed matter and other office supplies. They are immediately expensed off at the time of acquisition. However, supplies purchased and held in larger quantities for commercial and service activities, should be treated as inventories.
- 2) **Produced vehicles:** Vehicles produced by the entity are divided into following categories:
 - a) ***Vehicles to be used for product development:*** These vehicles are manufactured to support or improve the production activity and they are not manufactured for permanent use and therefore the auditor should ensure that they should not be considered as fixed assets and should be considered as a part of inventory. These should be charged off to expenses when the product is disposed or scrapped.

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- b) ***Vehicles for demonstration and public relations activities:*** The auditor should ensure that these vehicles are treated as inventory instead of fixed assets.

5.4 Following are examples of items which the auditor should ensure are not treated as inventories

- Standby equipment and replacement parts which can be used only in connection with an item of machinery and equipment and whose use is expected to be irregular are classified as fixed assets and accounted for accordingly. Minor replacement parts are expensed off on acquisition.
- Type-bound tools are not treated as inventories and form part of fixed assets.
- Leased vehicles are not treated as part of inventory.

Inventories Classification

5.5 In the automotive industry, inventories are classified under following category:

- 1) Production inventory,
- 2) Finished goods, and
- 3) Inventory (components) held for service and maintenance contracts.

A. Production Inventory

5.6 Inventories that are not classified as finished goods or components for service and maintenance contracts are classified as production inventories. Examples:

- Raw materials,
- Production materials,
- Consumable supplies,
- Work in progress.

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B. Finished Goods

5.7 Finished goods are inventories ready to be sold to the customers. While auditing for inventory, it should be taken care that these have been distinguished from work in progress. A certain item (e.g. an engine) can be treated as finished goods in the financials of one Company and work in progress in the financials of another Company. Finished goods are accounted for as inventories till the time they are sold to the customers and revenue is recognized.

C. Inventory (Components) Held for Service and Maintenance Contracts

5.8 Automobile manufacturers are required to keep inventory of components for service and maintenance purposes for specified period of time as mandated by regulatory authorities from time to time for each model. For instance, a particular model may be withdrawn from production and distribution. However, to ensure that the users who have purchased these models in past years can get these models repaired/ serviced in the future, automobile companies need to carry these inventories. The auditor should ensure that there is a proper system of technical evaluation to ensure proper valuation of such inventories at each reporting date.

D. Goods in Transit/Goods on Consignment

5.9 Goods-in-transit are the goods that have not yet arrived at the premises of the receiver but for which the supplier has fulfilled all the delivery obligations.

5.10 Goods on consignment are goods delivered to an external party who holds them on behalf of the delivering Company.

5.11 In the automotive industry, goods-in-transit and goods on consignment form a very significant part. The auditor should ensure that goods-in-transit are shown as inventory of the receiver entity and goods on consignment shown as inventory of the delivering entity.

Valuation of Inventories

5.12 Valuation of inventory in the automotive industry is carried out as per AS-2 Valuation of Inventories.

5.13 A detailed list of the types of costs to be included in the valuation of inventory in the automotive industry is stated in the box below.

Relevant types of costs to be included in the inventory value

The following list contains the types of costs that are relevant for inclusion in the value of finished goods.

1. Purchased materials

- Net purchase price.
- Import duties.
- Non-recoverable purchase taxes.
- Freight, packing and handling costs.
- Cost of tools and equipment entrusted to suppliers or subcontractors.
- Rejections and reworks.
- Operating expenses of the purchasing, procurement, incoming goods and quality control functions.

2. Production charges

- Direct manufacturing labor (wages, social charges and other personnel expenses) including direct temporary labor.
- Indirect manufacturing labor.
- Subcontracted production.
- Energy and water.
- Consumables.
- Maintenance of factory buildings, machinery and equipment.
- Historical cost depreciation of factory buildings, machinery and equipment.

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- Patents and royalties.
- Insurance premiums on production related equipment.
- Indirect taxes.
- Data processing relating to production activities.
- Cleaning, security and other services.
- Internal transport.

Valuation of Raw Materials

5.14 The auditor should ensure that raw materials are accounted for on the basis of actual cost incurred by the Company for purchase of the raw materials including the incidental costs such as rates and taxes, freight etc. There should not be any loading of indirect expenditure like salary cost or other overheads of the purchasing department in the cost of raw materials.

Valuation of Semi- Finished Goods and Finished Goods

5.15 In the automobile industry, cost of finished and semi-finished goods is calculated on the basis of Bill of Material (BOM) which is prepared for each product. At the time of checking the inventory valuation of finished goods, the auditor should ensure that all the items used for the production of goods are included with correct quantity in BOM and the BOM is valued on the basis of actual cost incurred by the entity instead of standard cost (used for the purpose of MIS). Standard cost may be used only if the results approximate the actual cost. In addition to that, as stated in AS-2, other variable and fixed overheads should also be allocated on semi-finished goods and finished goods on the basis of actual cost. The auditor should analyze the variances between the standard cost and actual costs incurred and obtain reasons for such variances from the management to ensure that there are no abnormal wastages/ pilferages. In case of abnormal wastages, the auditor should ensure that these are charged off to the statement of profit and loss and not inventorized.

5.16 In case of overheads where standard costing is used, variances between standards set and actual costs incurred are calculated and loaded on to closing stock of inventory.

General Description and Rules

5.17 If the net realizable value is lower than the historical cost, the auditor should ensure that the carrying value of such inventories have been written down to the net realizable value. In case where the net realizable value of finished goods is lower than cost, write down may be required for materials and other supplies held for use in production.

5.18 The carrying value of inventories can be written down because of physical or economic factors. They are listed as follows:

- When the product has been damaged or measures are needed to be taken for some reason to rectify the product before its use or sale.
- When the product is outdated or over-stocked.
- When the estimated net sales value does not cover already incurred and future costs related to the sales.

5.19 The write-down should be made as soon as the risk is observed or there are reasonable grounds to suppose that it exists. For products intended to be scrapped, a 100% provision should be made. The historical cost is retained in the accounts until the products have been physically scrapped or disposed off. All changes in the provision for diminution in the value of inventory are included in the statement of profit and loss. The auditors should ensure that the Company has a proper system to evaluate and identify non-moving/ slow moving items like stock of outdated models. Adequacy of provisions for such items made in the books of account should also be verified.

Inventory Control

Inventory Record and General Ledger

5.20 The auditor should check whether the entity has maintained proper inventory records of both quantities and cost.

5.21 While these records need not necessarily be maintained in the accounting department, under no circumstances should they

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be the responsibility of or in the custody of persons having access to or control over inventories, (i.e. purchasing, production, warehousing, incoming goods or shipping).

5.22 Where amounts are significant, separate sets of perpetually-updated inventory records, supported by ledger control accounts, should be maintained as follows:

- Raw materials.
- Production materials.
- Consumable supplies.
- Work in progress.
- Finished goods.
- Parts.
- New vehicles.
- Used vehicles.
- Inventory (components) held for service and maintenance contracts.
- Goods on consignment.

5.23 It is permissible to perpetually update records for work in progress and inventory (components) held for service and maintenance contracts, provided procedures exist for:

- Constant monitoring of the value of such inventory in relationship to factory loading,
- Assignment to a particular job, lot or department of each item of material, labour, overheads and additional costs where this is warranted,
- Constant controlling of work in progress by prompt close out and costing of completed jobs.

5.24 Balances of perpetual inventory records should be reconciled with the general ledger control accounts regularly.

Physical Stock Taking

5.25 As the inventory in the automotive industry is prone to theft or damage, adequate safeguards should exist to protect the

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inventory against theft, fire and other risks. A physical stock taking should be carried out at regular intervals by people independent of stock handling and recording in order to substantiate the accuracy of perpetual inventory records. This can take the form of a complete physical count at one time, or cyclical counts during the year, or even a statistical count where appropriate conditions exist to allow this.

5.26 All arrangements for physical stock taking should be reviewed by the external auditors to ensure the acceptability of the physical inventory results. The general ledger value should be adjusted immediately to reflect the result of the stock-taking.

5.27 Analyses of perpetual inventory should be performed regularly to identify obsolete, aged and excess goods. Physical stock taking should also be conducted in a manner that could identify damaged goods, so that these goods may be realistically valued and, where appropriate, steps can be taken for their disposal.

Verification of Inventory Consumption

5.28 Generally in the automotive industry, products have a specific bill of material (BOM) and consumption should not vary significantly as compared to the BOM. Consumption of raw materials or finished goods is verified by the auditor by comparing the consumption with that stated in the BOM specified for the product. The auditor should document all the variances observed, if any, in respect of any of the models and should discuss these variances with appropriate level of management.

Inventories with Third Parties

5.29 The auditor should ensure that the entity maintains proper records in respect of all its inventories lying with the job worker or third parties for processing. It should be ensured that for each reporting period, confirmations are received from each of such parties and they are valued properly. The auditor should verify that there is proper physical verification of these inventories conducted by the Company at regular intervals. The auditor should ensure that there is a proper system of monitoring wastages,

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obsolescence and slow moving items. This is a very important area in the automotive industry because a number of components are fabricated at third party premises and there is considerable movement of materials. The auditor should look into the agreement with these third parties and look into various aspects such as quantum of wastage allowed, quantitative reconciliation, input-output ratio used by such third parties in arriving at the wastages, excise records etc.

5.30 In case, these job workers happen to be related parties, the auditor's extent of checking may increase, considering the control environment of the entity.

5.31 Further, the auditor should also reconcile the movement in materials with the excise records and ensure compliance with all the excise rules.

Accounting for Scrap

5.32 Scrap is an important component in the manufacture of vehicles/automobile components. The scrap generation and the process in place surrounding the monitoring of such scrap is an important factor in establishing the internal controls operating in the inventory business cycle. The auditor needs to obtain a clear understand of the type and nature of scrap generated by the automobile companies and use the same in devising audit procedures for testing inventory. In particular, the auditor may consider the following:

- analyses the source, nature and extent of scrap generated during each month.
- obtain reasons for the significant variations in the scrap generated each month and corroborate the reasons with the variations in the consumption of the related source materials, the relevant input output ratios, the work in progress as at the end of the month and the finished goods manufactured during the month.
- check the excise records/production records to confirm the nature and extent of scrap generated.

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- analyses the process followed by the Company for the sale of scrap and the approval mechanisms in place.
- depending on the nature, extent and value of scrap generated and the sales pattern, consider the need for treating unsold scrap generated as inventory as at the balance sheet date.

5.33 Where such scrap is treated as inventory, valuation should normally be after taking into account the realizable value of such scrap. The auditor needs to verify the past sales pattern to ensure that the valuation is appropriate.

Accounting for Price Revisions

5.34 The main raw materials involved in the automobile industry are subject to periodical price revisions from the suppliers. The auditor should have periodical discussions with the client personnel to understand the process of such price revisions and make sure that such revisions are appropriately dealt with in the books of account of the Company. The auditor also needs to make sure that the impact on account of such price revision on the inventory balances are duly given taking into account the period for which the price revisions are given effect to.

Illustrative Audit Procedures

Identifying and Assessing the Risk of Material Misstatement

5.35 There are various approaches an auditor may use to identify risk at the assertion level for classes of transactions, account balances, and disclosures. One way might be to think about the ways a class of transactions, account balance, or disclosure might be misstated by considering “what can go wrong” for each material class of transactions, account balance, and disclosure. Another way is to consider what particular concerns one has about each assertion in addition to the risk of misstatement described by the assertion itself.

5.36 The auditor should assess each identified risk to determine whether it is a significant risk. This is intended to be a judgment decision based on the auditor’s cumulative knowledge of the entity.

5.37 When Information Technology (IT) is used to initiate, record, process, or report transactions or other financial data for inclusion in the financial statements, the systems and programs may include controls related to the corresponding assertions for material accounts or that may be critical to the effective functioning of manual controls that depend on IT. In such a scenario, the involvement of an IT specialist should be assessed.

5.38 The auditor will need to identify the risk of material misstatement in the financial statements and develop the audit plan accordingly. When the auditor has determined that a significant risk exists, the auditor will have to obtain an understanding of the entity’s controls, including control activities, relevant to that risk.

5.39 Hence, these audit procedures will vary according to the given situation.

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Inventory

Material Classes of Transactions, Account Balances and Disclosures	Assertions		Audit Procedures
Inventory		A	System update
			Update and document the understanding of the controls and the accounting system through a review of the system notes in the planning section.
		B	Recording accuracy
	Existence	1	Obtain a schedule of inventories and the detailed priced stock ledger.
	Completeness	2	Check the totals of the stock ledger and the schedule.
	Completeness	3	Trace amounts in the - schedule to the stock ledger and agree the totals to the general ledger, trial balance and the balance sheet.
		C	Review of balance
	Valuation & Allocation, Rights & Obligations, Completeness, Existence	1	<p>Review and explain movements between current year, prior year and budgeted amounts for year-end stocks segregated by type and, if possible, further broken down by product lines and/or location as follows:</p> <ul style="list-style-type: none"> • Amounts as a percentage of total. • Finished goods in

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			<p>terms of number of months cost of sales.</p> <ul style="list-style-type: none"> • Raw materials in terms of number of months usage. • Inventory aging .
		D	Observe and Test Count Inventories
		1	Prior to and/or on the date at which physical inventories will be observed:
	Existence		<ul style="list-style-type: none"> • Obtain from the entity, a copy of the instructions of physical verification of inventories.
	Existence, Rights & Obligations		<ul style="list-style-type: none"> • Determine the location of significant inventories and discuss the timing and method of inventory verification (e.g. physical count, reliance on perpetual records, confirmation with third parties etc.) with the entity. Assess the adequacy of the methods to be used. If there are multiple locations, determine those at which inventories will be observed and test counts performed. If some of the locations are to be attended by other offices, ensure that adequate instructions have been mailed to these offices.
	Existence		<ul style="list-style-type: none"> • Determine that

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			management has verified inventories at reasonable periods and whether any significant discrepancies have been noted on such verification.
		2	On the date of physical verification, perform test counts of inventories and:
	Existence, Rights & Obligations		<ul style="list-style-type: none"> Make a selection of items from the entity's count records (e.g. perpetual records, count tags) and perform test counts. Resolve discrepancies promptly based on supporting documents and/or recounts of the items, and note the disposition of such discrepancies.
	Rights & Obligations, Existence		<ul style="list-style-type: none"> Make a selection of items from the entity's stock records and perform test counts. Resolve discrepancies promptly based on supporting documents and/or recounts of the items, and note the disposition of such discrepancies.
	Rights & Obligations, Existence		<ul style="list-style-type: none"> Determine that the count records contain sufficient details to enable us to subsequently trace to final inventory sheets.

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	Rights & Obligations, Existence Completeness		<ul style="list-style-type: none"> Make a selection of items from the count sheets and trace quantities to stock records and vice versa.
	Rights & Obligations, Existence Completeness		<ul style="list-style-type: none"> Make a selection of inventory items from the floor and trace quantities to the entity's count records.
	Rights & Obligations, Existence		<ul style="list-style-type: none"> Determine that work in progress relate to current jobs.
		3	If it is not practicable to observe inventories owned by the entity but held by others, consider whether alternative audit procedures provide sufficient appropriate audit evidence of the existence and condition to conclude that no reference needs to be made in the audit report to a scope limitation.
	Rights & Obligations, Existence		<ul style="list-style-type: none"> Prepare, or have the entity prepare, confirmation requests. The requests should ask for confirmation of quantities held, the condition of the inventories, and whether they are free from lien or charge.
	Rights & Obligations, Existence		<ul style="list-style-type: none"> Mail the confirmation requests under the auditor's control, determine that the requests are properly addressed (i.e. obtain audit evidence about the accuracy and

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			completeness of addresses provided by the entity) and request that all replies be sent directly to the auditor's office.
		4	If inventories in the hands of public warehouses or other outside custodians represent a significant proportion of current or total assets, obtain reasonable assurance with respect to their existence by applying one or more of the following audit procedures as considered necessary in the circumstances:
	Rights & Obligations, Existence		<ul style="list-style-type: none"> Obtain an independent accountant's report on the warehouseman's control procedures relevant to custody of goods or apply alternative procedures at the warehouse to gain reasonable assurance that information received from the warehouseman is reliable.
	Rights & Obligations, Existence		<ul style="list-style-type: none"> Observe physical counts of the goods, if practicable and reasonable.
	Rights & Obligations, Existence		<ul style="list-style-type: none"> If warehouse receipts were pledged as collateral, confirm with lenders pertinent details of the pledged receipts (on a test

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			basis, if appropriate).
	Rights & Obligations	5	On the date of physical observation, ascertain that items not owned by the entity (e.g. stock on consignment from suppliers) are identified and excluded from the count of entity-owned inventories. Perform test counts, and obtain independent confirmation of significant items.
	Rights & Obligations, Existence	6	If unable to attend the physical inventory count on the date planned due to unforeseen circumstances, take or observe some physical counts on an alternate date and if, necessary perform audit procedures on intervening transactions (see Steps 7 through 13).
		7	On the date of physical inventory verification observation, tour the entity's facilities and based on inquiry and observation, note the following:
	Rights & Obligations, Existence, Completeness		<ul style="list-style-type: none"> Whether the inventory is arranged in an orderly manner to facilitate an accurate count.
	Existence, Valuation & Allocation		<ul style="list-style-type: none"> The existence of any defective, obsolete, or unsaleable items.
	Rights & Obligations, Existence		<ul style="list-style-type: none"> The treatment of inventory at or near the shipping and receiving areas, as well as inventories

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			held but not owned, or any other inventories for which ownership is in question.
	Completeness	8	Determine that all items have been counted by the entity and have been tagged or listed on count sheets.
	Completeness, Existence	9	<p>Determine that appropriate procedures were performed to prevent double counting or not counting any inventory and to resolve any count discrepancies.</p> <ul style="list-style-type: none"> Obtain a list of goods sold but not despatched. Ensure that this is excluded from the inventory to be valued as at the period end. Ensure that machinery spares already capitalized are not included again in inventory.
	-	10	Obtain a record of inventory count documents used and unused.
	Valuation & Allocation	11	Determine that the entity has maintained proper records of its inventories and discrepancies noted between the physical stocks and the book stocks have been properly dealt with in the books of account.
		12	On the date of observation, obtain copies or note the details of the

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			following documents, and determine whether the items included in them were excluded from or included in the physical count:
	Completeness, Rights & Obligations,		<ul style="list-style-type: none"> The latest receiving documents (for purchases and sales returns) prepared before the count.
	Completeness, Rights & Obligations,		<ul style="list-style-type: none"> The latest shipping documents (for sales and purchase returns) prepared before the count.
	Completeness, Rights & Obligations,		<ul style="list-style-type: none"> If available, the first receiving and/or shipping documents prepared after the count.
		13	Evaluate results of the tests.
		E	Test book to physical adjustments
	Existence, Rights & Obligations Completeness	1	If the entity does not perform an annual physical count of each item of inventory, perform procedures to confirm that the entity's procedures or methods are sufficiently reliable to produce results substantially the same as those which would be obtained by a count of all items each year.
	Valuation & Allocation	2	Review book to physical adjustments made as a result of either a complete physical count at an interim date or cycle counts.

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	Valuation & Allocation	3	Consider the nature and amounts of the adjustments, and management's explanation for significant adjustments. If cycle counts were used:
	Existence, Rights & Obligations Completeness		<ul style="list-style-type: none"> Assess the adequacy of management's policies concerning the frequency and scope of cycle counts. Determine that the frequency and the scope of the cycle counts were in accordance with management's stated policies.
	Existence, Rights & Obligations Completeness		<ul style="list-style-type: none"> Assess whether there is a basis for relying on the perpetual records at year end.
	Existence, Rights & Obligations Completeness Valuation & Allocation	4	If there are no perpetual records or such records are not reconciled to the general ledger, and if the cost of inventories at year end is determined based on a 'roll-forward' of purchase and cost of sales transactions since the interim adjustments to physical, assess the reasonableness of management's methods for computing costs of sales in the intervening period from the interim count date to year end.
	Existence, Rights & Obligations, Completeness, Valuation &	5	If the magnitude and trend of book to physical adjustments indicate that there is a specific significant risk that year end balances in inventory

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	Allocation		accounts will be misstated unless a physical inventory is taken on or near the balance sheet date, then either:
			<ul style="list-style-type: none"> Discuss with management the need for a year-end inventory count; or
			<ul style="list-style-type: none"> If reliable perpetual records exist and are reconciled to the general ledger, perform additional test counts at or after year end to obtain assurance that quantities in such records are reasonably accurate.
		6	Evaluate results of the tests.
		F	Roll Forward Test for Inventories Price Tested prior to year end
	-	1	Understand the impact of significant accounting policies and compliance with applicable accounting pronouncements on inventory balances.
	Completeness, Valuation & Allocation	2	Perform substantive analytical procedures to test inventory balances at the year-end. Consider using the following data, as applicable, to develop an expectation of inventory balances at the year-end:
			<ul style="list-style-type: none"> Prior period balances.
			<ul style="list-style-type: none"> Monthly amounts of cost of sales and purchases in the

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			intervening period from the date at which inventory cost was tested to the balance sheet date compared to such monthly amounts in prior years and in the current year prior to the interim testing date.
			<ul style="list-style-type: none"> • Trends in book to physical adjustments made in the current year and prior years.
			<ul style="list-style-type: none"> • Trends in sales, cost of sales, and gross margins.
			<ul style="list-style-type: none"> • Reconciliation of specific account balances in the intervening period.
	Completeness, Valuation & Allocation	3	Determine that the data used to make independent estimates is independent and reliable and if information produced by the entity is being used, obtain audit evidence about the accuracy and completeness of the data.
	Completeness, Valuation & Allocation	4	If the data is not independent, separately audit the data. In assessing the reliability of the data gathered, consider the source of the data and the conditions under which it was granted.
	-	5	Determine the threshold – the amount that represents the maximum difference between the expectations

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			and recorded year-end inventory balances that is acceptable without further investigation.
	-	6	Compare the expectation to the recorded balance and identify any differences. For any difference, that is more than the threshold, obtain, quantify, and corroborate explanations for the difference by performing further analysis or inquiry and examining supporting documents. Explanation needs to be initially sought for the full amount of the difference, not just that part that exceeds the threshold.
	Existence, Rights & Obligations Completeness Valuation & Allocation	7	Consider investigating the following:
			<ul style="list-style-type: none"> Any unusual pattern in the differences.
			<ul style="list-style-type: none"> Whether the differences between the actual and budgeted amounts are so close that it could imply that management has manipulated either or both items. Use professional skepticism to evaluate whether such considerations give rise to any specific or pervasive risk as a result of fraud risks.

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		8	Test transactions during the intervening period between the date at which inventory cost was tested and year end:
	Completeness		<ul style="list-style-type: none"> Obtain a reconciliation of the interim inventory balances to the year end balances.
	Completeness		<ul style="list-style-type: none"> Agree purchases totals to purchase journals.
	Valuation & Allocation, Rights & Obligations, Existence		<ul style="list-style-type: none"> Examine supporting documents to verify other significant entries.
		9	Make a selection of entries to purchase journals in the intervening period between the interim testing date and year end and trace the selected entries to purchase invoices and receiving records.
	Valuation & Allocation, Rights & Obligations		<ul style="list-style-type: none"> Verify additions and extensions on the invoices.
	Cut Off		<ul style="list-style-type: none"> Determine that the purchases were recorded in the correct period.
		10	Evaluate results of the tests.
		G	Test the Final Inventory Compilation
		1	Obtain the final, priced inventory compilation and perform the following (the compilation should reflect the quantities counted at

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			the physical observation date):
	Valuation & Allocation, Rights & Obligations, Completeness		<ul style="list-style-type: none"> Test the summarization and reconciliation of the total to the general ledger and trace significant reconciling items, if any, to supporting documentation.
	Completeness		<ul style="list-style-type: none"> Trace quantities of items test counted or confirmed by us on the physical verification date to the compilation. Reconcile any discrepancies based on supporting documents.
	Completeness Rights & Obligations		<ul style="list-style-type: none"> For sites visited by us compare the compilation to the record of count documents obtained on the physical observation date. Obtain and corroborate explanations for any added items.
	Valuation & Allocation		<ul style="list-style-type: none"> Review the compilation for unusual or negative balance items or costs. Obtain and corroborate explanations for any such items.
	Valuation & Allocation		<ul style="list-style-type: none"> Obtain or prepare a list of the highest items by quantity and value for the current

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			and prior year. Investigate the reasons for any significant differences.
	Valuation & Allocation, Rights & Obligations		<ul style="list-style-type: none"> Where goods have been delivered to customers on consignment or sale or return basis, determine that such goods have been included in the compilation and excluded from receivables.
		2	Using the cut-off documents obtained during the inventory count, along with related vouchers, purchase invoices, sales invoices, debit notes, credit notes and goods inward notes perform the following:
	Completeness, Cut Off		<ul style="list-style-type: none"> Verify that the following items included in the physical inventory count were also included in the compilation:
			<ul style="list-style-type: none"> * Goods received prior to the count for which a purchase or credit note was recorded on or before the count date.
			<ul style="list-style-type: none"> * Goods shipped subsequent to the count for which a sale or debit note was recorded after

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			<p>the count date.</p> <ul style="list-style-type: none"> * All sales returns from customers which have been received or credit notes have been issued prior to period end.
	Completeness, Cut Off		<ul style="list-style-type: none"> • Verify that the following items excluded from the physical inventory count were also excluded from the compilation:
			<ul style="list-style-type: none"> * Goods shipped prior to the count for which a sale or debit note was recorded on or before the count date.
			<ul style="list-style-type: none"> * Goods received subsequent to the count for which a purchase or credit note was recorded after the count date.
		3	Make a selection of items from the final, priced inventory compilation and perform the following:
	Completeness Valuation & Allocation		<ul style="list-style-type: none"> • Trace the quantities to the original count documents.
	Valuation & Allocation		<ul style="list-style-type: none"> • Test the extension of quantities and unit costs.
			<ul style="list-style-type: none"> • Obtain an understanding of the elements that make up the unit costs of

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			inventory.
	Valuation & Allocation		* Verify unit costs by examining the most recent purchase invoices showing quantities equal to the quantities used to determine final FIFO costs, and recompute the costs (in case FIFO is followed).
	Valuation & Allocation		* Verify that unit costs are based on purchase invoices and not supplier's price lists.
	Valuation & Allocation		* Verify that unit costs are adjusted for trade discounts, rebates, other price reductions and inter-unit unrealized profits have been properly eliminated.
	Valuation & Allocation Valuation & Allocation		* Verify that the unit cost includes: <ul style="list-style-type: none"> - Acquisition and production costs. - Freight, duty and other related costs where material. - Overhead expenses that are clearly related to inventory

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			<p>production.</p> <ul style="list-style-type: none"> - Any price revisions which have been agreed with the suppliers. <p>* Verify that the unit. costs excludes:</p> <ul style="list-style-type: none"> - Selling expenses. - Abnormal freight. - Abnormal handling costs. - Amounts of wasted materials (spoilage). - Claims recoverable from various authorities in respect of expenses that are not debited to the profit & loss account. - Generally, general and administrative expenses, except for the portion of such expenses that are clearly related to inventory production.
	Valuation & Allocation Rights & Obligations		<ul style="list-style-type: none"> • Verify that items such as abnormal freight, abnormal handling costs and amounts of wasted materials (spoilage) are treated

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			as current period charges by agreeing the amounts to the appropriate general ledger accounts.
	Valuation & Allocation		<ul style="list-style-type: none"> • Ensure that excise duty has been accrued as a liability and included in the valuation of finished stock.
	Valuation & Allocation		<ul style="list-style-type: none"> • If the entity has changed the composition of the elements of costs from the prior year, such a change is an accounting policy change. If such a change has occurred, perform the following:
			<ul style="list-style-type: none"> * Verify that excise duty and sales tax set off is not included in valuation of raw materials and stores and spares if cenvat credit and sales tax set off has been credited to purchases.
			<ul style="list-style-type: none"> * Obtain documentation supporting management's justification for the change in composition of the elements of cost.
			<ul style="list-style-type: none"> * Determine that the change in the composition of the elements of cost

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			represents a preferable change. (Prefer ability is determined on the basis of whether the new principle constitutes an improvement in financial reporting).
			* Determine if the entity appropriately accounted for the change in the composition of cost.
	Completeness Rights & Obligations Existence	4	If the book to physical adjustments is significant, inquire whether any unexplained shortage of physical stock represents unrecorded sales or whether any unexplained excess of physical stock represents unrecorded purchases.
		5	Evaluate results of the tests.
		H	Test Inventory Aging
	Valuation & Allocation, Completeness	1	Obtain the inventory aging, and the reconciliation of the inventory aging to the general ledger and/or stock ledger. Agree applicable amounts from the inventory aging and reconciliation to the general ledger and trace significant reconciling items, if any, to supporting documents.
	Valuation & Allocation	2	Using the selections made at G.3, test the accuracy of

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			the inventory aging by tracing invoice details for the price testing selections to the inventory aging for proper categorization within the aging buckets.
	Valuation & Allocation	3	Determine that the percentages of inventory by each aging category (and department, if applicable) to total inventory are consistent and comparable with prior periods and/or industry metrics.
	Valuation & Allocation	4	Determine that the accounting policies and procedures for developing the inventory aging are appropriate and are applied consistently. Review changes in the aging categories during the period and consider their reasonableness in view of prior history and current information.
		5	Review the aged items of inventory and ensure whether these pertain to products of the Company which are still being sold. Ensure adequacy of provision, if required.
		6	In the case of machinery spares, these are generally consumed over a longer period of time as compared to other inventory. Ensure adequate provision is made for such inventory. Obtain a list of obsolete inventory as per technical evaluation done by the

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			Company. Ensure adequate provision is made.
		7	Evaluate results of the tests.
		I	Test late cut-off of inventory purchases
	Cut Off	1	Make a selection of recorded inventory purchases in the five (5) day period prior to the year-end and trace selected purchase invoices to receiving reports. Determine that the purchases were recorded in inventory in the correct period.
	Cut Off	2	Make a selection of initial records of receipts of goods that occurred in the five (5) day period after the year-end and trace selected receiving records to purchase invoices. Determine that the purchases were recorded in inventory in the correct period.
		3	Evaluate results of the tests.
		J	Test early cut-off of debit notes
	Cut Off	1	Inquire into returns to vendors in the five (5) day period prior to the year-end. Determine that the debit notes were recorded as credits to inventory in the correct period.
	Cut Off	2	Make a selection of recorded debit notes in the

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			five (5) day period after the year-end and trace the debit notes to shipping records. Determine that they were recorded as credits to inventory in the correct period.
	Cut Off	3	Review miscellaneous credits to inventory accounts recorded in the five (5) day period after year end. Trace the credits to supporting documents and determine that they were recorded in the correct period.
		4	Evaluate results of the tests.
		K	Goods in Transit
		1	If goods in transit are included in inventory, perform the following:
	Rights & Obligations, Existence		<ul style="list-style-type: none"> Trace amounts to supplier's invoice and dispatch documents.
	Rights & Obligations, Existence		<ul style="list-style-type: none"> Determine that the items were received shortly after the year end date.
	Completeness, Cut Off		<ul style="list-style-type: none"> Check that the invoices have been included in creditors.
	Completeness, Cut Off	2	If goods in transit include transfers from other locations of the entity, determine that these goods have been excluded from the inventory of that other location.
		L	Test provision for inventory
	Valuation &	1	Inventory should be stated

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	Allocation		<p>at the lower of cost or and net realizable value, Net realizable value is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale.</p> <p>Materials and other supplies held for use in the production of inventories are not written down below cost if the finished products in which they will be incorporated are expected to be sold at or above cost. However, when there has been a decline in the price of materials and it is estimated that the cost of the finished products will exceed net realizable value, the materials are written down to net realizable value. In such circumstances, the replacement cost of the materials may be the best available measure of their net realizable value.</p>
	Completeness	2	Obtain a schedule of provision for inventory showing beginning and ending balances, write-offs, and provisions. Test the summarization of the schedule and trace the ending balance and the amount of the current year provision to the general ledger.
	Valuation &	3	Evaluate the

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	Allocation		reasonableness of the methods and assumptions management used to estimate the provision.
	Valuation & Allocation	4	If net realizable value is lower than cost, and management has not provided for this, determine if the exception in Step L.1 exists.
	Valuation & Allocation	5	If management's methods and assumptions were reasonable, test the data and assumptions underlying the estimate, and recompute the estimate.
	Valuation & Allocation	6	<p>If management's methods and assumptions were NOT reasonable, develop an independent range of reasonable estimates and determine whether the management's estimate falls within that range. Consider the following factors, as applicable, in developing an independent range of reasonable estimates:</p> <ul style="list-style-type: none"> • Market value of specific items that are obsolete or defective. • Held in quantities excessive in relation to demand, or devalued • Inventory turnover. • Trend in gross margins. • Trend in sales. • Trend in quantities on hand. • Disposition of prior

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			<p>year obsolete items.</p> <ul style="list-style-type: none"> • Ratio of inventory to assets. • Large capitalized variances. • Purchase or sales commitments.
	Completeness, Valuation & Allocation	7	Determine that the data used to make independent estimate is independent and reliable and if information produced by the entity is being used, obtain audit evidence about the accuracy and completeness of the data.
	Valuation & Allocation	8	If the data is not independent, separately audit the data. In assessing the reliability of the data gathered, consider the source of the data and the conditions under which it was granted.
	Valuation & Allocation	9	Determine that any defective, obsolete, or unsaleable inventories noted during the physical observation have been appropriately considered and written down.
	Valuation & Allocation	10	Inquire as to whether any sales incentives have been offered that will result in a loss on sale of the product (e.g. hold discussions with entity personnel outside the accounting department). Determine that inventory related to such products has been evaluated for impairment and was

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			separately written down or appropriately considered by performing the following:
			<ul style="list-style-type: none"> If the inventory has been separately written down, obtain management's impairment analysis and evaluate the reasonableness of the methods and assumptions used to determine the impairment loss. If management's methods and assumptions were reasonable, test the data and assumptions underlying the impairment analysis, and recompute the impairment loss.
		11	Evaluate results of the tests.
		M	Test Allocations of Labour and Overhead
	Valuation & Allocation	1	Obtain the entity's computation of allocation of labour and overhead to specific items of inventory or to the inventory as a whole when standard costing is not used. Assess the reasonableness of management's allocation of methods and assumptions.
	Valuation & Allocation	2	For allocation of labour and overhead to specific items of inventory (e.g. those items selected under

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			Section G.3) or to the inventory as a whole:
			<ul style="list-style-type: none"> Trace labour rates and production hours to supporting documents (e.g. union contracts, production records).
			<ul style="list-style-type: none"> Determine that the bases for allocating various types of overhead expenses are reasonable. Trace key amounts shown in the computations to general ledger balances and other supporting documents.
			<ul style="list-style-type: none"> Recompute the extensions and additions of labour and overhead allocations.
	Valuation & Allocation	3	Determine if the entity's allocation of fixed production overheads were based on the normal capacity of the production facilities by performing the following:
			<ul style="list-style-type: none"> Inquire as to the entity's policy for determining when the production level of inventory is considered normal, abnormally high, abnormally low or if a plant is considered idle plant.
			<ul style="list-style-type: none"> For those periods in which production was determined to be

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			abnormally high, abnormally low or if a plant was considered idle, obtain documentation supporting that assessment.
			<ul style="list-style-type: none"> Determine that for instances in which the production level was considered abnormally high, that the amount of fixed overhead allocated to each unit of production was not decreased.
			<ul style="list-style-type: none"> Determine that for instances in which the production level was considered abnormally low or the plant was considered idle that the amount of fixed overhead allocated to each unit of production was not increased.
			<ul style="list-style-type: none"> Verify that unallocated overheads were recognized as expense in the period in which the costs were incurred by agreeing the amounts to the appropriate general ledger account.
		4	Evaluate results of the tests.
		N	Test Elimination of Inter-Divisional Profit
		1	Obtain a schedule of the entity's computations of

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			inter-divisional profit elimination. Perform the following:
	Valuation & Allocation, Completeness		<ul style="list-style-type: none"> Review inter-divisional accounts and the prior year calculation of the elimination of inter-divisional profit in inventory accounts. Determine that the schedule is complete and that the calculation method is consistent with that used in the prior year.
	Valuation & Allocation,		<ul style="list-style-type: none"> Trace significant amounts in the schedule to the final inventory compilation and other supporting documents.
	Valuation & Allocation		<ul style="list-style-type: none"> Recompute the inter-divisional profit and trace the amount to the general ledger.
		O	Test Standard Costs
	Valuation & Allocation	1	Ascertain and determine the entity's process for establishing standard costs. Specifically determine:
			<ul style="list-style-type: none"> Which products and inventory items are valued using standard costing.
			<ul style="list-style-type: none"> How frequently costs are revised.
			<ul style="list-style-type: none"> Whether the basis of calculating standard costs is consistent with the basis used in prior years.

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			<ul style="list-style-type: none"> What cost data is used to set standards.
			<ul style="list-style-type: none"> What other factors are considered in building the standards (e.g. inflation, capacity level, efficiency targets).
			<ul style="list-style-type: none"> How price and volume variances from standard costs are recorded in the accounting records.
			<ul style="list-style-type: none"> What review procedures are followed to identify variances which should be excluded from the inventory valuation (e.g. excess material usage, labour stoppages etc).
	Valuation & Allocation	2	Make a selection of inventory items (see Section G.3). For each item selected, verify:
			<ul style="list-style-type: none"> If there have been no significant changes in the entity's business, and the prior year standard costing methodology was deemed reasonable and reliable, compare the current year standard cost to the prior year standard cost. Discuss significant differences with management.
			<ul style="list-style-type: none"> Verify materials standard cost using recent purchase invoices and material

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			quantities to bills of material and product specifications.
			<ul style="list-style-type: none"> Review labour and overhead components of standard cost for reasonableness considering the entity's basis for allocation.
			<ul style="list-style-type: none"> Determine whether assumptions used to take account of normal wastage, operating capacity etc. are reasonable.
	Valuation & Allocation	3	<p>Review the standard cost file (or request the entity to run an edit report) to identify unusual relationships such as:</p> <ul style="list-style-type: none"> Overhead cost with no labour cost. Labour or overhead cost with no material cost. Current year standard cost significantly greater than prior year standard cost.
	Valuation & Allocation	4	<p>Verify that the entity has updated its standard cost file on a basis that is consistent within the industry in which it operates, and assess the timing of the update for reasonableness. If standard costs have not changed during the year:</p>
			<ul style="list-style-type: none"> Check variance adjustments to inventories and consider whether an

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			acceptable valuation can be achieved by use of old standards.
			<ul style="list-style-type: none"> Trace standards from prior year's working papers to standard prices used to value current year's inventories.
			<ul style="list-style-type: none"> For new products for which new standards have been set, test the cost data used in setting these standards.
	Valuation & Allocation	5	Determine the reasonableness of the levels of production upon which standards are based in the light of 'normal capacity'. Consider the effect where actual production is significantly above or below the levels used is setting the standards.
	Valuation & Allocation	6	If standards have been changed after the balance sheet date, review the standards used at the balance sheet date for valuation of inventories with the new standard and investigate for any large or unusual fluctuations.
	Valuation & Allocation	7	Make a selection of purchase and wage transactions during the year and check the amounts recorded to the variance accounts by calculating the difference between standard costs and the actual cost of

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			goods and services purchased and labour.
	Valuation & Allocation	8	Review variance accounts for the entire year for unusual entries and investigate such entries.
		9	Evaluate results of the tests.
		P	Test presentation of inventory
	-	1	Understand the impact of significant accounting policies and compliance with applicable accounting pronouncements on inventory.
	Classification & Understand-ability, Accuracy & Valuation, Completeness, Occurrence & rights and obligations	2	<p>Determine that amounts presented as inventory are properly recorded, classified and/or disclosed as required by the Revised Schedule VI of the Companies Act and other accounting pronouncements:</p> <ul style="list-style-type: none"> • Inventories should be classified as: <ul style="list-style-type: none"> * Raw materials; * Work-in-progress; * Finished goods; * Stock-in-trade (in respect of goods acquired for trading); * Stores and spares; * Loose tools; * Others (specify nature). • Goods-in-transit should be disclosed under the relevant sub-head of

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			<p>inventories.</p> <ul style="list-style-type: none"> • Mode of valuation should be stated. • the accounting policies adopted in measuring inventories including the cost formula used should be disclosed. • the total carrying amount of inventories and its classification appropriate to the enterprise should be disclosed. • Provision for diminution in the value of inventories. • Inventories pledged or assigned. • Significant purchase commitments or other contingencies. • Inventories not held for sale.
		Q	Conclusion
	-	1	<p>Document the results of the audit procedures performed, the significant points considered in arriving at the conclusion, and a brief statement of the conclusion itself.</p>
	-	2	<p>Consider including the following when documenting the conclusion:</p> <ul style="list-style-type: none"> • A description of the risks associated with the account balance and how these risks were addressed in the substantive testing. • The relevant potential

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			<p>errors and control objectives for each account balance or disclosure being tested.</p> <ul style="list-style-type: none"> • The substantive procedures performed or a cross-reference to where the substantive procedures are performed, including identification of both direct and indirect tests for the related potential errors. • The results of substantive tests, including misstatements identified, and how such results support the conclusion on the potential errors for each account balance or disclosure. • The tests of controls performed or a cross reference to where the tests of controls performed are documented. • The results of tests of controls, including deficiencies identified, and how such results support the conclusion as to whether control reliance has been obtained for the potential errors for each account balance or disclosure.
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Chapter 6

Other Assets, Loans and Advances

Non- Recoverable Tooling Advance

6.1 Generally, all the components are not manufactured by the automobile Company. It gives contracts to manufacture parts/components to be used specifically in the production of a particular vehicle to other vendors. The Company gives an advance (non-recoverable) to these vendors for the purchase of capital assets (machines) in order to manufacture these parts/components. Such advances could be a means of financing the vendor and should be accounted for as per the agreement between the management and vendor.

6.2 The auditor should review the agreement entered into with the vendor to establish whether the capital assets belongs to the Company or to the vendor. If the capital asset belongs to the Company, it should be capitalized and written off during the period as set out in the agreement. However, if such component becomes out dated due to change in technology or the Company has stopped taking supply of such component, the Company should write off the remaining balance of advance immediately. If the capital asset does not belong to the Company, the advance should be expensed off.

Service Tax Credit Recoverable Account

6.3 Service tax paid for the services availed is debited to this account. The auditor should review this account with the objective of determining whether or not the entire balance can be utilized as a credit against the service tax liability. The auditor should also verify whether the credit can be taken and whether service tax has been utilized according to the service tax rules. For example, if the invoices are not complete or are defective or certain entries in the invoices are not legible, the Company may not be able to claim the input credit. In such cases, the auditor may consider whether such balances should be written off.

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Prepaid Expenses

6.4 The auditor should verify the prepaid expenses in the same manner as followed in other industries. Therefore, the auditor should examine whether the basis of the allocation of expenditure to different periods is reasonable. Expenses such as insurance premiums, advance rent, discounting charges are examples of some expenses that are paid in advance.

Interest Receivable

6.5 This includes interest accrued on bank deposits, employee loans and advances. The auditor should verify the same in a manner similar to that followed in any other industry.

6.6 The auditor should ensure that interest income is recognized accurately in the books of account by verifying the principal amount, the rate of interest and the period of loan.

Advance to Suppliers for Materials, Expenses and Capital Goods

6.7 Advances given to the suppliers for plant and machinery, vehicles, building material, are included under the advance for capital goods. Other capital advances will include advances for leasehold improvements, electrical equipments like UPS, DG sets, security systems, office equipments, furniture and fittings, etc.

6.8 Similarly advances for materials and expenses may include advances towards repairs and maintenance, purchase of items of spares and stores, advertising costs, etc. The auditor should review these balances in a manner similar to that followed in other industries.

6.9 Due to inappropriate flow of information, the liability and advance accounts may both be inflated. The auditor should verify that proper provisioning of such expenses is done in the books of account and verify that the liability is netted off with the appropriate advance account. Such errors generally occur in a non-ERP based environment. The auditor should, however, review the balances in advance accounts to ensure that they include only actual advances.

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6.10 All of the above advances may be audited in a manner similar to that followed in the case of any other industries by verifying the nature of advances, the agreement terms, policy, approvals, aging and recoverability. Capital advances should be shown under the head 'Long term Loans and Advances' as per the requirements of Revised Schedule VI.

Security Deposits

6.11 Security deposits with various government authorities (e.g., on account of telephone, electricity, tax, customs, excise etc.) and with others (e.g., deposits in respect of premises taken on rent) should be checked with reference to documents containing relevant terms and conditions, and receipts obtained from the parties concerned. The auditor should ensure that the agreement against which a security deposit has been given is still valid and the amount is recoverable from the party.

Balance with Excise Authorities

6.12 This account represents the various account balances standing in the books with the various government authorities such as Excise, VAT, Entry Tax etc. The auditor should verify the amount standing in the excise returns and VAT returns filed by the Company with the various Government Authorities. The auditor should verify that the net debit balances pending adjustment/recovery should be disclosed in this account.

Other Items

6.13 Other items that are generally included under current assets are as follows:

- Salary advances.
- Employee loans.
- Inter-company balances.
- Advance tax and TDS recoverable.
- Any other amounts receivable from government.

The auditor should follow the usual audit procedures for all such account balances.

Illustrative Audit Procedures

Identifying and Assessing the Risk of Material misstatement

6.14 There are various approaches an auditor may use to identify risk at the assertion level for classes of transactions, account balances, and disclosures. One way might be to think about the ways a class of transactions, account balance, or disclosure might be misstated by considering “what can go wrong” for each material class of transactions, account balance, and disclosure. Another way is to consider what particular concerns one has about each assertion in addition to the risk of misstatement described by the assertion itself.

6.15 The auditor should assess each identified risk to determine whether it is a significant risk. This is intended to be a judgment decision based on the auditor’s cumulative knowledge of the entity.

6.16 When Information Technology (IT) is used to initiate, record, process, or report transactions or other financial data for inclusion in the financial statements, the systems and programs may include controls related to the corresponding assertions for material accounts or that may be critical to the effective functioning of manual controls that depend on IT. In such a scenario, the involvement of an IT specialist should be assessed.

6.17 The auditor will need to identify the risk of material misstatement in the financial statements and develop the audit plan accordingly. When the auditor has determined that a significant risk exists, the auditor will have to obtain an understanding of the entity’s controls, including control activities, relevant to that risk.

6.18 Hence, these audit procedures will vary according to the given situation.

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Loans, Advances and Other Assets

Material Classes of Transactions, Account Balances and Disclosures	Assertions		Audit Procedures
Loans, Advances and Other Assets		A	System update
		1	Update and document the understanding of the controls and the accounting system through a review of the system notes in the planning section.
		B	Recording accuracy
	Completeness	1	Obtain/prepare a schedule of all loans and advances and other current assets. Test the total and the reconciliation of the total to: <ul style="list-style-type: none"> • Trial balance. • General ledger. • Balance sheet.
	Completeness	2	Obtain/prepare a schedule under the following main headings and agree the total to the trial balance and general ledger. <ul style="list-style-type: none"> • Capital advances. • Advances to suppliers. • Other advances. • Balances with Customs, Central Excise, Port Trust, etc. • Tax deducted at source and advance payment of tax. • Bills of exchange. • Staff advances/loans.

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			<ul style="list-style-type: none"> Loans given to companies and other entities. Security and other deposits. Prepaid expenses.
		C	Review of balances
	Valuation & Allocation, Completeness	1	<p>Review and explain movements between current year, prior year and budgeted amounts for:</p> <ul style="list-style-type: none"> individual type and aggregate advances by location, type, staff cadre, ageing. aggregate and individual prepaid expenses. aggregate and individual other asset balances. Provision for doubtful advances and deposits.
	Existence, Valuation & Obligation, Rights & Obligations	2	Investigate for any journal entries recorded in the general ledger or subsidiary ledger and other adjustments made in the preparation of the financial statements at the year-end and test the appropriateness of such entries.
	Valuation & Allocation	3	Review entries in respective ledger accounts for the year for significant credit balances and check for any misstatements.
	Valuation & Allocation, Rights & Obligations	4	Review entries in respective ledger accounts for the year and investigate for any large or unusual items.
		D	Confirm loans and advances
	Existence, Rights &	1	Prepare, or have the entity prepare, confirmation

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	Obligations, Completeness, Valuation & Allocation		requests for the balances selected. On the confirmation, consider including outstanding balance and a statement of accounts.
			<ul style="list-style-type: none"> Mail the confirmation requests under the auditor's control, determine that the requests are properly addressed (i.e. obtain audit evidence about the accuracy and completeness of addresses provided by the client) and request that all replies be sent directly to the auditor's office.
			<ul style="list-style-type: none"> Send second request for non-replies. Request the entity to follow up, if necessary.
			<ul style="list-style-type: none"> Compare replies to requests. Prepare, or have the entity prepare, reconciliation of exceptions. Trace reconciling items to supporting documents.
			<ul style="list-style-type: none"> Inquire into any significant disputed balances. Investigate as necessary.
	Rights & Obligations, Valuation & Allocation	2	If tests of details include examination of supporting documentation for which a document cannot be located and no other acceptable alternative evidence can be found, consider the selected items to have misstatements equal to the book value of the unsupported amounts.

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	Rights & Obligations, Valuation & Allocation	3	If the misstatements of the unexamined documents would lead us to conclude the account balance or disclosure contains material misstatement, consider performing alternative procedures that will provide us with sufficient appropriate audit evidence to form a conclusion on the account balance or disclosure.
		4	Evaluate results of the tests.
		E	Test advances to suppliers
	Completeness, Rights & Obligations, Valuation & Allocation	1	Obtain the schedule of advances to suppliers and agree the totals to the general ledger. Trace significant reconciling items, if any, to supporting documents.
	Valuation & Allocation	2	Agree selected individual balances to suppliers' ledger account.
		3	Make a selection of significant advances and perform the following:
	Completeness, Rights & Obligations, Valuation & Allocation		<ul style="list-style-type: none"> • Determine reasons for such advances. • Investigate their recoverability. • Investigate reasons for delays, if any, in adjusting balances. • Verify subsequent realizations/adjustments. • Agree advances paid to terms stated in purchase orders and other supporting documents. • If any interest is chargeable on these advances, ensure that this has been collected and

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			<p>accounted for.</p> <ul style="list-style-type: none"> • Verify if any of the advances paid appear to be in the nature of loans.
	Completeness, Valuation & Allocation	4	<p>Make a selection of balances from the schedule of advance to suppliers and trace the balances to subsequent adjustments or cash receipt records. Trace unpaid/unadjusted balances to vendor correspondence, if any.</p>
		5	Evaluate results of the tests.
		F	Test Loans and advances
	Completeness, Rights & Obligations, Valuation & Allocation	1	<p>Obtain a schedule of the following loans and advances and agree the totals to the general ledger. Trace significant reconciling items, if any, to supporting documents:</p> <ul style="list-style-type: none"> • staff loans and advances. • loans to companies. • loans to other entities.
	Rights & Obligations, Valuation & Allocation	2	<p>Review the terms and conditions of all loans granted to entities listed in the register maintained under Section 301 of the Companies Act, 1956 and verify that these are not prejudicial to the interests of the entity with regard to comparative terms for:</p> <ul style="list-style-type: none"> • security offered. • rate of interest. • terms of repayment. • other conditions attached.
	Valuation & Allocation	3	<p>If the terms and conditions of any loan appear to be prima facie prejudicial to the interests of the entity, obtain</p>

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			written explanation from management as to why it should not be so considered in the audit report.
	Valuation & Allocation	4	Inquire if the stipulations regarding payment of interest and principal have been followed and if not what steps have been taken to ensure compliance.
	Existence, Rights & Obligations, Valuation & Allocation	5	For significant balances ensure that: <ul style="list-style-type: none"> the staff to whom such loans have been given are in the service of the Company. recoveries are made on a regular basis as mentioned in the stated terms. interest, if receivable, has been accounted.
	Rights & Obligations, Valuation & Allocation	6	Check compliance of sections 77, 292, 295, 370, 372A of the Companies Act.
		7	Evaluate results of the tests.
		G	Test Other advances
	Completeness, Rights & Obligations, Valuation & Allocation	1	Obtain the schedule of other advances and agree the totals to the trial balance and general ledger. Trace significant reconciling items, if any, to supporting documents.
	Valuation & Allocation	2	Verify if any balances are in the nature of loans.
	Valuation & Allocation	3	Review major balances and identify amounts that are overdue. Trace such balances to subsequent cash receipts and to vendor correspondence, if any.

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	Completeness, Rights & Obligations, Valuation & Allocation	4	Make a selection of deposits and determine the conditions under which such deposits were made and the need for existence of such deposits. Trace the individual deposits to deposit receipts and other correspondence, if any, and verify whether interest if applicable, has been collected and accounted.
		5	Evaluate results of the tests.
		H	Test Prepaid Expense Balances
	Rights & Obligations, Valuation & Allocation	1	Review the information in prior year working papers and/or inquire concerning the nature of each significant prepaid expense account and the policies and procedures used to account for them.
	Rights & Obligations, Valuation & Allocation	2	Understand the impact of significant accounting policies and compliance with applicable accounting pronouncements on prepaid expense balances.
	Valuation & Allocation	3	Inquire as to the reasons for significant changes in prepaid expense balances since the prior year.
	Valuation & Allocation	4	Determine that the accounting policies and procedures for setting up prepaid expenses as assets and for amortizing them to expense are appropriate and are applied consistently.
	Rights & Obligations, Valuation & Allocation	5	In the course of performing procedures for prepaid balances, consider whether the audit evidence supports the understanding of prepaid

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			expense accounting policies and procedures and their propriety.
	Completeness, Rights & Obligations, Valuation & Allocation	6	Perform substantive analytical procedures to test prepaid expense balances. Consider using the following data, as applicable, to develop an expectation of significant prepaid balances at the year-end:
			<ul style="list-style-type: none"> • balances of prepaid expenses in prior years (e.g. balances at the prior year end). • balances at preceding dates in the current year. • prior and current year expenditures, amortization to expense, and their timing.
	Valuation & Allocation	7	Determine that the data used to make independent estimates is independent and reliable and if information produced by the client is being used, obtain audit evidence about the accuracy and completeness of the data.
	Valuation & Allocation	8	In assessing the reliability of the data gathered, consider the source of the data and the conditions under which it was gathered.
	-	9	Determine the threshold – the amount that represents the maximum difference between the expectations and the recorded prepaid expense amounts that is acceptable without further investigation.
	-	10	Compare the expectation to the recorded balance and identify any differences. For

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			any difference that is more than the threshold, obtain, quantify, and corroborate explanations for the difference by performing further analysis or inquiry and examining supporting documents. Explanation needs to be initially sought for the full amount of the difference, not just that part that exceeds the threshold.
	Valuation & Allocation	11	Also consider investigating the following:
			<ul style="list-style-type: none"> Any unusual pattern in the differences.
			<ul style="list-style-type: none"> Whether the differences between the actual and budgeted amounts are so close that it could imply that management has manipulated either or both items. Use professional skepticism to evaluate whether the considerations give rise to any specific or pervasive risk as a result of fraud risks.
	Completeness, Rights & Obligations, Valuation & Allocation	12	Make a selection of recorded prepaid expense balances and perform the following:
			<ul style="list-style-type: none"> Obtain a roll-forward schedule showing the beginning and ending balances, additions, and amortization expense.
			<ul style="list-style-type: none"> Investigate any large or unusual items.
	Rights & Obligations,	13	Make a selection of the recorded additions and trace

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	Valuation & Allocation		them to supporting documents. (e.g. invoices and evidence of the period over which the expense is recognized)
			<ul style="list-style-type: none"> Recompute the amortization to expense and determine that expectations of future benefits are reasonable.
		14	Evaluate results of the tests.
		I	Test Accrued income
		1	<i>Income accrued on investments is to be tested along with investments. Such amounts are disclosed as other current assets.</i>
	Rights & Obligations, Valuation & Allocation	2	Make a selection from subsidiary records of accrued income and test such income by examining subsequent receipts or testing the accrual using records supporting the amounts and the selected accruals.
	Completeness	3	Agree total of other accrued income to the general ledger.
	Rights & Obligations, Valuation & Allocation	4	Test the calculation of other accrued income. Assess and, if necessary, test, the accuracy of the supporting data. Recompute the estimates.
		J	Test provision for doubtful advances/deposits write off
	Valuation & Allocation	1	Determine that the accounting policies and procedures for estimating and recording provisions for doubtful advances/ deposits and advances write off are appropriate and consistently applied.

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	Completeness	2	Obtain a schedule of the provision for doubtful advances/ deposits showing opening and closing balances, write-offs and recoveries. Trace the closing balance and the amount of advance write off to the general ledger and trial balance.
	Rights & Obligations, Valuation & Allocation	3	Check that advance write offs and provision for doubtful advances/deposits has been included in the draft resolution to be considered by the board of directors along with the adoption of accounts.
	Valuation & Allocation	4	Make a selection of advance write-offs recorded in the general ledger and review documents and correspondence supporting uncollectability and determine that the write-offs were authorized.
	Valuation & Allocation	5	Evaluate the reasonableness of the methods and assumptions management used to estimate the provision for doubtful advances/deposits and whether the methods for calculating such provisions are applied consistently.
	Valuation & Allocation	6	If management's methods and assumptions were reasonable test the data and assumptions underlying the estimate, and recompute the estimate. Compare, where possible, estimates made in prior periods with the actual results of those periods and consider management's or the directors' review and approval

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			procedures.
	Valuation & Allocation	7	If management's methods and assumptions were NOT reasonable, develop an independent range of reasonable estimates and determine whether the management's estimate falls within that range. Consider the following factors, as applicable, in developing an independent range of reasonable estimates:
			<ul style="list-style-type: none"> • Collectability of significant overdue accounts. • Collectability of large advances. • Collections, write-offs and recoveries after year end. • Collections, write-offs and recoveries during the year and in the prior years. <p>Discuss the results with the management.</p>
	Completeness, Valuation & Allocation	8	Determine that the data used to make independent estimates is independent and reliable and if information produced by the client is being used, obtain audit evidence about the accuracy and completeness of the data.
	Valuation & Allocation	9	In assessing the reliability of the data gathered, consider the source of the data and the conditions under which it was gathered.
	Rights & Obligations, Valuation &	10	Where advances have been given to subsidiaries or to related parties, review net

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	Allocation		worth of such entities from the latest financial results. Examine need for provision against such balances.
	Valuation & Allocation	11	Prepare a list of advances which in the auditor's opinion are doubtful of recovery with reasons and discuss the same with the management.
		12	Evaluate results of the tests.
		K	Test Balances Denominated in Foreign Currencies
	Completeness	1	Inquire and consider other available evidence, if any, to identify transactions in foreign currency.
	Valuation & Allocation	2	Agree the closing rate(s) used to published records and test the translation calculation wherever the items are monetary items as defined in AS 11.
	Valuation & Allocation	3	Trace currency translation adjustments to the general ledger.
		L	Test Presentation of Loans and Advances
	Classification & Understandability, Accuracy & Valuation	1	Understand the impact of significant accounting policies and compliance with applicable accounting pronouncements on loans and advances.
	Classification & Understandability, Accuracy & Valuation, Completeness, Occurrence & rights and obligations	2	Determine that amounts presented as loans and advances are properly recorded, classified and/or disclosed as required by Schedule VI to the Companies Act: <ul style="list-style-type: none"> Advances and loans to subsidiaries.

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			<ul style="list-style-type: none"> • Advances and loans to partnership firms in which the Company or any of its subsidiaries is a partner. • Bills of exchange. • Advances recoverable in cash or in kind or for value to be received. • Balances with customs, port trust etc. • Above items need to be further classified into: <ul style="list-style-type: none"> * Considered good and in respect of which the Company is fully secured. * Considered good for which the Company holds no security other than the debtor's personal security. * Considered doubtful or bad. • Due by directors or other officers of the Company. • Where a guarantee has been furnished in respect of a debt without the backing of tangible security, it should be ensured that the debt is classified as unsecured. • Due by directors or other officers of the Company or any of them either severally or jointly with any other person. • Due by firms or private companies respectively in which any director is a partner or a director or a member. • Due from other companies under the
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			<p>same management [section 370(1B)] with the names of the companies.</p> <ul style="list-style-type: none"> The maximum amount due by directors or other officers of the Company at any time during the year.
	Accuracy & Valuation	3	The provision for doubtful advances should not exceed the amount stated to be considered doubtful or bad and any such surplus of such provision, if already created, should be shown under Reserves and Surplus.
	Completeness	4	Obtain a list of related party balances and determine that all identified related parties with balances at year end are included in the list.
	Classification & Understand-ability, Accuracy & Valuation, Completeness	5	Examine significant transactions together with the related documents and determine whether they are properly authorized and that the economic substance of the transactions support their recording. Trace the amounts in the list to the trial balance.
	Occurrence & rights and obligations	6	Obtain confirmation of balances.
		M	Conclusion
	-	1	Document the results of the audit procedures performed, the significant points considered in arriving at the conclusion, and a brief statement of the conclusion itself.
	-	2	Consider including the following when documenting the conclusion:

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			<ul style="list-style-type: none"> • A description of the risks associated with the account balance and how these risks were addressed in the substantive testing. • The relevant potential errors and control objectives for each account balance or disclosure being tested. • The substantive procedures performed or a cross-reference to where the substantive procedures are performed, including identification of both direct and indirect tests for the related potential errors. • The results of the substantive tests, including misstatements identified, and how such results support the conclusion on the potential errors for each account balance or disclosure. • The tests of controls we performed or a cross reference to where the tests of controls performed are documented. • The results of the tests of controls, including deficiencies identified, and how such results support the conclusion as to whether control reliance for the potential errors for each account balance or disclosure has been obtained.
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Chapter 7

Current Liabilities and Provisions

7.1 Provisions and liabilities are present obligations arising from past events, the settlement of which is expected to result in an outflow of resources embodying economic benefits. An essential characteristic of a provision or a liability is that the enterprise has a current obligation i.e. a duty or a responsibility to act or perform in a certain way. Obligations may be legally enforceable as a consequence of a binding contract or a statutory requirement. This is normally the case with, for example, amounts payable for goods and services received. However, obligations can also arise from the normal business practices, customs, and a desire to maintain good business relations or to act in an equitable manner. If, for example, an enterprise decides to rectify faults in its products, even when they become apparent after the expiry of the warranty period, the amounts that are expected to be expensed off in respect of goods already sold are provisions. Provisions and liabilities are shown separately in the balance sheet.

7.2 Provisions can be distinguished from other liabilities such as trade payables and accruals because in the measurement of provisions substantial degree of estimation is involved with regard to the future expenditure required in settlement.

Warranty

7.3 Provision for warranty is an important term in relation to the automotive industry.

7.4 Warranties and similar measures taken by a manufacturer and/or a seller are intended to protect the buyer from different types of defects in the product. This covers everything from material and assembly defects to the fact that the product does not meet its previously established standards.

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7.5 Warranty can be a contractual warranty or a campaign warranty as explained below-

A. Contractual Warranty

7.6 In the automotive industry, usually every vehicle delivered from an authorized station is covered by a factory warranty in accordance with the specific conditions. This warranty is known as a contractual warranty and is provided on the sale of the product.

If specific guidance is issued to dealers to extend the cover during the warranty period for certain items and components, future related costs should be included in the provision e.g., for a particular vehicle model, warranty for engine may be extended from one year to three years.

7.7 Contractual warranty costs must be recognized on an accrual basis on the date of sale and should be computed taking into account the following:

- Period of the warranty,
- Average time lag between the sale of a product by the Company and the sale to an end-customer by the dealer,
- Average time lag between the occurrence of a fault and the time of the actual expense to the Company.

7.8 Warranty accrual should be based on warranty cost statistics and take into account anticipated changes in the quality indexes and costs. These costs should be reviewed regularly by the management.

7.9 The auditor should ensure that the provision for warranty is recognized by the Company in accordance with the contract after considering the period of warranty and historical data with respect to the old models. Actual claims received are a good indicator of the provision that may be necessary. In case of new models, provision should be recognized on the basis of estimation of expenses by the management. This estimation should be supported by reasonable and supportable assumptions.

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Illustration

Background

X Auto Limited, a manufacturer of car model – Alpha, provides to its customers a warranty for any manufacturing default for a period of one year from the vehicle's sale. Assuming Alpha model was launched in the market 5 years ago.

Solution

X should recognize the provision for warranty on sale of Alpha. As assumed above, the model Alpha was launched 5 years ago. X should calculate warranty cost using the historical data and calculate warranty cost incurred for a year. Further, X should also consider anticipated changes in the quality indexes and future costs.

Audit procedures

- The terms of the warranty agreement should be checked by the auditor to ensure that all costs related to warranty have been considered.
- The historical data should be checked on test check basis to ensure its accuracy.

7.10 New product warranty costs should be estimated by using statistics for comparable existing products, taking into account anticipated changes in the quality indexes. Further, every automotive Company before launching the vehicle in the market prepares the business case model (budget) for specific vehicle models and engineers estimate the warranty cost that would be incurred for the initial years. The auditors should evaluate the assumptions in detail to ensure the accuracy of the same.

Illustration

Background

Assuming model Alpha is recently launched in the market.

Solution

X should recognize the provision for warranty on the sale of Alpha.

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Since the model Alpha is launched recently, there would be no historical data available with respect to the warranty cost of Alpha. Now, X should calculate warranty cost using the business case model (as explained above) and should also consider statistics for comparable existing products, taking into account the anticipated changes in the quality indexes.

Audit procedures

- The terms of the warranty agreement should be checked by the auditor to ensure that all costs related to warranty have been considered.
- The assumptions considered in the business case (budget) should be evaluated in detail.
- The comparable historical data, if available, should be checked on a test check basis to ensure the accuracy of the same.

7.11 The auditor should ensure that the estimated refunds from the suppliers ("vendor recoveries") should be recognized only when the receipt of such refunds is virtually certain. Historical statistics should be used in order to support the level of highly probable refunds. Estimated refunds should be shown separately in the balance sheet.

7.12 To the extent warranty claims are expected to be settled through the delivery of replacement parts and components, the auditor should ensure that the warranty provision is calculated on a cost basis, i.e. the provision should not cover the Company's future gross profit on the delivery of such parts and components.

B. Campaign Warranty

7.13 Campaign warranty is a warranty cover decided after the sale of the product, which generally relates to specific safety and technical problems. In certain circumstances, the customers are officially required to bring back their vehicle for repair or testing e.g. call back of vehicles; in other cases, repairs are carried out free of charge when the customer brings back his vehicle.

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Campaign warranty costs must be recognized on an accrual basis on the date of the decision and should be computed taking into account the following:

- Number of units of the product produced during the period the problem occurred,
- Estimated proportion of the units produced affected by the problem in question,
- Estimated proportion of the units concerned that will be repaired,
- Estimated cost of parts and labor.

7.14 The auditor should ensure that the provision for campaign warranty is recognized once it has been approved/announced by the Company and is created on the basis of the estimated cost to be incurred by the Company in order to correct such defects.

7.15 Estimated refunds from the suppliers and the future gross profit on replacement parts and components should be treated as described under “contractual warranty” above.

C. Purchased Extended Warranty

7.16 In the recent years, automotive companies are launching purchased warranty schemes in the market which is over and above the normal warranty. In these schemes, usually some amount is charged to the customer. For instance, in a normal warranty scheme only manufacturing default is covered whereas in a purchased extended warranty scheme, all types of repairs, certain part replacements, defects etc. are also covered, usually for a period of 2 to 3 years.

7.17 The auditing issues herein would include the following:

- recognition of revenue for the amounts collected from the buyer.
- recognition of the warranty cost.
- recognition of the upfront loss in the contract.

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- as this extended warranty is for more than a year, matching of cost with revenue over the period.

Illustration

Background

X Auto Limited, a manufacturer of car model – Alpha, has launched a purchased extended warranty scheme for a period of 3 years along with the sale of car. The sale price of Alpha is Rs. 500,000 and Rs. 10,000 is collected for this extended warranty scheme. X has determined that total extended warranty cost would be Rs. 16,000 over the period.

Solution

X should recognize the revenue of Rs. 500,000 on sale of vehicle. Rs. 10,000 collected on sale of extended warranty scheme should be recognized over the period i.e., 36 months. Therefore, revenue would be as follows: Year I – Rs. 3,333.33; year II – Rs. 3,333.33; Year III – Rs. 3,333.33.

The upfront loss of Rs. 6,000 should be recognized immediately on the sale of Alpha.

The policy for recognizing the cost should be reviewed by the Company on regular basis. It is prudent to recognize the cost in proportion to the revenue recognized.

Audit procedures

- The terms of the extended purchase warranty agreement should be checked by the auditor to ensure that the revenue and cost has been accounted correctly.
- Since the data may be voluminous, arithmetic accuracy should be ensured by the auditors.
- The historical data should be checked on a test check basis to ensure the accuracy.

Provision for Retrospective Price Amendments

7.18 Due to price fluctuations in the market and as per the terms of arrangement with the vendors, automobile companies may sometimes have to pay its vendors for an increase in the prices of goods purchased from them.

7.19 Based on further negotiations with the vendors, the Company finalizes the price increase that needs to be given to the vendor. The increase in prices could be retrospective or sometimes prospective.

7.20 The Company needs to make a provision for all retrospective price amendments in the books of account. The Company should ensure the following:

- 1) Prepare a list of all vendors where a price increase provision needs to be made.
- 2) Whether goods received for which the price increase provision is to be made are in stock or consumed.
- 3) Debit inventory if the goods are in stock or debit consumption if the goods are already consumed and credit vendor with the amount of price increase.

7.21 The auditor should ensure the following:

- 1) Appropriate approvals are in place for the price amendments.
- 2) Provision is made for all the goods received as per the terms of contract/ agreement with the supplier.
- 3) Analyze all subsequent supplier claims to ensure completeness of the provision made.

Other Items

7.22 Other items that are included under liabilities and provisions are as follows:

- Deposits from customers/dealers.

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- Advances from customers.
- Legal disputes, such as litigation and claims.
- Book overdrafts.
- Dividend payable.
- Unpaid salary balance.
- Employee recoveries.
- TDS deducted.
- Sundry creditors for materials, expenses and capital goods.
- Stale cheques not presented by payee for which the liability is restored.
- Service tax payable.
- Interest accrued but not due.
- Provision for gratuity and leave encashment.

These balances may be verified in a manner similar to that followed in other industries.

Illustrative Audit Procedures

Identifying and Assessing the Risk of Material Misstatement

7.23 There are various approaches an auditor may use to identify risk at the assertion level for classes of transactions, account balances, and disclosures. One way might be to think about the ways a class of transactions, account balance, or disclosure might be misstated by considering “what can go wrong” for each material class of transactions, account balance, and disclosure. Another way is to consider what particular concerns one has about each assertion in addition to the risk of misstatement described by the assertion itself.

7.24 The auditor should assess each identified risk to determine whether it is a significant risk. This is intended to be a judgment decision based on the auditor’s cumulative knowledge of the entity.

7.25 When Information Technology (IT) is used to initiate, record, process, or report transactions or other financial data for inclusion in the financial statements, the systems and programs may include controls related to the corresponding assertions for material accounts or that may be critical to the effective functioning of manual controls that depend on IT. In such a scenario, the involvement of an IT specialist should be assessed.

7.26 The auditor will need to identify the risk of material misstatement in the financial statements and develop the audit plan accordingly. When the auditor has determined that a significant risk exists, the auditor will have to obtain an understanding of the entity’s controls, including control activities, relevant to that risk.

7.27 Hence, these audit procedures will vary according to the given situation.

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Material Classes of Transactions, Account Balances and Disclosures	Assertions		Illustrative Audit Procedures (these procedures will vary according to the given situation)
Current liabilities and Provisions			
		A	System update
		1	Update and document the understanding of the controls and the accounting system through a review of the system notes in the planning section.
		B	Recording accuracy
	Completeness	1	Obtain a schedule of current liabilities and Provisions. Test the total and reconciliation of the total to: <ul style="list-style-type: none"> • Trial balance. • General ledger. • Balance sheet.
		C	Review of balances
	Completeness, Valuation & Allocation, Rights & Obligations	1	Review and explain movements between current year, prior year and budgeted amounts for all significant amounts.
	Rights & Obligations	2	Review the information in prior year working papers and/or enquire concerning the nature of each significant account and the policies and procedures used to account

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			for them.
	Valuation & Allocation, Rights & Obligations	3	Determine that the accounting policies and procedures for identifying when liability should be recorded are applied consistently.
	Valuation & Allocation	4	Compare payments subsequent to year end with year-end other current liabilities.
	Valuation & Allocation, Rights & Obligations	5	Investigate for any journal entries recorded in the general ledger or subsidiary ledger and other adjustments made in the preparation of the financial statements at the year end and test the appropriateness of such entries.
	Valuation & Allocation, Rights & Obligations	6	Obtain an understanding of the business rationale for significant transactions that are outside the normal course of business of the entity, or that otherwise appear to be unusual given the understanding of the entity and its environment and other information obtained during the audit engagement.
		D	Test Unusual Items
	Valuation & Allocation, Rights & Obligations, Existence	1	Review the other payables control account for the year and investigate the nature of large and unusual items (e.g. entries not arising from normal posting sources, debit entries that do not arise from payment sources) and trace to supporting documents. Review the control account for the first month subsequent to year-end and investigate

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			for large and unusual items that do not follow expected trends.
	Valuation & Allocation, Rights & Obligations	2	Review payable accounts with significant debit balances and check for any misstatements.
	Valuation & Allocation, Rights & Obligations, Existence	3	Review old outstanding balances and determine if these are periodically reviewed by the management and action taken to liquidate such balances.
		4	Evaluate results of the tests.
		E	Test the Propriety of Accrued Expenses and Other Liabilities Accounting Policies and Procedures
	Completeness, Valuation & Allocation, Rights & Obligations	1	Review the information in prior-year working papers and/or inquire concerning the policies and procedures used to account for significant accrued expenses (such procedures may include identifying who determines the need for the accrual, who accumulates reliable data on which to base accruals, who reviews and approves accruals, who compares recorded accruals with subsequent results).
	Valuation & Allocation	2	Inquire as to the reasons for significant changes in accrued expense since the prior year-end.
	Valuation & Allocation, Rights & Obligations	3	Understand the impact of significant accounting policies and compliance with applicable accounting pronouncements on accrued expense balances and

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			determine that the accounting policies and procedures for identifying when accrued expenses should be recorded are appropriate and applied consistently.
	Valuation & Allocation	4	In the course of performing audit procedures in this program, consider whether the audit evidence examined supports the understanding of the accrued expenses accounting policies and procedures and their propriety.
		5	Evaluate results of the tests.
		F	Test Accrued Expenses and Other Liabilities
	Valuation & Allocation, Rights & Obligations, Completeness	1	Obtain the payables trial balance and test the summarization and reconciliation of the total to the general ledger. Trace significant reconciling items, if any, to supporting documents.
	Valuation & Allocation, Rights & Obligations	2	For selected subsequent cash disbursements or unpaid invoices that indicate liabilities incurred but not recorded as accounts payable at the year-end, ascertain whether they were recorded in an appropriate accrued expense account.
	Valuation & Allocation, Rights & Obligations	3	Inquire of management and review information in prior-year working papers concerning the nature of recorded accrued expenses and identify the specific need for such accrual.
		4	Obtain a roll-forward schedule by provision type,

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			and test the reconciliation to the general ledger:
	Valuation & Allocation, Rights & Obligations		<ul style="list-style-type: none"> For the provision existing at the beginning of the year, verify that the provision is still valid.
	Valuation & Allocation, Rights & Obligations		<ul style="list-style-type: none"> Test the charges/additions to the provision.
	Valuation & Allocation, Rights & Obligations		<ul style="list-style-type: none"> Test the reversals of the provisions made in the prior period.
	Valuation & Allocation, Rights & Obligations, Completeness		<ul style="list-style-type: none"> Search for contingent liabilities, and consider the need to record additional provision.
	Valuation & Allocation, Rights & Obligations		<ul style="list-style-type: none"> Consider the effects of subsequent events to provision and contingent liability.
	Valuation & Allocation,		<ul style="list-style-type: none"> Evaluate the overall reasonableness of the ending provision balances.
	Valuation & Allocation, Rights & Obligations	5	For contingent liabilities identified, understand the nature and evaluate the reasonableness of the disclosures.
	Completeness	6	Inquire and consider other available evidence, if any, that unrecorded or under recorded liabilities exist. Consider the following sources of evidence, among others, as applicable:
			<ul style="list-style-type: none"> Prior year balances of accrued expense accounts.

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			<ul style="list-style-type: none"> • Prior and current year balances of related expense accounts.
			<ul style="list-style-type: none"> • Minutes of meetings of those charged with governance.
			<ul style="list-style-type: none"> • Discussions with internal legal counsel.
			<ul style="list-style-type: none"> • Responses to letters of inquiry to independent legal counsel.
			<ul style="list-style-type: none"> • Employee benefit plans (e.g. pension, medical, vacation, deferred compensation), and reports from actuaries, insurance companies etc.
			<ul style="list-style-type: none"> • Subsequent payroll records.
			<ul style="list-style-type: none"> • Periodic expenses (e.g. rent, rates, utilities).
			<ul style="list-style-type: none"> • Interest on loan.
			<ul style="list-style-type: none"> • Sales commissions
			<ul style="list-style-type: none"> • Significant contracts for services performed in the audit period.
			<ul style="list-style-type: none"> • Information about changes made or planned in the entity's business, including changes in operating strategy, and the industry in which the entity operates.
			<ul style="list-style-type: none"> • Regulatory or examination reports.
			<ul style="list-style-type: none"> • Subsequent significant disbursements.
	Rights &	7	For accrued expenses that

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	Obligations		have not changed significantly since the prior year-end, assess whether the circumstances requiring the accruals in the prior year still exist.
	Valuation & Allocation, Rights & Obligations	8	For accruals that are based primarily on known data (i.e. that are not accounting estimates), examine documents supporting the amounts accrued (e.g. service contracts or invoices, subsequent payroll records, property tax statements etc) and cash disbursements in the period subsequent to the year-end.
		9	For accrued expenses that are accounting estimates (e.g. accrued vacation), perform the following procedures:
	Valuation & Allocation, Rights & Obligations, Existence		<ul style="list-style-type: none"> Obtain written documentary evidence supporting the estimates.
	Valuation & Allocation, Rights & Obligations		<ul style="list-style-type: none"> Evaluate the reasonableness of the methods and assumptions management used to make the estimates.
	Valuation & Allocation, Rights & Obligations		<ul style="list-style-type: none"> If management's methods and assumptions were reasonable, test the data and assumptions underlying the estimates and recompute the estimates.
	Completeness		<ul style="list-style-type: none"> Determine that the data used to make

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			independent estimates is independent and reliable and if using information produced by the client, obtain audit evidence about the accuracy and completeness of the data.
	Valuation & Allocation		<ul style="list-style-type: none"> • In assessing the reliability of the data gathered, consider the source of the data and the conditions under which it was gathered.
	Valuation & Allocation, Rights & Obligations, Completeness		<ul style="list-style-type: none"> • If management's methods and assumptions were not reasonable, develop an independent range of reasonable estimates and determine whether management's estimates fall within that range (Note: The factors that might be considered will vary according to the nature of the liabilities).
			<ul style="list-style-type: none"> * Identify those factors and assumptions that are relevant to developing the estimate.
			<ul style="list-style-type: none"> * Accumulate and test relevant supporting data.
	Valuation & Allocation, Rights & Obligations, Completeness		<ul style="list-style-type: none"> • If the recorded estimate falls outside of the independent range, post the difference between the management's estimate and the nearest point in the auditor's expected range as a likely misstatement on

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			‘Evaluation of Misstatements’.
	Valuation & Allocation, Rights & Obligations, Existence	10	For selected accruals with significant balances in the prior year that no longer exist or that have significantly lower balances in the current year:
			<ul style="list-style-type: none"> Assess whether the circumstances requiring the accruals in the prior year no longer exist or whether they warrant reductions in the amounts accrued.
			<ul style="list-style-type: none"> If the accounts consist of only one or very few transactions (e.g. a prior year accrual for a legal liability), trace the disposition of the liability to supporting documents.
		11	Evaluate results of the tests.
		G	Test deductions from employees payroll
	Valuation & Allocation, Rights & Obligations, Completeness	1	Perform substantive analytical procedures to test the amounts to be deducted from employees (for PF and ESIC contributions) and trace the contribution by the entity during the year. Consider developing an expectation of the contribution payable during the year based on:
			<ul style="list-style-type: none"> Prior period balances.
			<ul style="list-style-type: none"> Monthly amounts of salaries during the year compared to such monthly amounts in the prior year.
	Completeness	2	Determine that the data used to make independent

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			estimates is independent and reliable and if information produced by the entity is used, obtain audit evidence about the accuracy and completeness of the data.
	Valuation & Allocation	3	In assessing the reliability of the data gathered, consider the source of the data and the conditions under which it was gathered.
	-	4	Determine the threshold – the amount that represents the maximum difference between the expectation and the recorded contributions that is acceptable without further investigation.
	-	5	Compare the expectation to the recorded balance and identify any differences. For any difference that is more than the threshold, obtain, quantify, and corroborate explanations for the difference by performing further analysis or inquiry and examining supporting documents. Explanation needs to be initially sought for the full amount of the difference, not just that part that exceeds the threshold.
		6	Consider investigating the following:
	Valuation & Allocation, Rights & Obligations		<ul style="list-style-type: none"> Any unusual pattern in the differences.
	Valuation & Allocation, Rights & Obligations,		<ul style="list-style-type: none"> Whether the differences between the actual and budgeted amounts are so close that it could imply that management

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	Completeness		has manipulated either or both items. Use professional skepticism to evaluate whether the considerations give rise to any specific or pervasive risk as a result of fraud risks.
	Valuation & Allocation, Rights & Obligations	7	Corroborate explanations by examining supporting evidence and/or by enquiries directed to persons outside the entity or to independent persons inside the entity.
	Valuation & Allocation, Rights & Obligations, Completeness	8	For selected payments for wages and salaries, check amounts deducted from employees' pay and corresponding contribution by the entity with reference to the rates to be applied, eligible employees, components of pay etc.
	Valuation & Allocation, Rights & Obligations	9	Investigate reasons for any differences and determine whether any errors have been corrected subsequently by adjustment of employees' deductions.
	Valuation & Allocation, Rights & Obligations	10	Review deductions for the year and identify any delays made in depositing deductions in time.
		11	Evaluate results of the tests.
		H	Test liability for sales tax etc.
	Valuation & Allocation, Completeness	1	Review sales tax returns for the last quarter and check adequacy of accrual at the year-end. Trace payments to subsequent disbursement records.
	Valuation &	2	Review the present status of

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	Allocation, Rights & Obligations, Completeness, Existence		assessments in progress and identify any demands received during the year from authorities and inquire on the status of such demands:
			<ul style="list-style-type: none"> Where the demands are disputed by the entity and an appeal has been filed, or in the process of being filed, consider disclosure of such demands as a contingent liability.
			<ul style="list-style-type: none"> Where the entity has provided against the demand, consider the adequacy of such provision.
	Valuation & Allocation, Rights & Obligations, Existence	3	Determine and note any undisputed amounts of sales tax, income tax, service tax, customs duty, excise duty, wealth tax and cess which was outstanding for more than six months as at the year-end.
		4	Evaluate results of the tests.
		I	Test acceptances
	Valuation & Allocation, Rights & Obligations, Completeness, Existence	1	Where bills of exchange are used as a mode of payment to vendors, determine that the accounting policies and procedures for recording such transactions are appropriate. [At the year-end, outstanding bills of exchange accepted but not matured are accounted for as one of the period end entries].
	Valuation & Allocation, Rights & Obligations,	2	Obtain the schedule of bills accepted but not matured at the year-end and test the summarization and the reconciliation of the total to

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	Completeness		the general ledger. Trace significant reconciling items, if any, to the bills payable register and supporting documents.
	Valuation & Allocation, Completeness	3	Make a selection of bills accepted but not matured from the bills payable register and trace to supporting documents and subsequent payments.
	Existence, Completeness	4	For bills of significant amounts, consider obtaining confirmation from parties.
	Valuation & Allocation	5	Test calculation of accrued interest, if any on bills payable.
		6	Evaluate results of the tests.
		J	Test unclaimed dividends
	Completeness	1	Obtain details of unclaimed dividend at the year-end and test the summarization. Trace the total to the general ledger.
	Valuation & Allocation, Rights & Obligations	2	Determine that the provisions of section 205A as regards the transfer of unpaid and/or unclaimed dividends in a separate bank account and/or to the Central government have been complied with.
		3	Evaluate results of the tests.
		K	Test deferred income
	Valuation & Allocation, Rights & Obligations, Completeness	1	For significant sources of income, consider if any income should be deferred to future periods. Consider that the deferral is appropriate and consistent with the prior year.
	Valuation & Allocation, Rights &	2	Test calculation of deferred income and trace to supporting documents.

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	Obligations		
		3	Evaluate results of the tests.
		L	Test Balances Denominated in Foreign Currencies
	Completeness	1	Inquire and consider other available evidence, if any, to identify foreign suppliers with which purchase transactions were in foreign currency.
	Valuation & Allocation	2	Agree the closing rate(s) used to published records and test the translation calculation for items which are monetary as per Accounting Standard 11.
	Valuation & Allocation	3	Trace currency translation adjustments to the general ledger.
		M	Test movements on Provisions
	Valuation & Allocation	1	If any costs have been charged against provisions, determine that such charge is appropriate based on the circumstances.
	Valuation & Allocation, Rights & Obligations	2	For amounts released to the profit & loss account, assess whether the circumstances requiring the provisions in the prior year no longer exist or whether they warrant reductions in the amounts accrued.
	Valuation & Allocation	3	Inquire into any other movements in provisions and check that they are appropriate based on circumstances and is adequately supported.
	Completeness	4	Determine that the treatment of over or under provisions

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			arising from provisions since the prior year-end is appropriate.
		N	Test provision for gratuity
	Valuation & Allocation, Rights & Obligations, Completeness	1	Understand the impact of significant accounting policies and compliance with applicable accounting pronouncements on gratuity payable to employees of the entity.
	Valuation & Allocation, Rights & Obligations, Completeness, Existence	2	Inquire and determine the procedures adopted by the entity for payment of gratuity and test the provision for the following:
			<ul style="list-style-type: none"> • Payments are made from the funds of the entity. Test the year-end provision recorded in the general ledger on the basis of an actuarial valuation.
			<ul style="list-style-type: none"> • Payments are made by a trust set up by the entity. Test the year-end contribution to the trust on the basis of an actuarial valuation.
			<ul style="list-style-type: none"> • Payments are made through a scheme administered by the insurance service provider. Test the year-end contribution to the insurance service provider as intimated by the insurance service provider.
	Rights & Obligations, Existence	3	Obtain a copy of the trust deed and rules, current year and prior year valuation

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			report of the actuary, any other statements issued by the actuary subsequent to the last valuation report.
	Valuation & Allocation, Rights & Obligations, Completeness, Existence	4	If liability for payment of gratuity is determined by an actuarial valuation, review the valuation report of the actuary and ensure through discussions with the actuary:
			<ul style="list-style-type: none"> Reasonableness of the data provided by the entity for the purpose of an actuarial valuation and whether such data is comparable to industry norms.
			<ul style="list-style-type: none"> Effect on the valuation of any legislative changes, if any, since the date of the year-end valuation.
			<ul style="list-style-type: none"> Effect on the valuation of any changes in the scheme or rules, if any, since the date of the year-end valuation.
			<ul style="list-style-type: none"> Recommendation of the actuary for dealing with any material surplus or deficiency.
			<ul style="list-style-type: none"> Cost of any past service benefit awards made during an inter-valuation period for which no allowance was made in the funding plan.
			<ul style="list-style-type: none"> Any additional reports by the actuary or any other matters concerning the valuation.
			<ul style="list-style-type: none"> Reason for any qualification/reservation by the actuary in his

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			valuation report.
	Valuation & Allocation	5	If the liability for payment of gratuity is not determined by an actuarial valuation (number of employees being few), test the basis adopted for recording an estimate and ensure that such estimate is, at the minimum, in line with the Payment of Gratuity Act.
		6	Evaluate results of the tests.
		0	Test Other Provisions
	Valuation & Allocation, Rights & Obligations, Completeness	1	Understand the impact of significant accounting policies and compliance with applicable accounting pronouncements for provisions.
	Valuation & Allocation, Rights & Obligations, Completeness	2	Inquire of management and review information in prior-year working papers concerning the nature of recorded provisions and identify the specific need for such provisions.
		3	Obtain a roll-forward schedule of provisions showing beginning and ending balances, current-year adjustments and current-year provisions and perform the following:
	Valuation & Allocation, Rights & Obligations, Completeness		<ul style="list-style-type: none"> Test the mathematical accuracy of the schedule and agree the beginning balances to prior year working papers and the ending balances and current-year provisions to the general ledger. Trace significant reconciling items, if any, to supporting documents.

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	Valuation & Allocation, Rights & Obligations		<ul style="list-style-type: none"> For the provision existing at the beginning of the year, verify that the provision is still valid.
	Valuation & Allocation		<ul style="list-style-type: none"> Test the charges/additions to the provision.
	Valuation & Allocation		<ul style="list-style-type: none"> Test the reversals of the provisions made in the prior period.
	Valuation & Allocation, Rights & Obligations, Completeness		<ul style="list-style-type: none"> Search for contingent liabilities, and consider the need to record additional provision.
	Valuation & Allocation, Rights & Obligations		<ul style="list-style-type: none"> Consider the effects of subsequent events to provision and contingent liability.
	Valuation & Allocation		<ul style="list-style-type: none"> Evaluate the overall reasonableness of the ending provision balances.
	Completeness	4	Inquire and consider other available evidence, if any, that unrecorded or under recorded provisions exist. Consider the following sources of evidence, among others, as applicable:
			<ul style="list-style-type: none"> Prior year balances of provisions.
			<ul style="list-style-type: none"> Minutes of meetings of those charged with governance.
			<ul style="list-style-type: none"> Warranties granted.
			<ul style="list-style-type: none"> Maintenance obligations under contracts.
			<ul style="list-style-type: none"> Cost of completion of contracts which have been included in the

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			turnover.
			<ul style="list-style-type: none"> • Gratuity benefits not covered by gratuity schemes.
			<ul style="list-style-type: none"> • Other claims against the entity.
	Valuation & Allocation, Rights & Obligations	5	For provisions that have not changed significantly since the prior year-end, assess whether the circumstances requiring the provisions in the prior year still exist.
	Valuation & Allocation, Rights & Obligations, Existence	6	For provisions that are based primarily on known data (i.e. that are not accounting estimates), examine documents supporting the provisions.
		7	For provisions that are accounting estimates, perform the following procedures:
	Valuation & Allocation, Rights & Obligations		<ul style="list-style-type: none"> • Obtain written documentary evidence supporting the estimates.
	Valuation & Allocation		<ul style="list-style-type: none"> • Evaluate the reasonableness of the methods and assumptions management used to make the estimates.
	Valuation & Allocation		<ul style="list-style-type: none"> • If management's methods and assumptions were reasonable, test the data and assumptions underlying the estimates and recompute the estimates.
	Completeness		<ul style="list-style-type: none"> • Determine that the data used to make independent estimates is

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			independent and reliable and if information produced by the entity is being used, obtain audit evidence about the accuracy and completeness of the data.
	Valuation & Allocation		<ul style="list-style-type: none"> • In assessing the reliability of the data gathered, consider the source of the data and the conditions under which it was gathered.
	Valuation & Allocation, Rights & Obligations, Completeness		<ul style="list-style-type: none"> • If management's methods and assumptions were not reasonable, develop an independent range of reasonable estimates and determine whether management's estimates fall within that range (Note: The factors that might be considered will vary according to the nature of the liabilities).
			<ul style="list-style-type: none"> * Identify those factors and assumptions that are relevant to developing the estimate.
			<ul style="list-style-type: none"> * Accumulate and test relevant supporting data.
			<ul style="list-style-type: none"> • If the recorded estimate falls outside of the independent range, post the difference between the management's estimate and the nearest point in the auditor's expected range as a likely misstatement.

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	Valuation & Allocation, Rights & Obligations	8	For selected provisions with significant balances in the prior year that no longer exist or that have significantly lower balances in the current year:
			<ul style="list-style-type: none"> Assess whether the circumstances requiring the provisions in the prior year no longer exist or whether they warrant reductions in the amounts accrued.
		9	Evaluate results of the tests.
		P	Test Presentation of Provisions
	Classification & Understandability, Accuracy & Valuation, Completeness, Occurrence & rights and obligations	1	Understand the impact of significant accounting policies and compliance with applicable accounting pronouncements on provisions.
	Classification & Understandability, Accuracy & Valuation, Occurrence & rights and obligations	2	<p>Determine that amounts presented as provisions are properly recorded, classified and/or disclosed as required by Schedule VI to the Companies Act:</p> <ul style="list-style-type: none"> Provision for taxation. Provision for contingencies. Provision for provident fund scheme. Provision for insurance, pension and other staff benefit schemes. Provision for warranty. Provision for liquidated damages. Provision for anticipated

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			<p>loss on contracts.</p> <ul style="list-style-type: none"> • Provision for interim, proposed final dividend and dividend tax. • Other provisions.
		Q	Test Presentation of Accrued Expenses
	Classification & Understand-ability, Accuracy & Valuation, Completeness, Occurrence & rights and obligations	1	<p>Understand the impact of significant accounting policies and compliance with applicable accounting pronouncements on other current liabilities.</p>
	Classification & Understand-ability, Accuracy & Valuation, Occurrence & rights and obligations	2	<p>Determine that amounts presented as other current liabilities are properly recorded, classified and/or disclosed as required by Schedule VI of the Companies Act:</p> <ul style="list-style-type: none"> • Acceptances. • Advance payments. • Dues to subsidiary companies. • Unclaimed dividends. • Interest accrued but not due on loans. • Other liabilities, if any. • Balance in current account with directors and/or managers.
	Accuracy & Valuation	3	<p>Check that security deposits received from employees are kept in a separate bank account</p>
	Classification & Understand-ability,	4	<p>If applicable, determine that the balances listed below are properly classified. Extract</p>

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	Accuracy & Valuation		the following information:
			<ul style="list-style-type: none"> Debit balances in accrued expenses.
	Classification & Understandability, Accuracy & Valuation, Completeness, Occurrence & rights and obligations	5	If applicable, determine that the items listed below are properly recorded, classified, and/or disclosed. Extract the following information:
			<ul style="list-style-type: none"> Accrued expenses owed to related parties.
			<ul style="list-style-type: none"> Lease obligations.
	Completeness	6	Obtain from the management the information identifying all known related parties, account balances and transactions, and test the information for completeness.
	Classification & Understandability, Accuracy & Valuation, Occurrence & rights and obligations	7	Examine the identified related party balances or transactions, and obtain sufficient appropriate audit evidence as to whether these account balances or transactions have been properly recorded and disclosed.
		R	Conclusion
	-	1	Document the results of the audit procedures performed, the significant points considered in arriving at the conclusion, and a brief statement of the conclusion itself.
	-	2	Consider including the following when documenting the conclusion:

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		<ul style="list-style-type: none">• A description of the risks associated with the account balance and how these risks were addressed in the substantive testing.• The relevant potential errors and control objectives for each account balance or disclosure being tested.• The substantive procedures performed or a cross-reference to where the substantive procedures are performed, including identification of both direct and indirect tests for the related potential errors.• The results of substantive tests, including misstatements identified, and how such results support the conclusion on the potential errors for each account balance or disclosure.• The tests of controls performed or a cross reference to where the tests of controls performed are documented.• The results of tests of controls, including deficiencies identified, and how such results support the conclusion as to whether control reliance for the potential errors for each account balance or disclosure has been obtained.
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Chapter 8

Other Income

8.1 While auditing other income, the auditor is primarily concerned with obtaining a reasonable assurance that the income recorded is based on the transactions that took place during the relevant period and pertains to the entity, that there is no unrecorded income, and that the income is recorded in the proper amounts and is allocated to the proper period.

Brand Fees

8.2 Generally, in the automobile industry oil, paint, tyre etc. suppliers enter into an agreement with the Company in order to promote their brand. The automobile Company charges fees from these companies for using their brand name on the product. Such income is recognized as "Other Income" in the statement of profit and loss.

8.3 The auditor should verify the rates with the agreement and ensure that the accounting is in accordance with the agreement.

Scrap Sales

8.4 Besides steel, in an automobile industry, other metals such as aluminium and copper can also be scrapped and have a high salvage value. It is always cheaper, more efficient and environment friendly to recover metals from scrap than by mining and processing raw materials. Unbroken windows and windshields are removed intact and are resold to the car owners who need replacements. Broken glasses can be recycled. The leftover is put in a crusher that uses a mobile bailing press or a flattener to crush the car and then, is run through a hammer mill that smashes the remains into fist-sized pieces. These can be sold as scrap. Besides auto salvage yards and scrap recyclers, there is an industry of auto scavengers and auctioneers who compete to be the middlemen in obtaining cash for scrap cars by selling the cars to the highest bidder. Besides this, removable parts like

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headlights, taillights, blinkers, mirrors, parts of the exhaust system, seats etc. which can be resold as used repair parts, major parts such as transmissions and engines can also be sold to auto parts companies who can rebuild these parts and sell them in the market.

8.5 The auditor should ensure that Company has an appropriate control system for approving generation of scrap and wastages/rejections. These rejections and wastages should be analyzed by the appropriate authority levels in the Company on a timely basis. The auditor should also analyze input out ratios and compare the scrap generation with past trend and document reason for major variances, if any.

8.6 The auditor should check the controls the Company has with respect to accounting and safe storage of scrap. The auditor should also verify the accounting treatment for the scrap sales. Generally, all the auctions are on advance receipts basis. The bidding documents, procedure of auction and settlement for the same should be verified along with the deduction of proper TCS on the transaction.

Accounting for Export Benefits

8.7 One significant item of other income for automobile companies is the various export benefits that they get from the government agencies. These export benefits could be in the form of duty drawback, duty credits etc. The auditor should review the accounting policy followed by the Company in accounting for such export benefits and ensure that the same is reasonable. Normally export benefits are accounted for on accrual basis considering the eligibility of the Company and when there is no uncertainty in receiving the same. The auditor should verify the licenses and other approvals received from the government entitling the Company to these export benefits. The auditor should verify whether the export benefits have been accounted for in respect of all export sales during the period under audit unless the same does not qualify for recognition under the principles laid down in A 9- Revenue Recognition.

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8.8 The auditor should also ensure that appropriate disclosures are made for the accounting policy followed by the Company in respect of accounting for export benefits.

Provisions Written Back

8.9 Any excess provision of the previous year, which no longer may be required, is credited to the statement of profit and loss.

8.10 The auditor should enquire about the reasons for these provisions written back and why these provisions were created originally. The correspondences with the supplier, if any, should be checked. It should be ensured that the provisions written back are old and management is able to prove that these are no longer payable.

Interest on Income Tax Refunds

8.11 Where an assessment order is received during the year, the auditor should examine the assessment order and if any interest is received along with the amount of refund, it should be considered as income. In case, where the assessment results in a fresh demand, the auditor should consider the need for additional provisioning. Where an assessment order is received during the course of audit, the auditor should examine and consider its impact, if any, on the accounts and the financial statements.

8.12 It is not prudent to recognize interest on a possible refund which has not been determined in any order received from the tax authorities.

Profit on Sale of Investments

8.13 Profit on the sale of investments (in the form of quoted investments, units of mutual funds, debentures etc.) is included under this head. The auditor should verify this in a manner similar to that followed in any other industry.

Profit on Sale of Fixed Assets

8.14 This includes profit (net of any loss) on sale of land, buildings, furniture, motor vehicles, plant and machinery etc.

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8.15 The auditor should verify the supporting documents for the sale such as the management approval, the policy of the Company, invoices, quotations invited to verify the transaction etc.

8.16 The auditor should verify the entries made in the fixed asset register in order to check the accuracy of the transactions.

Interest Income

8.17 Automobile industry is a capital-intensive industry. Most companies carry large amounts of debts in their balance sheets and rarely, have surplus funds. However, the entity may have invested temporary surplus funds in fixed deposits. Interest on such deposits may be verified by the auditor in a manner similar to that followed in any other industry. The auditor should verify the computation of the interest, its accounting and the TDS details related to it. TDS details can be verified from the Form 16A.

8.18 Interest can also be received on inter-Company deposits placed with the group companies or other corporate bodies. The auditor should ensure that the interest is recognized accurately in the books of accounts by verifying the principal amount, the rate of interest and the period of loan.

8.19 Interest on delayed payments by customers should be verified with reference to the terms of sales.

Income from Investments

8.20 This includes the income derived from the investment portfolio by way of interest and dividend including dividends received from subsidiaries and joint ventures in India/abroad.

8.21 The auditor should ensure that income is recognized accurately in the books of accounts by verifying the principal amount, the rate of interest and the period of investment.

Dividends

8.22 Dividends received should be checked with reference to counterfoils of dividend warrants. As per AS 9, Revenue Recognition, dividends should be recognized when the right to receive the payment is established.

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8.23 The auditor should ensure that dividend income is recognized accurately in the books of accounts by verifying the principal amount and the dividend rate declared by the investee Company.

Foreign Exchange Fluctuations

8.24 Foreign exchange difference is the difference resulting from reporting the same number of units of a foreign currency in the reporting currency at different exchange rates. Exchange rate is the ratio for exchange of two currencies. Foreign currency is a currency other than the reporting currency of an enterprise.

8.25 Foreign currency transactions are recorded at the rates of exchange prevailing on the date of the transactions according to AS-11.

8.26 There are two types of gains related to foreign exchange fluctuation:

1. Realized Gain: The gain which is actually realized during the year and not arising due to restatement of monetary items at the closing rate.
2. Unrealized Gain: Monetary foreign currency assets and liabilities are translated into rupees at the rate of exchange prevailing on the balance sheet date.

8.27 The differences arising on the translation of monetary assets and liabilities (unrealized) and realized gains and losses on foreign currency transactions are recognized in the profit and loss account.

8.28 The auditor should verify the accounting treatment of the exchange rate differences and should ensure that it is in accordance with AS-11.

Miscellaneous Receipts

8.29 Recovery of liquidated damages under a contract, late payment charges from the customers, interest on staff loans and advances, insurance claims, stale check credits etc. are credited to this account.

Illustrative Audit Procedures

Identifying and Assessing the Risk of Material misstatement -

8.30 There are various approaches an auditor may use to identify risk at the assertion level for classes of transactions, account balances, and disclosures. One way might be to think about the ways a class of transactions, account balance, or disclosure might be misstated by considering “what can go wrong” for each material class of transactions, account balance, and disclosure. Another way is to consider what particular concerns one has about each assertion in addition to the risk of misstatement described by the assertion itself.

8.31 The auditor should assess each identified risk to determine whether it is a significant risk. This is intended to be a judgment decision based on the auditor’s cumulative knowledge of the entity.

8.32 When Information Technology (IT) is used to initiate, record, process, or report transactions or other financial data for inclusion in the financial statements, the systems and programs may include controls related to the corresponding assertions for material accounts or that may be critical to the effective functioning of manual controls that depend on IT. In such a scenario, the involvement of an IT specialist should be assessed.

8.33 The auditor will need to identify the risk of material misstatement in the financial statements and develop the audit plan accordingly. When the auditor has determined that a significant risk exists, the auditor will have to obtain an understanding of the entity’s controls, including control activities, relevant to that risk.

8.34 Hence, these audit procedures will vary according to the given situation.

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Other Income

Material Classes of Transactions, Account Balances and Disclosures	Assertions		Audit Procedures
Other Income		A	System update
		1	Update and document the understanding of the controls and the accounting system through a review of the system notes in the planning section.
		B	Recording accuracy
	Completeness	1	Obtain/prepare a schedule of various heads of accounts in other income. Test the total and reconciliation of the total to: <ul style="list-style-type: none"> • Trial balance. • General ledger. • Profit & Loss Account.
		C	Review of balances
	Occurrence, Accuracy, Completeness	1	Review and explain movements between current year, prior year and budgeted amounts for all significant amounts.
	Classification	2	Review the information in prior year working papers and/or inquire the nature of each significant account and the policies and procedures used to account for them.
	Accuracy	3	Determine that the accounting policies and procedures for identifying

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			when other income should be recorded are applied consistently.
	Accuracy, Occurrence	4	Investigate for any journal entries recorded in the general ledger or subsidiary ledger and other adjustments made in the preparation of the financial statements at the year end and test the appropriateness of such entries.
	Accuracy, Classification, Occurrence	5	Review accounts for the year and investigate the nature of large and unusual items (e.g. credit entries that do not arise from receipt) and trace to supporting documents.
	Accuracy, Classification, Occurrence	6	Review income accounts with significant debit balances and check for any misstatements.
		7	Investigate all significant variations.
		D	Test Other Income
			<i>Certain account balances in other income (e.g. profit on sale of fixed assets would be tested in the Model Audit Programs for fixed assets. It is important to avoid any repetition.</i>
	Occurrence, Accuracy, Completeness	1	Perform substantive analytical procedures to test other income by developing an expectation of other income from independent data.
	Occurrence, Accuracy, Completeness	2	Consider disaggregating the data used to build the expectations and the

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			recorded operating expenses at a level of detail sufficient to enable us to obtain the desired level of assurance based on a comparison of the amounts. Consider the following means of disaggregation:
			<ul style="list-style-type: none"> • By period.
			<ul style="list-style-type: none"> • By account, product line, or both.
			<ul style="list-style-type: none"> • By division or location.
	Accuracy	3	Determine that the data used to make independent estimates is independent and reliable and if information produced by the client is being used, obtain audit evidence about the accuracy and completeness of the data.
	Accuracy	4	In assessing the reliability of the data gathered, consider the source of the data and the conditions under which it was gathered.
	-	5	Determine the threshold – the amount that represents the maximum difference between the expectations and the recorded other income that is acceptable without further investigation.
	-	6	Compare the expectations to the recorded amounts and identify any differences. For any difference that is more than the threshold, obtain, quantify, and corroborate explanations for the difference by performing

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			further analysis or inquiry and examining supporting documents. Explanation needs to be initially sought for the full amount of the difference, not just that part that exceeds the threshold.
		7	Also consider investigating the following:
	Occurrence, Accuracy		<ul style="list-style-type: none"> Any unusual pattern in the differences.
	Occurrence, Accuracy		<ul style="list-style-type: none"> Whether the differences between the actual and budgeted amounts are so close that it could imply that management has manipulated either or both items. Use professional skepticism to evaluate whether the considerations give rise to any specific or pervasive risk as a result of fraud risks.
		8	Make a selection of recorded other income from independent source documents and perform the following:
	Completeness		<ul style="list-style-type: none"> Test the numerical sequence of the source records, if numerically controlled, or otherwise test the completeness of the records.
	Occurrence, Accuracy		<ul style="list-style-type: none"> Trace the selection to an invoice or other supporting documents.
	Accuracy		<ul style="list-style-type: none"> Verify additions and extensions on the invoice.

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	Accuracy		<ul style="list-style-type: none"> Test calculation of other income.
	Cut Off		<ul style="list-style-type: none"> Determine that the income was recorded in the correct period.
	Completeness		<ul style="list-style-type: none"> Trace the amount to the general ledger.
		9	Evaluate results of the tests.
		E	Test operating leases where entity is a lessor
		1	Obtain schedules of operating leases where entity is a lessor showing beginning and ending balances and lease additions and terminations during the current period and perform the following:
	Completeness		<ul style="list-style-type: none"> Test summarization of the schedule.
	Completeness		<ul style="list-style-type: none"> Trace ending balances to the general ledger.
	Accuracy, Occurrence		<ul style="list-style-type: none"> Trace details to agreements.
	Accuracy		<ul style="list-style-type: none"> Determine the propriety of capitalization for items included.
	Accuracy		<ul style="list-style-type: none"> Determine the propriety of the depreciation methods used.
	Accuracy, Occurrence		<ul style="list-style-type: none"> Trace the lease income to the general ledger and cash receipt records.
	Completeness	2	Make inquiries of management, and consider whether evidence obtained

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			from other audit procedures indicates the existence of additional leases.
		3	Make a selection of items from the beginning balances and current period additions column of the schedule.
	Accuracy, Occurrence		<ul style="list-style-type: none"> Trace the minimum lease payments and the period of the lease to supporting documents (e.g. lease agreements). Recompute current period depreciation expense.
	Accuracy, Occurrence	4	Prepare, or have the entity prepare, confirmation requests for all leases at Step E.1. On the confirmation, consider including outstanding balance and rental income received.
			<ul style="list-style-type: none"> Mail the confirmation requests under the auditor's control, determine that the requests are properly addressed (i.e. obtain audit evidence about the accuracy and completeness of addresses provided by the entity) and request that all replies be sent directly to the auditor's office.
			<ul style="list-style-type: none"> Send second request for non-replies. Request the entity to follow up, if necessary.
			<ul style="list-style-type: none"> Compare replies to

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			requests. Prepare, or have the entity prepare, reconciliation of exceptions. Trace reconciling items to supporting documents (e.g. lease agreements, bank statements) and determine that the lease rental income has been properly recorded.
			<ul style="list-style-type: none"> Trace non-replies to subsequent cash receipts from lessees.
			<ul style="list-style-type: none"> Inquire into any significant disputed balances. Investigate as necessary.
		5	Evaluate results of the tests.
		F	Test Foreign Currency Transactions
	Completeness	1	Inquire and consider other available evidence, if any, to identify transactions in foreign currency.
	Accuracy	2	Agree the closing rate(s) used to published records and test the translation calculation for items which are monetary in nature as per Accounting Standard 11.
	Accuracy, Classification	3	Trace currency translation adjustments to the general ledger.
		G	Test scrap sales
	Accuracy, Occurrence, Completeness	1	Perform substantive analytical procedures to test scrap sales. Consider developing an expectation of

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			scrap sales during the year:
			<ul style="list-style-type: none"> Historical and current year trends in scrap sales.
			<ul style="list-style-type: none"> Historical and current year trends in costs of scrap sales and gross margins.
			<ul style="list-style-type: none"> Beginning and ending balances in scrap inventory accounts.
	Accuracy	2	Determine that the data used to make independent estimate is independent and reliable and if information produced by the client is being used, obtain audit evidence about the accuracy and completeness of the data.
	Accuracy	3	In assessing the reliability of the data gathered, consider the source of the data and the conditions under which it was gathered.
	-	4	Determine the threshold – the amount that represents the maximum needed to identify a significant difference between the expectation and the recorded scrap sales balance that is acceptable without further investigation.
	-	5	Compare the expectation to the recorded balance and identify any differences. For any difference that is more than the threshold, obtain, quantify, and corroborate explanations for the difference by performing

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			further analysis or inquiry and examining supporting documents. Explanation needs to be initially sought for the full amount of the difference, not just that part that exceeds the threshold.
	Accuracy, Completeness, Classification	6	We also consider investigating the following:
			<ul style="list-style-type: none"> Any unusual pattern in the differences.
			<ul style="list-style-type: none"> Whether the differences between the actual and budgeted amounts are so close that it could imply that management has manipulated either or both items. Use professional skepticism to evaluate whether the considerations give rise to any specific or pervasive risk as a result of fraud risks.
		7	Perform tests of details of scrap sales:
	Accuracy, Occurrence		<ul style="list-style-type: none"> Trace the item to a sales invoice.
	Accuracy		<ul style="list-style-type: none"> Verify additions and extensions on the invoice.
	Accuracy		<ul style="list-style-type: none"> Ensure that VAT and excise duty has also been included in the sales invoice. Trace excise duty on the invoice with the excise records.
	Accuracy,		<ul style="list-style-type: none"> Agree the sales to

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	Occurrence		advances received from the dealers. Trace the advance received to cash receipt records.
	Classification	8	Investigate the reasons for generation of scrap (i.e. normal or abnormal). Verify that scrap generation documents have been properly authorized.
	Occurrence	9	Consider confirmation of scrap sales.
		10	Evaluate results of the tests.
		H	Test Presentation of Other Income
	Classification, Understand-ability, Valuation, Accuracy	1	Understand the impact of significant accounting policies and compliance with applicable accounting pronouncements on other income.
	Classification & Understand-ability, Valuation & Allocation Classification & Understand-ability Classification & Understand-ability, Valuation & Allocation Classification & Understand-ability,	2	Determine that amounts presented as other income are properly recorded, classified and/or disclosed as required by Schedule VI of the Companies Act: <ul style="list-style-type: none"> • Interest and dividend from investments (showing separately interest/dividend from subsidiary companies, income from long-term and current investments as well as from trade investments and other investments. • Gross income, showing separately taxes deducted at source. • Profit on disposal of long-

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	Valuation & Allocation Classification & Understandability, Valuation & Allocation Classification & Understandability, Valuation & Allocation, Completeness, Occurrence & rights and obligations		<p>term and current investments.</p> <ul style="list-style-type: none"> • Profit on sale of fixed assets. • Miscellaneous income. • Earnings in foreign exchange classified under: • Royalty, know-how, professional and consultancy fees. • Interest and dividend. • Other income, indicating the nature thereof. • Income from related parties.
		I	Conclusion
	-	1	<p>Document the results of the audit procedures performed, the significant points considered in arriving at the conclusion, and a brief statement of the conclusion itself.</p>
	-	2	<p>Consider including the following when documenting the conclusion:</p> <ul style="list-style-type: none"> • A description of the risks associated with the account balance and how these risks were addressed in the substantive testing. • The relevant potential errors and control objectives for each account balance or disclosure being tested. • The substantive procedures performed or

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			<p>a cross-reference to where the substantive procedures are performed, including identification of both direct and indirect tests for the related potential errors.</p> <ul style="list-style-type: none">• The results of the substantive tests, including misstatements identified, and how such results support the conclusion on the potential errors for each account balance or disclosure.• The tests of controls performed or a cross reference to where the tests of controls performed are documented.• The results of the tests of controls, including deficiencies identified, and how such results support the conclusion as to whether control reliance for the potential errors for each account balance or disclosure has been obtained.
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**Technical Guide on Audit of
Non-Banking Financial
Companies
(*Revised Edition 2012*)**

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Foreword

Non-banking financial companies (NBFCs) are an important segment of the Indian financial sector. They raise funds from the public and provide loans to various entrepreneurs, not only in the corporate sector and organized sector but also in the unorganised sector, especially, to the small-scale industries and the self-employed. NBFCs are playing a significant role in the financial sector by broadening and diversifying the range of services provided by the financial sector to the public.

However, NBFCs are also prone to misuse of public funds, irregularities in functioning, unsustainability of operations, bankruptcies. Therefore, the role of statutory audits of NBFCs is very important to bring discipline in the functioning of NBFCs. Audit of NBFCs involves many peculiarities which can be addressed through a technical audit guide dealing with various aspects of audit of NBFCs.

I am happy that the Auditing and Assurance Standards Board of ICAI has brought out this Revised Edition of the Technical Guide on Audit of Non-Banking Financial Companies whose first edition was issued in the year 2010. I am also happy that the Technical Guide is quite comprehensive in its coverage, dealing with various aspects of audit of NBFCs, including the various circulars/notifications, guidelines issued by the RBI relating to NBFCs.

At this juncture, I wish to place my appreciation for CA. Abhijit Bandyopadhyay, Chairman, Auditing and Assurance Standards Board for continuing his proactive initiatives to help the members in conducting audits in real life situations in various industries in the form of such industry specific Technical Guides. I am sure the members would find this Technical Guide immensely useful. I also eagerly look forward to more such Technical Guides and other technical publications from the Auditing and Assurance Standards Board.

June 25, 2012
New Delhi

CA. Jaydeep Narendra Shah
President, ICAI

Preface

A sound financial sector is important for financial stability and higher economic growth in the country. Financial intermediaries like Non Banking Financial Companies (NBFCs) play very important role in the financial sector, particularly in a developing economy like ours. NBFCs, particularly, the Micro Finance Institutions (MFIs) are an important link in bridging the funding requirements of the people living in the remotest corner of the country. Given their importance in the financial sector, the NBFCs are recognized as being complementary to the banking sector.

Given the large quantum of public money that is handled by them and spread of their client base, NBFCs operate under strict regulatory regime of the Reserve Bank of India (RBI). RBI, in turn, has issued detailed registration requirements as well as a number of prudential guidelines to ensure proper functioning of NBFCs and, above all, protect the public interest. Compliance with these registration requirements and also the prudential guidelines, particularly, those that are critical to the continuity of operations and the financial reporting framework of the NBFCs is, therefore, a prime focus area in audit of NBFCs.

It, therefore, gives me immense pleasure to place in your hands the 2012 edition of the Guide to Audit of Non Banking Financial Companies, which is completely revised version of its 2010 edition. This revised Guide has heightened focus on aspects such as knowledge of the operating and the financial reporting environment, including how the requirements of the revised Schedule VI to the Companies Act, 1956 would apply to NBFCs. It also contains comprehensive guidance on areas of concern for auditors of NBFCs, especially, the balances with other banks, money market instruments, etc. The Guide also extensively deals with areas of accounting and regulatory concern in respect of NBFCs, viz., investments and income recognition and related aspects such as securities held for trading, portfolio investments, treasury operations, credit function, loans, accounts with depositors, capital and reserves, income recognition, prudential guidelines of RBI, etc. The Appendices to the Guide contain illustrative audit report / certificate templates, illustrative audit

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checklist, etc., that I am sure will come handy to the auditors of NBFCs.

At this juncture, I wish to place on record, my sincere gratitude to CA. Harinderjit Singh, Gurgaon and his team comprising CA. A Jayashankar and CA Ridhima Dubey squeezing time out of their pressing preoccupations for developing this 2012 revised Guide.

I also wish to express my sincere thanks to, CA. Jaydeep N. Shah, President, ICAI as well as, CA. Subodh Kumar Agrawal, Vice President, ICAI whose vision, guidance and support I have been privileged to receive in the activities of the Board.

Many thanks are also due to my Council colleagues at the Board, viz., CA. Shiwaji Bhikaji Zaware, Vice Chairman, CA. Amarjit Chopra, CA. Anuj Goyal, CA. G. Ramaswamy, CA. Jayant P. Gokhale, CA. J. Venkateswarlu, CA. Naveen N.D. Gupta, CA. Nilesh S. Vikamsey, CA. Pankaj Inderchand Jain, CA. Pankaj Tyagee, CA. Rajendra Kumar P., CA. S. Santhanakrishnan, CA. V. Murali, and Central Government nominee, Shri Gautam Guha and also to the co-opted members at the Board, viz., CA. Raj Agrawal, CA. Vinay Balse, CA. Purshotam Gaggar, CA. Pramod S. Shingte, CA. Partha Sarathi De for their dedication and support to the work plan of the Board and bringing them to fruition. I also wish to place on record my thanks to the special invitees to the Board, viz., Prof. Manoj Anand, CA. B. Padmaja, CA. Amit Roy, Shri S. Ravindran, CA. Khurshed Pastakia, CA. Gopal Mahadevan, CA. Anil Sharma, CA. N. D. Gupta, CA. Raj Kumar Aggarwal, CA. Jaideep Bhargava, CA. Shashi Gupta and CA. Santosh Gupta for their support to the Board. I also wish to thank the Secretariat of the Auditing and Assurance Standards Board for their efforts in giving the Guide its final shape.

I am confident that this Revised Technical Guide would be well received by not only the members carrying out audits of NBFCs but also other interested readers.

July 6, 2012
Kolkata

CA. Abhijit Bandyopadhyay
Chairman,
Auditing and Assurance Standards Board

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Chapter 1

Introduction

1.1 Non banking financial companies or NBFCs, play an important part of the Indian economy. The areas in which these entities play an important role traditionally include equipment leasing, hire-purchase, making loans and investments. Given the nature of these companies, through Chapter III B of the Reserve Bank of India Act, 1934, the Reserve Bank of India (RBI) was entrusted with the regulation and supervision with the following objectives:

- to ensure healthy growth of the financial companies;
- to ensure that these companies function as a part of the financial system within the policy framework, in such a manner that their existence and functioning do not lead to systemic aberrations; and that
- to sustain the quality of surveillance and supervision exercised by the Bank over the NBFCs by keeping pace with the developments that take place in this sector of the financial system.

What is an NBFC?

1.2 A Non-Banking Financial Company (NBFC) is a company registered under the Companies Act, 1956 and is engaged in the business of loans and advances, acquisition of shares/stock/bonds/debentures/securities issued by Government or local authority or other securities of like marketable nature, leasing, hire-purchase, insurance business, chit business but does not include any institution whose principal business is that of agriculture activity, industrial activity, sale/purchase/construction of immovable property.

1.3 Section 45-I(f) of Reserve Bank of India Act, 1934 defines non-banking financial company as

- (i) a financial institution which is a company;

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- (ii) a non-banking institution which is a company and which has as its principal business the receiving of deposits, under any scheme or arrangement or in any other manner, or leading in any manner;
- (iii) such other non-banking institution or class of such institutions, as the Bank may, with the previous approval of the Central Government and by notification in the Official Gazette, specify.

Need for Registration of NBFC

1.4 Section 45-IA of the Reserve Bank of India Act, 1934 provides that a non-banking financial company shall not commence or carry on business of a non-banking financial institution without –

- (a) obtaining a certificate of registration issued under Chapter IIIB of the said Act; and
- (b) having the net owned fund of twenty-five lakh rupees or such other amount, not exceeding two hundred lakh rupees, as the Bank may, by notification in the Official Gazette, specify.

1.5 Reserve Bank of India vide its Press Release dated 8th April 1999 has announced that *“in order to identify a particular company as a non-banking financial company (NBFC), it will consider both, the assets and the income pattern as evidenced from the last audited balance sheet of the company to decide its principal business. The company will be treated as an NBFC if its financial assets are more than 50 per cent of its total assets (netted off by intangible assets) and income from financial assets should be more than 50 per cent of the gross income. Both these tests are required to be satisfied as the determinant factor for principal business of a company.”*

1.6 Reserve Bank of India vide its Notification No. DNBS 132/CGM (VSNM)–99, dated 20/04/1999 has increased the requirement of “net owned fund” from Rs. 25 lakh to Rs.200 Lakh for the NBFC which commences business of a non-banking financial institution on or after April 21, 1999.

Meaning of Business of a Non-banking Financial Institution

1.7 Section 45-I(a) of the Reserve Bank of India Act, 1934 provides

“Business of a non-banking financial institution” means carrying on of the business of a financial institution referred to in clause (c) and includes business of a non-banking financial company referred to in clause (f). Clause (f) defines an NBFC.

Meaning of Financial Institution

1.8 Section 45-I(c) of the Reserve Bank of India Act, 1934 provides

“financial institution” means any non-banking institution which carries on as its business or part of its business any of the following activities, namely:-

- (i) the financing, whether by way of making loans or advances or otherwise, of any activity other than its own;
- (ii) the acquisition of shares, stock, bonds, debentures or securities issued by a Government or local authority or other marketable securities of a like nature;
- (iii) letting or delivering of any goods to a hirer under a hire-purchase agreement as defined in clause (c) of section 2 of the Hire Purchase Act, 1972 (26 of 1972);
- (iv) the carrying on of any class of insurance business;
- (v) managing, conducting or supervising, as foreman, agent or in any other capacity, of chits or kuries as defined in any law which is for the time being in force in any State, or any business, which is similar thereto;
- (vi) collecting, for any purpose or under any scheme or arrangement by whatever name called, monies in lump sum or otherwise, by way of subscriptions or by sale of units, or other instruments or in any other manner and awarding prizes or gifts, whether in cash or kind, or disbursing monies in any other way, to persons from whom monies are collected or to any other person, but

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does not include any institution, which carries on as its principal business

- (a) agricultural operations; or
- (aa) industrial activity; or
- (b) the purchase or sale of any goods (other than securities) or the providing of any services; or
- (c) the purchase, construction or sale of immovable property, so, however, that no portion of the income of the institution is derived from the financing of purchases, constructions or sales of immovable property by other persons;

Explanation- For the purposes of this clause, "industrial activity" means any activity specified in sub-clauses (i) to (xviii) of clause (c) of section 2 of the Industrial Development Bank of India Act, 1964 (18 of 1964).

Effect of Non Registration

1.9 Sub-section (4A) of Section 58B of the Reserve Bank of India Act, 1934 provides as follows:

"If any person contravenes the provisions of sub-section (1) of section 45-IA, he shall be punishable with imprisonment for a term which shall not be less than one year but which may extend to five years and with fine which shall not be less than one lakh rupees but which may extend to five lakh rupees."

1.10 Section 58C provides as follows:

- (1) "Where a person committing a contravention or default referred to in section 58B is a company, every person who at the time the contravention or default was committed, was incharge of, and was responsible to, the company for the conduct of the business of the company, as well as the company, shall be deemed to be guilty of the contravention or default and shall be liable to be proceeded against and punished accordingly:

Provided that nothing contained in this sub-section shall render any such person liable to punishment if he proves

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that the contravention or default was committed without his knowledge or that he had exercised all due diligence to prevent the contravention or default.”

- (2) Notwithstanding anything contained in sub-section (1), where an offence under this Act has been committed by a company and it is proved that the same was committed with the consent or connivance of, or is attributable to any neglect on the part of, any director, manager, secretary, or other officer or employee of the company, such director, manager, secretary, other officer or employee shall also be deemed to be guilty of the offence and shall be liable to be proceeded against and punished accordingly.”

Regulatory Environment

1.11 NBFCs, like banks, are subject to the prudential norms, capital adequacy norms, rules and regulations formulated by the RBI, which is the principal regulator for the financing and NBFC sector in India.

1.12 RBI issued the Non Banking Financing Companies (Reserve Bank) Directions, 1977, guidelines on prudential norms and various other directions and clarifications, from time to time for governing the activities of NBFCs. Central Government, during 1974, introduced 58A in the Companies Act, 1956 which empowered Central Government to regulate acceptance and renewal of deposits and to frame rules in consultation with Reserve Bank of India prescribing (a) the limit up to, (b) the manner and (c) the conditions subject to which deposits may be invited or accepted / renewed by companies. The Central Government in consultation with RBI framed the Companies (Acceptance of Deposits) Rules, 1975.

1.13 The RBI Act, 1934 was amended in 1997 authorising the Reserve Bank to determine policies, and issue directions to NBFCs regarding income recognition, accounting standards, NPAs, capital adequacy etc. In addition to above, the listed NBFCs are required to adhere to the listing agreement and rules framed by SEBI on Corporate Governance.

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1.14 RBI being the regulatory authority for NBFCs, issues circulars from time to time monitoring the activities of NBFCs. The ambit of regulation include the type of activities that can be carried out by NBFCs, prudential norms for income recognition, classification of their lending as well as periodic submission of returns and reports to RBI.

1.15 A list of regulatory requirements (circulars) and the issues that need to be considered by the auditor are given in **Appendix C** to the Guide. The auditor should check the link for full text of the circular and related updates from RBI.

Type of NBFCs- Compliance and Regulatory Perspective

1.16 Currently, NBFCs registered with RBI are being classified as:

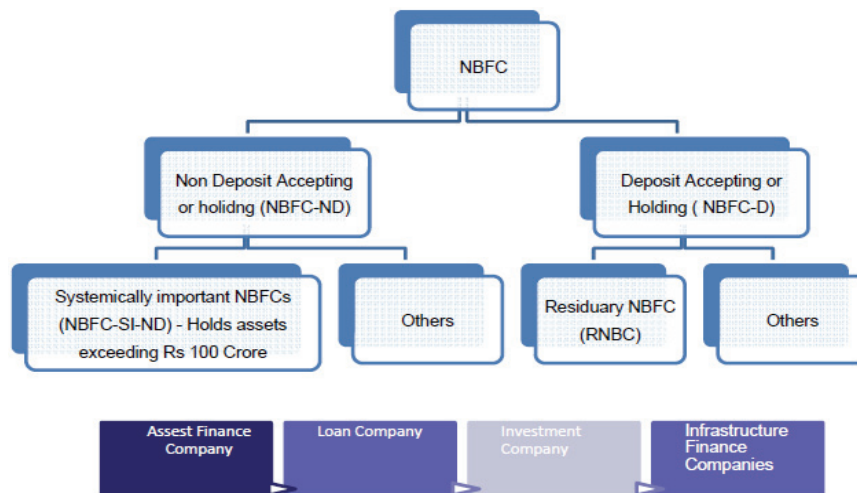
- *Asset Finance Company (AFC)* - The main activity of an AFC is financing of physical assets supporting productive / economic activity. These may be in the areas such as automobiles, tractors, lathe machines, generator sets, earth moving and material handling equipments and general purpose industrial machines.
- *Investment Company (IC)* which mainly deal in acquisition of shares and securities of other companies. A core investment company would be a company which acquires shares and securities of Group companies.
- *Loan Company (LC)*: Loan companies primarily provide finance (whether by making loans or advances or otherwise for any activity), other than its own activity.
- *Infrastructure Finance Companies*: This category of NBFCs deploys a minimum of three-fourths of their total assets in infrastructure loans. The net owned funds of this category of NBFCs are more than Rs 300 crores and they should have a minimum credit rating of 'A' or equivalent and the Capital to Risk-Weighted Assets Ratio (CRAR) is 15% (with a minimum Tier I Capital of 10%).
- *Core Investment Company (CIC)*: These are NBFCs which carry on the business of acquisition of shares and

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securities in group companies and satisfies four conditions stated in the regulatory framework for Core Investment Companies issued by RBI.

- *Infrastructure Debt Fund- Non- Banking Financial Company (IDF-NBFC)* - Infrastructure Debt Funds (IDFs) are funds set up to facilitate the flow of long-term debt into infrastructure projects. The IDF will be set up either as a trust or as a company. A trust based IDF would normally be a Mutual Fund (MF) while a company based IDF would normally be a NBFC.
- *Non-Banking Financial Company - Micro Finance Institution (NBFC-MFI)* - An NBFC-MFI is defined as a non-deposit taking NBFC (other than a company licensed under Section 25 of the Indian Companies Act, 1956) that fulfils certain conditions.

The above type of companies may be further classified into those accepting deposits or those not accepting deposits.



Core Investment Companies, Infrastructure Debt Fund NBFC and NBFC – Micro Finance Institution (other than Companies Act, 1956 - Section 25 companies) are non deposit holding Companies.

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Others

Housing Finance Companies

1.17 National Housing Board set up by the Government of India is the Apex authority regulating the housing finance companies. The Housing Finance Companies (NHB) Directions, 2010 deals with matters relating to acceptance of deposits by housing finance companies, prudential norms for income recognition, accounting standards, asset classification, provision for bad and doubtful assets, capital adequacy and concentration of credit/ investments to be observed by the housing finance companies and matters to be included in the auditors report by the auditors of such housing finance companies and matters ancillary and incidental thereto and amended the said directions from time to time.

Scope of the Technical Guide

1.18 The Guide is applicable to all kinds of NBFCs. The purpose of this Guide is to provide practical assistance to auditors and to promote good practice in applying Standards on Auditing (SAs) to the audit of financial statements of NBFCs. It is not, however, intended to be an exhaustive listing of the procedures and practices to be used in such an audit. In conducting an audit in accordance with SAs, the auditor is required to comply with all the requirements of all the SAs. Further this Guide may not be applicable where there is a specific requirement imposed by the regulatory authorities governing the NBFCs/ Investment companies.

1.19 The Guide attempts to address the assertions made in respect of financing activities in the entity's financial statements. The approach in this Guide is based on the elements of the financial statements as well as the nature of activity of the NBFCs. However, when obtaining audit evidence to support the financial statement assertions, the auditors should carry out procedures based on the types of activities the entity carries out and the way in which those activities affect the financial statement assertions.

Chapter 2

Audit of NBFCs – Points for Consideration

Business Understanding

2.1 NBFCs are required to register under the following three broad categories, viz.

- (i) NBFCs accepting public deposit
- (ii) NBFCs not accepting / holding public deposit
- (iii) Core investment companies

The regulatory requirement may vary depending upon the category to which the NBFC belongs. It is therefore important for the auditors to understand the nature of business environment. This would help the auditor to plan and conduct audit in an efficient manner. For instance in the case of an NBFC accepting public deposit, the audit objectives may include procedures to confirm compliance with regulatory requirements in respect of public deposits accepted by the NBFC.

Exemptions

2.2 Certain categories of Companies (other than banking companies) are exempt from all or some of the requirements of Chapter IIIB of RBI Act, 1934. They are

- (a) Housing Finance Institutions
- (b) Merchant Banking Companies
- (c) Micro finance Institutions
- (d) Mutual Benefit companies
- (e) Government Companies

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- (f) Venture Capital Fund Companies
- (g) Nidhi Companies
- (h) Chit Fund Companies
- (i) Mortgage Companies
- (j) Securitisation and reconstruction companies.
- (k) Insurance Companies

2.3 The auditor may remember the following while understanding the category of NBFC:

- A loan company or an investment company shall have finance assets and finance income in excess of 50% of the total assets and total income respectively.
- In the case of an asset finance company, the aggregate of financing real / physical assets supporting economic activity should be greater than 60% of total assets and the income arising therefrom should be greater than 60% of total income.
- For an infrastructure company, a minimum of 75% of the total assets are to be deployed in infrastructural loans and finance income should be greater than 50% of total income.

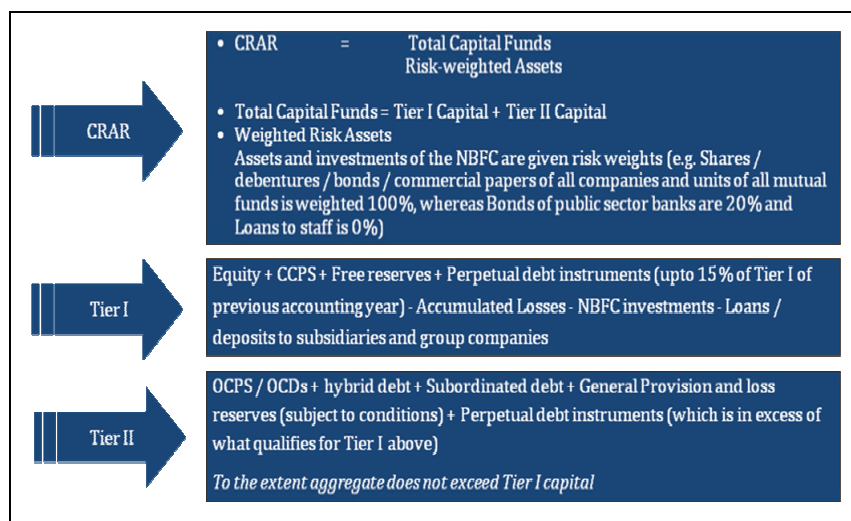
The auditor should refer to the prudential norms for the directions provided by RBI with regard to income recognition, provisioning, accounting for investments.

Capital Risk-Weighted Asset Ratio (CRAR)

2.4 Every systematically Important Non Deposit taking NBFC should maintain a CRAR of 12% which shall be increased to 15% by March 2011. RBI has also made this rate of 15% applicable to all deposit taking NBFCs through a notification dated February 17, 2011.

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Computation of CRAR (illustrative)



Computation of Net Owned Funds

- Any NBFC seeking registration as NBFC with RBI should have a minimum Net Owned Fund of Rs 2 crores
- The Net Owned Fund can be computed by the following step by step process (illustrative):

Step 1	Paid-up equity capital and Free reserves (A)	XX
Step 2	Less: Accumulated balance of loss, Deferred revenue expenditure and book value of other intangible assets (B)	X
Step 3	(C) = (A) minus (B)	XX
Step 4	Sum up the figures, if any, under the following items: a) Investments in shares of Subsidiaries, companies in the same group, other NBFCs	X

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	b) Book value of debentures, bonds, outstanding loans and advances (including hire-purchase and lease finance) made to Subsidiaries, companies in the same group c) Deposits with Subsidiaries, companies in the same group If the resultant figure exceeds 10% of (C), find out the excess = (D)	
Step 5	NOF = (C) minus (D)	XX

Compulsory Convertible Preference Shares (CCPs)/Compulsory convertible debentures (CCDs) are not considered for calculation of Net Owned Funds.

Credit Concentration Norms for Systemically Important Non-Deposit accepting NBFC (NBFC-ND-SI) (% of Owned Funds) (Illustrative)

Single / Group* Exposure Limits	Lending	Investment	Both
Single Borrower	15%	15%	25%
Single Group of Borrowers	25%	25%	40%
<u>Infrastructure Loan / Investment</u>	Addl. 5%	Addl. 5%	Addl. 5%
Single borrower	Addl. 10%	Addl. 10%	Addl. 10%
Single group of borrowers			

2.5 Group companies are to be determined as per Companies Act, 1956 and limits are to be computed as percentage of owned funds.

- Additional limit of 5% is available to Asset Finance Company.

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- Ceiling applicable for funding to NBFC's own group as well as borrower group.
- An Investment in Debentures is treated as loan and not investment.
- NBFCs not accepting 'public funds' or 'not issuing guarantees' may apply to RBI for modification in above limits.
- Definition of 'public funds' includes bank borrowings, debentures, guarantees, Optionally Convertible Preference Shares / Optionally Convertible Debentures / OCPS / OCDs / CCDs do not form a part of the 'owned funds' definition.

Computation of Owned Funds (Illustrative)

	Paid up Equity Capital	XX
Add	Compulsorily Convertible Preference Shares	XX
Add	Free Reserves	XX
Add	Share Premium	XX
Add	Capital Reserves (representing surplus arising out of sale proceeds of assets) (other than reserves created by revaluation of asset)	XX
Less	Accumulated loss balance	X
Less	Book value of intangible assets	X
Less	Deferred Revenue expenditure	X

Group Company Investments

2.6 Exemption from Prudential Norms is available to NBFCs whose principal business is of acquisition of securities; and satisfying following conditions:

- Holding investments in securities of its group / holding / subsidiary companies with book value of such holding not

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less than 90% of its total assets and does not trade in such securities; and

- Not accepting /holding any Public Deposits and
- Not a NBFC-ND-SI

2.7 There are certain end use restrictions for the finance availed from banks for the activities of NBFCs such as:

- Following activities are not eligible for Bank Credit:
 - For Bills discounted/rediscounted by NBFCs.
 - Investments by NBFCs in any company/entity by way of shares, debentures, etc.
 - For unsecured loans/inter-corporate deposits by NBFCs to/in any company.
 - All types of loans and advances by NBFCs to their subsidiaries, group companies.
 - Finance to NBFCs for further lending to individuals for subscribing to Initial Public Offerings.
 - Bridge loans or interim finance against capital/debenture issues and/or in form of loans of a bridging nature pending raising of long term funds from market by way of capital, deposit, etc.

2.8 The auditor should plan his work to meet the overall audit objective of expressing an opinion on the truth & fairness of the financial statements. In the planning stage the auditor should gather relevant organisational information for creating his audit plan. The preliminary study would help the auditor in the following:

- Understand the business issues and the associated risks.
- Help in communication with the management and where required, with those charged with governance on timely basis.
- It would help the auditor to identify the issues that may require special attention in the audit.

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- The auditor would be able to develop an audit scope that may add value to the entity by focussing on areas more meaningful to the management.

Financial Reporting Framework

2.9 The Non-banking Financial (Deposit Accepting) Directions, 2007 in clause 5 states that Accounting Standards and Guidance Notes issued by the Institute of Chartered Accountants of India (ICAI) shall be followed in so far as they are not inconsistent with any of these directions. Subsequent to notification of Central Government (Accounting Standard) Rules, 2006, same needs to be complied with by the NBFC if it is a company, However, in absence of any available guidance therein, they may consider applicability of various guidance issued under the authority of ICAI.

Compliance with Revised Schedule VI to the Companies Act, 1956

2.10 Ministry of Corporate Affairs *vide* its Notification No. S.O.447(E) dated February 28, 2011 (As amended by Notification no.F.No.2/6/2008-CL-V dated March 30, 2011) has revised the existing Schedule VI to the Companies Act, 1956 and made it applicable to all companies for the financial statements to be prepared for the financial year commencing on or after April 1, 2011. In this regard ICAI has also published a guidance note –“Guidance Note on The Revised Schedule VI to the Companies Act, 1956”. Reference should be made to these authoritative pronouncements.

Chapter 3

Auditing Framework

3.1 Auditors are required to ensure compliance with the Standards on Auditing issued by the Institute of Chartered Accountants of India while discharging their audit obligation. Certain important standards that are considered by the auditor are as follows.

Objective and Scope of the Audit of Financial Statements

3.2 The objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements of the NBFC are prepared, in all material respects, in accordance with an identified financial reporting framework. The auditor's report indicates the financial reporting framework that has been used to prepare the NBFC's financial statements.

Agreeing to the Terms of Engagement

3.3 The engagement letter documents and confirms the auditor's acceptance of the appointment, the objective and scope of the audit, the extent of the auditor's responsibilities and the form of audit reports.

3.4 Some of the characteristics are unique to NBFCs and indicate the areas where the auditors and assistants may require special skills. In considering the objective and scope of the audit and the extent of the responsibilities, the auditor should consider his own skills and competence and those of his assistants to conduct the engagement. In doing so, the auditor should consider the following factors:

- The need for sufficient expertise in the aspects of financing relevant to the audit of the NBFC's business activities.
- The need for expertise in the context of the IT systems and communication networks the NBFC uses.

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Audit Planning

3.5 A well designed audit plan is necessary for the auditor to conduct an effective and efficient audit.

3.6 The audit plan gives details of the audit objectives and steps the auditor should consider, to ensure that all important issues in the audit are covered. A well designed audit plan includes the following:

- Obtaining a sufficient knowledge of the entity's business and governance structure, and a sufficient understanding of the accounting and internal control systems, including risk management and internal audit functions;
- Considering the assessments of inherent and control risks i.e. the risk that material misstatements occur (inherent risk) and the risk that the NBFC's system of internal control does not prevent or detect and correct such misstatements on a timely basis (control risk);
- Determining the nature, timing and extent of the audit procedures to be performed; and
- Considering the appropriateness of the going concern assumption regarding the entity's ability to continue its operation for the foreseeable future, which will be the period used by management in making its assessment under the financial reporting framework. This period will ordinarily be for a period of at least one year after the balance sheet date.

Table A: Obtaining Knowledge of the NBFC's Business

The auditor needs to understand:

- *Corporate governance structure:* Corporate governance plays a particularly important role in NBFCs; many regulators set out requirements for NBFCs to have effective corporate governance structures. Accordingly the auditor should obtain an understanding of the NBFC's corporate governance structure and how those charged with governance discharge their responsibilities for the supervision, control and direction of the NBFC.

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- The economic and regulatory environment prevailing in the principal countries in which the NBFC operates.
- The market conditions existing in each of the significant sectors in which the NBFC operates.
- *Products and Services:* In obtaining and maintaining that knowledge, the auditor is aware of the many variations in the basic deposit, loan and treasury services that are offered by NBFCs in response to market conditions. The auditor should obtain an understanding of the nature of services rendered or financial transactions undertaken through instruments such as letters of credit, acceptances, interest rate futures, forward and swap contracts, options and other similar instruments in order to understand the inherent risks and the auditing, accounting and disclosure implications thereof.
- *Service Organisation:* If the NBFC uses service organizations to provide core services or activities, such as cash and securities settlement, back office activities or internal audit services, the responsibility for compliance with rules and regulations and sound internal controls remains with those charged with governance and the management of the outsourcing NBFC. The auditor should consider legal and regulatory restrictions, and obtains an understanding of how the management and those charged with governance monitor that the system of internal control (including internal audit) operates effectively. SA 402, "Audit Considerations Relating to an Entity Using a Service Organization" gives further guidance on this subject.
- *Risk:* There are a number of risks associated with financing activities that are important in that, they serve to shape financing operations. The auditor should obtain an understanding of the nature of these risks and how the NBFC manages them. This understanding allows the auditor to assess the levels of inherent and control risks associated with different aspects of a NBFC's operations and to determine the nature, timing and extent of the audit procedures.

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3.7 In developing an overall plan for the audit of the financial statements of a NBFC, the auditor should give particular attention to:

- The complexity of the transactions undertaken by the NBFC and the documentation in respect thereof;
- The extent to which any core activities are provided by service organizations;
- Regulatory considerations;
- The extent of IT and other systems used by the NBFC;
- The expected assessments of inherent and control risks;
- The work of internal auditor;
- The assessment of audit risk;
- The assessment of materiality;
- Management's representations;
- The involvement of other auditors;
- Contingent liabilities and off-balance sheet items;
- The geographic spread of the NBFC's operations and the co-ordination of work between different audit teams;
- Transactions with related parties; and
- Going concern considerations.

Audit Evidence

3.8 The auditor should review the NBFC's sources of revenue, and obtain sufficient appropriate audit evidence regarding the following:

- (a) The accuracy and completeness of the NBFC's accounting records relating to such transactions.
- (b) The existence and operating effectiveness of key controls to limit the risks arising from such transactions.
- (c) The adequacy of provisions, if any, for loss which may be required.
- (d) The adequacy of financial statement disclosures and presentation.

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3.9 The auditor is required to obtain sufficient appropriate audit evidence and should design and perform audit procedures that are appropriate in the circumstances for this purpose.

3.10 It is important for an auditor to consider the relevance and reliability of the information gathered/obtained as audit evidence. The auditor may need to consider the audit evidence prepared by the entity, audit evidence provided by third parties as well as by the external expert. The auditor needs to evaluate the competence, capability and objectivity of that expert as well as his independence and should evaluate work performed by an expert.

3.11 The auditor is required to check the accuracy and completeness of the information and evaluate whether it is sufficient and detailed for audit purposes.

3.12 Since the transactions of NBFCs are substantially financial in nature, the underlying documents / agreements form important audit evidence for the auditor. The auditor should verify all the relevant documents for gathering sufficient appropriate audit evidence.

The Auditor's Responsibility to Consider, Detect Fraud and/or Error in an Audit of Financial Statements

3.13 It is the primary responsibility of the management and those charged with governance to prevent and detect frauds. The auditor is only concerned with frauds that cause a material misstatement in the financial statements. Misstatements may arise from fraudulent financial reporting and/or misappropriation of assets.

3.14 Fraudulent activities may take place within a NBFC by, or with the knowing involvement of, management or personnel of the NBFC. Alternatively, fraud may be perpetrated on a NBFC without the knowledge or complicity of the NBFC's employees.

3.15 Frauds may include:

- fraudulent financial reporting without the motive of personal gain, (for example, to conceal trading losses), or

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- misappropriation of the assets for personal gain that may or may not involve the falsification of records.

3.16 SA 240, "The Auditor's Responsibility to Consider Fraud and Error in an Audit of Financial Statements" gives detailed guidance on the nature of the auditor's responsibilities with respect to fraud. Because of the characteristics of fraud, the auditor's exercise of professional skepticism is important when considering the risks of material misstatement due to fraud. Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence. Furthermore, professional skepticism requires an ongoing questioning of whether the information and evidence obtained suggests that a material misstatement due to fraud has occurred.

3.17 Members of the audit team should engage in a timely discussion with management and also discuss, as a team, the potential for material misstatement due to fraud. The discussion among the audit team members about the susceptibility of the entity's financial statements to material misstatement due to fraud should include a consideration of the known external and internal factors affecting the entity that might (a) create incentives or pressures for management and others to commit fraud, (b) provide the opportunity for fraud to be perpetrated, and (c) indicate a culture or environment that enables management to rationalize committing fraud. Communication among the audit team members about the risks of material misstatement due to fraud also should continue throughout the audit.

Risk Assessment and Internal Controls

3.18 Any audit of NBFCs should include the evaluation of internal controls either as a part of the audit methodology or as a basis for reliance being gathered as a part of the audit. The extent of assessment of the controls would depend on the audit objectives of the auditor. The auditor should assess the effectiveness of controls over a period of time and the auditor should develop the audit plan on the basis of evaluation of the internal controls. For instance, in using computer programmes to test data files, the auditor, probably with the help of system

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auditor, should evaluate controls over program libraries containing programs being used for audit purposes to determine the extent to which the programs are protected from unauthorised access/modification.

Using the Work of an Expert

3.19 The auditor of an NBFC may come across various occasions where he may have to rely on the work of an expert. They mostly relate to the assets given as security against the lending of NBFCs. Some examples are:

- Valuations of certain types of assets, for example, land and buildings, plant and machinery etc.
- Legal opinions concerning interpretations of agreements, statutes, regulations, notifications, circulars, etc.

3.20 Following factors would determine the need to consider the work of an expert:

- materiality of the item being examined in relation to the financial information as a whole;
- nature and complexity of the item including the risk of error therein; and
- other audit evidence available with respect to the item.

Table B: Evaluating the Work of an Expert

(a)	Evaluate the professional competence, objectivity and experience of the expert by considering the following:
(i)	the expert's professional qualifications, for example, professional certification, license or other recognition of the competence of the expert in the field, as appropriate;
(ii)	the experience and reputation of the expert in the field in which the auditor is seeking audit evidence;
(iii)	the expert's objectivity or relationship, if any, to the client, including but not limited to financial interests or employment relationships.

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- (b) Obtain sufficient appropriate evidence that the expert's work is adequate for the purposes of the audit (i.e. it constitutes appropriate audit evidence in support of the financial statement assertions being considered), by considering:
 - (i) the objectives and the scope of the expert's work;
 - (ii) the source data used;
 - (iii) the assumptions and methods used and if appropriate, their consistency with the prior period;
 - (iv) when the expert carried out the work;
 - (v) the reasons for any changes in assumptions and methods compared with those used in the prior period; and
 - (vi) the results of the expert's work in the light of both the overall knowledge of the business and the results of the audit procedures.
- (c) Consider obtaining, in conjunction with the entity or independently, audit evidence in the form of reports, opinions, valuations and statements of an expert.
- (d) Where the expert's work should be subject to a recognised methodology, for example published by organisation to which expert belongs, confirm this has been used. The risk that an expert's objectivity will be impaired increases when the expert is:
 - (i) employed by the entity; or
 - (ii) related in some other manner to the entity, for example, by being financially dependent upon or having an investment in the entity.
- (e) Considering the results of assessment of the expert's work
 - (i) If the findings of the expert support the related assertions in the financial statements, it may be reasonably concluded that sufficient competent evidential matter has been obtained. In these circumstances, no reference to the use of expert should be included in the auditor report.

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- (ii) If the results of the expert's work do not provide sufficient appropriate audit evidence or if the results are not consistent with other audit evidence, additional procedures should be applied which may include obtaining the opinion of another expert or performing additional audit procedures. Consider the implications on the audit opinion if auditor is unable to obtain adequate assurance. If considered necessary, decide to issue a modified audit report, consider referring to or describing the work of the expert (including the identity of the expert and the extent of the expert's involvement). In these circumstances, obtain the permission of the expert before making such a reference.

While considering the competence or objectivity of the expert, it is necessary to discuss any reservations with management and consider whether sufficient appropriate audit evidence can be obtained concerning the work of an expert. If the results of the expert's work do not provide sufficient appropriate audit evidence, or if the results are not consistent with other audit evidence, there is need to resolve the matter and consider the possibility to modify audit report.

To an extent based on materiality and inherent risk, document the understanding of the matters as below:

- (a) the objectives and scope of the expert's work;
- (b) clarification of the expert's representations as to his relationship, if any, to the client;
- (c) confidentiality of the client information;
- (d) the methods or assumptions to be used, for example, if property is involved, the client's plans and intentions for the property;
- (e) the extent of the expert's access to appropriate records and files;
- (f) a comparison of the methods or assumptions to be used with those used in the preceding period;

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- (g) the expert's understanding of the auditor's use of the expert's findings in relation to the representations in the financial statements;
- (h) the form and content of the expert's report in relation to the representations in the financial statements; and
- (i) the intended use of the expert's report including the possible communication to third parties of the expert's identity and extent of involvement.

Consider whether the expert has used source data which is appropriate in the circumstances, by, for example:

- (a) making inquiries of the expert to determine how the expert has obtained satisfaction that the source data is sufficient, relevant and reliable; and
- (b) performing audit procedures, based on materiality and inherent risk, on the data provided by the client to the expert to obtain reasonable assurance that the data is appropriate, including:
 - (i) verify the completeness of the information provided to the expert;
 - (ii) examine listing of transactions, account balances or other information provided to the expert; and
 - (iii) consider discussing the work performed with the expert.

When the expert's findings include a range of results using different assumptions, ensure that management's assessment of the findings, and decisions taken on the assumptions, is reasonable.

Representations by Management

3.21 The objective of the auditor is to obtain written representations from the management and where appropriate, those charged with governance that they believe that they have fulfilled their responsibility for the preparation of the financial statements and for the completeness of the information provided to the auditor.

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3.22 Although the written representations provide necessary audit evidence, they do not provide sufficient appropriate audit evidence on their own about any matters with which they deal. The auditor should obtain audit evidence independently about the fulfillment of management's responsibilities or about specific assertions.

Responsibility of Joint Auditors

3.23 In many cases the auditor may conduct the audit of an NBFC jointly with another independent auditor. In such situations the auditor is required to comply with the requirements of the auditing standard on responsibility of joint auditors.

Consideration of Laws and Regulations in an Audit of Financial Statements

3.24 NBFCs are governed by various regulations of RBI concerning their conduct of business and reporting requirements. This is apart from the usual compliance and reporting requirements of the Companies Act under which it is incorporated as well as SEBI regulations, if it is a listed entity.

3.25 The auditor should understand the compliance requirements under various enactments which would help the conduct of audit. With the business getting complex and globalisation of finance business, the monitoring agencies make amendments to the existing rules and regulations. The auditor should be aware of such amendments affecting the entity audited.

Documentation

3.26 Apart from the usual audit documentation, it is very helpful for the auditor to prepare and retain audit documentation of all the significant matters identified during the audit and how those were addressed. Audit summary may facilitate effective and efficient reviews and inspections of the audit documentation, particularly for large and complex audits. Further, the preparation of such a summary may assist the auditor's consideration of the significant matters. It may also help the auditor to consider whether, in light of the audit

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procedures performed and conclusions reached, there is any individual relevant SA objective that the auditor has not met or is unable to meet that would prevent the auditor from achieving the auditor's overall objective.

3.27 The documentation is not limited to records prepared by the auditor but may include other appropriate records such as minutes of meetings prepared by the entity's personnel and agreed by the auditor. Others with whom the auditor may discuss significant matters may include other personnel within the entity, and external parties, such as persons providing professional advice to the entity.

3.28 The auditor also needs to have proper audit documentation to provide evidence how inconsistencies identified during the audit have been addressed.

Reporting

3.29 Apart from the reporting under Section 227 (4A) of the Companies Act, 1956, the RBI, through Section 45MA of the RBI Act (Part of Chapter III B of RBI Act) lays out the powers and duties of the auditors of an NBFC.

- Section 45 MA(1) - Casts duty on auditors to inquire if NBFC has submitted to the RBI, the requisite information, statements or particulars regarding deposits accepted by it. On exception, the auditors need to report to RBI the "aggregate of such deposits held" by NBFC.
- Section 45 MA(2) - Where auditors report or intend to report to RBI under Section 45 MA (1) above, the matter should also be included in his report u/s 227 (2) of Companies Act, 1956.
- Section 45 MA(1A) - Empowers RBI to issue directions to NBFCs or auditors of NBFCs relating to Balance Sheet, Profit and Loss Account, disclosures or other matters.

3.30 RBI had also issued a revised Non-Banking Financial Companies Auditor's Report (Reserve Bank) Directions, 2008, which has been notified on July 1, 2009. The auditor, in addition to the report under Section 227 of the Companies Act, 1956, should also make a separate report to the Board of Directors on

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specific matters. Where the report is modified, the reasons therefore needs to be given by the auditor.

3.31 While the auditors need to report on whether the NBFC has obtained a Certificate of Registration, some of the matters to be reported to Board of Directors of Non Deposit taking NBFCs are as follows:

- Whether the Board of Directors has passed a resolution for non- acceptance of any public deposits;
- Whether the Company has accepted any public deposit during the year/period ; and
- Whether the Company has complied with the prudential norms on income recognition, accounting standards, asset classification, provisioning for bad and doubtful debts etc.

3.32 In addition, for Systemically Important NBFCs (NBFC-SI-ND), the auditor also needs to comment on the correctness of Capital Adequacy Ratio (CAR) and conformity / compliance with the minimum Capital to Risk Assets Ratio (CRAR), disclosed in the return submitted to the RBI in Form NBS 7; and the adherence to timelines for furnishing NBS 7.

3.33 Additionally following matters are to be reported by the auditors to Board of Directors of deposit taking NBFCs:

- Whether public deposits (including unsecured non convertible debentures/bonds and deposits from shareholders in case of a public limited company) accepted are within the limits prescribed under the Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998. (Referred to as Public Deposits Directions) ;
- If the deposits accepted are in excess of limits prescribed above, whether the same has been regularized as per Public Deposit Directions;
- Whether an Assets Finance Company (AFC) having a CRAR less than 15% or an Investment Company or Loan Company is accepting deposits without Minimum Investment Grade Credit Rating from an approved credit rating agency.

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- Whether the company has complied with the prudential norms on income recognition, accounting standards, asset classification, provisioning for bad and doubtful debts, and concentration of credit/investments as specified in the directions issued by the RBI in terms of the Non-Banking Financial (Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007.
- Whether the credit rating is in force and deposits outstanding at any point of time during the year was within the limit prescribed by rating agency;
- Whether the company has defaulted in payment of interest and principal to depositors when such interest and/or principal became due. asset classification, provisioning for bad and doubtful debts and so on have been complied with;
- Whether the company has complied with the liquid assets requirement as prescribed by the RBI in exercise of powers under section 45-IB of the Act.
- Whether there has been any non-compliance with Chapter III- B of RBI Act, the Non- Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions 1998 and the Non- Banking Financial (Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007.

3.34 In addition, Exception Reporting i.e. reporting only on Instances of non compliances is required to be made to the RBI for modified audit opinions, or comments on the specified matters. The auditor of NBFC should also be familiar with Chapter IIIB of the RBI Act and the notifications issued thereon. The auditor should be aware of the above circular and any amendments therein.

3.35 While issuing certificates and reports other than the audit report, the auditor should consider the requirements of the Guidance Note on Audit Reports and Certificates for Special Purposes issued by the ICAI.

Appendix A to the Guide contains specified audit report and other reporting templates for the benefit of users.

Chapter 4

Areas of Audit Concern

4.1 The auditor has to identify the assertions that are ordinarily of particular importance in relation to the typical items in a NBFC's financial statements. The following paragraphs describe some of the audit considerations that help the auditor to plan substantive procedures and suggest some of the techniques that could be used in relation to the items selected by the auditor for testing. The procedures do not represent an exhaustive list of procedures that need to be performed, nor do they represent a minimum requirement that should always be performed.

4.2 Following are the key areas which the auditor must be aware while conducting the audit of NBFCs.

Balances with Other Banks

4.3 The auditor should consider third party confirmations of the balance as persuasive audit evidence.

4.4 The auditor should understand and evaluate key controls in place to assess the operating effectiveness of key controls, on sample basis test check bank reconciliations and perform cut-off procedures.

4.5 The auditor should consider whether the balances with other NBFCs as at the date of the financial statements represent bona fide commercial transactions or whether any significant variation from normal or expected levels reflects transactions entered into primarily to give a misleading impression of the financial position of the NBFC or to improve liquidity and asset ratios (often known as "window-dressing").

Money Market Instruments

4.6 The auditor should consider the need for physical inspection or confirmation with external custodians and the

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reconciliation of the related amounts with the accounting records.

4.7 The auditor should consider the feasibility of checking for receipt of the related income as a means of establishing ownership. The auditor must pay particular attention to establishing the ownership of instruments held in bearer form. The auditor also should consider whether there are any encumbrances on the title to the instruments.

4.8 The auditor should test for the existence of sale and forward repurchase agreements for evidence of unrecorded liabilities and losses.

4.9 The auditor should consider the appropriateness of the valuation techniques including estimates as employed by management.

4.10 The auditor should consider whether there is a need to test for accrual of income earned on money market instruments, which in some cases is through the amortization of a purchase discount.

4.11 The auditor also should consider whether:

- The relationship between the types of securities owned and the related income is reasonable; and
- All significant gains and losses from sales and revaluations have been reported in accordance with the financial reporting framework (for example, where gains and losses on trading securities are treated differently from those on investment securities).

Other Financial Assets

4.12 The auditor should examine the underlying documentation supporting the purchase of such assets/sale in order to determine whether all rights and obligations, such as warranties and options, have been properly accounted for. Additionally, the auditor should consider the appropriateness of the valuation techniques employed. Since there may not be established markets for such assets, it may be difficult to obtain independent evidence of value. Additionally, even where such evidence exists, there may be a question as to whether there is

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sufficient depth to existing markets to rely on quoted values for the asset in question and for any related offsetting hedge transactions that the NBFC has entered into in those markets. The auditor should also consider the nature and extent of any impairment reviews that management has carried out and whether their results are reflected in the assets' valuations.

Investments

A. Securities Held-for-Trading Purposes

4.13 In respect of investments held for trading, the auditor needs to consider the internal control considerations and audit procedures in respect of trading operations. Another important consideration would be to ensure that these are consistent with the investment policy of the company.

4.14 The auditor should consider physical inspection of securities or confirmation with external custodians and the reconciliation of the amounts with the accounting records.

4.15 The auditor should consider the feasibility of checking for receipt of the related income as a means of establishing ownership. The auditor must pay particular attention to establishing the ownership of securities held in bearer form. The auditor also should consider whether there are any encumbrances on the title to the securities.

B. Portfolio Investments

4.16 In many cases the audit of a NBFC's portfolio investments does not differ from the audit of portfolio investments held by any other entity. However, there are some special aspects that need to be considered in respect of NBFCs. The auditor should verify whether the NBFC has any statutory requirement for maintenance of certain portfolio of Investments.

4.17 The auditor should consider the value of the assets supporting the security value, particularly in respect of securities that are not readily marketable. The accounting norms of the investment may require that the depreciation, if any, in each scrips shall be fully provided for and appreciation, if any shall be ignored in accordance with RBI regulation and

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IGAAP. Rather, the auditor should also consider the nature and extent of any impairment reviews that management has carried out and whether their results are reflected in the assets' valuations.

C. Accounting for Investments

4.18 The auditor should consider the RBI prudential norms guidelines with regard to accounting for investments. The requirements are summarised below:

- i) The Board of the Company should frame investment policy and implement the same.
- ii) The criteria to classify the investments as current investments and long term investments should be clearly spelt out.
- iii) The aforesaid classification should be made at the time of making the investments
- iv) There should not be inter-class transfer on adhoc basis and if necessary, it should be done only at the beginning of each half year with the approval of the Board and the transfer should be scrip wise at book value or market value, whichever is lower. Depreciation, if any, in each scrip shall be provided and appreciation, if any, should be ignored and there should not be netting off of any gain in one scrip against depreciation in another scrip.
- v) Quoted current investments should be grouped under the following categories:
 - (a) Equity shares,
 - (b) Preference shares,
 - (c) Debentures and bonds,
 - (d) Government securities including treasury bills,
 - (e) Units of mutual fund, and
 - (f) Others.
- vi) Quoted current investments for each category shall be valued at cost or market value whichever is lower. For this purpose, investments in each category shall be

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considered scrip-wise and cost and market value aggregated for all investments in each category. If the aggregate market value for the category is less than aggregate cost for that category, net depreciation shall be provided for or charged to the profit and loss account. If aggregate market value for the category exceeds the aggregate cost for the category, the net appreciation shall be ignored. Depreciation in one category of investments shall not be set off against appreciation in another category.

- vii) Unquoted equity shares in the nature of current investments shall be valued at cost or break up value, whichever is lower. However, non-banking financial companies may substitute fair value for the break up value of the shares, if considered necessary. Where the balance sheet of the investee company is not available for two years, such shares shall be valued at one Rupee only.
- viii) Unquoted preference shares in the nature of current investments shall be valued at cost or face value, whichever is lower.
- (ix) Investments in unquoted Government securities or Government guaranteed bonds shall be valued at carrying cost.
- (x) Unquoted investments in the units of mutual funds in the nature of current investments shall be valued at the net asset value declared by the mutual fund in respect of each particular scheme.
- (xi) Commercial papers shall be valued at carrying cost.
- (xii) A long term investment shall be valued in accordance with the Accounting Standard issued by ICAI.
- (xiii) Unquoted debentures shall be treated as term loans or other type of credit facilities depending upon the tenure of such debentures for the purpose of income recognition and asset classification.

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Table C: Valuation of Securities

Financial reporting frameworks often prescribe different valuation bases for securities depending on whether they are held for trading purposes, held as portfolio investments, or held for hedging purposes. For example, a financial reporting framework might require trading securities to be carried at market value, portfolio investments at historic cost subject to impairment reviews, and hedging securities on the same basis as the underlying assets they hedge.

Management's intentions determine whether any particular security is held for a given purpose, and hence the valuation basis to be used. If management's intentions change, the valuation basis changes too. Accordingly, when securities have been transferred from one category to another, the auditor obtains sufficient appropriate audit evidence to support management's assertions as to their revised intentions. The possibility of changing an asset's categorization provides management with an opportunity for fraudulent financial reporting, as it would be possible to recognize a profit or avoid recognizing a loss by changing the categorization of particular security/securities.

The auditor also should consider whether to re-perform the valuation calculations and the extent of tests of the controls over the NBFC's valuation procedures. Additionally, the auditor should also consider whether:

- The relationship between the types of securities owned and the related income is reasonable; and
- All significant gains and losses from sales and revaluations have been reported in accordance with the financial reporting framework (for example, where gains and losses on trading securities are treated differently from those on investment securities).

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D. Investments in Subsidiaries and Associated Entities

4.19 In many cases the audit of a NBFCs investments in subsidiaries and associated entities does not differ from the audit of such investments held by any other entity.

4.20 The auditor should consider the implications of any legal or practical requirement for the NBFC to provide future financial support to ensure the maintenance of operations (and hence the value of the investment) of subsidiaries and associated companies. The auditor should consider whether the related financial obligations are recorded as liabilities of the NBFC.

4.21 The auditor should determine whether appropriate adjustments are made when the accounting policies of subsidiaries/associates accounted for on an equity basis or consolidated do not conform to those of the NBFC.

Table D: Impairment/Estimates

A.	Factors that may indicate an impairment condition
a)	the decline in fair value is attributable to specific adverse conditions affecting a particular investment.
b)	the decline in fair value is attributable to specific conditions, such as conditions in an industry or in a geographic area, rather than to general market conditions.
c)	management does not possess both the intent and the ability to hold the investment for a period of time sufficient to allow for any anticipated recovery in fair value.
d)	the decline in fair value has existed for an extended period of time.
e)	dividends have been reduced or eliminated, or scheduled interest payments on debt securities have not been made.
f)	the financial condition of the issuer has deteriorated.

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- g) market values have declined. Consider performing the following, if available.
- i. test, to an extent based on materiality and inherent risk, the market values of investments by comparing the market value to their sources. Sources for market values include:
 - obtain market quotations for investments listed on national exchanges or over-the-counter markets from sources such as financial publications or the exchanges;
 - for certain other investments, market quotations may be obtained from broker-dealers who are market makers in those investments; and
 - if quoted market prices are not available, the estimate of fair value should be based on the best information available in the circumstances. The estimate of fair value should consider prices for similar assets and the results of valuation techniques to the extent available in the circumstances. Examples of valuation techniques include the present value of estimated expected future cash flows, option-pricing models, matrix pricing, option-adjusted spread models, and fundamental analysis.
 - ii. determine whether any decline in value below cost is properly reflected in the financial statements where appropriate; and
 - iii. if appropriate, consider the need for use of specialists to determine the market value of certain investments. Consider steps in the

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audit area "Use of the work of experts."

B. Valuation and Disclosure of Long Term Investments

1. The auditor should perform audit procedures designed to obtain sufficient appropriate audit evidence for valuation and disclosure of long term investments in accordance with the financial reporting framework.
2. When long-term investments are material to the financial statements, the auditor should obtain sufficient appropriate audit evidence regarding their valuation and disclosure.
3. Other procedures would ordinarily include:
 - a) In the case of quoted securities, considering related financial statements and other information, such as market quotations, which provide an indication of value and comparing such values to the carrying amount of the investments up to the date of the auditor's report.
 - b) In case of unquoted securities, ascertaining the method adopted by the entity for determining the value of such securities as at the year end. The auditor should examine whether the method adopted by the entity is one of the recognised methods of valuation of securities such as Profit Earning Capacity Value method [PECV], Break-up value method, Capitalization of yield method, Yield to maturity method, etc.
 - c) In the case of investments other than in the form of securities, ensuring that the market value has been ascertained on the basis of authentic market reports, and /or based on expert's opinion, if warranted.
 - d) If such values do not exceed the carrying amounts, the auditor should consider whether a write-down is required. If there is an uncertainty as to whether the carrying amount will be recovered, the auditor should consider whether appropriate adjustments and/or disclosures have been made.

C. Management Representations

The auditor should obtain written representation from

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management concerning:

- (a) The completeness of information provided regarding valuation and disclosure of long term investments.
- (b) The valuation of long term investments in the financial statements including adequacy of provision for diminution in such values, wherever required.

4.22 The auditor should be aware of the restrictions imposed on the kind of investments and the limits for such investments. These are usually prescribed in the prudential norms guidelines for NBFCs issued by RBI.

4.23 Presently RBI, *vide* its circular for prudential norms, has imposed following restrictions on investments:

- a) Restriction on investments in land and building and unquoted shares: This restriction is in respect of an asset finance company accepting public deposits. The regulations prohibit the asset finance company from investing in land and buildings as well as unquoted shares beyond 10% of its owned fund. Those which were acquired in satisfaction of debts shall be disposed off within a period of three years or within such period as extended by RBI. However investment in an insurance company is not considered in the restriction imposed by RBI.
- b) No NBFC shall lend to any single borrower exceeding fifteen percent of its owned fund and any single group of borrowers exceeding twenty five percent of its owned fund.
- c) No non-banking financial company shall,
 - (i) lend to
 - (a) any single borrower exceeding fifteen per cent of its owned fund; and
 - (b) any single group of borrowers exceeding twenty five per cent of its owned fund;
 - (ii) invest in

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- (a) the shares of another company exceeding fifteen per cent of its owned fund; and
 - (b) the shares of a single group of companies exceeding twenty five per cent of its owned fund;
- (iii) lend and invest (loans/investments taken together) exceeding
 - (a) twenty five per cent of its owned fund to a single party; and
 - (b) forty per cent of its owned fund to a single group of parties.

Provided that the ceiling on credit/investment concentration shall not be applicable to a residuary non-banking company in respect of investments in approved securities, bonds, debentures and other securities issued by a Government company or a public financial institution or a scheduled commercial bank under the provisions of paragraphs 6(1)(a) and 6(1)(b) of the Residuary Non-Banking Companies (Reserve Bank) Directions, 1987.

Provided further that the ceiling on the investment in shares of another company shall not be applicable to a non-banking financial company in respect of investment in the equity capital of an insurance company upto the extent specifically permitted, in writing, by the Reserve Bank of India.

Provided further that any non-banking financial company, classified as Asset Finance Company by the Reserve Bank of India, may in exceptional circumstances, exceed the above ceilings on credit/investment concentration to a single party or a single group of parties by 5 per cent of its owned fund, with the approval of its Board.

Notes:

- (1) For determining the limits, off-balance sheet exposures shall be converted into credit risk by applying the conversion factors as explained in paragraph 16.

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- (2) The investments in debentures for the purposes specified in this paragraph shall be treated as credit and not investment.
- (3) These ceilings shall be applicable to the credit/investment by such a non-banking financial company to companies/firms in its own group as well as to the borrowers/ investee company's group.

Loans

4.24 The auditor should consider the loan booking, approval and disbursement process, subsequent collections and collateral management. The auditor also should consider the appropriateness of the provision for loan. The auditor should understand the laws and regulations that may influence the amounts determined by management. RBI's prudential norms provide guidance to NBFCs on recognition and measurement of loans, establishment of loan loss provisions, credit risk disclosure in financial statements and related matters. It sets out views on sound loan accounting and disclosure practices and so may influence the financial reporting framework within which a NBFC prepares its financial statements.

4.25 The major audit concern is the adequacy of the recorded provision for loan losses. In establishing the nature, extent and timing of the work to be performed, the auditor should consider the following factors:

- Know Your Client/Customer (KYC) procedures performed.
- Credit approval process including authorisation.
- Loan documentation obtained from the existing/prospective borrower, test check the documents for borrower's financial position/ credit worthiness.
- Internal credit rating assigned to borrower.
- Credit monitoring by credit committee.
- Scope and extent of work performed by internal audit department.
- Collateral coverage (if any).

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- Given the relative importance of foreign lending, the auditor should ordinarily examine:
 - The information on the basis of which the NBFC assesses and monitors the country risk and the criteria (for example, specific classifications and valuation ratios) it uses for this purpose; and
 - Whether and, if so, by whom credit limits are set for the individual countries, what the limits are and the extent to which they have been reached.
- The auditor is also required to verify whether there has been any window dressing, i.e., sanction of new loans to repay an existing doubtful loan. This method may be resorted to by the NBFC to cover up bad loans.

Accounts with Depositors

A. General

4.26 The auditor should assess the system of internal control over accounts with depositors. The auditor also should consider performing confirmation and analytical procedures on average balances and on interest expense to assess the reasonableness of the recorded deposit balances.

4.27 The auditor should determine whether deposit liabilities are classified in accordance with regulations and relevant accounting principles.

4.28 Where deposit liabilities have been secured by specific assets, the auditor should consider the need for appropriate disclosure.

4.29 The auditor should also consider need for disclosure where the NBFC has a risk due to economic dependence on a few large depositors or where there is an excessive concentration of deposits due within a specific time.

B. Deposits in Transit

4.30 The auditor should determine whether items in transit between branches, between the NBFC and its consolidated subsidiaries, and between the NBFC and counterparties, are

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eliminated and that reconciling items have been appropriately addressed and accounted for.

Additionally, the auditor should examine individual items comprising the balance that have not been cleared within a reasonable time period and also should consider whether the related internal control procedures are adequate to ensure that such items have not been temporarily transferred to other accounts in order to avoid their detection.

Capital and Reserves

4.31 Banking regulators pay close attention to a NBFC's capital and reserves in monitoring the level of a NBFC's activities and in determining the extent of its operations. Small changes in capital or reserves may have a large effect on a NBFC's ability to continue operating, particularly if it is near to its permitted minimum capital ratios. In such circumstances there are greater pressures for management to engage in fraudulent financial reporting by miscategorising assets and liabilities or by describing them as being less risky than they actually are.

4.32 The auditor should consider whether capital and reserves are adequate for regulatory purposes (for example, to meet capital adequacy requirements), the disclosures have been appropriately calculated and that the disclosures are both appropriate and in accordance with the applicable financial reporting framework. In many jurisdictions auditors are required to report on a wide range of disclosures about the NBFC's capital and its capital ratios, either because that information is included in the financial statements or because there is requirement to make a separate report to regulatory supervisors.

In addition, where applicable regulations provide for restrictions on the distribution of retained earnings, the auditor should consider whether the restrictions are adequately disclosed and complied with.

Income Recognition

4.33 The financial reporting framework i.e. recognised accounting principles would guide the income recognition. For instance:

- **Income including interest/discount or any other charges on NPA:** shall be recognised only when it is actually realised. Any such income recognised before the asset became non-performing and remaining unrealised shall be reversed.
- **Hire purchase assets,** where instalments are overdue for more than 12 months, income shall be recognised only when hire charges are actually received. Any such income taken to the credit of profit and loss account before the asset became non-performing and remaining unrealised shall be reversed.
- **Leased assets:** where lease rentals are overdue for more than 12 months, the income shall be recognised only when lease rentals are actually received. The net lease rentals taken to the credit of profit & loss account before the asset became non-performing and remaining unrealised shall be reversed.
- **Income from investments:** Income from dividend on shares of corporate bodies and units of mutual funds shall be taken into account on cash basis. Provided where dividend has been declared by the corporate in its AGM, income can be recognised on accrual basis. However, income from securities, bonds, and debentures of corporate bodies and from Government securities/bonds has to be accounted on accrual basis.
- **Securitisation/Factoring/Assignment Transactions:** The company is a registered NBFC-ND-SI engaged in micro-finance activities which involves lending of micro loans. The company primarily funds its operations through external term loans from banks and financial institutions. As a means of financing, the company enters into transactions like factoring, securitisation and assignment, with certain banks and financial institutions.

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The accounting in the instant case would be driven by the ICAI guidance note on 'Securitisation' and in case of factorisation, reference can be made to the principles laid down in the Expert Advisory Committee Opinion. The 'assignment' transactions are usually different from both securitisation and factoring and are largely driven by the industry practice and the agreement. Some of the entities are in the practice of deferring the upfront gain/loss arising on the 'assignment of portfolio of receivables', at the same time others may be recognising it upfront. The assignment agreement plays an important role in determining the appropriate accounting and thus auditors are required to closely monitor those supplemented with a high level of documentation.

Table E: Complexity of Transaction

Perform the following with regard to the revenue recognition policies (perform in conjunction with sales/revenue audit area):

- update understanding of the company's accounting policies for recording revenue;
- for judgmental areas within client's policies, assess reasonableness of judgments and obtain supporting documentation, as appropriate; and
- determine whether the policy is consistent with prior years and is reasonable in light of the industry.

Where limited or no comfort has been obtained from controls, test deferred revenue balances at year-end in order to obtain the desired level of assurance by performing the following:

- a) for selected account balances, examine supporting invoices and/or contracts and determine the products sold and/or services provided;
- b) based on the company's revenue recognition policies, verify the amount of revenue that should be deferred and amortized at year-end for the particular products sold and/or services provided; and
- c) test to ensure that the deferred revenue balance was recorded at the appropriate amount by tracing to the

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detailed deferred revenue listing.

Where significant comfort has been obtained from controls, review the results of analytical procedures and the results of test of controls and, where appropriate, select account balances and test deferred revenue balances at year-end by performing steps (a) to (c) above.

In case of complex transaction, where no financial reporting guidelines exist, auditor needs to be extra careful while discharging its obligation and they may resume to following approach:

- Exercise due care in evaluating the terms of the agreement entered between the Banks/FIs and the company to understand vesting of the rights, title and interest of the loan portfolio is assigned to the purchaser (i.e. the Bank/FI) by the company. Understanding the roles & responsibilities of the company post assignment agreement i.e. whether the company is acting only as a “Collection Agent”.
- Giving due consideration to diverse industry practices.
- In absence of any reporting guidelines prescribed, it would be appropriate to draw reference to the existing generally accepted accounting principles.
- Evaluating whether based on the agreement it would be appropriate to de-recognise the portfolio on the assignment as the company transfer the associated risk and reward and show the collateral amount as “receivable” under “current asset”.
- In case where the company does not retain any effective control and substantial risk/reward has been transferred to the assignee and is acting as collection agent, whether income or loss arising on assignment of portfolio have been recognised upfront.
- Extent of disclosures given in the financial statement and whether it can be concluded to be appropriate.

RBI Prudential Norms for Income Recognition, Classification as NPAs

4.34 RBI issues guidelines containing norms for recognition of income, provisioning for bad debts and classification of such debts in the financial statements of NBFCs, investment valuation, accounting for investments, capital adequacy norms etc.. The master circulars issued by RBI consolidate all the circulars issued on various aspects regulated by RBI.

4.35 The auditor is required to be fully aware of the provisions of the Prudential Norms directions of RBI. Some of such RBI's prudential norms directions are given below:

1. Mortgage Guarantee Companies Prudential Norms (Reserve Bank) Directions, 2008.
2. Non-Banking Financial (Non-Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007.
3. Non-Banking Financial (Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007.

The aforesaid circulars are given in the Appendix at the end of this Guide. These circulars can also be downloaded from RBI website (www.rbi.org.in)

The Appendix also contains other circulars for easy reference together with link through which full text of the circulars can be accessed.

Foreign Direct Investment & External Commercial Borrowings

a. Foreign Direct Investment

Link: http://dipp.nic.in/English/Policies/FDI_Circular_01_2012.pdf

4.36 NBFCs can avail 100% FDI through automatic route subject to the following conditions:

- a) Minimum capitalization norms for fund based NBFCs -
US\$ 0.5 million to be brought upfront for FDI up to 51%;
US\$ 5 million to be brought upfront for FDI above 51%

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and up to 75%; and US\$ 50 million out of which US\$ 7.5 million to be brought upfront and the balance in 24 months, for FDI beyond 75% and up to 100%.

- b) Minimum capitalization norms for non-fund based NBFC activities- US\$ 0.5 million, subject to the condition that such company would not be allowed to set up any subsidiary for any other activity nor it can participate in the equity of NBFC holding / operating company. Non-fund based activities would include Investment Advisory services, Financial consultancy, Forex Broking, Money changing Business and Credit Rating Agencies.
- c) Foreign investors can set up 100% operating subsidiaries without the condition to disinvest a minimum of 25% of its equity to Indian entities subject to bringing in US\$ 50 million without any restriction on number of operating subsidiaries without bringing additional capital.
- d) Joint venture operating NBFCs that have 75% or less than 75% foreign investment will also be allowed to set up subsidiaries for undertaking other NBFC activities subject to the subsidiaries also complying with the applicable minimum capital inflow.
- e) Compliance with the guidelines of the RBI.

b. External Commercial Borrowings

Link: http://rbi.org.in/scripts/BS_ViewMasCirculardetails.aspx?id=5786

Automatic route

4.37 Non-Banking Financial Companies (NBFCs) except Infrastructure Finance Companies are not eligible to raise ECB through automatic route.

4.38 Infrastructure Finance Companies (IFCs) i.e. Non Banking Financial Companies (NBFCs) categorized as IFCs by the Reserve Bank are permitted to avail of ECBs, including the outstanding ECBs, up to 50 per cent of their owned funds, for on-lending to the infrastructure sector as defined under the ECB policy, subject to their complying with the following conditions:

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- i) compliance with the norms prescribed in the DNBS Circular DNBS.PD.CCNo.168 / 03.02.089 / 2009-10 dated February 12, 2010
- ii) hedging of the currency risk in full. Designated authorised dealer should ensure compliance with the extant norms while certifying the ECB application.

4.39 Issuance of guarantee, standby letter of credit, letter of undertaking or letter of comfort by banks, Financial Institutions and Non-Banking Financial Companies (NBFCs) from India relating to ECB is not permitted.

Approval route

4.40 The following types of proposals for ECB are covered under the approval route:

- a) ECB beyond 50 per cent of the owned funds by financial institutions which are classified as Infrastructure Finance Companies are considered on a case to case basis.
- b) NBFCs, through approval route, are eligible borrowers for ECB with minimum average maturity of 5 years from multilateral financial institutions, reputable regional financial institutions, official export credit agencies and international banks to finance import of infrastructure equipment for leasing to infrastructure projects.
- c) Infrastructure Finance Companies (IFCs) i.e. Non-Banking Financial Companies (NBFCs), categorized as IFCs, by the Reserve Bank, are permitted to avail of ECBs, including the outstanding ECBs, beyond 50 per cent of their owned funds, for on-lending to the infrastructure sector as defined under the ECB policy, subject to their complying with the following conditions: (i) compliance with the norms prescribed in the DNBS Circular DNBS.PD.CCNo.168 / 03.02.089 / 2009-10 dated February 12, 2010 (ii) hedging of the currency risk in full. Designated authorised dealer should ensure compliance with the extant norms while certifying the ECB application.

Chapter 5

Operations of an NBFC

Treasury Operations

5.1 Treasury operations, in this context, represent all activities relating to the purchase, sale, borrowing and lending of financial instruments. Financial instruments may be securities, money market instruments or derivative instruments. Investment companies/NBFCs usually enter into such transactions for their own use (for example, for the purpose of hedging risk exposures) or for meeting customers' needs. They also carry out, to a larger or smaller extent, trading activities. Trading may be defined as the purchase and sale (or origination and closing) of financial instruments (including derivatives) with the intention of deriving a gain from the change in market price parameters (for example, foreign exchange rates, interest rates, equity prices) over time. NBFCs manage and control their treasury activities on the basis of the various risks involved rather than on the basis of the particular type of financial instrument dealt with. The auditor is required to consider the audit implications of derivatives acquired by the entities.

5.2 The auditor needs to check that the NBFC/ Investment companies have well documented investment policy describing the nature of treasury operations proposed to be undertaken by the company as well as setting out the limits / authorisation for such operations.

Internal Controls in Treasury Operations

5.3 Generally, treasury operations involve transactions that are recorded by IT systems. The risk of processing error in such transactions is ordinarily low provided they are processed by reliable systems. Consequently, the auditor should test whether key processing controls and procedures are operating effectively before assessing the level of inherent and control risks as low. Typical controls in a treasury environment are

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listed below. These include controls that address business risks of entities and do not necessarily represent controls that address audit risks and that are tested by the auditor in order to assess the levels of inherent and control risks.

General Audit Procedures

5.4 Certain audit procedures apply to the environment in which treasury activities are carried out. To understand this environment, the auditor initially should obtain an understanding of the scale, volume, complexity and risk of treasury activities. The auditor is required to understand the importance of treasury activities relative to other business of the NBFC and should understand the framework within which the treasury activities take place.

5.5 Once the auditor has obtained this understanding and has performed tests of controls with satisfactory results, the auditor should ordinarily assess the accuracy of the recording of transactions entered into during the period and related profits and losses:

- by reference to deal tickets and confirmation slips;
- the completeness of transactions and proper reconciliation between the front office and accounting systems of open positions at the period end;
- the existence of outstanding positions by means of third party confirmations at an interim date or at the period end;
- the appropriateness of the exchange rates, interest rates or other underlying market rates used at the period end date to calculate unrealized gains and losses;
- the appropriateness of the valuation models and assumptions used to determine the fair value of financial instruments outstanding as at the year end; and
- the appropriateness of the accounting policies used particularly around income recognition and the distinction between hedged and trading instruments.

Relevant aspects of treasury operations that generally pose increased audit risks are addressed below.

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Changes in Products or Activities

5.6 Particular risks often arise where new products or activities are introduced. To address such risks the auditor should initially seek to confirm that predefined procedures are in place for these cases. Generally, the entity should commence such activities only when the smooth flow of the new transactions through the controls system is ensured, the relevant IT systems are fully in place (or where adequate interim system support is in place) and the relevant procedures are properly documented. Newly traded instruments are ordinarily subject to careful review by the auditor, who should initially obtain a list of all new products traded during the period (or a full list of all instruments transacted). Based on this information, the auditor should establish the associated risk profile and seeks to confirm the reliability of the internal control and accounting systems.

Reliance on Computer Experts

5.7 Due to the volume of transactions, virtually all NBFCs/investment companies support the treasury transactions cycle using IT systems. Due to the complexity of systems in use and the procedures involved, the auditor should ordinarily seek the assistance of IT experts to supply appropriate skills and knowledge in the testing of systems and relevant account balances.

Purpose for which Transactions are Undertaken

5.8 The auditor should consider whether the NBFC holds speculative positions in financial instruments or hedges them against other transactions. The purpose for entering such transactions, whether hedging or trading, should be identified at the inception stage in order for the correct accounting treatment to be applied. Where transactions are entered for hedging purposes, the auditor should consider the appropriate accounting treatment and presentation of such transactions and the matched assets/liabilities, in accordance with relevant accounting requirements.

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Valuation Procedures

Table F: Determination of value of instruments

The auditor might test all portfolio valuations as of the date of the financial statements. The auditor might test transactions on dates selected from the period under audit for agreement with the values computed by the company. The extent of those tests should be based on the auditor's judgment after considering the tolerable misstatement, the assessed risk of material misstatement, and the degree of assurance the auditor plans to obtain.

When investments are valued by the investment company using a valuation model (including an internally developed matrix pricing model), the auditor should obtain an understanding of the entity's process for determining fair value, including:

- controls over the process used to determine fair value measurements, including, for example, controls over data and the segregation of duties between investment management functions and those responsible for undertaking the valuations;
- the expertise and experience of those determining fair value measurements;
- the role of information technology in the valuation process, including the integrity of change controls and security procedures for valuation models and information systems;
- significant assumptions used in determining fair value, as well as the process used to develop and apply management's assumptions, including whether management used available market information in order to develop the assumptions;
- documentation supporting management's assumptions; and
- controls over the consistency, timeliness, completeness and reliability of data used in valuation models.

The role of the company's board of directors in establishing valuation policies, and the conformity of the model with those policies and the rules or regulatory authorities should be considered.

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5.9 Where the entity has adopted AS 30, both the balance sheet items and off-balance sheet financial instruments are ordinarily valued at market or fair value, except for those financial instruments which are used for hedging purposes, which, under many financial reporting frameworks, are valued on the same basis as the underlying item being hedged. Where market prices are not readily available for an instrument, financial models that are widely used by the banking industry may be used to determine the fair value. In addition to disclosure of the notional amounts of open positions, the disclosure may be required of the potential risk arising, as for example, the credit risk equivalent and replacement value of such outstanding instruments.

5.10 The auditor should ordinarily test the valuation models used, including the controls surrounding their operation, and considers whether details of individual contracts, valuation rates and assumptions are appropriately entered into such models. Many of these instruments/ contracts have evolved in the recent past and hence, while testing their valuation, the auditor should bear the following factors in mind:

- There may be no legal precedents concerning the terms of the underlying agreements. This makes it difficult to assess the enforceability of those terms.
- There may be a relatively small number of management personnel who are familiar with the inherent risks of these instruments. This may lead to a higher risk of misstatements occurring and a greater difficulty in establishing controls that would prevent misstatements or detect and correct them on a timely basis.

5.11 Some of these instruments have not existed through a full economic cycle (bull and bear markets, high and low interest rates, high and low trading and price volatility) and it may therefore be more difficult to assess their value with the same degree of certainty as for more established instruments. Similarly, it may be difficult to predict with a sufficient degree of certainty the price correlation with other offsetting instruments used by the NBFC to hedge its positions.

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5.12 There can be situations when the market conditions are not normal leading to high volatility in valuation rates. The models used for valuing such instruments may not operate properly in such conditions. The complexity of certain instruments requires specialised skill and knowledge. If the auditor does not have the professional competence to perform the necessary audit procedures, advice is sought from experts in this field.

5.13 A further issue of particular interest to the auditor is transactions entered into at rates outside the prevailing market rates; these often involve the risk of hidden losses or fraudulent activity. The auditor should obtain sufficient appropriate audit evidence concerning the reliability of such rates. The auditor should consider reviewing a sample of the identified transactions.

The Credit Function

5.14 The credit function may conveniently be divided into the following categories:

- Origination and disbursement
- Monitoring
- Collection
- Periodic review and evaluation

Origination and Disbursement

5.15 The auditor should consider whether the NBFC has obtained complete and informative loan applications, including financial statements of the borrower, the source of the loan repayment and the intended use of proceeds. For this NBFC should have written guidelines as to the criteria to be used in assessing loan applications (for example, interest coverage, margin requirements, debt-to-equity ratios etc.). Where required the NBFC should obtain credit reports or have independent investigations conducted on prospective borrowers.

5.16 The auditor has to verify whether the NBFC has procedures in use to ensure that related party lending has been identified.

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Planning

5.17 The auditor should obtain knowledge and understanding of the NBFC's method of controlling credit risk. This includes matters such as the following:

- The NBFC's exposure monitoring process and its system for ensuring that all connected party lending has been identified and aggregated.
- The NBFC's method for appraising the value of exposure, collateral and for identifying potential and definite losses.

The NBFC's Lending Practices and Customer Base

5.18 The auditor should consider whether the exposure review program ensures independence from the lending functions including whether the frequency is sufficient to provide timely information concerning emerging trends in the portfolio and general economic conditions and whether the frequency is increased for identified problem credits.

5.19 The auditor should consider the qualifications of the personnel involved in the credit review function. The industry is changing rapidly and fundamentally creating a lack of qualified lending expertise. The auditor should consider whether credit review personnel possess the knowledge and skills necessary to manage and evaluate lending activities.

5.20 The auditor should consider, through information previously generated, the causes of existing problems or weaknesses within the system. The auditor should consider whether these problems or weaknesses present the potential for future problems.

5.21 The auditor should review management reports and should consider whether they are sufficiently detailed to evaluate risk factors.

5.22 It is difficult to define and audit related party lending transactions because the transactions with related parties are not easily identifiable. Reliance is primarily upon management to identify all related parties and related-party transactions and such transactions may not be easily detected by the NBFC's internal control systems. The auditor should obtain an

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understanding as to how management identifies, records and monitor related party transactions. The auditor should challenge management's process and test key controls in identification, accounting and reporting of related party transactions.

Tests of Controls

5.23 The auditor should obtain knowledge and understanding of the NBFC's method of controlling credit risk. This includes matters such as:

- The portfolio exposure and the various features and characteristics of the exposures;
- The exposure documentation used by the investing company;
- What constitutes appropriate exposure documentation for different types of exposures; and
- The entity's procedures and authority levels for granting an exposure.

5.24 The auditor should review the lending policies and consider:

- Whether the policies are reviewed and updated periodically to ensure they are relevant with changing market conditions; and
- Whether those charged with governance have approved the policies and whether the NBFC is in compliance.

5.25 The auditor should examine the exposure review reporting system, including credit file memoranda and an annual schedule or exposure review plan, and should consider whether it is thorough, accurate and timely and whether it will provide sufficient information to allow management to both identify and control risk. Consider whether the reports include:

- Identification of problem credits;
- Current information regarding portfolio risk; and
- Information concerning emerging trends in the portfolio and lending areas

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5.26 The auditor should consider the nature and extent of the scope of the exposure review, including the following:

- Method of exposure selection.
- Manner in which exposures are reviewed including:
 - An analysis of the current financial condition of the borrower which addresses repayment ability, and
 - Tests for documentation exceptions, policy exceptions, non-compliance with internal procedures, and violations of laws and regulations.

5.27 The auditor should consider the effectiveness of the credit administration and portfolio management by examining the following:

- Management's general lending philosophy in such a manner as to elicit management responses;
- The effect of credits not supported by current and complete financial information and analysis of repayment ability;
- The effect of credits for which exposure and collateral documentation are deficient;
- The volume of exposures improperly structured, for example, where the repayment schedule does not match exposure purpose;
- The volume and nature of concentrations of credit, including concentrations of classified credits. (NPAs)
- The appropriateness of transfers of low quality credits to or from another affiliated office.
- The accuracy and completeness of credit monitoring reports.
- Competency of senior management and credit department personnel.

Substantive Procedures

5.28 The auditor should consider the extent of management's knowledge of the NBFC's own credit exposure problems

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through selective exposure file reviews. Selection criteria include the following:

- Accounts with an outstanding balance equal to or greater than a specified amount.
- Accounts on a "Watch List" with an outstanding balance in excess of a specified amount.
- Accounts with a provision in excess of a specified amount.
- Accounts that are handled by the department that manages the higher risk accounts.
- Accounts where principal or interest of more than a specified amount is in arrears for more than a specified period.
- Accounts where the amount outstanding is in excess of the authorized credit line/limit.
- Accounts with entities operating in industries or countries that the auditor's own general economic knowledge indicates could be at risk.
- Problem accounts identified by the NBFC's regulatory authorities and problem accounts selected in the prior year.

5.29 In addition, where the NBFC's personnel have been requested to summarize characteristics of all exposures over a specified size grouped on a connection basis, the auditor should review the summaries. Exposures with the following characteristics may indicate a need for a more detailed review:

- Large operating loss in the most recent fiscal year.
- Sustained operating losses (for example, 2 or more years).
- A high leveraged facility (for example, debt –equity ratio in excess of 2:1—the ratio will vary by industry).
- Failure to comply with terms of agreements and covenants.
- Modified audit report.

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- Information provided not current or complete.
- Advances significantly unsecured or secured substantially by a guarantee.
- Accounts where reviews not performed by NBFC management on a timely basis.

5.30 The auditor should select the exposures for detailed review from the exposure listings above using the sample selection criteria determined above and obtains the documents necessary to consider the collectability of the exposures. These may include the following:

- The exposure and security documentation files.
- Arrears listings or reports.
- Activity summaries.
- Previous doubtful accounts listings.
- The non-current exposure report.
- Financial statements of the borrower.
- Security valuation reports.

5.31 Using the exposure documentation file, the auditor should:

- Ascertain the exposure type, interest rate, maturity date, repayment terms, security and stated purpose of the exposure;
- Consider whether security documents bear evidence of registration as appropriate, and that the NBFC has received appropriate legal advice about the security's legal enforceability;
- Consider whether the fair value of the security appears adequate (particularly for those exposures where a provision may be required) to secure the exposure and that where applicable, the security has been properly insured. Critically evaluate the collateral appraisals, including the appraiser's methods and assumptions;
- Evaluate the collectability of the exposure and consider the need for a provision against the account;

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- Determine whether the appropriate authority levels within the NBFC have approved the exposure application or renewal;
- Review periodic financial statements of the borrower and note significant amounts and operating ratios (that is, working capital, earnings, shareholders' equity and debt-to-equity ratios); and
- Review any notes and correspondence contained in the exposure review file. Notes the frequency of review performed by the NBFC's staff and considers whether it is within NBFC guidelines.

5.32 In addition to assessing the adequacy of the provisions against individual exposures, the auditor should consider whether any additional provisions need to be established against particular categories or classes of exposures (for example, credit card exposures and country risk exposures) and assesses the adequacy of any provisions that the NBFC may have established through discussions with management.

Chapter 6

Governance

6.1 The need of best practices and greater transparency, to protect the interests of the stake-holders in the corporate sector has led to the specification of Corporate Governance guidelines by RBI. Its universal applicability has no exception to the Non-Banking Financial Companies (NBFCs) which too are essentially corporate entities. Listed NBFCs which are required to adhere to listing agreement and rules framed by SEBI on Corporate Governance are already required to comply with SEBI prescriptions on Corporate Governance.

6.2 In order to enable NBFCs to adopt best practices and greater transparency in their operations certain guidelines have been proposed for consideration of the Board of Directors of the class of NBFCs.

6.3 Though it is not a duty of the auditor to ensure compliance with corporate governance norms, it would be appropriate for the auditor to understand the corporate governance structure of the NBFC. This may assist the auditor in communication with management and those charged with governance and also in evaluating the internal controls in the organisation.

Table G: Auditor may consider following with regard to internal governance and reporting

Audit Committee
<ul style="list-style-type: none">• Review written audit committee charter.• Sufficiency of length of audit committee meetings and level of discussion to accomplish the committee's objectives.• Understanding among audit committee, management, fund's chief compliance officer, internal auditors and independent auditors to provide constructive feedback on each other's performance, and identify improvements that

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can be made to enhance each party's effectiveness.

- Means used to keep current with fund industry, regulatory and auditing/accounting/tax developments affecting responsibilities of audit committee members (continuing education).
- Sufficiency of audit committee's relationships and meetings (general and private session) and other interactions with management, fund's chief compliance officer and internal and independent auditors.
- Mutual understanding among the audit committee, fund's chief compliance officer, internal and external auditors of expected communication about matters requiring special or immediate attention.
- Review/approve any written report/disclosure made in public filings of audit committee activities.
- Internal auditor's observations concerning:
 - internal control over financial reporting, including management's procedures for monitoring service providers' controls;
 - management's and service providers' ability to maintain adequate internal control over financial reporting during periods of higher growth and activity or increase in the number of funds or complexity of their investments; or, alternatively, due to cost reduction programs resulting from declining revenues and profitability;
 - communication protocols between fund accounting and reporting functions and other service providers;
 - errors in NAV/per share, their causes, and any corrective actions taken as a result;
 - areas where alternative or extended audit procedures were required because of inadequate records or controls; and
 - sufficiency and timeliness of improvements to internal control over financial reporting made as a

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result of recommendations provided in current or prior audits.

Internal Control over Compliance with Laws and Regulations

- Non-compliance with laws and regulations could have a material effect on financial statements:
 - scope of work performed or oversight or advice provided in such areas by management, compliance staff, internal and external counsel.
- Significant elements of the annual review of the fund's compliance program administered by its chief compliance officer, including (i) those elements pertaining to service providers; (ii) the nature and extent of forensic testing performed; and (iii) findings and any corrective actions taken or necessary to take.
- Significant changes in compliance policies and procedures.
- Status of any legal matters (if any) that could have a material effect on the financial statements.
- Procedures used to identify potential conflicts of interest and ways in which such circumstances are managed and disclosed.
- Unusual or nonrecurring transactions affiliates, and/or other related parties, including nature and extent of related disclosures:
 - procedures for identifying and recording unusual revenue items, such as litigation settlements.
- Identification and review of related party transactions and adequacy of disclosures.
- Nature and extent of information appearing in shareholder report outside of financial statements.
- Assurance that independent auditor received full cooperation from all parties relevant to audit and no restrictions were placed on his work.

Chapter 7

Miscellaneous

Applicability of Other Laws

7.1 The auditor should consider the applicability of other laws while checking the transactions entered into by the NBFC. These laws include the Indian Contracts Act 1872, Sale of Goods Act 1930, Indian Stamp Act 1899, Negotiable Instruments Act 1881, Motor Vehicles Act 1961, Limitation Act 1963.

Opening and Closing of Branches

7.2 NBFCs are to comply with the provisions contained in Non Banking Financial Companies Acceptance of Deposits (Reserve Bank) Directions, 1998 regarding opening and closing of branches/ offices by NBFCs which are entitled to accept public deposits. As per the directions applicable to all NBFCs except Residuary Non Banking Companies and Miscellaneous Non Banking Companies, NBFC shall open its branch or appoint agents to collect deposits only on fulfilling following criteria:

- NBFC should have a certificate of registration from RBI.
- If Net Owned Funds (NOF) is upto Rs 50 Crore it can open branch within the State where its registered office is situated. For NOF more than Rs 50 Crore and with a credit rating AA and above, NBFC is permitted to open branch anywhere in India.
- NBFC shall notify RBI about its proposal to open the branch.

While closing its branch, NBFC should publish such intention in newspaper and should notify RBI, 90 days before the proposed closure.

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Inspection by RBI

7.3 NBFCs are subject to inspection by RBI under section 45N of the Reserve Bank of India Act, 1934. Where any exceptions are noted NBFCs are required to rectify the same and report compliance. The auditor should examine the report and consider the exceptions noted in such inspection reports.

ICAI Announcement on NBFCs dated September 18, 2007

7.4 Based on communication received from RBI, ICAI has made an announcement to its members on September 18, 2007 listing out certain irregularities in NBFC which are required to be reported by the auditors but one or more of them have not been reported by some auditors. The auditor should be aware of the list of irregularities pointed out by the RBI. The full text of the announcement is given in the Appendix to the Guide.

KYC Norms

7.5 RBI from time to time issues guidelines requiring NBFC to apply enhanced due diligence measures on high risk customers. Any contravention or non compliance of the guidelines would attract penalties imposed by RBI.

Appendix A

Illustrative Audit Report/ Certificate Templates

**Certificate/Report that may be required to be issued
for Registration as NBFC**

Appendix A - IA

Board of Directors

[Name & Address of the Company]

Auditor's Report

- 1) This report is issued in accordance with the terms of our agreement dated [date].
- 2) The accompanying Statement of the capital funds, risk assets/ exposures and risk asset ratio etc. (the "Annex II Statement") as on [month] [date], [year] of [name of the Company] (the "Company") has been prepared by Company's Management and certified by the [Managing Director/ Chief Executive Officer of the Company or his authorised representative], pursuant to the requirements of 'Requirements to be complied with and documents to be submitted to Reserve Bank of India (RBI) by Non Banking Financial Companies for obtaining Certificate and Registration from RBI under Section 45-IA of the Reserve Bank of India Act, 1934 ("the Act") (the 'Requirement Checklist'), which we have initialled for identification purposes only.

Management's Responsibility

- 3) The preparation of the Annex II Statement is the responsibility of the Management of the Company including the creation and maintenance of all accounting and other records supporting its contents. This responsibility includes the design, implementation and maintenance of internal control relevant to the

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preparation and presentation of the Annexure II Statement and applying an appropriate basis of preparation; and making estimates that are reasonable in the circumstances.

- 4) The Management is also responsible for ensuring that the Company complies with the requirements of the Act (including the legal and statutory formalities) with respect to obtaining Certificate and Registration from RBI under Section 45 IA of the Act and for providing all relevant information to RBI.

Auditors' Responsibility

- 5) Pursuant to the Requirements Checklist it is our responsibility to obtain reasonable assurance and report that the amounts in Parts A, B, C, D, E, F, G, H and I of the Annex II Statement are in accordance with the books of account and other records of the Company produced to us for our examination.
- 6) We conducted our examination in accordance with the 'Guidance Note on Audit Reports and Certificates for Special Purposes' issued by the Institute of Chartered Accountants of India.

Conclusion

- 7) Based on our examination as above, and the information and explanations given to us, we report that, the amounts in Parts A, B, C, D, E, F, G, H and I of the Annex II Statement are in accordance with the books of account and other records of the Company produced to us for our examination.

Restrictions on Use

- 8) This report has been issued for the sole use of the Board of Directors of the Company, to whom it is addressed, for submission to the Reserve Bank of India pursuant to the Company's application for registration as a Non-Banking Financial Company with the Reserve Bank of India under Section 45-IA of the Reserve Bank of India Act, 1934, and should not be used by any other person or for any other purpose. [Name of the Firm] neither accepts nor

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assumes any duty or liability for any other purpose or to any other party to whom our report is shown or into whose hands it may come without our prior consent in writing.

For [Insert Firm's name]

Firm Registration Number: [Insert Firm's Registration number]

Chartered Accountants

Signature

[Insert Partner's Name]

Partner

Membership Number:

[Place of the Signature]

[Date]

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Appendix A – I-B

Board of Directors

[Name of the Company]

[Address]

Auditors' Report

- 1) This report is issued in accordance with the terms of our agreement dated [date].
- 2) The accompanying declaration by [Name of the Company] (hereinafter referred to as "the Company") certifying that the Company is not carrying on any Non Banking Financial Company activity for the period [Date] to [Date] (herein after referred to as the "NBFC Activity Declaration"), has been prepared by the Company's Management and certified by [Name of MD/CEO of the Company or his authorized representative) pursuant to the requirement of 'Requirements to be complied with and documents to be submitted to Reserve Bank of India(RBI) by Non Banking Financial Companies for obtaining Certificate and Registration from RBI under Section 45-IA of the Reserve Bank of India Act,1934 (Act) (the 'Requirement Checklist'), which we have initialed for identification purpose only.

Management's Responsibility

- 3) The preparation of the NBFC Activity Declaration is the responsibility of the Management of the Company including the creation and maintenance of all accounting and other records supporting its contents. This responsibility includes the design, implementation and maintenance of internal control relevant to the preparation and presentation of the NBFC Activity Declaration, and applying an appropriate basis of preparation; and making estimates that are reasonable in the circumstances.

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- 4) The Management is also responsible for ensuring that the Company complies with the requirements of the Act (including the legal and statutory formalities) with respect to obtaining Certificate and Registration from RBI under Section 45 IA of the Act and for providing all relevant information to RBI.

Auditors' Responsibility

- 5) Pursuant to the Requirements Checklist it is our responsibility to examine the books and other records of the Company and obtain reasonable assurance and form an opinion that the NBFC Activity Declaration is in compliance with the requirements of the Company's registration as a Non-Banking Financial Company as set out in Requirement's Checklist.
- 6) We conducted our examination in accordance with the 'Guidance Note on Audit Reports and Certificates for Special Purposes' issued by the Institute of Chartered Accountants of India.

Opinion

- 7) Based on our examination as above, and the information and explanations given to us, in our opinion, the accompanying NBFC Activity Declaration is in compliance with the requirements of the Company's registration as a Non-Banking Financial Company as set out in the Requirements Checklist.

Restrictions on Use

- 8) This report has been issued for the sole use of the Board of Directors of the Company, to whom it is addressed, for submission to the Reserve Bank of India pursuant to the Company's application for registration as a Non-Banking Financial Company with the Reserve Bank of India under Section 45-IA of the Reserve Bank of India Act, 1934, and should not be used by any other person or for any other purpose. [Name of the Firm] neither accepts nor assumes

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any duty or liability for any other purpose or to any other party to whom our report is shown or into whose hands it may come without our prior consent in writing

For [Insert Firm's name]

Firm Registration Number: [Insert Firm's Registration number]

Chartered Accountants

Signature

[Insert Partner's Name]

Partner

Membership Number:

[Place of the Signature]

[Date]

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Appendix A – I-C

Board of Directors

[Name of the Company]

[Address]

Auditors' Certificate

- 1) This certificate is issued in accordance with the terms of our agreement dated [date].
- 2) The accompanying Declaration by [Name of the Company] (herein after referred to as "the Company") certifying that the Company is not holding / shall not accept Public Deposit for the period [date] to [Date] (herein after referred to as the "Public Deposits Declaration") has been prepared by the Company's Management and certified by [Name of MD/CEO of the Company or his authorized representative], pursuant to the requirements of 'Requirements to be complied with and documents to be submitted to Reserve Bank of India (RBI) by Non Banking Financial Companies for obtaining Certificate and Registration from RBI under Section 45-IA of the Reserve Bank of India Act,1934 (the 'Act') (the 'Requirement Checklist'), which we have initialed for identification purposes only.

Management's Responsibility

- 3) The preparation of the Public Deposits Declaration is the responsibility of the Management of the Company including the creation and maintenance of all accounting and other records supporting its contents. This responsibility includes the design, implementation and maintenance of internal control relevant to the preparation and presentation of the Public Deposits Declaration, and applying an appropriate basis of preparation; and making estimates that are reasonable in the circumstances

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- 4) The Management is also responsible for ensuring that the Company complies with the requirements of the Act (including the legal and statutory formalities) with respect to obtaining Certificate and Registration from RBI under Section 45 IA of the Act and for providing all relevant information to RBI.

Auditors' Responsibility

- 5) Pursuant to the Requirements Checklist it is our responsibility to examine the books and other records of the Company and certify that the accompanying Public Deposits Declaration is in compliance with the requirements of the Company's registration as a Non-Banking Financial Company as set out in Requirement's Checklist.
- 6) We conducted our examination in accordance with the 'Guidance Note on Audit Reports and Certificates for Special Purposes' issued by the Institute of Chartered Accountants of India.

Conclusion

- 7) Based on our examination as above, and the information and explanations given to us, we certify that the accompanying Public Deposits Declaration is in compliance with the requirements of the Company's registration as a Non-Banking Financial Company as set out in the Requirements Checklist.

Restrictions on Use

- 8) This certificate has been issued for the sole use of the Board of Directors of the Company, to whom it is addressed, for submission to the Reserve Bank of India pursuant to the Company's application for registration as a Non-Banking Financial Company with the Reserve Bank of India under Section 45-IA of the Act, and should not be used by any other person or for any other purpose. [Name of the Firm] neither accepts nor assumes any duty or liability for any other purpose or to any other

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party to whom our report is shown or into whose hands it
may come without our prior consent in writing

For [Insert Firm's name]

Firm Registration Number: [Insert Firm's Registration number]

Chartered Accountants

Signature

[Insert Partner's Name]

Partner

Membership Number:

[Place of the Signature]

[Date]

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Appendix A - I-D

Board of Directors
[Name of the Company]
[Address]

Auditors' Certificate

- 1) This certificate is issued in accordance with the terms of our agreement dated [date].
- 2) The accompanying Statement of Computation of Net Owned Funds ("the Statement") as on [month] [date], [year] of [Name of the Company] (the "Company") has been prepared by Company's Management and certified by the [Managing Director/ Chief Executive Officer of the Company or his authorised representative] pursuant to the requirements as specified in circular DNBS (PD) C.C. No. 114 /03. 02.059/2007-08 dated June 17, 2008, as amended ("the Circular") and which we have initialled for identification purposes only.

Management's Responsibility

- 3) The preparation of the Statement is the responsibility of the Management of the Company including the creation and maintenance of all accounting and other records supporting its contents. This responsibility includes the design, implementation and maintenance of internal control relevant to the preparation and presentation of the Statement, and applying an appropriate basis of preparation; and making estimates that are reasonable in the circumstances
- 4) The Management is also responsible for ensuring that the Company complies with the requirements of the Act (including the legal and statutory formalities) with respect to obtaining Certificate and Registration from RBI under Section 45 IA of the Act and for providing all relevant information to RBI.

Auditors' Responsibility

- 5) Pursuant to the Circular it is our responsibility to examine the books and other records of the Company and certify

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that the accompanying Statement is in accordance with the requirements of the Circular.

- 6) We conducted our examination in accordance with the 'Guidance Note on Audit Reports and Certificates for Special Purposes' issued by the Institute of Chartered Accountants of India.

Conclusion

- 7) Based on our examination as above, and the information and explanations given to us, we certify that :
- a) the Statement is computed in accordance with the requirements as specified in the Circular and
 - b) the computation therein is arithmetically correct.

Restrictions on Use

- 8) This certificate has been issued for the sole use of the Board of Directors of the Company, to whom it is addressed, for submission to the Reserve Bank of India in connection with the Company's planned activities as a Non Banking Financial Company and should not be used by any other person or for any other purpose. [Name of the Firm] neither accepts nor assumes any duty or liability for any other purpose or to any other party to whom our report is shown or into whose hands it may come without our prior consent in writing.

For [Insert Firm's name]

Firm Registration Number: [Insert Firm's Registration number]

Chartered Accountants

Signature

[Insert Partner's Name]

Partner

Membership Number:

[Place of the Signature]

[Date]

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Appendix A - 1-E

Board of Directors

[Name of the Company]

[Address]

Auditors' Certificate

- 1) This certificate is issued in accordance with the terms of our agreement dated [date].
- 2) The accompanying statement of foreign direct investment in [Name of the Company] (hereinafter referred to as "the Company") as at [date] (the "FDI Statement") contains the details [] has been prepared by the Company's Management and certified by the [Managing Director/ Chief Executive Officer of the Company or his authorised representative] , pursuant to the requirements of FEMA Notification 94/2003-RB dated June 18, 2003 (the "RBI Circular"), which have been initialled by us for identification purpose only.

Management's Responsibility

- 3) The preparation of the FDI Statement is the responsibility of the Management of the Company including the creation and maintenance of all accounting and other records supporting its contents. This responsibility includes the design, implementation and maintenance of internal control relevant to the preparation and presentation of the FDI Statement, and applying an appropriate basis of preparation; and making estimates that are reasonable in the circumstances.
- 4) The Management is also responsible for ensuring that the Company complies with the requirements of the Act (including the legal and statutory formalities) with respect to obtaining Certificate and Registration from RBI under Section 45 IA of the Act and for providing all relevant information to RBI.

Auditors' Responsibility

- 5) Pursuant to the RBI Circular it is our responsibility to examine the books and other records of the Company and certify that the Company is in compliance with the RBI Circular.

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- 6) We conducted our examination in accordance with the 'Guidance Note on Audit Reports and Certificates for Special Purposes' issued by the Institute of Chartered Accountants of India.

Conclusion

- 7) Based on our examination as above, and the information and explanations, we certify that, to the best of our knowledge, the Company, is in compliance with the terms and conditions contained within FEMA Notification 94/2003-RB dated June 18, 2003 and as consolidated by Reserve Bank of India's Master Circular No.[*] dated [*].

Restrictions on Use

- 8) This certificate has been issued for the sole use of the Board of Directors of the Company, to whom it is addressed, for submission to the Reserve Bank of India pursuant to the Company's application for registration as a Non-Banking Financial Company with the Reserve Bank of India under Section 45-IA of the Reserve Bank of India Act, 1934 and should not be used by any other person or for any other purpose. [Name of the Firm] neither accepts nor assumes any duty or liability for any other purpose or to any other party to whom our report is shown or into whose hands it may come without our prior consent in writing.

For [Insert Firm's name]

Firm Registration Number: [Insert Firm's Registration number]

Chartered Accountants

Signature

[Insert Partner's Name]

Partner

Membership Number:

[Place of the Signature]

[Date]

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Appendix A - 1F

Board of Directors

[Name of the Company]

[Address]

Auditors' Certificate

- 1) This certificate is issued in accordance with the terms of our agreement dated [date].
- 2) The accompanying declaration by [Name of the Company] (herein after referred to as "the Company") certifying whether the Company has engaged in any capital market activity for the period [Date] to [Date] (the "Capital Market Activity Declaration") has been prepared by the Company's Management and certified by [Name of MD/CEO of the Company or his authorized representative) pursuant to the requirements as set out in item number 24 of the 'Requirements to be complied with and documents to be submitted to Reserve Bank of India (RBI) by Non Banking Financial Companies for obtaining Certificate and Registration from RBI under Section 45-IA of the Reserve Bank of India Act,1934('the Act") (the "Requirements Checklist"), which we have initialled for identification purpose only.

Management's Responsibility

- 3) The preparation of the Capital Market Activity Declaration is the responsibility of the Management of the Company including the creation and maintenance of all accounting and other records supporting its contents. This responsibility includes the design, implementation and maintenance of internal control relevant to the preparation and presentation of the Capital Markets Activity Declaration, and applying an appropriate basis of preparation; and making estimates that are reasonable in the circumstances
- 4) The Management is also responsible for ensuring that the Company complies with the requirements of the Act (including the legal and statutory formalities) with respect to obtaining Certificate and Registration from RBI under Section 45 IA of the Act and for providing all relevant information to RBI.

Auditors' Responsibility

- 5) Pursuant to the RBI Circular it is our responsibility to examine the books and other records of the Company

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and certify that the Company is in compliance with the Requirements Checklist.

- 6) We conducted our examination in accordance with the 'Guidance Note on Audit Reports and Certificates for Special Purposes' issued by the Institute of Chartered Accountants of India

Conclusion

- 7) Based on our examination as above, and the information and explanations (including Management representations) given to us, we certify that, to the best of our knowledge, the accompanying Capital Market Activity Declaration is in compliance with the requirements of the Company's registration as a Non-Banking Financial Company as set out in the Requirements Checklist

Restrictions on Use

- 8) The certificate has been issued for the sole use of the Board of Directors of the Company, to whom it is addressed, for submission to the Reserve Bank of India pursuant to the Company's application for registration as a Non-Banking Financial Company with the Reserve Bank of India under Section 45-IA of the Reserve Bank of India Act, 1934, and should not be used by any other person or for any other purpose. [Name of the Firm] neither accepts nor assumes any duty or liability for any other purpose or to any other party to whom our report is shown or into whose hands it may come without our prior consent in writing

For [Insert Firm's name]

Firm Registration Number: [Insert Firm's Registration number]

Chartered Accountants

Signature

[Insert Partner's Name]

Partner

Membership Number:

[Place of the Signature]

[Date]

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Report with NBS 1 Quarterly Return

Appendix A - II

Auditor's Report

- 1) This report is issued in accordance with the terms of our engagement dated [*]
- 2) The accompanying declaration in Form- NBS 1 Annual Return on Deposits (the "Return") prepared by [Name of the Company] (the "Company") to obtain reasonable assurance as to whether financial information in Parts 1 to 11 of the Return are in accordance with the audited financial statements of the Company as at and for the year ended [month][date], [year] and the books of account and other records of the Company. The Return has been prepared by the Company pursuant to the terms and conditions contained in Notification No.DFC.118/DG(SPT)-98 dated January 31, 1998 (the "Notification") issued by the Reserve Bank of India. We have initialled the Return for identification purposes only.

Management's responsibility

- 3) The preparation of the Return is the responsibility of the Management of the Company including the creation and maintenance of all accounting and other records supporting its contents. This responsibility includes the design, implementation and maintenance of internal control relevant to the preparation and presentation of the Return and applying an appropriate basis of preparation; and making estimates that are reasonable in the circumstances
- 4) The Management is also responsible for ensuring that the Company complies with the requirements of the Act (including the legal and statutory formalities) with respect to obtaining Certificate and Registration from RBI under Section 45 IA of the Act and for providing all relevant information to RBI.

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Auditors' Responsibility

- 5) Pursuant to the Notification, it is our responsibility to report on the matters furnished in the Parts 1 to 11 of the Return based on our examination of the matters in the Return with reference to the audited financial statements as at and for the year ended [month][date], [year]¹ on which we have issued an unmodified audit opinion vide our audit report dated [month][date][year] and the books of account and other records maintained by the Company.
- 6) Our audits of the above mentioned financial statements of the Company was conducted in accordance with the generally accepted auditing standards in India and other applicable authoritative pronouncements issued by the Institute of Chartered Accountants of India. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. Our audit were not planned and performed in connection with any transactions to identify matters that may be of potential interest to third parties.²
- 7) We conducted our examination of the Return in accordance with the 'Guidance Note on Audit Reports and Certificates for Special Purposes' issued by the Institute of Chartered Accountants of India.

Opinion

- 8) Based on our examination as above and the information and explanations given to us, to the best of our knowledge and according to the information and explanations given to us and as shown by the records examined by us, in our opinion, the financial information disclosed in Parts 1 to 11 of the Return is in agreement with audited financial statements of the Company as at

¹ As applicable

² To be included only where the books and records of the Company include its audited financial statements.

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and for the year ended [month][date], [year] and the books of account and other records of the Company.

Restrictions on Use

- 9) This report is addressed to and provided to the Company solely for the purpose of enabling it to comply with its obligations under the Notification to submit the statutory auditors' certificate , and should not be used by any other person or for any other purpose. Accordingly, we do not accept or assume any liability or any duty of care for any other purpose or to any other person to whom this report is shown or into whose hands it may come without our prior consent in writing.

For [Firm Name]
Firm Registration Number: []
Chartered Accountants

[Name of Signing Partner]
Partner
Membership Number: []

Place:
Date:

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Appendix A III

Certificate on Monthly Return

Board of Directors

[Address]

Auditor's Certificate

1. This certificate is issued in accordance with the terms of our agreement dated [Date]
2. The accompanying monthly return (the "Return") of *[Name of the Company]* comprising important financial parameters of non banking financial companies has been prepared by the Company's Management and certified by *[Name of MD/CEO of the Company or his authorized representative]* pursuant to the requirements of DNBS (RID) C.C. No. 57/02.05.15/2005-06 dated September 6, 2005 issued by the Reserve Bank of India as compiled in Reserve Bank of India's Master Circular DNBS.PD.CC. No.[*]dated July 1, [*] (the "RBI Circular") which we have initialled for identification purpose only.

Management's Responsibility

3. The preparation of the Return is the responsibility of the Management of the Company including the creation and maintenance of all accounting and other records supporting its contents. This responsibility includes the design, implementation and maintenance of internal control relevant to the preparation and presentation of the Return and applying an appropriate basis of preparation; and making estimates that are reasonable in the circumstances
4. The Management is also responsible for ensuring that the Company complies with the requirements of the RBI Circular (including the legal and statutory formalities) with respect to filing of the Return and for providing all relevant information to RBI.

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Auditors' Responsibilities

5. Pursuant to the RBI Circular it is our responsibility to examine the books and other records of the Company and certify whether:
 - a) The data furnished in Monthly Return is correct
 - b) The Company has accepted any public deposits
 - c) Company has complied with the prudential norms relating to income recognition, accounting standards, asset classification and provisioning for bad and doubtful debts prescribed by the Reserve Bank of India for non banking financial companies as applicable to it.³
6. We conducted our examination in accordance with the 'Guidance Note on Audit Reports and Certificates for Special Purposes' issued by the Institute of Chartered Accountants of India.

Conclusion

7. Based on our examination as above and the information and explanations given to us, we certify that, to the best of our knowledge and according to the information and explanations given to us and as shown by the records examined by us:
 - (a) The data furnished in the attached return are correct.
 - (b) The Board of Directors of the company have passed a resolution in its meeting held on [month, day, year] for non-acceptance of any public deposits.⁴
 - (c) The company has not accepted any public deposits during the year ended March 31, [year].⁵
 - (d) The Company has complied with prudential norms relating to income recognition, accounting standards, asset classification and provisioning for

³ As applicable

⁴ As applicable

⁵ As applicable

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bad and doubtful debts prescribed by the Reserve Bank of India for non banking financial companies as applicable to it.⁶

Restrictions on Use

8. This certificate has been issued for the sole use of the Board of Directors of the Company, to whom it is addressed, for submission of the Return to the Reserve Bank of India pursuant to RBI Circular and should not be used by any other person or for any other purpose. [Name of the Firm] neither accepts nor assumes any duty or liability for any other purpose or to any other party to whom our report is shown or into whose hands it may come without our prior consent in writing.

For [Insert Firm's name]

Firm Registration Number: [Insert Firm's Registration number]

Chartered Accountants

Signature

[Insert Partner's Name]

Partner

Membership Number:

[Place of the Signature]

[Date]

⁶ As Applicable

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Certificate on Statement of Assets and Income Pattern

Appendix A-IV

Board of Directors

Company

Address

Auditors' Certificate

1. This certificate is issued in accordance with the terms of our agreement dated [Date]
2. The accompanying Statement of assets and income pattern (the "Statement") of [*Name of the Company*] (the "Company"), as on [month] [date], [year], has been prepared and certified by the [Managing Director/ Chief Executive Officer of the Company or his authorised representative] pursuant to Master Circular No. DNBS (PD) CC No.[*] dated July 1, [*] as amended from time to time issued by Reserve Bank of India ["RBI Master Circular"]. We have initialled the Statement for identification purposes only.

Management's Responsibility

3. The preparation of the Statement is the responsibility of the Management of the Company including the creation and maintenance of all accounting and other records supporting its contents. This responsibility includes the design, implementation and maintenance of internal control relevant to the preparation and presentation of the Statement and applying an appropriate basis of preparation; and making estimates that are reasonable in the circumstances
4. The Management is also responsible for ensuring that the Company complies with the requirements of the RBI Circular (including the legal and statutory formalities) with respect to filing of the Return and for providing all relevant information to RBI.

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Auditors' Responsibility

5. Pursuant to RBI Master Circular, it is our responsibility to examine the books and other records of the Company and certify whether :
 - i) The Statement is in accordance with the books and records of the Company, and
 - ii) The Company continues to undertake the business of a Non Banking Financial Institution requiring it to hold the certificate of registration under section 45 IA of Reserve Bank of India Act,1934 for the financial year ended [month][date][year].
6. We conducted our engagement in accordance with the 'Guidance Note on Audit Reports and Certificates for Special Purposes' issued by the Institute of Chartered Accountants of India

Conclusion

7. Based on our examination as above, and the information and explanations given to us, we certify that:
 - a. the Statement is in accordance with the books and records and the information and explanations given to us and
 - b. the Company continues to undertake the business of a Non Banking Financial Institution (NBFI) requiring it to hold Certificate of Registration under Section 45 IA of Reserve Bank of India Act, 1934 for the financial year ended [month] [date] [year].

Restriction on Use

8. This certificate has been issued for the sole use of the Board of Directors of the Company, to whom it is addressed, for submission of the Statement to the Reserve Bank of India pursuant to RBI Master Circular and should not be used by any other person or for any other purpose. [Name of the Firm] neither accepts nor assumes any duty or liability for any other purpose or to any other party to whom our report is shown or into

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whose hands it may come without our prior consent in writing.

For [Insert Firm's name]
Firm Registration Number: [Insert Firm's Registration number]
Chartered Accountants

Signature
[Insert Partner's Name]
Partner
Membership Number:

[Place of the Signature]
[Date]

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For Systemically Important Non Deposit taking NBFCs

Appendix A- V

Auditor's Additional Report

Board of the Directors

[Name of the Company]

[Address]

1. This report is issued in accordance with the terms of our agreement dated [Date].
2. We have audited the Balance Sheet of [Name of the Company] (hereinafter referred to as the "Company") as at March 31, [] and the related Profit and Loss Account and Cash Flow Statement for the year ended on that date, issued our report dated [].

Management's Responsibility for the Financial Statements

3. The Company's Management is responsible for the preparation of these financial statements that give a true and fair view of the financial position, financial performance and cash flows of the Company in accordance with the Accounting Standards referred to in sub-section (3C) of section 211 of 'the Companies Act, 1956' of India (the "Act"). This responsibility includes the design, implementation and maintenance of internal control relevant to the preparation and presentation of the financial statements that give a true and fair view and are free from material misstatement, whether due to fraud or error.

Auditors' Responsibility

4. Pursuant to the requirements of Non-Banking Financial Companies Auditor's Report (Reserve Bank) Directions, 2008 (the "Directions") it is our responsibility to examine the books and records of the Company and report on the matters specified in the Directions to the extent applicable to the Company:
5. We conducted our examination in accordance with the Guidance Note on Special Purpose Audit reports and Certificates issued by Institute of Chartered Accountants of India.

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Conclusion

6. Based on our examination of the books and records of the Company as produced for our examination and the information and explanations given to us we further report that:
- 6.1 The Company is engaged in the business of non-banking financial institution and has obtained a certificate of registration *[Certificate Reference]* dated *[month, day, year]* from the Reserve Bank of India ('the Bank'), Department of Non-Banking Supervision, Mumbai Regional Office.
 - 6.2 The company is entitled to continue to hold such CoR in terms of its asset/income pattern as on March 31, *[year]*.
 - 6.3 Based on the criteria set forth by the Bank in Company Circular No. DNBS.PD. CC No. 85 / 03.02.089 /2006-07 dated December 6, 2006 for classification of NBFCs as Asset Finance Company (AFC), the non-banking financial company has been correctly classified as AFC as defined in Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998 with reference to the business carried on by it during the applicable financial year.⁷
 - 6.4 Based on the criteria set forth by the Bank in the Notification viz; Non-Banking Financial Company-Micro Finance Institutions (Reserve Bank) Directions, 2011 dated December 02, 2011 (MFI Directions) for classification of NBFCs as NBFC-MFIs, the non-banking financial company has been correctly classified as NBFC-MFI as defined in the aforesaid MFI Directions with reference to the

⁷ Delete this paragraph if not found applicable

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business carried on by it during the applicable financial year⁸

- 6.5 The Board of Directors of the Company has passed a resolution in its meeting held on *[month, day, year]* for non-acceptance of public deposits
- 6.6 The Company has not accepted any public deposits during the year ended *[month, day, year]*.
- 6.7 The Company has complied with the prudential norms relating to income recognition, accounting standards, asset classification and provisioning for bad and doubtful debts as applicable to it in terms of Non-Banking Financial (Non – Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007.
- 6.8 The annual statement of capital funds, risk assets / exposures and risk asset ratio (NBS – 7) has been furnished to the Bank on *[month, day, year]* within the stipulated period based on the unaudited books of account. The Company had correctly arrived at and disclosed the capital adequacy ratio, based on the unaudited books of account, in the return submitted to the Bank in Form NBS – 7 and such ratio is in compliance with the minimum CRAR prescribed by the Bank.

Restriction on Use

- 7. This report is issued pursuant to our obligations under Non-Banking Financial Companies Auditor's Report (Reserve Bank) Directions, 2008 to submit a report on exceptions, noted while issuing our report dated [] on additional matters as stated in the above directions, to Reserve Bank of India and should not be used by any other person or for any other purpose. [Name of the Firm] neither accepts nor assumes any duty or liability for any

⁸ Delete this paragraph if not found applicable

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other purpose or to any other party to whom our report is shown or into whose hands it may come without our prior consent in writing.

For [Insert Firm's name]
Firm Registration Number:[Insert Firm's Registration number]
Chartered Accountants

Signature
[Insert Partner's Name]
Partner
Membership Number:

[Place of the Signature]
[Date]

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Exception Reporting

Appendix A-VI

Board of the Directors

[Name of the Company]

[Address]

1. This report is issued in accordance with the terms of our agreement dated [Date].
2. We have audited the Balance Sheet of [Name of the Company] (hereinafter referred to as the “Company”) as at March 31, [] and the related Profit and Loss Account and Cash Flow Statement for the year ended on that date, issued our report dated [].

Management’s Responsibility for the Financial Statements

3. The Company’s Management is responsible for the preparation of these financial statements that give a true and fair view of the financial position, financial performance and cash flows of the Company in accordance with the Accounting Standards referred to in sub-section (3C) of section 211 of ‘the Companies Act, 1956’ of India (the “Act”). This responsibility includes the design, implementation and maintenance of internal control relevant to the preparation and presentation of the financial statements that give a true and fair view and are free from material misstatement, whether due to fraud or error.

Auditors’ Responsibility

4. As required by the Non-Banking Financial Companies Auditor's Report (Reserve Bank) Directions, 2008 (the “Directions”) and on the basis of such checks of the books and records of the Company as we considered appropriate and the information and explanations given to us during the course of our audit, we give below a statement on the matters specified in paragraphs 5 of the said Directions to the extent applicable to the Company:

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5. We conducted our examination in accordance with the Guidance Note on Special Purpose Audit reports and Certificates issued by the Institute of Chartered Accountants of India.

Basis for exception reporting

6. [Provide brief background of requirement]

Exception Report

7. *We draw your attention to Note [*] of Schedule [*] of the financial statements for the year ended March 31,[], regarding [qualification]*

Restriction on Use

8. This report is issued pursuant to our obligations under Non-Banking Financial Companies Auditor's Report (Reserve Bank) Directions, 2008 to submit a report on exceptions, noted while issuing our report dated [] on additional matters as stated in the above directions, to Reserve Bank of India and should not be used by any other person or for any other purpose. [Name of the Firm] neither accepts nor assumes any duty or liability for any other purpose or to any other party to whom our report is shown or into whose hands it may come without our prior consent in writing.

For [Insert Firm's name]

Firm Registration Number: [Insert Firm's Registration number]
Chartered Accountants

Signature

[Insert Partner's Name]

Partner

Membership Number:

[Place of the Signature]

[Date]

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Independent Auditor's Report (As per SA 700 (Revised))

To the Members of [Company Name]

Report on the Financial Statements

1. We have audited⁹ the accompanying financial statements of [Name of the company] (the "Company"), which comprise the Balance Sheet as at [Month Date, Year], and the Statement of Profit and Loss and Cash Flow Statement for the year then ended, and a summary of significant accounting policies and other explanatory information, which we have signed under reference to this report.

Management's¹⁰ Responsibility for the Financial Statements

2. The Company's Management is responsible for the preparation of these financial statements that give a true and fair view of the financial position, financial performance and cash flows of the Company in accordance with the Accounting Standards referred to in sub-section (3C) of section 211 of 'the Companies Act, 1956' of India (the "Act"). This responsibility includes the design, implementation and maintenance of internal control relevant to the preparation and presentation of the financial statements that give a true and fair view and are free from material misstatement, whether due to fraud or error.

Auditors' Responsibility

3. Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with the Standards on Auditing issued by the Institute of Chartered Accountants of India. Those Standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

⁹ If the opinion is being disclaimed, replace "We have audited" with "We were engaged to audit"

¹⁰ The auditor's report shall describe management's responsibility for the preparation of the financial statements in the manner in which that responsibility is described in the terms of the audit engagement. The description shall include an explanation that management is responsible for the preparation of the financial statements in accordance with the applicable financial reporting framework; this responsibility includes the design, implementation and maintenance of internal control relevant to the preparation of financial statements that are free from material misstatement, whether due to fraud or error."

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4. An audit involves performing procedures to obtain audit evidence, about the amounts and disclosures in the financial statements. The procedures selected depend on the auditors' judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditors consider internal control relevant to the Company's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of the accounting estimates made by Management, as well as evaluating the overall presentation of the financial statements.
5. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion¹¹.

Basis for Qualified/ Adverse/ Disclaimer of Opinion¹²

6. [If issuing a qualified or adverse opinion or if the opinion is being disclaimed provide a clear description of all of the substantive reasons and, unless impracticable, a quantification of the possible effect(s) on the financial information.]

Opinion¹³

7. In our opinion, and to the best of our information and according to the explanations given to us, the accompanying financial statements give the information required by the Act in the manner so required and give a

¹¹ If the audit opinion is qualified or adverse, substitute paragraph 5 with "We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified/ adverse⁴ audit opinion."

If the opinion is being disclaimed, substitute paragraph 5 with "Because of the matter(s) described in the Basis for Disclaimer of Opinion paragraph, however, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion."

¹² As applicable

¹³ If the audit opinion is qualified or adverse, "Opinion" should be substituted with "Qualified Opinion" or "Adverse Opinion" and if the opinion is being disclaimed, substitute "Opinion" with "Disclaimer of Opinion". The text in paragraph 7 is for an unmodified opinion.

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true and fair view in conformity with the accounting principles generally accepted in India:

- (a) in the case of the Balance Sheet, of the state of affairs of the Company as at [Month Date, Year];
- (b) in the case of the Statement of Profit and Loss, of the profit/ loss¹⁴ for the year ended on that date; and
- (c) in the case of the Cash Flow Statement, of the cash flows for the year ended on that date.

Emphasis of Matter

- 8. [If including an emphasis of matter paragraph in the report, include a clear reference to the matter being emphasised and to where relevant disclosures that fully describe the matter can be found in the financial statements, and indicate that the opinion is not modified in respect of the matter emphasised.]

Other Matter¹⁵

- 9 The financial statements of the Company as at [Month] [Date], [Year] and for the year then ended were audited by another firm of chartered accountants who, vide their report dated [month][day], [year], expressed an unmodified opinion on those financial statements.

Report on Other Legal and Regulatory Requirements

- 10. As required by 'the Companies (Auditor's Report) Order, 2003', as amended by 'the Companies (Auditor's Report) (Amendment) Order, 2004', issued by the Central Government of India in terms of sub-section (4A) of section 227 of the Act (hereinafter referred to as the "Order"), and on the basis of such checks of the books and records of the Company as we considered appropriate and according to the information and explanations given to us, we give in the Annexure a statement on the matters specified in paragraphs 4 and 5 of the Order.

OR

This report does not contain a statement on the matters specified in paragraphs 4 and 5 of 'the Companies

¹⁴ As applicable

¹⁵ To be included in the first year of appointment as statutory auditors.

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(Auditor's Report) Order, 2003', as amended by 'the Companies (Auditor's Report) (Amendment) Order, 2004', issued by the Central Government of India in terms of sub-section (4A) of section 227 of the Act as, in our opinion, and according to the information and explanations given to us, the Order is not applicable in the case of the Company.

11. As required by section 227(3) of the Act, we report that:
- (a) We have obtained all the information and explanations which, to the best of our knowledge and belief, were necessary for the purpose of our audit;
 - (b) In our opinion, proper books of account as required by law have been kept by the Company so far as appears from our examination of those books [and proper returns adequate for the purposes of our audit have been received from branches not visited by us]¹⁶;
 - (c) The Balance Sheet, Statement of Profit and Loss, and Cash Flow Statement dealt with by this Report are in agreement with the books of account [and with the returns received from branches not visited by us]¹⁷;
 - (d) In our opinion, the Balance Sheet, Statement of Profit and Loss, and Cash Flow Statement dealt with by this report comply with the Accounting Standards referred to in sub-section (3C) of section 211 of the Act;
 - (e) On the basis of written representations received from the directors as on [balance sheet date], and taken on record by the Board of Directors, none of

¹⁶ Applicable if the Company has branch offices. In case branch offices are audited by other auditors, whose reports have been forwarded to you, include the following as (c); and the remaining subparagraphs in this template – (c) through (e) – will need to be renumbered (d) through (f)

“(c) The report(s) on the accounts of the Branch office(s) audited under Section 228 by other auditors has/ have been forwarded to us in accordance with Section 228(3)(c) and has/ have been considered in preparing this Report;

¹⁷ As Applicable

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the directors is disqualified as on [balance sheet date], from being appointed as a director in terms of clause (g) of sub-section (1) of section 274 of the Act.

For [Name of the Firm]

Firm Registration Number:

Chartered Accountants

.....

[Name]

[Place of the Signature]

Partner

[Date]

Membership Number

<p>The footnotes contain guidance relating to the preparation of the report and should not appear in the report issued to the client.</p>

Appendix B

Illustrative Audit Checklist

COMPLIANCES FOR NBFC

Reference	Particulars	Frequency	Applicability
Under Reserve Bank of India Act, 1934			
Section 45-IA	<p>NBFC have to make application for registration with RBI and shall not commence or carry on business of a non-banking financial institution without obtaining registration from RBI and maintaining NOF.</p> <p>NOF requirement for NBFC registered</p> <p>Before 21/04/1999 = Rs. 25 lacs</p> <p>On or after 21/04/1999 = Rs. 200 lacs</p>	One time	All NBFC
Section 45-IB	<p>Maintenance of percentage of assets</p> <p>Invest and continue to invest 5% to 25% (specified by RBI) of deposits outstanding on the last working day of the second preceding quarter in unencumbered approved securities.</p> <p>Notification No. DFC.121/ED(G)-98 dated 31.01.1998 and</p>	Ongoing	NBFC accepting / holding Public Deposit

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	No. DFC(COC) NO.108-ED(JRP)-97 dated 30.04.1997		
Section 45-IC	Reserve Fund Every NBFC shall create a reserve fund and transfer therein a sum not less than 20% of its net profit every year as disclosed in the profit and loss account and before any dividend is declared.	Yearly	All NBFC
Section 45-M	Duty of NBFC to furnish statements etc., required by Bank	When asked for	All NBFC

Under Non-Banking Financial Companies (non-Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007

Master circular: RBI 2011-12/19 DNBS (PD) CC No.225/03.02.001 / 2011-12 dated July 1, 2011

Reference	Particulars	Frequency	Applicability
Para 3, 4, 5, 6	Income recognition Income from NPA shall be recognized only when actually realised. All unrealised income on NPA shall be reversed.	Ongoing	All NBFC

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	<p>Income from investment Dividend income on shares and units of Mutual Funds shall be taken on cash basis. Income from Bonds and Debentures from Govt. Securities may be taken on accrual basis. Income from securities (guaranteed by Central Govt. or State Govt.) may be taken on accrual basis.</p>		
	<p>Accounting Standards Accounting standards and guidance notes issued by ICAI shall be followed</p>		
	<p>Accounting of investment 1. Board of Directors shall frame Investment Policy and implement the same. 2. Classify the investments into Current and Long Term Investment 3. No inter-class transfer on ad hoc basis 4. Inter-class</p>		

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	<p>transfer, if warranted, shall be effected only on April 1 or October 1, with the approval of Board of Directors</p> <p>5. Investment shall be transferred scrip wise, from Current Investment to long – term investment or <i>vice versa</i> at book value or market value, whichever is lower.</p> <p>6. Quoted Current Investment shall, for the purpose of valuation, shall be valued at cost or market value, whichever is lower.</p> <p>7. Unquoted equity shares in the nature of current investment shall be valued at cost or break-up value, whichever is lower.</p> <p>8. Long term Investment shall be valued in accordance with Accounting Standard issued by ICAI.</p>		
Para 7	<p>Need for Policy on Demand / Call Loans</p> <p>Policy for demand / call loan shall be framed</p>	Ongoing	All NBFC giving loan etc.

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Para 8, 9 and 10	Asset classification Assets shall be classified as Standard, Sub-standard, Doubtful and Loss assets.	Ongoing	All NBFC
	Provisioning requirements Provision for assets (i.e. loans, advances or other credit facilities including bills purchased & discounted, Leased and hire purchased assets) shall be made Disclosure in the Balance Sheet Separately disclosure the provisions made as per para 9, without netting them from the income or against the value of assets. Unlike deposit taking NBFCs, systematically important non deposit taking NBFCs are required to disclose following particulars Capital to Risk Assets Ratio (CRAR) Exposure to real estate sector, both direct and indirect;	Yearly	All NBFC

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	and Maturity pattern of assets and liabilities."]		
Para 11	Constitution of Audit Committee Company having assets of Rs.50 crore and above shall constitute an Audit Committee.	Ongoing	NBFC having assets of Rs. 50 crore and above
Para 12 and 13	Accounting Year Every NBFC shall prepare its B/S and P/L as on 31 st March Schedule to the Balance Sheet Every NBFC shall append to its B/S particulars in the format as set in schedule	Yearly	All NBFC
Para 14	Transaction in Government Securities NBFC shall hold investment in approved securities in a dematerialised form only.	Ongoing	All NBFC
Para 15	Submission of Auditors Certificate That the Company is engaged in the business of NBFI requiring it to hold a Certificate of Registration u/s 45IA of RBI Act indicating income and assets pattern	Latest by 30 th June every year.	All NBFC

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	of the company making it eligible for classification as Asset Finance, loan or Investment Company.		
Para 16	Requirement as to Capital adequacy Company shall maintain a minimum capital ratio (consisting of Tier I and Tier II capital) which shall not be less than 10% of its weighted asset and the risk adjusted value of off-balance sheet items.	Ongoing	Systemically important – ND taking NBFC
Para 17	Loan against NBFC's own shares prohibited No loan against own shares shall be given	Ongoing	All NBFC
Para 18	Concentration of credit / investment Restriction has been specified (Lend or invest to single person 15% and group 25%) (Both lend and invest 25% and 40% respectively)	Ongoing	Systemically important – ND taking NBFC

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Para 19	Information in regard to change of address, directors, auditors, Principal officer, etc. Information to be submitted by every NBFC company within 30 days from the date of occurrence of any change	Within 30 days of occurrence of any change	All NBFC
Para 20	Norms relating to Infrastructure Loan Restructuring of Infrastructure Loan.		All NBFC giving Infrastructure Loan
Para20A	NBFCs are not to be partners in partnership firms Should opt for early retirement if already a partner		All NBFCs

Under various Notification / Press release issued by Reserve Bank

Reference	Particulars	Frequency	Applicability
	Notification : RBI/2011-12/21 DNBS.PD.CC. No.227/ 03.10.042/ 2011-12 dated July 1, 2011 RBI/2011-12/195 DNBS(PD).CC. No.243/03.02.02/20 11-12 dated	Monthly/ quarterly /half yearly/ Annual	All NBFCs

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	September 22, 2011 Returns to be submitted by NBFCs		
	Master Circular: RBI/2011-12/23 DNBS.PD.CC. No.229/03.10.042/2011-12 July 1, 2011 Frauds – Future approach towards monitoring of frauds in NBFC. Report on actual/suspected Frauds Quarterly report on frauds outstanding Quarterly progress report on frauds of Rs 1 Lakh and above.	Form FMR-1 Form FMR-2 Form FMR-3	All NBFC
	RBI/2011-12/25 DNBS (PD) CC No.231/03.10.42/2011-12 dated July 1, 2011 NBFC is required to formulate a policy on Know your customer (KYC) and Anti Money Laundering measures and put in place with the approval of Board of Directors within 3 months of the date of circular.		All NBFC

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	<p>Appointment of Principal officer-Maintenance of record under rule 3 of Money Laundering Act (PMLA), 2002 (cash/suspicious transactions)</p> <p>Report information relating to cash and suspicious transactions to the Director Financial Intelligence Unit , New Delhi</p>		All NBFC
	<p>RBI/2011-12/26 DNBS (PD) CC No. 232/03.10.042/2011-12 dated July 1, 2011</p> <p>Fair Practice Code to be framed and approval of the same by the Board of Directors of the Company within one month from the date of circular.</p> <p>Board of Directors of NBFC to lay out appropriate internal principles and procedures in determining interest rates, processing and other charges on the guidelines indicated in fair</p>		All NBFC

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	<p>practice code.</p> <p>To ensure that excessive interest, beyond a certain level are not charged (interest rates are not regulated by RBI)</p>		
	<p>Notification No. DNBS(PD)CC. No. 94/03.05.002/2006-07 dated 08.05.2007</p> <ul style="list-style-type: none"> - Rotation of audit partner every three years - Guidelines on Corporate Governance. 1. Constitution of Audit Committee 2. Constitution of Nomination Committee 3. Constitution of Risk Management Committee 4. Framing internal guidelines on corporate governance 5. Information to be placed before the Board at regular interval, prescribed by the Board: - progress made in putting in place a 		<p>Assets Size of Rs. 20 crore and above</p> <p>And</p> <p>Systemically important – ND taking NBFC</p>

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	<p>progressive risk management system, and risk management policy and strategy followed</p> <p>- conformity with corporate governance standards, viz, in the composition of various committees, their role and functions, periodicity of the meeting and compliance with coverage and review functions etc</p>		
	<p>Connected Lending</p> <p>The NBFC should comply with the instructions on connected lending relationship, as detailed in Annexure.</p> <p><i>Note: These directions are put on hold)</i></p>		<p>Systemically important – ND taking NBFC</p>

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	GUIDELINES FOR ASSET –LIABILITY MANAGEMENT (ALM) /2011-12/30 DNBS (PD) CC No.236 /03.02.001/2011-12 dated July 1, 2011		
	Half-yearly Return for the period ended 31 st March and 30 th September, in three parts: (i) Statement of structural liquidity (ii) Statement of Short term dynamic liquidity (iii) Statement of Interest Rate Sensitivity	Within one month of ending of half-year	All NBFCs
	Constitution of Asset Liability Management Committee (ALCO)		All NBFCs
	Board of Directors should oversee the implementation of the system and review its functioning periodically.		All NBFCs

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Under Non-Banking Financial Companies (Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007

Master circular: RBI/2011-12/18 DNBS (PD) CC No.224/03.02.001/ 2011-12 dated July 1, 2011

Reference	Particulars	Frequency	Applicability
Para 3, 4, 5, 6	Income recognition Income from NPA shall be recognized only when actually realised. All unrealised income on NPA shall be reversed.	Ongoing	All NBFC
	Income from investment Dividend income on shares and units of Mutual Funds shall be taken on cash basis. Income from Bonds and Debentures from Govt. Securities may be taken on accrual basis. Income from securities (guaranteed by Central Govt. or State Govt.) may be taken on accrual basis.		
	Accounting Standards Accounting standards and guidance notes issued by ICAI shall be followed		
	Accounting of investment		

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	<p>1. Board of Directors shall frame Investment Policy and implement the same.</p> <p>2. Classify the investments into Current and Long Term Investment</p> <p>3. No inter-class transfer on ad hoc basis</p> <p>4. Inter-class transfer, if warranted, shall be effected only on April 1 or October 1, with the approval of Board of Directors</p> <p>5. Investment shall be transferred scrip wise, from Current Investment to long – term investment or <i>vice versa</i> at book value or market value, whichever is lower.</p> <p>6. Quoted Current Investment shall, for the purpose of valuation, shall be valued at cost or market value, whichever is lower.</p> <p>7. Unquoted equity shares in the nature of current investment shall be valued at cost</p>		
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	<p>or break-up value, whichever is lower.</p> <p>8. Long term Investment shall be valued in accordance with Accounting Standard issued by ICAI.</p>		
Para 7	<p>Need for Policy on Demand / Call Loans</p> <p>Policy for demand / call loan shall be framed</p>	Ongoing	All NBFC giving loan etc.
Para 8, 9 and 10	<p>Asset classification</p> <p>Assets shall be classified as Standard, Sub-standard, Doubtful and Loss assets.</p>	Ongoing	All NBFC
	<p>Provisioning requirements</p> <p>Provision for assets (i.e. loans, advances or other credit facilities including bills purchased & discounted, Leased and hire purchased assets) shall be made</p>	Ongoing	

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	Disclosure in the Balance Sheet Separately disclosure the provisions made as per para 9, without netting them from the income or against the value of assets. Unlike deposit taking NBFCs, systematically important non deposit taking NBFCs are required to disclose following particulars Capital to Risk Assets Ratio (CRAR) Exposure to real estate sector, both direct and indirect; and Maturity pattern of assets and liabilities."	Yearly	
Para 11	Constitution of Audit Committee Company having assets of Rs.50 crore and above shall constitute an Audit Committee.	Ongoing	NBFC having assets of Rs.50 crore and above
Para 12 and 13	Accounting Year Every NBFC shall prepare its B/S and P/L as on 31 st March	Yearly	All NBFC

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	Schedule to the Balance Sheet Every NBFC shall append to its B/S particulars in the format as set in schedule		
Para 14	Transaction in Government Securities NBFC shall hold investment in approved securities in a dematerialised form only.	Ongoing	All NBFC
Para 15	Submission of Auditors Certificate - That the Company is engaged in the business of NBFIs requiring it to hold a Certificate of Registration u/s 45IA of RBI Act indicating income and assets pattern of the company making it eligible for classification as Asset Finance, loan or Investment Company.	Latest by 30 th June every year.	All NBFC
Para 16	Requirement as to Capital adequacy Company shall maintain a minimum capital ratio (consisting of Tier I and Tier II capital)	Ongoing.	All NBFC

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	which shall not be less than 10% of its weighted asset and the risk adjusted value of off-balance sheet items.		
Para 17	Loan against NBFC's own shares prohibited No loan against own shares shall be given	Ongoing	All NBFC
Para 18	NBFC not to lend or invest if it failed to repay the deposits as long as the default exists	Ongoing	All NBFC
Para 19	Restriction on investment in land and building and unquoted shares Investment should not exceed 10% of its owned fund (exception – investment in buildings for own use) (exception for loan or investment company- investment in unquoted shares should not exceed 20% of owned funds) Asset acquired in satisfaction of debts to be disposed off within three years and not included in the ceiling.		Asset Finance company and Loan or Investment company

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Para 20	Concentration of credit / investment Restriction has been specified (Lend or invest to single person 15% and group 25%) (Both lend and invest 25% and 40% respectively)	Ongoing	Not applicable to residuary NBFC and Asset finance company can exceed the limit by 5% with board approval
Para20A	NBFCs are not to be partners in partnership firms		All NBFCs
Para 21	Submission of half yearly returns Form NBS 2	Within 3 months of the end of the half year	All NBFC
Para 22	Exposure to Capital market Submission of Form NBS 6	Monthly return within 7 days from the end of the month	All NBFC with total assets over Rs 100 crore
Para 23	Norms relating to Infrastructure loan Applicable to restructuring /reschedulement/renewal in the terms of agreement for loan	Ongoing	All NBFC which has lent infrastructure loan

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Controls Check-list

Strategic controls

Have those charged with governance established a formal policy for the entity's treasury business that sets out:

- The authorized activities and products the investment company can trade
- The procedures for measuring, analyzing, supervising and controlling risks;
- The extent of risk positions permissible, after taking into account the risk they regard as acceptable;
- The appropriate limits and procedures covering excesses over defined limits;
- The procedures, including documentation, that must be complied with before new products or activities are introduced;
- The type and frequency of reports to those charged with governance; and
- The schedule and frequency, with which the policy is reviewed, updated and approved
- Compliance with regulatory requirements

Operational controls

- Is there appropriate segregation of duties between the front office and back office?
- Are the following activities conducted independently of the front office/business unit:
 - i. Confirmation of trades;
 - ii. Recording and reconciliation of positions and results;
 - iii. Valuation of trades or independent verification of market prices; and
 - iv. Settlement of trades
 - v. Does the NBFC have a code of conduct for its dealers that addresses the following:

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- Prohibiting dealers from trading on their own account;
- Restricting acceptance of gifts and entertainment activities;
- Confidentiality of customer information;
- Identification of approved counterparties; and
- Procedures for the review of dealers' activities by management?
- Are remuneration policies structured to avoid encouraging excessive risk taking?
- Are new products entered only after appropriate approvals are obtained and adequate procedures and risk control systems are in place?

Limits and trading activity

- Does the entity have a comprehensive set of limits in place to control the market, credit and liquidity risks for the whole institution, business units and individual dealers? Some commonly used limits are notional or volume limits (by currency or counterparty), stop loss limits, gap or maturity limits, settlement limits and value-at-risk limits (for both market and credit risks).
- Are limits allocated to risks in line with the overall limits of the NBFC which may be based on regulatory requirement?
- Do all dealers know their limits and the use thereof? Does every new transaction reduce the available limit immediately?
- Are procedures in place that covers excesses over limits?

Risk measurement and management

- Is there an independent risk management function (sometimes referred to as Middle Office) for measuring, monitoring and controlling risk? Does it report directly to those charged with governance and senior management? Assess if there are any independence related issues.

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- Which method is employed to measure the risk arising from trading activities (for example, position limits, sensitivity limits, value at risk limits, etc.)? Is the method employed is in line with treasury risk management policy.
- Are the risk control and management systems adequately equipped to handle the volume, complexity and risk of treasury activities?
- Does the risk measurement system cover all portfolios, all products and all risks?
- Is appropriate documentation in place for all elements of the risk system (methodology, calculations, parameters)?
- Are all trading portfolios revalued and risk exposures calculated regularly, at least daily for active dealing operations? How actively treasury head evaluates daily profit and loss position and associated risks.
- Are risk management models, methodologies and assumptions used to measure risk and to limit exposures regularly assessed, documented and updated continuously to take account of altered parameters, etc?
- Are stress situations analyzed and "worst case" scenarios (which take into account adverse market events such as unusual changes in prices or volatilities, market illiquidity or default of a major counterparty) conducted and tested?
- Does management receive timely and meaningful reports? How management uses reports? Are decisions documented / agreed and communicated among decision makers in a timely manner.
- How frequently risk committee, treasury committee meet and whether actions taken/ decisions recorded in the minutes of such meetings.

Confirmations

Does the NBFC have written procedures in use:

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- For the independent receipt of all incoming confirmations and their matching to pre-numbered copies of internal trade tickets;
- For independent comparison of signatures on incoming confirmations to specimen signatures;
- For the independent confirmation of all deals for which no inward confirmation has been received; and
- For the independent follow-up of discrepancies on confirmations received?

Settlement of transactions

- Are settlement instructions exchanged in writing with counterparties by the use of inward and outward confirmations?
- Are settlement instructions compared to the contracts?
- Are settlements made only by appropriate authorized employees independent of the initiation and recording of transactions and only on the basis of authorized, written instructions?
- Are all scheduled settlements (receipts and payments) notified daily in writing to the settlement department so that duplicate requests and failures to receive payments can be promptly detected and followed-up?
- Are accounting entries either prepared from or checked to supporting documentation by operational employees, other than those who maintain records of uncompleted contracts or perform cash functions?

Recording

- Are exception reports generated for excesses in limits; sudden increases in trading volume by any one trader, customer or counterparty; transactions at unusual contract rates, etc? Are these monitored promptly and independently of the dealers?
- The daily reconciliation of dealer's positions and profits with the accounting records and the prompt investigation of all differences; and

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- Regular reports to management in appropriate detail to allow the monitoring of the limits referred to above?
- Does the NBFC have an accounting system that allows it to prepare reports that show its spot, forward, net open and overall positions for the different types of products, for example:
 - By purchase and sale, by currency;
 - By maturity dates, by currency; and
 - By counterparty, by currency?
 - Are open positions revalued periodically (for example, daily) to current values based on quoted rates or rates obtained directly from approved independent sources?

Credit Function Checklist

- Are loan approval limits based on the overall credit policy and lending officer's authority and experience?
- Is appropriate lending committee or board of director approval required for loans exceeding prescribed limits?
- Is there appropriate segregation of duties between the loan approval function and the loan disbursement monitoring, collection and review functions?
- Is the ownership of loan collateral and priority of the security interest verified?
- Does the NBFC ensure that the borrower signs a legally enforceable document as evidence of an obligation to repay the loan?
- Are guarantees examined to ensure that they are legally enforceable?
- Is the documentation supporting the loan application reviewed and approved by an employee independent of the lending officer?
- Is there a control to ensure the appropriate registration of security (for example, recording of liens with governmental authorities)?

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- Is there adequate physical protection of notes, collateral and supporting documents?
- Is there a control to ensure that loan disbursements are recorded immediately?
- Is there a control to ensure that to the extent possible, loan proceeds are used by the borrower for the intended purpose?

Monitoring

- Are trial balances prepared and reconciled with control accounts by employees who do not process or record loan transactions?
- Are reports prepared on a timely basis of loans on which principal or interest payments are in arrears?
- Are these reports reviewed by employees independent of the lending function?
- Are there procedures in use to monitor the borrower's compliance with any loan restrictions (for example, covenants) and requirements to supply information to the NBFC?
- Are there procedures in place that require the periodic reassessment of collateral values?
- Are there procedures in place to ensure that the borrower's financial position and results of operations are reviewed on a regular basis?
- Are there procedures in place to ensure that key administrative dates, such as the renewal of security registrations, are accurately recorded and acted upon as they arise?

Collection

- Are the records of principal and interest collections and the updating of loan account balances maintained by employees independent of the credit granting function?
- Is there a control to ensure that loans in arrears are followed up for payment on a timely basis?

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- Are there written procedures in place to define the NBFC's policy for recovering outstanding principal and interest through legal proceedings, such as foreclosure or repossession?
- Are there procedures in place to provide for the regular confirmation of loan balances by direct written communication with the borrower by employees independent of the credit granting and loan recording functions, as well as the independent investigation of reported differences?

Periodic review and evaluation

- Are there procedures in place for the independent review of all loans on a regular basis, including:
- The review of the results of the monitoring procedures referred to above; and
- The review of current issues affecting borrowers in relevant geographic and industrial sectors?
- Are there appropriate written policies in effect to establish the criteria for:
- The establishment of loan loss provisions;
- The cessation of interest accruals (or the establishment of offsetting provisions);
- The valuation of collateral security for loss provisioning purposes;
- The reversals of previously established provisions;
- The resumption of interest accruals; and
- The writing off of loans?
- Are there procedures in place to ensure that all required provisions are entered into the accounting records on a timely basis?

Appendix C

Illustrative List of Circulars/ Notifications issued by RBI

A list of important master circulars issued by RBI upto May 29, 2012 is given below for reference. Readers may note that the full text of circulars is not given in this appendix and only relevant extracts from the circulars have been taken. A link to the website is also given wherefrom full text of the circular can be accessed.

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S.No	Circular / Notification Reference
1	Non-Banking Financial Companies Auditor's Report (Reserve Bank) Directions, 2008.
2	Compliance with FDI norms- Half yearly certificate from Statutory Auditors of NBFCs
3	Submission of certificate from Statutory Auditor to the Bank
4	Returns to be submitted by NBFCs
5	Non-Banking Financial (Non-Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007
6	Non-Banking Financial (Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007
7	Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998
8	Miscellaneous Non-Banking Companies (Reserve Bank) Directions, 1977
9	Miscellaneous Instructions to All Non-Banking Financial Companies

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10	Master Circular - Miscellaneous Instructions to NBFC-ND-SI
11	Introduction of New Category of NBFCs - Non Banking Financial Company-Micro Finance Institutions' (NBFC-MFIs) – Directions
12	Non Banking Financial Company-Micro Finance Institutions (NBFC-MFIs) - Provisioning Norms-Extension of time
13	Mortgage Guarantee Companies Investment (Reserve Bank) Directions, 2008
14	Notification as amended up to June 30, 2011 – Mortgage Guarantee Company (Reserve Bank) Guidelines, 2008
15	Mortgage Guarantee Companies Prudential Norms (Reserve Bank) Directions, 2008
16	Directions/instructions issued to the Securitisation Companies/ Reconstruction Companies
17	The Securitisation Companies and Reconstruction Companies (Reserve Bank) Guidelines and Directions, 2003
18	Regulatory Framework for Core Investment Company (CICs)
19	Infrastructure Finance Companies
20	Know Your Customer' (KYC) Guidelines – Anti Money Laundering Standards (AML) -'Prevention of Money Laundering Act, 2002 - Obligations of NBFCs in terms of Rules notified there under
21	Corporate Governance
22	Fair Practice Code
23	Frauds – Future approach towards monitoring of frauds in NBFCs

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24	Exemptions from RBI Act, 1934
25	Notification of change in or take over of management of the business of the borrower by securitisation and reconstruction companies (Reserve Bank) Guidelines, 2010
26	Allied activities- entry into insurance business, issue of credit card and marketing and distribution of certain products
27	NBFCs-ND-SI issuing guarantees - Applicability of exemption from Concentration norms
28	Opening of Branch-Subsidiary-Joint Venture-Representative office or Undertaking Investment Abroad by NBFCs
29	Implementation of Green Initiative of the Government
30	NBFCs - Infrastructure Debt Funds(IDFs)
31	Revised Capital Adequacy Framework for Off-Balance Sheet Items for NBFCs
32	Revised Capital Adequacy Framework for Off-Balance Sheet Items for NBFCs-Clarification
33	Monitoring of frauds - All Non-Deposit taking NBFCs with asset size of Rs.100 crore and above and Deposit taking NBFCs
34	Non- Reckoning Fixed Deposits with Banks as Financial Assets
35	Lending Against Security of Single Product – Gold Jewellery
36	Foreign Investment in NBFC Sector under the FDI Scheme – Clarification

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1. Non-Banking Financial Companies Auditor's Report (Reserve Bank) Directions, 2008
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Master Circular: RBI/2011-12/20 DNBS (PD) CC No. 226/03.02.001/2011-12 dated July 1, 2011

Link: http://www.rbi.org.in/scripts/BS_ViewMasCircularDetails.aspx?id=6565

The Reserve Bank of India had issued Directions to the auditors of Non-Banking Financial Companies under Section 45 MA of the RBI Act, 1934, vide Notification No. DFC. 117 /DG (SPT)-98 dated January 2, 1998.

The Directions have been consolidated and in supersession of said Directions viz. the Non-Banking Financial Companies Auditor's Report (Reserve Bank) Directions, 1998 the new Directions are being issued vide Notification No. DNBS(PD)201/DG(VL)/2008 dated September 18, 2008, for meticulous compliance.

Auditors to submit additional Report to the Board of Directors

In addition to the Report made by the auditor under Section 227 of the Companies Act, 1956 (1 of 1956) on the accounts of a non-banking financial company examined for every financial year ending on any day on or after the commencement of these Directions, the auditor shall also make a separate report to the Board of Directors of the Company on the following matters.

(A) In the case of all non-banking financial companies

I. Whether the company is engaged in the business of non-banking financial institution and whether it has obtained a Certificate of Registration (CoR) from the Bank.

II. In the case of a company holding CoR issued by the Bank, whether that company is entitled to continue to hold such CoR in terms of its asset/income pattern as on March 31 of the applicable year.

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Note: A reference in this regard is invited to paragraph 15 of the Non-Banking Financial (Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007 in respect of deposit taking NBFCs and paragraph 15 of Non-Banking Financial (Non- Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007 in respect of non-deposit taking NBFCs.

III. Based on the criteria set forth by the Bank in Company Circular No. DNBS.PD. CC No. 85/03.02.089 /2006-07 dated December 6, 2006 for classification of NBFCs as Asset Finance Company (AFC), whether the non-banking financial company has been correctly classified as AFC as defined in Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998 with reference to the business carried on by it during the applicable financial year.

(B) In the case of a non-banking financial company accepting/holding public deposits

Apart from the matters enumerated in (A) above, the auditor shall include a statement on the following matters, namely:-

- (i) Whether the public deposits accepted by the company together with other borrowings indicated below viz;
 - (a) from public by issue of unsecured non-convertible debentures/bonds;
 - (b) from its shareholders (if it is a public limited company) and
 - (c) which are not excluded from the definition of 'public deposit' in the Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998 are within the limits admissible to the company as per the provisions of the Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998;
- (ii) Whether the public deposits held by the company in excess of the quantum of such deposits permissible to it under the provisions of Non-Banking Financial Companies Acceptance of Public Deposits (Reserve

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Bank) Directions, 1998 are regularised in the manner provided in the said Directions;

- (iii) Whether an Asset Finance Company having Capital to Risk Assets Ratio (CRAR) less than 15% or an Investment Company or a Loan Company as defined in paragraph 2(1)(ia), (vi) and (viii) Respectively of Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998 is accepting "public deposit" without minimum investment grade credit rating from an approved credit rating agency;
- (iv) In respect of NBFCs referred to in clause (iii) above, whether the credit rating, for each of the fixed deposits schemes that has been assigned by one of the Credit Rating Agencies listed in Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998
 - (a) is in force; and
 - (b) whether the aggregate amount of deposits outstanding as at any point during the year has exceeded the limit specified by the such Credit Rating Agency;
- (v) In case of NBFCs having Net Owned Funds of Rs 25 lakh and above but less than Rs 200 lakhs, whether the public deposit held by the companies is in excess of the quantum of such deposit permissible to it in terms of Notification No. DNBS. 199/CGM (PK) - 2008 dated June 17, 2008 and whether such company :
 - (a) has frozen its level of deposits as on the date of that Notification; or
 - (b) has brought down its level of deposits to the level of revised ceiling of deposits in terms of that Notification.
- (vi) Whether the company has defaulted in paying to its depositors the interest and /or principal amount of the deposits after such interest and/or principal became due;

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- (vii) Whether the company has complied with the prudential norms on income recognition, accounting standards, asset classification, provisioning for bad and doubtful debts, and concentration of credit/investments as specified in the Directions issued by the Reserve Bank of India in terms of the Non-Banking Financial (Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007.
- (viii) Whether the capital adequacy ratio as disclosed in the return submitted to the Bank in terms of the Non-Banking Financial (Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007 has been correctly determined and whether such ratio is in compliance with the minimum CRAR prescribed therein;
- (ix) Whether the company has complied with the liquid assets requirement as prescribed by the Bank in exercise of powers under section 45-IB of the RBI Act and whether the details of the designated bank in which the approved securities are held is communicated to the office concerned of the Bank in terms of NOTIFICATION NO.DNBS.172/CGM(OPA)-2003 dated July 31, 2003;
- (x) Whether the company has furnished to the Bank within the stipulated period the return on deposits as specified in the NBS 1 to the Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998;
- (xi) Whether the company has furnished to the Bank within the stipulated period the half-yearly return on prudential norms as specified in the Non-Banking Financial (Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007;
- (xii) Whether, in the case of opening of new branches or offices to collect deposits or in the case of closure of existing branches/offices or in the case of appointment of agent, the company has complied with the requirements contained in the Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998.

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(C) In the case of a non-banking financial company not accepting public deposits

Apart from the aspects enumerated in (A) above, the auditor shall include a statement on the following matters, namely: -

- (i) Whether the Board of Directors has passed a resolution for non- acceptance of any public deposits.
- (ii) Whether the company has accepted any public deposits during the relevant period/year;
- (iii) Whether the company has complied with the prudential norms relating to income recognition, accounting standards, asset classification and provisioning for bad and doubtful debts as applicable to it in terms of Non-Banking Financial (Non- Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007.
- (iv) In respect of Systemically Important Non-deposit taking NBFCs as defined in paragraph 2(1)(xix) of the Non-Banking Financial (Non- Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007
 - (a) whether the capital adequacy ratio as disclosed in the return submitted to the Bank in form NBS-7, has been correctly arrived at and whether such ratio is in compliance with the minimum CRAR prescribed by the Bank;
 - (b) whether the company has furnished to the Bank the annual statement of capital funds, risk assets/exposures and risk asset ratio (NBS-7) within the stipulated period.

(D) In the case of a company engaged in the business of non-banking financial institution not required to hold CoR subject to certain conditions

Apart from the matters enumerated in (A)(I) above, the auditor shall include a statement on the following matters, namely:

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Where a Company has obtained a specific advice from the Bank that it is not required to hold CoR from the Bank whether the company is complying with the conditions stipulated as advised by the Bank.

Reasons to be stated for unfavourable or qualified statements

Where, in the auditor's report, the statement regarding any of the items referred to in paragraph 3 above is unfavourable or qualified, the auditor's report shall also state the reasons for such unfavourable or qualified statement, as the case may be. Where the auditor is unable to express any opinion on any of the items referred to in paragraph 3 above, his report shall indicate such fact together with reasons therefor.

Obligation of auditor to submit an exception report to the Bank

(I) Where, in the case of a non-banking financial company, the statement regarding any of the items referred to in paragraph 3 above, is unfavourable or qualified, or in the opinion of the auditor the company has not complied with: the provisions of Chapter III B of Reserve Bank of India Act, 1934 (Act 2 of 1934); or the Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998; or Non-Banking Financial (Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007; or Non-Banking Financial (Non- Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007; it shall be the obligation of the auditor to make a report containing the details of such unfavourable or qualified statements and/or about the non-compliance, as the case may be, in respect of the company to the concerned Regional Office of the Department of Non-Banking Supervision of the Bank under whose jurisdiction the registered office of the company is located as per Second Schedule to the Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998.

(II) The duty of the Auditor under sub-paragraph (I) shall be to report only the contraventions of the provisions of RBI Act, 1934, and Directions, Guidelines, instructions referred to in sub-

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paragraph (1) and such report shall not contain any statement with respect to compliance of any of those provisions.

Repeal and saving

The Non-Banking Financial Companies Auditor's Report (Reserve Bank) Directions, 1998 shall stand repealed by these Directions. Notwithstanding such repeal,

- (a) any action taken, purported to have been taken or initiated under the Directions hereby repealed shall, continue to be governed by the provisions of said Directions.
- (b) any reference in other Notifications issued by the Bank containing reference to the said repealed Directions, shall mean reference to these Directions, namely, Non-Banking Financial Companies Auditor's Report (Reserve Bank) Directions, 2008 after the date of repeal.

<h2>2. Compliance with FDI norms-Half yearly certificate from Statutory Auditors of NBFCs</h2>

RBI/2009-10/304 DNBS (PD).CC.No.167 /03.10.01 /2009-10 dated February 4, 2010

Link: <http://rbi.org.in/scripts/NotificationUser.aspx?Id=5488&Mode=0>

NBFCs are required to adhere to FEMA provisions with regard to FDI investments. NBFCs having FDI whether under automatic route or under approval route have to comply with the stipulated minimum capitalisation norms and other relevant terms and conditions, as amended from time to time under which FDI is permitted.

As such these NBFCs are required to submit a certificate from their Statutory Auditors on half yearly basis (half year ending September and March) certifying compliance with the existing terms and conditions of FDI. Such certificate may be submitted not later than one month from the close of the half year to which the certificate pertains, to the Regional Office in whose jurisdiction the head office of the company is registered.

3. Submission of certificate from Statutory Auditor to the Bank

RBI/2009-10/187 DNBS (PD) CC. No. 162/03.05.002/2009-2010 dt October 22 , 2009

Link : http://www.rbi.org.in/scripts/BS_NBFCNotificationView.aspx?id=5322

Certificate to the effect that NBFC is engaged in the business of non-banking financial institution requiring it to hold a Certificate of Registration under Section 45-IA of the RBI Act. This circular forms part of prudential norms directions.

4. Returns to be submitted by NBFC

Master Circular : RBI/2011-12/21 DNBS.PD.CC. No.227/03.10.042/ 2011-12 dated July 1, 2011

Link : http://www.rbi.org.in/scripts/BS_ViewMasCirculardetails.aspx?id=6'578

NBFCs are required to submit various returns to RBI w.r.t. their deposit acceptance, prudential norms, compliance.

NBFCs are required to submit various returns to RBI with respect to their deposit acceptance, prudential norms compliance, ALM etc. Detailed instructions regarding submission of returns by NBFCs have been issued through various company circulars. A list of such returns to be submitted by NBFCs-D, NBFCs-ND-SI and others is as under:

A. Returns to be submitted by deposit taking NBFCs

- 1. NBS-1** Annual Returns on deposits in First Schedule (Inserted vide Notification No.DFC.118/DG (SPT)-98 dated January 31, 1998).
- 2. NBS-2** Half-yearly return on Prudential Norms is required to be submitted by NBFC accepting public deposits (Inserted vide Notification No. DNBS.192 /DG (VL)-2007 dated February 22, 2007).
- 3. NBS-3** Quarterly return on Liquid Assets by deposit taking NBFC (Inserted vide Notification No DFC(COC) No.108.ED(JRP)/97 dated April 30, 1997).

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- 4. NBS-4** Monthly return of critical parameters by a rejected company holding public deposits (Inserted vide DNBS (PD) CC. No. 19/02.01/2001-02 dated April 22, 2002).
- 5. NBS-5** Monetary and supervisory return by NBFC having public deposits of Rs.20 crore and above (Inserted vide DNBS (PD) CC. No.19/02.01/2001-02 dated April 22, 2002).
- 6. NBS-6** Monthly return on exposure to capital market by deposit taking NBFC with total assets of Rs 100 crore and above (Inserted vide Notification No. DNBS. 192 / DG (VL)-2007 dated February 22, 2007).
- 7. Half-yearly ALM return** by NBFC holding public deposits of more than Rs.20 crore or asset size of more than Rs. 100 crore (Inserted vide DNBS (PD).CC.No.15 /02.01 / 2000-2001 dated June 27, 2001).
- 8.** Audited Balance sheet and Auditor's Report by NBFC accepting public deposits (Inserted vide Notification No.DFC.118/DG (SPT)-98 dated January 31, 1998).

B. Returns to be submitted by NBFCs-ND-SI

- 1. NBS-7** An annual statement of capital funds, risk weighted assets, risk asset ratio etc., as at end of March every year for NBFC-ND-SI (Inserted vide DNBS.PD/ CC.No. 93 / 03.05.002 /2006-07 dated April 27, 2007).
- 2. Monthly Return on Important Financial Parameters of NBFCs-ND-SI** (Inserted vide DNBS (RID) C.C. No. 57/02.05.15/2005-06 dated September 6, 2005) **ALM returns:**
 - 3.** Statement of short term dynamic liquidity in format ALM [NBS-ALM1] -Monthly,
 - 4.** Statement of structural liquidity in format ALM [NBS-ALM2] Half Yearly,
 - 5.** Statement of Interest Rate Sensitivity in format ALM - [NBS-ALM3], Half yearly (Inserted vide Notification No. DNBS. 200 / CGM(PK)-2008 dated August 1, 2008).

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C. Quarterly return on important financial parameters of non deposit taking NBFCs having assets of more than Rs, 50 crore and above but less than Rs 100 crore

Basic information like name of the company, address. NOF, profit / loss during the last three years has to be submitted quarterly by non-deposit taking NBFCs with asset size between Rs 50 crore and Rs 100 crore (Inserted vide DNBS.PD/CC.No.130 / 03.05.002 /2008-09 dated September 24, 2008).

D. Other Returns

1. As at the end of March every year, all NBFCs are required to submit an annual certificate duly certified by the Statutory Auditors that the company is engaged in the business of NBFI requiring it to hold the CoR. The certificate shall also indicate the asset / income pattern of the NBFC for making it eligible for classification as AFC, Investment Company, or Loan Company (Inserted vide DNBS (PD) C.C. No. 79 /03.05.002/ 2006-07 September 21, 2006 and DNBS (PD) C.C. No. 81 / 03.05.002/ 2006-07 dated October 19, 2006).

2. NBFC with FDI has to submit a half yearly (half year ending March and September) certificate to the effect that it has complied with the minimum capitalisation norms and that its activities are restricted to the activities prescribed under FEMA (Inserted vide DNBS (PD).CC. No 167 /03.10.01 /2009-10 dated February 04, 2010).

Sr. No	Name of the Return	Short Name	Period-icity	Refere-nce Date	Repor-ting Time	Due on	Purpose	To be submit- ed by
1	Annual Returns By deposit taking NBFCs (As required by "Non-Banking Financial Companies Acceptance of Public	NBS1	Annual	31st March	6 months	30th Sept	Details of Assets And Liabilities	NBFCs-D

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	Deposits (Reserve Bank) Directions, 1998".)							
2	Half-Yearly Statement of Capital Funds, Risk Assets etc as required under the Non-Banking Financial Companies Prudential Norms (Reserve Bank) Directions 2007 By deposit taking NBFCs	NBS2	Half Yearly	31st March / 30th Sept	3 months	30th June / 31st Dec	Capital Funds, Risk Assets, Asset Classification etc	NBFCs-D
3	Quarterly Return on Statutory Liquid Assets as per Section 45 IB of the Act By Deposit Taking NBFCs	NBS3	Quarterly	31st March/ 30th June/ 30th Sept/ 31st Dec	15 days	15th April/ 15th July/ 15th Oct/ 15th Jan	Statutory Liquid Assets	NBFCs-D
4	Quarterly Return on Repayment of Deposits by the Rejected Companies holding Public Deposits (The return was subsequently simplified for better response)	NBS4	-do-	-do-	-do-	-do-	Details of Public Deposits, Other Liabilities	NBFCs holding public deposits whose application for Certificate of Registration under Section

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								45-IA of RBI Act, 1934 have been rejected
5	Quarterly submission of Monetary and Supervisory Return	NBS5	Quarterly	31st March/ 30th June/ 30th Sept/ 31st Dec	10 days	10th April/ 10th July/ 10th Oct/ 10th Jan	Components of Assets, Liabilities, Interest Rates, Cash Inflow/Outflow etc.	NBFCs-D holding Public Deposits of Rs.20 crore and above as per the last audited balance sheet.
6	Monthly Return on Capital Market Exposure	NBS6	Monthly	As at the end of the month	7days	7th day of next month	Details of Capital Market Exposure	NBFCs-D
7	Annual Return of Capital Funds, Risk-Asset Ratio from NBFCs-ND-SI (Supervisory Return)	NBS7	Annual	31st March	3 months	30th June	Capital Funds, Risk Assets, Risk Weighted off-balance sheet items (Non-Funded Exposures), Asset Classification etc.	NBFCs-ND-SI
8	Asset-Liability Management (ALM) Return	ALM	Half yearly	31st March/ 30th Sept	1 month	30th April / 30th Oct	Structural Liquidity, Short-term dynamic liquidity, Interest Rate sensitivity etc.	NBFCs-D having public deposit of Rs 20 crore
9	A Statement of short term	ALM-1	Monthly	As at end of	10 days	10th day of next	Short-term dynamic	NBFC-ND-SI

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	dynamic liquidity in format ALM - NBS-ALM1			the month		month	liquidity	
10	Statement of structural liquidity in format ALM – NBS-ALM2	ALM-2	Half yearly	31st March/ 30th Sept	20 days	20th April / 20th Oct	Structural liquidity	NBFC-ND-SI
11	Statement of Interest Rate Sensitivity in format ALM-NBS-ALM3.	ALM-3	Half yearly	31st March/ 30th Sept	20 days	20th April / 20th Oct	Interest Rate sensitivity	NBFC-ND-SI
12	Monthly Return on Important Financial Parameters of NBFCs not accepting/holding public deposits and having asset size of Rs.100 crore and above	100 Crore NBFCs-ND-SI	Monthly	end of every month	7days	7th of next month	Sources and Application of Funds, Profit and Loss Account, Asset Classification, Bank's/FIs exposure on the company, Details of Capital Market Exposure, Foreign Sources etc.	NBFC-ND-SI
13	Quarterly return to be submitted by non-deposit taking NBFCs with asset size of Rs 50 crore and above but less than Rs 100 crore		Quarterly	31st March/ 30th June/ 30th Sept/ 31st Dec	within a period of one month from the close of the quarter		Basic information like name of the company, address. NOF, profit / loss during the last three years	

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Note: NBFCs-D -> Deposit taking Non-Banking Financial Companies (NBFCs); NBFCs-ND -> Non-Deposit taking NBFCs. NBFCs-ND-SI -> Non-Banking Financial Companies (NBFCs) not accepting/holding public deposits and having asset sizes of Rs.100 crore and above (also termed as Systemically Important NBFCs or in short NBFCs-ND-SI)

Returns to be submitted by NBFCs - Revised Formats

RBI/2011-12/195 DNBS (PD).CC. No.243/03.02.02/2011-12 dated September 22, 2011

Link: <http://www.rbi.org.in/scripts/NotificationUser.aspx?Mode=0&Id=672>

RBI has decided to rationalize the above mentioned returns to streamline the reporting system and to improve the present method of collecting data. Periodicity of submitting NBS 1 and NBS 2, which has been on annual and half yearly basis, respectively, has been made quarterly. NBS- 5 stands withdrawn as submission of NBS 1 has been made quarterly. Periodicity of submitting NBS 7 has been changed from annual to quarterly. Periodicity of submitting the remaining returns, namely, NBS 3, NBS 6, Monthly Return on Important Financial Parameters of NBFCs-ND-SI and Quarterly Return to be submitted by non-deposit taking NBFCs with asset size between ` 50 crore and ` 100 crore has not been changed. NBS-4 has also not been revised and the same format and periodicity continues. The Bank has since hosted the format of the Revised Returns viz., NBS 1, NBS 2, NBS 3, NBS 6, NBS 7 and the Monthly Return of NBFCs-ND-SI on the Bank's website, viz, <https://cosmos.rbi.org.in>. NBFCs shall submit all the returns specified in Para above, online in the revised formats. The first such return in NBS 1, NBS 2 and NBS 7 may be submitted beginning from the quarter ended June 2011, NBS-3, for the quarter ending September 2011. The monthly returns viz, NBS-6 and monthly return of NBFCs-ND-SI may be submitted beginning from September 2011. NBFCs-D which have not submitted the NBS 1 for March 2011 (annual) may also submit the same in the revised format urgently.

5. Non-Banking Financial (Non - Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007

Master Circular : RBI 2011-12/19 DNBS (PD) CC No.225/03.02.001 / 2011-12 dated July 1, 2011

Link : http://rbi.org.in/scripts/BS_ViewMasCircularDetails.aspx?id=6585

- (i) The provisions of these Directions save as provided for in clauses (ii) (iii) and (iv) hereinafter, shall apply to every non-banking financial company not accepting / holding public deposits “including an infrastructure finance company”,
- (ii) The provisions of paragraphs 16 and 18 of these Directions shall not apply to -
 - (a) a loan company;
 - (b) an investment company;
 - (c) an asset finance companywhich is not a systemically important non-deposit taking non-banking financial company.
- (iii) These Directions shall not apply to a non-banking financial company being an investment company;
Provided that, it is
 - (a) holding investments in the securities of its group/ holding/ subsidiary companies and book value of such holding is not less than ninety per cent of its total assets and it is not trading in such securities;
 - (b) not accepting/holding public deposit; and
 - (c) is not a systemically important non-deposit taking non-banking financial company.

However, the provisions of paragraphs 16 and 18 shall be applicable to such investment companies which are systemically important non-deposit taking non-banking financial company.

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- (iv) These Directions except the provisions of paragraph 19 shall not apply to non-banking financial company being a Government company as defined under Section 617 of the Companies Act, 1956 (1 of 1956) and not accepting / holding public deposit.

Income recognition

3. (1) The income recognition shall be based on recognised accounting principles.

(2) Income including interest/discount or any other charges on NPA shall be recognised only when it is actually realised. Any such income recognised before the asset became non-performing and remaining unrealised shall be reversed.

(3) In respect of hire purchase assets, where instalments are overdue for more than 12 months, income shall be recognised only when hire charges are actually received. Any such income taken to the credit of profit and loss account before the asset became non-performing and remaining unrealised, shall be reversed.

(4) In respect of lease assets, where lease rentals are overdue for more than 12 months, the income shall be recognised only when lease rentals are actually received. The net lease rentals taken to the credit of profit and loss account before the asset became non-performing and remaining unrealised shall be reversed.

Explanation

For the purpose of this paragraph, 'net lease rentals' mean gross lease rentals as adjusted by the lease adjustment account debited/credited to the profit and loss account and as reduced by depreciation at the rate applicable under Schedule XIV of the Companies Act, 1956 (1 of 1956).

Income from investments

4. (1) Income from dividend on shares of corporate bodies and units of mutual funds shall be taken into account on cash basis:

Provided that the income from dividend on shares of corporate bodies may be taken into account on accrual basis when such dividend has been declared by the corporate body in its annual

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general meeting and the non-banking financial company's right to receive payment is established.

(2) Income from bonds and debentures of corporate bodies and from Government securities/bonds may be taken into account on accrual basis:

Provided that the interest rate on these instruments is pre-determined and interest is serviced regularly and is not in arrears.

(3) Income on securities of corporate bodies or public sector undertakings, the payment of interest and repayment of principal of which have been guaranteed by Central Government or a State Government may be taken into account on accrual basis.

Accounting standards

5. Accounting Standards and Guidance Notes issued by the Institute of Chartered Accountants of India (referred to in these Directions as "ICAI") shall be followed insofar as they are not inconsistent with any of these Directions.

Accounting of investments

6. (1) (a) The Board of Directors of every non-banking financial company shall frame investment policy for the company and implement the same;
- (b) The criteria to classify the investments into current and long term investments shall be spelt out by the Board of the company in the investment policy;
- (c) Investments in securities shall be classified into current and long term, at the time of making each investment;
- (d) (i) There shall be no inter-class transfer on ad-hoc basis;
- (ii) The inter-class transfer, if warranted, shall be effected only at the beginning of each half year, on April 1 or October 1, with the approval of the Board;

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- (iii) The investments shall be transferred scrip-wise, from current to long-term or vice-versa, at book value or market value, whichever is lower;
- (iv) The depreciation, if any, in each scrip shall be fully provided for and appreciation, if any, shall be ignored;
- (v) The depreciation in one scrip shall not be set off against appreciation in another scrip, at the time of such inter-class transfer, even in respect of the scrips of the same category.

(2) Quoted current investments shall, for the purposes of valuation, be grouped into the following categories, viz.,

- (a) equity shares,
- (b) preference shares,
- (c) debentures and bonds,
- (d) government securities including treasury bills,
- (e) units of mutual fund, and
- (f) others.

Quoted current investments for each category shall be valued at cost or market value whichever is lower. For this purpose, the investments in each category shall be considered scrip-wise and the cost and market value aggregated for all investments in each category. If the aggregate market value for the category is less than the aggregate cost for that category, the net depreciation shall be provided for or charged to the profit and loss account. If the aggregate market value for the category exceeds the aggregate cost for the category, the net appreciation shall be ignored. Depreciation in one category of investments shall not be set off against appreciation in another category.

(3) Unquoted equity shares in the nature of current investments shall be valued at cost or break up value, whichever is lower. However, non-banking financial companies may substitute fair value for the break up value of the shares, if

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considered necessary. Where the balance sheet of the investee company is not available for two years, such shares shall be valued at one Rupee only.

(4) Unquoted preference shares in the nature of current investments shall be valued at cost or face value, whichever is lower.

(5) Investments in unquoted Government securities or Government guaranteed bonds shall be valued at carrying cost.

(6) Unquoted investments in the units of mutual funds in the nature of current investments shall be valued at the net asset value declared by the mutual fund in respect of each particular scheme.

(7) Commercial papers shall be valued at carrying cost.

(8) A long term investment shall be valued in accordance with the Accounting Standard issued by ICAI.

Note: Unquoted debentures shall be treated as term loans or other type of credit facilities depending upon the tenure of such debentures for the purpose of income recognition and asset classification.

Need for Policy on Demand/Call Loans

7. (1) The Board of Directors of every non-banking financial company granting/intending to grant demand/call loans shall frame a policy for the company and implement the same.

(2) Such policy shall, inter alia, stipulate the following, -

- (i) A cut off date within which the repayment of demand or call loan shall be demanded or called up;
- (ii) The sanctioning authority shall, record specific reasons in writing at the time of sanctioning demand or call loan, if the cut off date for demanding or calling up such loan is stipulated beyond a period of one year from the date of sanction;
- (iii) The rate of interest which shall be payable on such loans;
- (iv) Interest on such loans, as stipulated shall be payable either at monthly or quarterly rests;

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- (v) The sanctioning authority shall, record specific reasons in writing at the time of sanctioning demand or call loan, if no interest is stipulated or a moratorium is granted for any period ;
- (vi) A cut off date, for review of performance of the loan, not exceeding six months commencing from the date of sanction;
- (vii) Such demand or call loans shall not be renewed unless the periodical review has shown satisfactory compliance with the terms of sanction.

Asset Classification

8. (1) Every non-banking financial company shall, after taking into account the degree of well defined credit weaknesses and extent of dependence on collateral security for realisation, classify its lease/hire purchase assets, loans and advances and any other forms of credit into the following classes, namely :

- (i) Standard assets;
- (ii) Sub-standard assets;
- (iii) Doubtful assets; and
- (iv) Loss assets.

(2) The class of assets referred to above shall not be upgraded merely as a result of rescheduling, unless it satisfies the conditions required for the upgradation.

Provisioning requirements

9. Every non-banking financial company shall, after taking into account the time lag between an account becoming non-performing, its recognition as such, the realisation of the security and the erosion over time in the value of security charged, make provision against sub-standard assets, doubtful assets and loss assets as provided hereunder :-

Loans, advances and other credit facilities including bills purchased and discounted

(1) The provisioning requirement in respect of loans, advances and other credit facilities including bills purchased and discounted shall be as under:

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- | | | | | | | | | | |
|--|--|--|----------------|----------------|----|--------------------|----|-----------------------|----|
| (i) Loss Assets | The entire asset shall be written off. If the assets are permitted to remain in the books for any reason, 100% of the outstanding should be provided for; | | | | | | | | |
| (ii) Doubtful Assets | <p>(a) 100% provision to the extent to which the advance is not covered by the realisable value of the security to which the non-banking financial company has a valid recourse shall be made. The realizable value is to be estimated on a realistic basis;</p> <p>(b) In addition to item (a) above, depending upon the period for which the asset has remained doubtful, provision to the extent of 20% to 50% of the secured portion (i.e. estimated realisable value of the outstanding) shall be made on the following basis : -</p> <table border="0" style="margin-left: 40px;"> <tr> <td>Period for which the asset has been considered as doubtful</td> <td>% of provision</td> </tr> <tr> <td>Up to one year</td> <td>20</td> </tr> <tr> <td>One to three years</td> <td>30</td> </tr> <tr> <td>More than three years</td> <td>50</td> </tr> </table> | Period for which the asset has been considered as doubtful | % of provision | Up to one year | 20 | One to three years | 30 | More than three years | 50 |
| Period for which the asset has been considered as doubtful | % of provision | | | | | | | | |
| Up to one year | 20 | | | | | | | | |
| One to three years | 30 | | | | | | | | |
| More than three years | 50 | | | | | | | | |
| (iii) Sub-standard assets | A general provision of 10% of total outstanding shall be made | | | | | | | | |

Lease and hire purchase assets

- (2) The provisioning requirements in respect of hire purchase and leased assets shall be as under:

Hire purchase assets

- (i) In respect of hire purchase assets, the total dues (overdue and future instalments taken together) as reduced by

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- (a) the finance charges not credited to the profit and loss account and carried forward as unmatured finance charges; and
- (b) the depreciated value of the underlying asset, shall be provided for.

Explanation : For the purpose of this paragraph,

- (1) the depreciated value of the asset shall be notionally computed as the original cost of the asset to be reduced by depreciation at the rate of twenty per cent per annum on a straight line method; and
- (2) in the case of second hand asset, the original cost shall be the actual cost incurred for acquisition of such second hand asset.

Additional provision for hire purchase and leased assets

- (ii) In respect of hire purchase and leased assets, additional provision shall be made as under:
 - (a) Where hire charges or Nil
lease rentals are overdue
upto 12 months
 - (b) Where hire charges 10 percent of the net
or lease rentals are book value
overdue for more than 12
months but upto 24 months
 - (c) Where hire charges or 40 percent of the net
lease rentals are overdue book value
for more than 24 months
but upto 36 months
 - (d) Where hire charges or 70 percent of the net
lease rentals are overdue book value
for more than 36 but upto
48 months
 - (e) Where hire charges or 100 percent of the net
lease rentals are overdue book value
for more than 48 months

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- (iii) On expiry of a period of 12 months after the due date of the last instalment of hire purchase/leased asset, the entire net book value shall be fully provided for.

Notes:

- (1) The amount of caution money/margin money or security deposits kept by the borrower with the non-banking financial company in pursuance of the hire purchase agreement may be deducted against the provisions stipulated under clause (i) above, if not already taken into account while arriving at the equated monthly instalments under the agreement. The value of any other security available in pursuance to the hire purchase agreement may be deducted only against the provisions stipulated under clause (ii) above.
- (2) The amount of security deposits kept by the borrower with the non-banking financial company in pursuance to the lease agreement together with the value of any other security available in pursuance to the lease agreement may be deducted only against the provisions stipulated under clause (ii) above.
- (3) It is clarified that income recognition on and provisioning against NPAs are two different aspects of prudential norms and provisions as per the norms are required to be made on NPAs on total outstanding balances including the depreciated book value of the leased asset under reference after adjusting the balance, if any, in the lease adjustment account. The fact that income on an NPA has not been recognised cannot be taken as reason for not making provision.
- (4) An asset which has been renegotiated or rescheduled as referred to in paragraph (2) (1) (xvi) (b) of these Directions shall be a sub-standard asset or continue to remain in the same category in which it was prior to its renegotiation or reschedulement as a doubtful asset or a loss asset as the case may be. Necessary provision is required to be made as applicable to such asset till it is upgraded.

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- (5) The balance sheet to be prepared by the NBFC may be in accordance with the provisions contained in subparagraph (2) of paragraph 10.
- (6) All financial leases written on or after April 1, 2001 attract the provisioning requirements as applicable to hire purchase assets.

Disclosure in the balance sheet

10. (1) Every non-banking financial company shall separately disclose in its balance sheet the provisions made as per paragraph 9 above without netting them from the income or against the value of assets.

(2) The provisions shall be distinctly indicated under separate heads of account as under:-

- (i) provisions for bad and doubtful debts; and
- (ii) provisions for depreciation in investments.

(3) Such provisions shall not be appropriated from the general provisions and loss reserves held, if any, by the non-banking financial company.

(4) Such provisions for each year shall be debited to the profit and loss account. The excess of provisions, if any, held under the heads general provisions and loss reserves may be written back without making adjustment against them.

["(5) Every systemically important non-deposit taking non-banking financial company shall disclose the following particulars in its Balance Sheet Capital to Risk Assets Ratio (CRAR) Exposure to real estate sector, both direct and indirect; and Maturity pattern of assets and liabilities."]

Constitution of Audit Committee by non-banking financial companies

11. A non-banking financial company having assets of Rs. 50 crore and above as per its last audited balance sheet shall constitute an Audit Committee, consisting of not less than three members of its Board of Directors.

Explanation I: The Audit Committee constituted by a non-banking financial company as required under Section 292A of

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the Companies Act, 1956 (1 of 1956) shall be the Audit Committee for the purposes of this paragraph.

Explanation II: The Audit Committee constituted under this paragraph shall have the same powers, functions and duties as laid down in Section 292A of the Companies Act, 1956 (1 of 1956).

Accounting year

12. Every non-banking financial company shall prepare its balance sheet and profit and loss account as on March 31 every year. Whenever a non-banking financial company intends to extend the date of its balance sheet as per provisions of the Companies Act, it should take prior approval of the Reserve Bank of India before approaching the Registrar of Companies for this purpose.

Further, even in cases where the Bank and the Registrar of Companies grant extension of time, the non-banking financial company shall furnish to the Bank a proforma balance sheet (unaudited) as on March 31 of the year and the statutory returns due on the said date.

Schedule to the balance sheet

13. Every non-banking financial company shall append to its balance sheet prescribed under the Companies Act, 1956, the particulars in the schedule as set out in Annex

Transactions in Government securities

14. Every non-banking financial company may undertake transactions in Government securities through its CSDL account or its demat account: provided that no non-banking financial company shall undertake any transaction in government security in physical form through any broker.

Submission of a certificate from Statutory Auditor to the Bank

15. Every non-banking financial company shall submit a Certificate from its Statutory Auditor that it is engaged in the business of non-banking financial institution requiring it to hold

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a Certificate of Registration under Section 45-IA of the RBI Act. A certificate from the Statutory Auditor in this regard with reference to the position of the company as at end of the financial year ended March 31 may be submitted to the Regional Office of the Department of Non-Banking Supervision under whose jurisdiction the non-banking financial company is registered, (Inserted vide *Notification No. DNBS. 209 / CGM(ANR)-2009 dated October 22, 2009*) ["within one month from the date of finalization of the balance sheet and in any case not later than December 30th of that year."] Such certificate shall also indicate the asset / income pattern of the non-banking financial company for making it eligible for classification as Asset Finance Company, Investment Company or Loan Company.

Requirement as to capital adequacy

16. (1) Every systemically important non-deposit taking non-banking financial company shall maintain, with effect from April 1, 2007, a minimum capital ratio consisting of Tier I and Tier II capital which shall not be less than ten per cent of its aggregate risk weighted assets on balance sheet and of risk adjusted value of off-balance sheet items. Such ratio shall not be less than 12% by March 31, 2010 and 15% by March 31, 2011. (Inserted vide *Notification No. DNBS. 206 / CGM(ASR)-2009 dated May 26, 2009*).

(2) The total of Tier II capital, at any point of time, shall not exceed one hundred per cent of Tier I capital.

Explanations : On balance sheet assets

(1) In these Directions, degrees of credit risk expressed as percentage weightages have been assigned to balance sheet assets. Hence, the value of each asset / item requires to be multiplied by the relevant risk weights to arrive at risk adjusted value of assets. The aggregate shall be taken into account for reckoning the minimum capital ratio. The risk weighted asset

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shall be calculated as the weighted aggregate of funded items as detailed hereunder:

Weighted risk assets - On-Balance Sheet items		Percentage weight
(i)	Cash and bank balances including fixed deposits and certificates of deposits with banks	0
(ii)	Investments	
	(a) Approved securities [Except at (c) below]	0
	(b) Bonds of public sector banks	20
	(c) Fixed deposits/certificates of deposits/ bonds of public financial institutions	100
	(d) Shares of all companies and debentures/bonds/ commercial papers of all companies and units of all mutual funds	100
(iii)	Current assets	
	(a) Stock on hire (net book value)	100
	(b) Intercompany loans/deposits	100
	(c) Loans and advances fully secured against deposits held by the company itself	0
	(d) Loans to staff	0
	(e) Other secured loans and advances considered good	100
	(f) Bills purchased/discounted	100
	(g) Others (To be specified)	100
(iv)	Fixed Assets (net of depreciation)	
	(a) Assets leased out (net book value)	100
	(b) Premises	100
	(c) Furniture & Fixtures	100
(v)	Other assets	
	(a) Income tax deducted at source (net of provision)	0

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(b) Advance tax paid (net of provision)	0
(c) Interest due on Government securities	0
(d) Others (to be specified)	100

Notes : (1) Netting may be done only in respect of assets where provisions for depreciation or for bad and doubtful debts have been made.

(2) Assets which have been deducted from owned fund to arrive at net owned fund shall have a weightage of 'zero'.

(3) While calculating the aggregate of funded exposure of a borrower for the purpose of assignment of risk weight, such non-banking financial companies may net off the amount of cash margin/caution money/security deposits (against which right to set-off is available) held as collateral against the advances out of the total outstanding exposure of the borrower.

["(4) The counterparty credit risk, arising out of exposure of NBFCs to CCIL on account of securities financing transactions (CBLOs) will carry a risk weight of zero, as it is presumed that the CCP's exposures to their counterparties are fully collateralised on a daily basis, thereby providing protection for the CCP's credit risk exposures. The deposits / collaterals kept by NBFCs with CCIL will attract a risk weight of 20%".](Inserted vide Notification No. DNBS. 212 / CGM(ANR)-2009 dated December 1, 2009)

Off-balance sheet items

(2) In these Directions, degrees of credit risk exposure attached to off-balance sheet items have been expressed as percentage of credit conversion factor. Hence, the face value of each item requires to be first multiplied by the relevant conversion factor to arrive at risk adjusted value of off-balance sheet item. The aggregate shall be taken into account for reckoning the minimum capital ratio. This shall have to be again multiplied by the risk weight of 100. The risk adjusted value of the off-balance sheet items shall be calculated as per the credit conversion factors of non-funded items as detailed hereunder:-

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Nature of item		Credit conversion factor – Percentage
(i)	Financial & other guarantees	100
(ii)	Share/debenture underwriting obligations	50
(iii)	Partly-paid shares/debentures	100
(iv)	Bills discounted/rediscounted	100
(v)	Lease contracts entered into but yet to be executed	100
(vi)	Other contingent liabilities (To be specified)	50

Note: Cash margins/deposits shall be deducted before applying the conversion factor.

Loans against non-banking financial company's own shares prohibited

17. (1) No non-banking financial company shall lend against its own shares.

(2) Any outstanding loan granted by a non-banking financial company against its own shares on the date of commencement of these Directions shall be recovered by the non-banking financial company as per the repayment schedule.

Concentration of credit/investment

18. (1) On and from April 1, 2007 no systemically important non-deposit taking non-banking financial company shall,

- (i) lend to
 - (a) any single borrower exceeding fifteen per cent of its owned fund; and
 - (b) any single group of borrowers exceeding twenty five per cent of its owned fund;
- (ii) invest in
 - (a) the shares of another company exceeding fifteen per cent of its owned fund; and

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- (b) the shares of a single group of companies exceeding twenty five per cent of its owned fund;
- (iii) lend and invest (loans/investments taken together) exceeding
 - (a) twenty five per cent of its owned fund to a single party; and
 - (b) forty per cent of its owned fund to a single group of parties.

Provided that the ceiling on the investment in shares of another company shall not be applicable to a systemically important non-deposit taking non-banking financial company in respect of investment in the equity capital of an insurance company upto the extent specifically permitted, in writing, by the Reserve Bank of India.

Provided further that any systemically important non-deposit taking non-banking financial company, classified as Asset Finance Company by the Reserve Bank of India, may in exceptional circumstances, exceed the above ceilings on credit / investment concentration to a single party or a single group of parties by 5 per cent of its owned fund, with the approval of its Board.

Provided further that any systemically important non-deposit taking non-banking financial company not accessing public funds, either directly or indirectly, may make an application to the Bank for modifications in the prescribed ceilings.

Explanation: "Public funds" for the purpose of the proviso shall include funds raised either directly or indirectly through public deposits, Commercial Papers, debentures, inter-corporate deposits and bank finance.

(2) Every systemically important non-deposit taking non-banking financial company shall formulate a policy in respect of exposures to a single party / a single group of parties.

Notes:

(1) For determining the limits, off-balance sheet exposures shall be converted into credit risk by applying the conversion factors as explained in paragraph 16.

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(2) The investments in debentures for the purposes specified in this paragraph shall be treated as credit and not investment.

(3) These ceilings shall be applicable to the credit/investment by such a non- banking financial company to companies/firms in its own group as well as to the borrowers/ investee company's group.

Information in regard to change of address, directors, auditors, etc. to be submitted

19. Every non-banking financial company not accepting/holding public deposit shall communicate, not later than one month from the occurrence of any change in:

- (a) the complete postal address, telephone number/s and fax number/s of the registered/corporate office;
- (b) the names and residential addresses of the directors of the company;
- (c) the names and the official designations of its principal officers;
- (d) the names and office address of the auditors of the company; and
- (e) the specimen signatures of the officers authorised to sign on behalf of the company

to the Regional Office of the Department of Non-Banking Supervision of the Reserve Bank of India as indicated in the Second Schedule to the Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998.

Requirements for Infrastructure Finance Company

19A. An Infrastructure Finance Company shall, -

- i. not accept deposits from the public;
- ii. have net owned funds of Rs. 300 crore or above;
- iii. have a minimum credit rating 'A' or equivalent of CRISIL, FITCH, CARE, ICRA or equivalent rating by any other accredited rating agencies; and

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- iv. have a CRAR of 15 percent (with a minimum Tier I capital of 10 percent)].(Inserted vide Notification No. DNBS. 213 / CGM(ASR)-2010 dated February 12, 2010

Norms relating to Infrastructure loan

20. (1) Applicability

- (i) These norms shall be applicable to restructuring and/or rescheduling and/or renegotiation of the terms of agreement relating to infrastructure loan, as defined in paragraph 2(1)(viii) of these Directions which is fully or partly secured standard and sub-standard asset and to the loan, which is subjected to restructuring and/or rescheduling and/or renegotiation of terms.
- (ii) Where the asset is partly secured, a provision to the extent of shortfall in the security available shall be made while restructuring and/or rescheduling and/or renegotiation of the loans, apart from the provision required on present value basis and as per prudential norms.

(2) Restructuring, reschedulement or renegotiation of terms of infrastructure loan

The non-banking financial companies may, not more than once, restructure or reschedule or renegotiate the terms of infrastructure loan agreement as per the policy framework laid down by the Board of Directors of the company under the following stages:

- (a) before commencement of commercial production;
- (b) after commencement of commercial production but before the asset has been classified as sub-standard;
- (c) after commencement of commercial production and the asset has been classified as sub-standard:

Provided that in each of the above three stages, the restructuring and/or rescheduling and/or renegotiation of principal and / or of interest may take place, with or without sacrifice, as part of the restructuring or rescheduling or renegotiating package evolved.

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(3) Treatment of restructured standard loan

The rescheduling or restructuring or renegotiation of the instalments of principal alone, at any of the aforesaid first two stages shall not cause a standard asset to be re-classified in the sub-standard category, if the project is re-examined and found to be viable by the Board of Directors of the company or by a functionary at least one step senior to the functionary who sanctioned the initial loan for the project, within the policy framework laid down by the Board:

Provided that rescheduling or renegotiation or restructuring of interest element at any of the foregoing first two stages shall not cause an asset to be downgraded to sub-standard category subject to the condition that the amount of interest foregone, if any, on account of adjustment in the element of interest as specified later, is either written off or 100 per cent provision is made there against.

(4) Treatment of restructured sub-standard asset

A sub-standard asset shall continue to remain in the same category in case of restructuring or rescheduling or renegotiation of the instalments of principal until the expiry of one year and the amount of interest foregone, if any, on account of adjustment, including adjustment by way of write off of the past interest dues, in the element of interest as specified later, shall be written off or 100 per cent provision made there against.

(5) Adjustment of interest

Where rescheduling or renegotiation or restructuring involves a reduction in the rate of interest, the interest adjustment shall be computed by taking the difference between the rate of interest as currently applicable to infrastructure loan (as adjusted for the risk rating applicable to the borrower) and the reduced rate and aggregating the present value (discounted at the rate currently applicable to infrastructure loan, adjusted for risk enhancement) of the future interest payable so stipulated in the restructuring or rescheduling or renegotiation proposal.

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(6) Funded Interest

In the case of funding of interest in respect of NPAs, where the interest funded is recognized as income, the interest funded shall be fully provided for.

(7) Income Recognition norms

The income recognition in respect of infrastructure loan shall be governed by the provisions of paragraph 3 of these Directions;

(8) Treatment of Provisions held

The provisions held by the non-banking financial companies against non-performing infrastructure loan, which may be classified as 'standard' in terms of sub-paragraph (3) hereinabove, shall continue to be held until full recovery of the loan is made.

(9) Eligibility for upgradation of restructured sub-standard infrastructure loan

The sub-standard asset subjected to rescheduling and/or renegotiation and/or restructuring, whether in respect of instalments of principal amount, or interest amount, by whatever modality, shall not be upgraded to the standard category until expiry of one year of satisfactory performance under the restructuring and/or rescheduling and/or renegotiation terms.

(10) Conversion of debt into equity

Where the amount due as interest, is converted into equity or any other instrument, and income is recognized in consequence, full provision shall be made for the amount of income so recognized to offset the effect of such income recognition:

Provided that no provision is required to be made, if the conversion of interest is into equity which is quoted;

Provided further that in such cases, interest income may be recognized at market value of equity, as on the date of conversion, not exceeding the amount of interest converted to equity.

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(11) Conversion of debt into debentures

Where principal amount and/or interest amount in respect of NPAs is converted into debentures, such debentures shall be treated as NPA, ab initio, in the same asset classification as was applicable to the loan just before conversion and provision shall be made as per norms.

(12) Increase in exposure limits for Infrastructure related loan and investment

The systemically important non-deposit taking non-banking financial companies may exceed the concentration of credit/investment norms, as provided in paragraph 18 of these Directions, by 5 per cent for any single party and by 10 per cent for a single group of parties, if the additional exposure is on account of infrastructure loan and/ or investment.

["(12A) Infrastructure Finance Companies may exceed the concentration of credit norms as provided in paragraph 18 of the aforesaid Directions,

- (i) in lending to
 - (a) any single borrower, by ten per cent of its owned fund; and
 - (b) any single group of borrowers, by fifteen per cent of its owned fund;
- (ii) in lending to and investing in, (loans/investments taken together)
 - (a) a single party, by five percent of its owned fund; and
 - (b) a single group of parties, by ten percent of its owned fund."] (Inserted vide Notification No. DNBS. 213 / CGM(ASR)-2010 dated February 12, 2010

(13) Risk weight for investment in AAA rated securitized paper

The investment in "AAA" rated securitized paper pertaining to the infrastructure facility shall attract risk weight of 50 per cent for capital adequacy purposes subject to the fulfilment of the following conditions:

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- (i) The infrastructure facility generates income / cash flows, which ensure servicing / repayment of the securitized paper.
- (ii) The rating by one of the approved credit rating agencies is current and valid.

Explanation:

The rating relied upon shall be deemed to be current and valid, if the rating is not more than one month old on the date of opening of the issue, and the rating rationale from the rating agency is not more than one year old on the date of opening of the issue, and the rating letter and the rating rationale form part of the offer document.

- (iii) In the case of secondary market acquisition, the 'AAA' rating of the issue is in force and confirmed from the monthly bulletin published by the respective rating agency.
- (iv) The securitized paper is a performing asset.

20A NBFCs not to be partners in partnership firms

(inserted vide notification no. DNBS. 228 / CGM(US)-2011 dated March 30, 2011)

- (1) No non-banking financial company shall contribute to the capital of a partnership firm or become a partner of such firm.
- (2) A non-banking financial company, which had already contributed to the capital of a partnership firm or was a partner of a partnership firm shall seek early retirement from the partnership firm.

Exemptions

21. The Reserve Bank of India may, if it considers it necessary for avoiding any hardship or for any other just and sufficient reason, grant extension of time to comply with or exempt any non-banking financial company or class of non-banking financial companies, from all or any of the provisions of these Directions either generally or for any specified period,

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subject to such conditions as the Reserve Bank of India may impose.

Interpretations

22. For the purpose of giving effect to the provisions of these Directions, the Reserve Bank of India may, if it considers necessary, issue necessary clarifications in respect of any matter covered herein and the interpretation of any provision of these Directions given by the Reserve Bank of India shall be final and binding on all the parties concerned.

Repeal and Saving

23. (1) The Non-Banking Financial Companies Prudential Norms (Reserve Bank) Directions, 1998 shall stand repealed by these Directions.

(2) Notwithstanding such repeal, any circular, instruction, order issued under the Directions in sub-section (1) shall continue to apply to non-banking financial companies in the same manner as they applied to such companies before such repeal.

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Annexure 1

Schedule to the Balance Sheet of a Non-deposit Taking Non-banking Financial Company

(as required in terms of paragraph 13 of Non-Banking Financial (Non-Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007)

(Rs. in lakhs)

Particulars		Amount out- standing	Amount overdue
Liabilities side :			
(1)	Loans and advances availed by the non-banking financial company inclusive of interest accrued thereon but not paid: (a) Debentures : Secured Unsecured (other than falling within the meaning of public deposits*) (b) Deferred Credits (c) Term Loans (d) Inter-corporate loans and borrowing (e) Commercial Paper (f) Other Loans (specify nature) * Please see Note 1 below		
Assets side			
2	Break-up of Loans and Advances including bills receivables [other than those included in (4) below] : (a) Secured (b) Unsecured	Amount outstanding	
3	Break up of Leased Assets and stock on hire and other assets counting towards AFC activities		

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	(i) Lease assets including lease rentals under sundry debtors : (a) Financial lease (b) Operating lease		
	(ii) Stock on hire including hire charges under sundry debtors: (a) Assets on hire (b) Repossessed Assets		
	iii) Other loans counting towards AFC activities (a) Loans where assets have been repossessed (b) Loans other than (a) above		
4	Break-up of Investments : Current Investments : 1 Quoted : (i) Shares : (a) Equity (b) Preference (ii) Debentures and Bonds (iii) Units of mutual funds (iv) Government Securities (v) Others (please specify) 2 Unquoted : (i) Shares : (a) Equity (b) Preference (ii) Debentures and Bonds (iii) Units of mutual funds (iv) Government Securities (v) Others (please specify) Long Term investments : 1. Quoted : (i) Shares : (a) Equity (b) Preference		

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	(ii) Debentures and Bonds (iii) Units of mutual funds (iv) Government Securities (v) Others (please specify) 2. Unquoted : (i) Shares : (a) Equity (b) Preference (ii) Debentures and Bonds (iii) Units of mutual funds (iv) Government Securities (v) Others (please specify)			
5	Borrower group-wise classification of assets financed as in (2) and (3) above : Please see Note 2 below			
	Category	Amount net of provisions		
		Secured	Unsecured	Total
	1. Related Parties ** (a) Subsidiaries (b) Companies in the same group (c) Other related parties			
	2. Other than related parties			
	Total			
6	Investor group-wise classification of all investments (current and long term) in shares and securities (both quoted and unquoted): Please see note 3 below			
	Category	Market Value / Break up or fair value or NAV	Book Value (Net of Provisions)	
	1. Related Parties **			

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	(a) Subsidiaries (b) Companies in the same group (c) Other related parties		
	2. Other than related parties		
	Total		
	** As per Accounting Standard of ICAI (Please see Note 3)		
7	Other information		
	(i) Gross Non-Performing Assets (a) Related parties (b) Other than related parties (ii) Net Non-Performing Assets (a) Related parties (b) Other than related parties (iii) Assets acquired in satisfaction of debt		

Notes :

1. As defined in paragraph 2(1)(xii) of the Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998.
2. Provisioning norms shall be applicable as prescribed in Non-Banking Financial (Non-Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007
3. All Accounting Standards and Guidance Notes issued by ICAI are applicable including for valuation of investments and other assets as also assets acquired in satisfaction of debt. However, market value in respect of quoted investments and break up/fair value/NAV in respect of unquoted investments should be disclosed irrespective of whether they are classified as long term or current in (4) above.

6. Non-Banking Financial (Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007

Master Circular: RBI/2011-12/18 DNBS (PD) CC No.224/03.02.001/ 2011-12 dated July 1, 2011

Link: http://rbi.org.in/scripts/BS_ViewMasCirculardetails.aspx?id=6576

Notification No. DNBS.192/ DG (VL)-2007 dated February 22, 2007

The Reserve Bank of India, having considered it necessary in the public interest, and being satisfied that, for the purpose of enabling the Bank to regulate the credit system to the advantage of the country, it is necessary to issue the Directions relating to the prudential norms as set out below, in exercise of the powers conferred by Section 45JA of the Reserve Bank of India Act, 1934 (2 of 1934) and of all the powers enabling it in this behalf, and in supersession of the Non-Banking Financial Companies Prudential Norms (Reserve Bank) Directions, 1998 contained in Notification No. DFC. 119/DG(SPT)/98 dated January 31, 1998, gives to every non-banking financial company (other than Residuary Non-Banking Company) accepting/ holding public deposits and to every Residuary Non-Banking Company the Directions hereinafter specified.

Short title, commencement and applicability of the Directions:

1. (1) These Directions shall be known as the "Non-Banking Financial (Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007".

(2) These Directions shall come into force with immediate effect.

(3) (i) The provisions of these Directions, shall apply to:

- a. a non-banking financial company, except a mutual benefit financial company [and a mutual benefit company] as defined in the Non-Banking Financial Companies Acceptance of Public Deposits (Reserve

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Bank) Directions, 1998 and accepting/holding public deposit;

- b. a residuary non-banking company as defined in the Residuary Non-Banking Companies (Reserve Bank) Directions, 1987.

(ii) These Directions shall not apply to a non-banking financial company being a Government company as defined under Section 617 of the Companies Act, 1956 (1 of 1956) and accepting / holding public deposit.

Definitions

2. (1) For the purpose of these Directions, unless the context otherwise requires:

- (i) “break up value” means the equity capital and reserves as reduced by intangible assets and revaluation reserves, divided by the number of equity shares of the investee company;
- (ii) “carrying cost” means book value of the assets and interest accrued thereon but not received;
- (iii) “current investment” means an investment which is by its nature readily realisable and is intended to be held for not more than one year from the date on which such investment is made;
- (iv) “doubtful asset” means:
 - a. a term loan, or
 - b. a lease asset, or
 - c. a hire purchase asset, or
 - d. any other asset,which remains a sub-standard asset for a period exceeding 18 months;
- (v) “earning value” means the value of an equity share computed by taking the average of profits after tax as reduced by the preference dividend and adjusted for extra-ordinary and non-recurring items, for the immediately preceding three years

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and further divided by the number of equity shares of the investee company and capitalised at the following rate:

- a) in case of predominantly manufacturing company, eight per cent;
- (b) in case of predominantly trading company, ten per cent; and
- (c) in case of any other company, including non-banking financial company, twelve per cent;

NOTE : If, an investee company is a loss making company, the earning value will be taken at zero;

- (vi) “fair value” means the mean of the earning value and the break up value;
- (vii) “hybrid debt” means capital instrument which possesses certain characteristics of equity as well as of debt;
- (viii) ‘infrastructure loan’ means a credit facility extended by non-banking financial companies to a borrower, by way of term loan, project loan subscription to bonds/debentures/ preference shares / equity shares in a project company acquired as a part of the project finance package such that such subscription amount to be “in the nature of advance” or any other form of long term funded facility provided to a borrower company engaged in:
 - Developing or
 - Operating and maintaining, or
 - Developing, operating and maintainingany infrastructure facility that is a project in any of the following sectors:
 - (a) a road, including toll road, a bridge or a rail system;
 - (b) a highway project including other activities being an integral part of the highway project;

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- (c) a port, airport, inland waterway or inland port;
- (d) a water supply project, irrigation project, water treatment system, sanitation and sewerage system or solid waste management system;
- (e) telecommunication services whether basic or cellular, including radio paging, domestic satellite service (i.e., a satellite owned and operated by an Indian company for providing telecommunication service), "Telecom Towers" network of trunking, broadband network and internet services;
- (f) an industrial park or special economic zone;
- (g) generation or generation and distribution of power;
- (h) transmission or distribution of power by laying a network of new transmission or distribution lines;
- (i) construction relating to projects involving agro-processing and supply of inputs to agriculture;
- (j) construction for preservation and storage of processed agro-products, perishable goods such as fruits, vegetables and flowers including testing facilities for quality; and
- (k) [deleted]
- (l) any other infrastructure facility of similar nature.
- (ix) "loss asset" means:
 - (a) an asset which has been identified as loss asset by the non-banking financial company or its internal or external auditor or by the Reserve Bank of India during the inspection of the non-banking financial company, to the extent it is not written off by the non-banking financial company; and
 - (b) an asset which is adversely affected by a potential threat of non-recoverability due to

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either erosion in the value of security or non availability of security or due to any fraudulent act or omission on the part of the borrower;

- (x) “long term investment” means an investment other than a current investment;
- (xi) “net asset value” means the latest declared net asset value by the mutual fund concerned in respect of that particular scheme;
- (xii) “net book value” means:
 - (a) in the case of hire purchase asset, the aggregate of overdue and future instalments receivable as reduced by the balance of unmatured finance charges and further reduced by the provisions made as per paragraph 9(2)(i) of these Directions;
 - (b) in the case of leased asset, aggregate of capital portion of overdue lease rentals accounted as receivable and depreciated book value of the lease asset as adjusted by the balance of lease adjustment account.
- (xiii) ‘non-performing asset’ (referred to in these Directions as “NPA”) means:
 - a. an asset, in respect of which, interest has remained overdue for a period of six months or more;
 - b. a term loan inclusive of unpaid interest, when the instalment is overdue for a period of six months or more or on which interest amount remained overdue for a period of six months or more;
 - c. a demand or call loan, which remained overdue for a period of six months or more from the date of demand or call or on which interest amount remained overdue for a period of six months or more;

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- d. a bill which remains overdue for a period of six months or more;
- e. the interest in respect of a debt or the income on receivables under the head 'other current assets' in the nature of short term loans/advances, which facility remained overdue for a period of six months or more;
- f. any dues on account of sale of assets or services rendered or reimbursement of expenses incurred, which remained overdue for a period of six months or more;
- g. the lease rental and hire purchase instalment, which has become overdue for a period of twelve months or more;
- h. in respect of loans, advances and other credit facilities (including bills purchased and discounted), the balance outstanding under the credit facilities (including accrued interest) made available to the same borrower/beneficiary when any of the above credit facilities becomes non-performing asset:

Provided that in the case of lease and hire purchase transactions, a non-banking financial company may classify each such account on the basis of its record of recovery;

- (xiv) "owned fund" means paid up equity capital, preference shares which are compulsorily convertible into equity, free reserves, balance in share premium account and capital reserves representing surplus arising out of sale proceeds of asset, excluding reserves created by revaluation of asset, as reduced by accumulated loss balance, book value of intangible assets and deferred revenue expenditure, if any;
- (xv) "standard asset" means the asset in respect of which, no default in repayment of principal or payment of interest is perceived and which does

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not disclose any problem nor carry more than normal risk attached to the business;

- (xvi) "sub-standard asset" means:
- a. an asset which has been classified as non-performing asset for a period not exceeding 18 months;
 - b. an asset where the terms of the agreement regarding interest and / or principal have been renegotiated or rescheduled or restructured after commencement of operations, until the expiry of one year of satisfactory performance under the renegotiated or rescheduled or restructured terms:

Provided that the classification of infrastructure loan as a sub-standard asset shall be in accordance with the provisions of paragraph 23 of these Directions;

- (xvii) "subordinated debt" means an instrument, which is fully paid up, is unsecured and is subordinated to the claims of other creditors and is free from restrictive clauses and is not redeemable at the instance of the holder or without the consent of the supervisory authority of non-banking financial company. The book value of such instrument shall be subjected to discounting as provided hereunder:

Remaining Maturity of the instruments	Rate of discount
(a) Upto one year	100%
(b) More than one year but upto two years	80%
(c) More than two years but upto three years	60%
(d) More than three years but upto four years	40%
(e) More than four years but upto five years	20%

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to the extent such discounted value does not exceed fifty per cent of Tier I capital;

- (xviii) "substantial interest" means holding of a beneficial interest by an individual or his spouse or minor child, whether singly or taken together in the shares of a company, the amount paid up on which exceeds ten per cent of the paid up capital of the company; or the capital subscribed by all the partners of a partnership firm;
- (xix) "Tier I Capital" means owned fund as reduced by investment in shares of other non-banking financial companies and in shares, debentures, bonds, outstanding loans and advances including hire purchase and lease finance made to and deposits with subsidiaries and companies in the same group exceeding, in aggregate, ten per cent of the owned fund;
- (xx) "Tier II capital" includes the following:
 - (a) preference shares other than those which are compulsorily convertible into equity;
 - (b) revaluation reserves at discounted rate of fifty five percent;
 - (c) "General Provisions (including that for standard assets) and loss reserves to the extent these are not attributable to actual diminution in value or identifiable potential loss in any specific asset and are available to meet unexpected losses, to the extent of one and one fourth percent of risk weighted assets;"
 - (d) of one and one fourth percent of risk weighted assets;
 - (e) hybrid debt capital instruments; and
 - (f) subordinated debtto the extent the aggregate does not exceed Tier I capital.

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(2) Other words or expressions used but not defined herein and defined in the Reserve Bank of India Act, 1934 (2 of 1934) or the Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998 or the Residuary Non-Banking Companies (Reserve Bank) Directions, 1987 shall have the same meaning as assigned to them under that Act or those Directions. Any other words or expressions not defined in that Act or those Directions shall have the same meaning assigned to them in the Companies Act, 1956 (1 of 1956).

Income recognition

3. (1) The income recognition shall be based on recognised accounting principles.

(2) Income including interest/discount or any other charges on NPA shall be recognised only when it is actually realised. Any such income recognised before the asset became non-performing and remaining unrealised shall be reversed.

(3) In respect of hire purchase assets, where instalments are overdue for more than 12 months, income shall be recognised only when hire charges are actually received. Any such income taken to the credit of profit and loss account before the asset became non-performing and remaining unrealised, shall be reversed.

(4) In respect of lease assets, where lease rentals are overdue for more than 12 months, the income shall be recognised only when lease rentals are actually received. The net lease rentals taken to the credit of profit and loss account before the asset became non-performing and remaining unrealised shall be reversed.

Explanation

For the purpose of this paragraph, 'net lease rentals' mean gross lease rentals as adjusted by the lease adjustment account debited/credited to the profit and loss account and as reduced by depreciation at the rate applicable under Schedule XIV of the Companies Act, 1956 (1 of 1956).

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Income from investments

4. (1) Income from dividend on shares of corporate bodies and units of mutual funds shall be taken into account on cash basis:

Provided that the income from dividend on shares of corporate bodies may be taken into account on accrual basis when such dividend has been declared by the corporate body in its annual general meeting and the non-banking financial company's right to receive payment is established.

(2) Income from bonds and debentures of corporate bodies and from Government securities/bonds may be taken into account on accrual basis:

Provided that the interest rate on these instruments is pre-determined and interest is serviced regularly and is not in arrears.

(3) Income on securities of corporate bodies or public sector undertakings, the payment of interest and repayment of principal of which have been guaranteed by Central Government or a State Government may be taken into account on accrual basis.

Accounting standards

5. Accounting Standards and Guidance Notes issued by the Institute of Chartered Accountants of India (referred to in these Directions as "ICAI") shall be followed insofar as they are not inconsistent with any of these Directions.

Accounting of investments

6. (1) (a) The Board of Directors of every non-banking financial company shall frame investment policy for the company and implement the same;
- (b) The criteria to classify the investments into current and long term investments shall be spelt out by the Board of the company in the investment policy;
- (c) Investments in securities shall be classified into current and long term, at the time of making each investment;
- (d) (i) There shall be no inter-class transfer on ad-hoc basis;

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- (ii) The inter-class transfer, if warranted, shall be effected only at the beginning of each half year, on April 1 or October 1, with the approval of the Board;
- (iii) The investments shall be transferred scrip-wise, from current to long-term or vice-versa, at book value or market value, whichever is lower;
- (iv) The depreciation, if any, in each scrip shall be fully provided for and appreciation, if any, shall be ignored;
- (v) The depreciation in one scrip shall not be set off against appreciation in another scrip, at the time of such inter-class transfer, even in respect of the scrips of the same category.

(2) Quoted current investments shall, for the purposes of valuation, be grouped into the following categories, viz.,

- (a) equity shares,
- (b) preference shares,
- (c) debentures and bonds,
- (d) government securities including treasury bills,
- (e) units of mutual fund, and
- (f) others.

Quoted current investments for each category shall be valued at cost or market value whichever is lower. For this purpose, the investments in each category shall be considered scrip-wise and the cost and market value aggregated for all investments in each category. If the aggregate market value for the category is less than the aggregate cost for that category, the net depreciation shall be provided for or charged to the profit and loss account. If the aggregate market value for the category exceeds the aggregate cost for the category, the net appreciation shall be ignored. Depreciation in one category of investments shall not be set off against appreciation in another category.

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(3) Unquoted equity shares in the nature of current investments shall be valued at cost or break up value, whichever is lower. However, non-banking financial companies may substitute fair value for the break up value of the shares, if considered necessary. Where the balance sheet of the investee company is not available for two years, such shares shall be valued at one Rupee only.

(4) Unquoted preference shares in the nature of current investments shall be valued at cost or face value, whichever is lower.

(5) Investments in unquoted Government securities or Government guaranteed bonds shall be valued at carrying cost.

(6) Unquoted investments in the units of mutual funds in the nature of current investments shall be valued at the net asset value declared by the mutual fund in respect of each particular scheme.

(7) Commercial papers shall be valued at carrying cost.

(8) A long term investment shall be valued in accordance with the Accounting Standard issued by ICAI.

Note: Unquoted debentures shall be treated as term loans or other type of credit facilities depending upon the tenure of such debentures for the purpose of income recognition and asset classification.

Need for Policy on Demand/Call Loans

7. (1) The Board of Directors of every non-banking financial company granting/intending to grant demand/call loans shall frame a policy for the company and implement the same.

(2) Such policy shall, inter alia, stipulate the following, -

- i. A cut off date within which the repayment of demand or call loan shall be demanded or called up;
- ii. The sanctioning authority shall, record specific reasons in writing at the time of sanctioning demand or call loan, if the cut off date for demanding or calling up such loan is stipulated

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beyond a period of one year from the date of sanction;

- iii. The rate of interest which shall be payable on such loans;
- iv. Interest on such loans, as stipulated shall be payable either at monthly or quarterly rests;
- v. The sanctioning authority shall, record specific reasons in writing at the time of sanctioning demand or call loan, if no interest is stipulated or a moratorium is granted for any period;
- vi. A cut off date, for review of performance of the loan, not exceeding six months commencing from the date of sanction;
- vii. Such demand or call loans shall not be renewed unless the periodical review has shown satisfactory compliance with the terms of sanction.

Asset Classification

8. (1) Every non-banking financial company shall, after taking into account the degree of well defined credit weaknesses and extent of dependence on collateral security for realisation, classify its lease/hire purchase assets, loans and advances and any other forms of credit into the following classes, namely,:

- (i) Standard assets;
- (ii) Sub-standard assets;
- (iii) Doubtful assets; and
- (iv) Loss assets.

(2) The class of assets referred to above shall not be upgraded merely as a result of rescheduling, unless it satisfies the conditions required for the upgradation.

Provisioning requirements

9. Every non-banking financial company shall, after taking into account the time lag between an account becoming non-performing, its recognition as such, the realisation of the

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security and the erosion over time in the value of security charged, make provision against sub-standard assets, doubtful assets and loss assets as provided hereunder:

Loans, advances and other credit facilities including bills purchased and discounted

(1) The provisioning requirement in respect of loans, advances and other credit facilities including bills purchased and discounted shall be as under:

- (i) **Loss Assets** The entire asset shall be written off. If the assets are permitted to remain in the books for any reason, 100% of the outstanding should be provided for;
- (ii) **Doubtful Assets**
 - (a) 100% provision to the extent to which the advance is not covered by the realisable value of the security to which the non-banking financial company has a valid recourse shall be made. The realisable value is to be estimated on a realistic basis;
 - (b) In addition to item (a) above, depending upon the period for which the asset has remained doubtful, provision to the extent of 20% to 50% of the secured portion (i.e. estimated realisable value of the outstanding) shall be made on the following basis:

Period for which the asset has been considered as doubtful	% of Provision
Upto one year	20
One to three years	30
More than three years	50

- (iii) **Sub-standard assets** A general provision of 10% of total outstanding shall be made.

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Lease and hire purchase assets

(2) The provisioning requirements in respect of hire purchase and leased assets shall be as under:

Hire purchase assets

- (i) In respect of hire purchase assets, the total dues (overdue and future instalments taken together) as reduced by
- a. the finance charges not credited to the profit and loss account and carried forward as unmatured finance charges; and
 - b. the depreciated value of the underlying asset,
- shall be provided for.

Explanation :

For the purpose of this paragraph,

1. the depreciated value of the asset shall be notionally computed as the original cost of the asset to be reduced by depreciation at the rate of twenty per cent per annum on a straight line method; and
2. in the case of second hand asset, the original cost shall be the actual cost incurred for acquisition of such second hand asset.

Additional provision for hire purchase and leased assets

(ii) In respect of hire purchase and leased assets, additional provision shall be made as under:

- | | |
|--|----------------------------------|
| (a) Where hire charges or leaserentals are overdue upto 12 months | Nil |
| (b) where hire charges or lease rentals are overdue for more than 12 months but upto 24 months | 10 percent of the net book value |
| (c) where hire charges or lease rentals are overdue for more than 24 months but upto 36 months | 40 percent of the net book value |
| (d) where hire charges or lease rentals are overdue for more than 36 months but upto 48 months | 70 percent of the net book value |

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- (e) where hire charges or lease rentals are 100 percent of
overdue for more than 48 months the net book
value
- (iii) On expiry of a period of 12 months after the due date of the last instalment of hire purchase/leased asset, the entire net book value shall be fully provided for.

Notes:

1. The amount of caution money/margin money or security deposits kept by the borrower with the non-banking financial company in pursuance of the hire purchase agreement may be deducted against the provisions stipulated under clause (i) above, if not already taken into account while arriving at the equated monthly instalments under the agreement. The value of any other security available in pursuance to the hire purchase agreement may be deducted only against the provisions stipulated under clause (ii) above.
2. The amount of security deposits kept by the borrower with the non-banking financial company in pursuance to the lease agreement together with the value of any other security available in pursuance to the lease agreement may be deducted only against the provisions stipulated under clause (ii) above.
3. It is clarified that income recognition on and provisioning against NPAs are two different aspects of prudential norms and provisions as per the norms are required to be made on NPAs on total outstanding balances including the depreciated book value of the leased asset under reference after adjusting the balance, if any, in the lease adjustment account. The fact that income on an NPA has not been recognised cannot be taken as reason for not making provision.
4. An asset which has been renegotiated or rescheduled as referred to in paragraph (2) (1) (xvi) (b) of these Directions shall be a sub-standard asset or continue to remain in the same category in which it was prior to its renegotiation or reschedulement as a doubtful asset or a

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loss asset as the case may be. Necessary provision is required to be made as applicable to such asset till it is upgraded.

5. The balance sheet to be prepared by the non-banking financial company may be in accordance with the provisions contained in sub-paragraph (2) of paragraph 10.
6. All financial leases written on or after April 1, 2001 attract the provisioning requirements as applicable to hire purchase assets.

“9A. Every Non Banking Financial Company shall make provision for standard assets at 0.25 percent of the outstanding, which shall not be reckoned for arriving at net NPAs. The provision towards standard assets need not be netted from gross advances but shall be shown separately as ‘Contingent Provisions against Standard Assets’ in the balance sheet.”

Disclosure in the balance sheet

10. (1) Every non-banking financial company shall separately disclose in its balance sheet the provisions made as per paragraph 9 above without netting them from the income or against the value of assets.

(2) The provisions shall be distinctly indicated under separate heads of account as under:

- (i) provisions for bad and doubtful debts; and
- (ii) provisions for depreciation in investments.

(3) Such provisions shall not be appropriated from the general provisions and loss reserves held, if any, by the non-banking financial company.

(4) Such provisions for each year shall be debited to the profit and loss account. The excess of provisions, if any, held under the heads general provisions and loss reserves may be written back without making adjustment against them.

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Constitution of Audit Committee by non-banking financial companies

11. A non-banking financial company having assets of Rs. 50 crore and above as per its last audited balance sheet shall constitute an Audit Committee, consisting of not less than three members of its Board of Directors.

Explanation I: The Audit Committee constituted by a non-banking financial company as required under Section 292A of the Companies Act, 1956 (1 of 1956) shall be the Audit Committee for the purposes of this paragraph.

Explanation II: The Audit Committee constituted under this paragraph shall have the same powers, functions and duties as laid down in Section 292A of the Companies Act, 1956 (1 of 1956).

Accounting year

12. Every non-banking financial company shall prepare its balance sheet and profit and loss account as on March 31 every year. Whenever a non-banking financial company intends to extend the date of its balance sheet as per provisions of the Companies Act, it should take prior approval of the Reserve Bank of India before approaching the Registrar of Companies for this purpose.

Further, even in cases where the Bank and the Registrar of Companies grant extension of time, the non-banking financial company shall furnish to the Bank a proforma balance sheet (unaudited) as on March 31 of the year and the statutory returns due on the said date.

"Every non-banking financial company shall finalise its balance sheet within a period of 3 months from the date to which it pertains".

Schedule to the balance sheet

13. Every non-banking financial company shall append to its balance sheet prescribed under the Companies Act, 1956, the particulars in the schedule as set out in Annex 1.

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Transactions in Government securities

14. Every non-banking financial company may undertake transactions in Government securities through its CSGL account or its demat account: provided that no non-banking financial company shall undertake any transaction in government security in physical form through any broker.

Submission of a certificate from Statutory Auditor to the Bank

15. Every non-banking financial company shall submit a Certificate from its Statutory Auditor that it is engaged in the business of non-banking financial institution requiring it to hold a Certificate of Registration under Section 45-IA of the RBI Act. A certificate from the Statutory Auditor in this regard with reference to the position of the company as at end of the financial year ended March 31 may be submitted to the Regional Office of the Department of Non-Banking Supervision under whose jurisdiction the non-banking financial company is registered, ["within one month from the date of finalization of the balance sheet and in any case not later than December 30th of that year".] Such certificate shall also indicate the asset / income pattern of the non-banking financial company for making it eligible for classification as Asset Finance Company, Investment Company or Loan Company.

Requirement as to capital adequacy

16. (1) Every non-banking financial company shall maintain a minimum capital ratio consisting of Tier I and Tier II capital which shall not be less than twelve per cent of its aggregate risk weighted assets on balance sheet and of risk adjusted value of off-balance sheet items.

"[Such ratio shall not be less than fifteen percent by March 31, 2012.]"^Z

(2) The total of Tier II capital, at any point of time, shall not exceed one hundred per cent of Tier I capital.

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Explanations:

On balance sheet assets

(1) In these Directions, degrees of credit risk expressed as percentage weightages have been assigned to balance sheet assets. Hence, the value of each asset/item requires to be multiplied by the relevant risk weights to arrive at risk adjusted value of assets. The aggregate shall be taken into account for reckoning the minimum capital ratio. The risk weighted asset shall be calculated as the weighted aggregate of funded items as detailed hereunder:

Weighted risk assets - On-Balance Sheet items		Percentage weight
(i)	Cash and bank balances including fixed deposits and certificates of deposits with banks	0
(ii)	Investments	
(a)	Approved securities [Except at (c) below]	0
(b)	Bonds of public sector banks	20
(c)	Fixed deposits/certificates of deposits/ bonds of public financial institutions	100
(d)	Shares of all companies and debentures/bonds/ commercial papers of all companies and units of all mutual funds	100
(iii)	Current assets	
(a)	Stock on hire (net book value)	100
(b)	Inter-corporate loans/deposits	100
(c)	Loans and advances fully secured against deposits held by the company itself	0
(d)	Loans to staff	0
(e)	Other secured loans and advances considered good	100
(f)	Bills purchased/discounted	100

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	(g) Others (To be specified)	100
(iv)	Fixed Assets (net of depreciation)	
	(a) Assets leased out (net book value)	100
	(b) Premises	100
	(c) Furniture & Fixtures	100
(v)	Other assets	
	(a) Income tax deducted at source (net of provision)	0
	(b) Advance tax paid (net of provision)	0
	(c) Interest due on Government securities	0
	(d) Others (to be specified)	100

Notes:

- (1) Netting may be done only in respect of assets where provisions for depreciation or for bad and doubtful debts have been made.
- (2) Assets which have been deducted from owned fund to arrive at net owned fund shall have a weightage of 'zero'.
- (3) While calculating the aggregate of funded exposure of a borrower for the purpose of assignment of risk weight, non-banking financial companies may net off the amount of cash margin / caution money/security deposits (against which right to set-off is available) held as collateral against the advances out of the total outstanding exposure of the borrower.
- ["(4) The counterparty credit risk, arising out of exposure of NBFCs to CCIL on account of securities financing transactions (CBLOs) will carry a risk weight of zero, as it is presumed that the CCP's exposures to their counterparties are fully collateralised on a daily basis, thereby providing protection for the CCP's credit risk exposures. The deposits / collaterals kept by NBFCs with CCIL will attract a risk weight of 20%"].

Off-balance sheet items

- (2) In these Directions, degrees of credit risk exposure attached to off-balance sheet items have been expressed as percentage of credit conversion factor. Hence, the face value of

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each item requires to be first multiplied by the relevant conversion factor to arrive at risk adjusted value of off-balance sheet item. The aggregate shall be taken into account for reckoning the minimum capital ratio. This shall have to be again multiplied by the risk weight of 100. The risk adjusted value of the off-balance sheet items shall be calculated as per the credit conversion factors of non-funded items as detailed hereunder:-

Nature of item	Credit conversion factor – Percentage
i) Financial & other guarantees	100
ii) Share/debenture underwriting obligations	50
iii) Partly-paid shares/debentures	100
iv) Bills discounted/rediscounted	100
v) Lease contracts entered into but yet to be executed	100
vi) Other contingent liabilities (To be specified)	50

Note: Cash margins/deposits shall be deducted before applying the conversion factor.

Loans against non-banking financial company's own shares prohibited

17. (1) No non-banking financial company shall lend against its own shares.

(2) Any outstanding loan granted by a non-banking financial company against its own shares on the date of commencement of these Directions shall be recovered by the non-banking financial company as per the repayment schedule.

Non-banking financial company failing to repay public deposit prohibited from making loans and investments

18. A non-banking financial company which has failed to repay any public deposit or part thereof in accordance with the terms and conditions of such deposit, as provided in Section 45QA(1) of the Reserve Bank of India Act, 1934 (2 of 1934) shall not grant any loan or other credit facility by whatever name called or make any investment or create any other asset as long as the default exists.

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Restrictions on investments in land and building and Unquoted shares

19. (i) No Asset Finance Company, which is accepting public deposit, shall, invest in -

- (a) land or building, except for its own use, an amount exceeding ten percent of its owned fund;
- (b) unquoted shares of another company, which is not a subsidiary company or a company in the same group of the non-banking financial company, an amount exceeding ten percent of its owned fund.

(ii) No loan company or investment company, which is accepting public deposit, shall, invest in -

- (a) land or building, except for its own use, an amount exceeding ten percent of its owned fund ;
- (b) unquoted shares of another company, which is not a subsidiary company or a company in the same group of the non-banking financial company, an amount exceeding twenty percent of its owned fund:

Provided that the land or building or unquoted shares acquired in satisfaction of its debts shall be disposed off by the non-banking financial company within a period of three years or within such period as extended by the Bank, from the date of such acquisition if the investment in these assets together with such assets already held by the non-banking financial company exceeds the above ceiling;

Explanation

While calculating the ceiling on investment in unquoted shares, investments in such shares of all companies shall be aggregated.

Provided further that the ceiling on the investment in unquoted shares shall not be applicable to an Asset Finance Company or a loan company or an investment company in respect of investment in the equity capital of an insurance company upto the extent specifically permitted, in writing, by the Reserve Bank of India.

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"NBFCs not to be partners in partnership firms"

19A. (1) No non-banking financial company, which is accepting public deposit shall contribute to the capital of a partnership firm or become a partner of such firm.

(2) A non-banking financial company, which is accepting public deposit and which had already contributed to the capital of a partnership firm or was a partner of a partnership shall seek early retirement from the partnership firm.

Concentration of credit/investment

20. (1) No non-banking financial company shall,

- (i) lend to
 - (a) any single borrower exceeding fifteen per cent of its owned fund; and
 - (b) any single group of borrowers exceeding twenty five per cent of its owned fund;
- (ii) invest in
 - (a) the shares of another company exceeding fifteen per cent of its owned fund; and
 - (b) the shares of a single group of companies exceeding twenty five per cent of its owned fund;
- (iii) lend and invest (loans/investments taken together) exceeding
 - (a) twenty five per cent of its owned fund to a single party; and
 - (b) forty per cent of its owned fund to a single group of parties.

Provided that the ceiling on credit/investment concentration shall not be applicable to a residuary non-banking company in respect of investments in approved securities, bonds, debentures and other securities issued by a Government company or a public financial institution or a scheduled commercial bank under the provisions of paragraphs 6(1)(a) and 6(1)(b) of the Residuary Non-Banking Companies (Reserve Bank) Directions, 1987.

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Provided further that the ceiling on the investment in shares of another company shall not be applicable to a non-banking financial company in respect of investment in the equity capital of an insurance company upto the extent specifically permitted, in writing, by the Reserve Bank of India.

Provided further that any non-banking financial company, classified as Asset Finance Company by the Reserve Bank of India, may in exceptional circumstances, exceed the above ceilings on credit/investment concentration to a single party or a single group of parties by 5 per cent of its owned fund, with the approval of its Board.

Notes :

- (1) For determining the limits, off-balance sheet exposures shall be converted into credit risk by applying the conversion factors as explained in paragraph 16.
- (2) The investments in debentures for the purposes specified in this paragraph shall be treated as credit and not investment.
- (3) These ceilings shall be applicable to the credit/investment by such a non-banking financial company to companies/firms in its own group as well as to the borrowers/ investee company's group.

Submission of half yearly return

21. Non-banking financial companies including residuary non-banking companies referred to in paragraphs 1(3)(i)(a) and (b) shall submit a half-yearly return within three months of the expiry of the relative half-year as on September and March every year, in the format NBS 2 provided in Annex 2 to the Regional Office of the Department of Non-Banking Supervision of the Reserve Bank of India under whose jurisdiction the registered office of the company is located as per Second Schedule to the Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998 and Schedule B to Residuary Non-Banking Companies (Reserve Bank) Directions, 1987.

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Exposure to Capital Market

22. Every non-banking financial company (including residuary non-banking company) with total assets of Rs. 100 crore and above according to the previous audited balance sheet, shall submit a monthly return within a period of 7 days of the expiry of the month to which it pertains in the format NBS 6 provided in Annex 3 to the Regional Office of the Department of Non-Banking Supervision of the Reserve Bank of India as indicated in the Second Schedule to the Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998 and Schedule B to the Residuary Non-Banking Companies (Reserve Bank) Directions, 1987.

Norms relating to Infrastructure loan

23. (1) Applicability

- (i) These norms shall be applicable to restructuring and/or rescheduling and/or renegotiation of the terms of agreement relating to infrastructure loan, as defined in paragraph 2(1)(viii) of these Directions which is fully or partly secured standard and sub-standard asset and to the loan, which is subjected to restructuring and/or rescheduling and/or renegotiation of terms.
- (ii) Where the asset is partly secured, a provision to the extent of shortfall in the security available shall be made while restructuring and/or rescheduling and/or renegotiation of the loans, apart from the provision required on present value basis and as per prudential norms.

(2) Restructuring, reschedulement or renegotiation of terms of infrastructure loan.

The non-banking financial companies may, not more than once, restructure or reschedule or renegotiate the terms of infrastructure loan agreement as per the policy framework laid down by the Board of Directors of the company under the following stages:

- (a) before commencement of commercial production;

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- (b) after commencement of commercial production but before the asset has been classified as sub-standard;
- (c) after commencement of commercial production and the asset has been classified as sub-standard:

Provided that in each of the above three stages, the restructuring and/or rescheduling and/or renegotiation of principal and / or of interest may take place, with or without sacrifice, as part of the restructuring or rescheduling or renegotiating package evolved.

(3) Treatment of restructured standard loan

The rescheduling or restructuring or renegotiation of the instalments of principal alone, at any of the aforesaid first two stages shall not cause a standard asset to be re-classified in the sub-standard category, if the project is re-examined and found to be viable by the Board of Directors of the company or by a functionary at least one step senior to the functionary who sanctioned the initial loan for the project, within the policy framework laid down by the Board:

Provided that rescheduling or renegotiation or restructuring of interest element at any of the foregoing first two stages shall not cause an asset to be downgraded to sub-standard category subject to the condition that the amount of interest foregone, if any, on account of adjustment in the element of interest as specified later, is either written off or 100 per cent provision is made thereagainst.

(4) Treatment of restructured sub-standard asset

A sub-standard asset shall continue to remain in the same category in case of restructuring or rescheduling or renegotiation of the instalments of principal until the expiry of one year and the amount of interest foregone, if any, on account of adjustment, including adjustment by way of write off of the past interest dues, in the element of interest as specified later, shall be written off or 100 per cent provision made thereagainst.

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(5) Adjustment of interest

Where rescheduling or renegotiation or restructuring involves a reduction in the rate of interest, the interest adjustment shall be computed by taking the difference between the rate of interest as currently applicable to infrastructure loan (as adjusted for the risk rating applicable to the borrower) and the reduced rate and aggregating the present value (discounted at the rate currently applicable to infrastructure loan, adjusted for risk enhancement) of the future interest payable so stipulated in the restructuring or rescheduling or renegotiation proposal.

(6) Funded Interest:

In the case of funding of interest in respect of NPAs, where the interest funded is recognized as income, the interest funded shall be fully provided for.

(7) Income Recognition norms

The income recognition in respect of infrastructure loan shall be governed by the provisions of paragraph 3 of these Directions;

(8) Treatment of Provisions held

The provisions held by the non-banking financial companies against non-performing infrastructure loan, which may be classified as 'standard' in terms of sub-paragraph (3) hereinabove, shall continue to be held until full recovery of the loan is made.

(9) Eligibility for upgradation of restructured sub-standard infrastructure loan

The sub-standard asset subjected to rescheduling and/or renegotiation and/or restructuring, whether in respect of instalments of principal amount, or interest amount, by whatever modality, shall not be upgraded to the standard category until expiry of one year of satisfactory performance under the restructuring and/or rescheduling and/or renegotiation terms.

(10) Conversion of debt into equity

Where the amount due as interest, is converted into equity or any other instrument, and income is recognized in

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consequence, full provision shall be made for the amount of income so recognized to offset the effect of such income recognition:

Provided that no provision is required to be made, if the conversion of interest is into equity which is quoted;

Provided further that in such cases, interest income may be recognized at market value of equity, as on the date of conversion, not exceeding the amount of interest converted to equity.

(11) Conversion of debt into debentures

Where principal amount and/or interest amount in respect of NPAs is converted into debentures, such debentures shall be treated as NPA, ab initio, in the same asset classification as was applicable to the loan just before conversion and provision shall be made as per norms.

(12) Increase in exposure limits for Infrastructure related loan and investment.

The non-banking financial companies may exceed the concentration of credit/investment norms, as provided in paragraph 20 of these Directions, by 5 per cent for any single party and by 10 per cent for a single group of parties, if the additional exposure is on account of infrastructure loan and/ or investment.

(13) Risk weight for investment in AAA rated securitized paper

The investment in “AAA” rated securitized paper pertaining to the infrastructure facility shall attract risk weight of 50 per cent for capital adequacy purposes subject to the fulfilment of the following conditions:

- (i) The infrastructure facility generates income / cash flows, which ensures servicing / repayment of the securitized paper.
- (ii) The rating by one of the approved credit rating agencies is current and valid.

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Explanation:

The rating relied upon shall be deemed to be current and valid, if the rating is not more than one month old on the date of opening of the issue, and the rating rationale from the rating agency is not more than one year old on the date of opening of the issue, and the rating letter and the rating rationale form part of the offer document.

- (iii) In the case of secondary market acquisition, the 'AAA' rating of the issue is in force and confirmed from the monthly bulletin published by the respective rating agency.
- (iv) The securitized paper is a performing asset.

Exemptions

24. The Reserve Bank of India may, if it considers it necessary for avoiding any hardship or for any other just and sufficient reason, grant extension of time to comply with or exempt any non-banking financial company or class of non-banking financial companies, from all or any of the provisions of these Directions either generally or for any specified period, subject to such conditions as the Reserve Bank of India may impose.

Interpretations

25. For the purpose of giving effect to the provisions of these Directions, the Reserve Bank of India may, if it considers necessary, issue necessary clarifications in respect of any matter covered herein and the interpretation of any provision of these Directions given by the Reserve Bank of India shall be final and binding on all the parties concerned.

Repeal and saving

26. (1) The Non-Banking Financial Companies Prudential Norms (Reserve Bank) Directions, 1998 shall stand repealed by these Directions.

(2) Notwithstanding such repeal, any circular, instruction, order issued under the Directions in sub-section (1) shall continue to apply to non-banking financial companies in the

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same manner as they applied to such companies before such repeal.

7. Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998

Master Circular: RBI/2011-12/17 DNBS (PD) CC No 223/03.02.001/2011-12 dated July 1, 2011

Link: http://www.rbi.org.in/scripts/BS_ViewMasCirculardetails.aspx?id=6574

The Directions require compliance with certain terms and conditions while accepting deposits from public. The directions give the details of the deposits that would be construed as public deposits.

- NBFC to obtain credit rating for fixed deposits from approved credit rating agencies and inform RBI about any change in the ratings.
- Deposits are to be repayable after a minimum period of one year and not later than 5 years.
- Directions puts a ceiling on the deposit that can be taken by the NBFCs and this would depend upon the type of NBFC and its net owned funds.
- The NBFCs have to adhere to the ceiling on the interest rate that can be offered on their deposits.
- NBFC may, at their discretion, pay interest on overdue deposits which have not been claimed by the depositor on due date.
- NBFC cannot pay brokerage or commission for deposits collected through agents/ brokers.
- NBFC intending to accept public deposits should comply with the provisions of the Non-Banking Financial Companies and Miscellaneous Non-Banking Companies (Advertisement) Rules, 1977 and also give the prescribed particulars in their advertisements.
- There should be a minimum lock-in period of three months.

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- In every report of the Board of Directors laid before the company in a general meeting under sub-section (1) of section 217 of the Companies Act, 1956 (1 of 1956), there shall be included in the case of a non-banking financial company, the following particulars or information, namely :-
 - (i) the total number of accounts of public deposit of the company which have not been claimed by the depositors or not paid by the company after the date on which the deposit became due for repayment; and
 - (ii) the total amounts due under such accounts remaining unclaimed or unpaid beyond the dates referred to in clause (i) as aforesaid.
- Every NBFC is required to open a Constituent Subsidiary General Ledge (CSGL) account with a scheduled Bank or have a account with Stock Holding Corporation of India (SHCIL) for keeping unencumbered approved securities required to be maintained as per Section 45 –IB of RBI Act, 1934.
- NBFC to have a designated banker (Scheduled commercial Bank) and keep the unencumbered deposits with that bank) and the deposits can be withdrawn only for the purpose of repayment of depositors.
- Copies of audited balance sheet, profit and loss account, director's report and auditors report to be submitted to RBI within 15 days of the date of AGM.
- NBFC shall furnish to RBI a copy of the Auditor's report to the Board of Directors and a certificate from its auditor, to the effect that the full amount of liabilities to the depositors of the company, including interest payable thereon, are properly reflected in the balance sheet, and that the company is in a position to meet the amount of such liabilities to the depositors.
- The directions contain the format of the returns that need to be submitted to RBI.
- These directions are not applicable to

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- (a) insurance company
- (b) a loan company, an investment company, an asset finance company not accepting/holding any public deposit:
- (c) an investment company subject to certain conditions

8. Miscellaneous Non-Banking Companies (Reserve Bank) Directions, 1977

Master Circular : RBI/2011-12/24 DNBS (PD) CC No. 230/ 03. 02.001/2011-12 dated July 1, 2011

Link: http://rbi.org.in/scripts/BS_ViewMasCirculardetails.aspx?id=6582

These directions are applicable to every miscellaneous NBFCs which do not fall into any specific category of NBFCs. The extent of application is given in the circular.

A miscellaneous NBFC can accept deposits with a minimum maturity period of 6 months and a maximum period of 36 months subject to certain conditions.

Such NBFC are to maintain a register of deposits and the Board's report should furnish information regarding such deposits accepted by them.

Such deposits are subject to ceiling on the amount of deposit and the interest rate on the deposits.

The NBFCs are to furnish the applicable returns/ reports to RBI within the prescribed period.

The returns to be submitted are given as annexure in the circular.

9. Miscellaneous Instructions to All Non-Banking Financial Companies

Master Circular : RBI/2011-12/30 DNBS (PD) CC No.236 /03.02.001/2011-12 dated July 1, 2011

Link: http://rbi.org.in/scripts/BS_ViewMasCirculardetails.aspx?id=6588

Asset Liability Management (ALM) System for NBFCs - Guidelines

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It was decided to introduce an ALM System for the Non-Banking Financial Companies (NBFCs), as part of their overall system for effective risk management in their various portfolios. The abovementioned guidelines would be applicable to all the NBFCs irrespective of whether they are accepting / holding public deposits or not. However to begin with, NBFCs (engaged in and classified as equipment leasing, hire purchase finance, loan, investment and residuary non-banking companies) meeting the criteria of asset base of Rs.100 crore (whether accepting / holding public deposits or not) or holding public deposits of Rs. 20 crore or more (irrespective of their asset size) as per their audited balance sheet as of 31 March 2001 would be required to put in place the ALM System.

A system of half yearly reporting was put in place in this regard and the first Asset Liability Management return as on 30 September 2002 was to be submitted to RBI by only those NBFCs which are holding public deposits within a month of close of the relevant half year i.e., before 31 October 2002 and continue thereafter in similar manner. The half yearly returns would comprise of three parts :

- (i) Statement of structural liquidity in format ALM
- (ii) Statement of short term dynamic liquidity in format ALM and
- (iii) Statement of Interest Rate Sensitivity in format ALM.

In the case of companies not holding public deposits, separate supervisory arrangements would be made and advised in due course of time.

[Details in DNBS (PD).CC.No.15 /02.01/2000-2001 dated June 27, 2001)

Besides the above the circular contains following instructions:

- (a) Nomination rules under Section 45QB of RBI Act for NBFC deposits**

[Details in DNBS (PD) C.C.No.27/ 02.05 / 2003-04 dated July 28, 2003]

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(b) Safe custody of liquid assets/ Collection of interest on SLR securities

[Details in DNBS (PD) C.C. No. 28 / 02.02 / 2002-03 dated July 31, 2003, DNBS (PD) CC No. 37 / 02.02 / 2003-04 dated May 17, 2004]

(c) Prudential Norms Directions - Preparation of Balance Sheet as on March 31 of every year

Details in DNBS (PD) C.C. No. 43 / 05.02 / 2004-05 dated August 10, 2004]

(d) Certificate of Registration (CoR) issued under Section 45-IA of the RBI Act, 1934 – Continuation of business of NBFI - Submission of Statutory Auditors Certificate - Clarification

[Details in DNBS (PD) C.C. No. 79 / 03.05.002/ 2006-07 dated September 21, 2006 DNBS (PD) C.C. No. 81 / 03.05.002/ 2006-07 dated October 19, 2006]

(e) Operative instructions relating to relaxation/modification in Ready Forward Contracts, Settlement of Government Securities Transactions and Sale of securities allotted in Primary Issues

[Details in DNBS (PD) CC No. 38 /02.02/2003-04 dated June 11, 2004, DNBS (PD) CC No.49 /02.02/2004-05 dated June 9, 2005]

(f) FIMMDA Reporting Platform for Corporate Bond Transactions

SEBI has permitted FIMMDA to set up its reporting platform for corporate bonds. It has also been mandated to aggregate the trades reported on its platform as well as those reported on BSE and NSE with appropriate value addition.

All NBFCs would be required to report their secondary market transactions in corporate bonds done in OTC market, on FIMMDA's reporting platform with effect from September 1, 2007.

[Details in DNBS.PD/ C.C. No. 105/ 03.10.001/2007-08 dated July 31, 2007]

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(g) Prior Public Notice about change in control / management

Need for public notice before (a) closure of the branch/office by any NBFC (b) sale/transfer of ownership by an NBFC

- (a) NBFC should give at least three months public notice prior to the date of closure of any of its branches/ offices in, at least, one leading national news paper and a leading local (covering the place of branch/ office) vernacular language newspaper indicating therein the purpose and arrangements being made to service the depositors etc.

- (b) (i) A public notice of 30 days shall be given before effecting the sale of, or transfer of the ownership by sale of shares, or transfer of control, whether with or without sale of shares. Such public notice shall be given by the NBFC and also by the transferor, or the transferee or jointly by the parties concerned.

For this purpose, the term 'control' shall have the same meaning as defined in Regulation 2(1) (c) of the Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 1997.

- (ii) The public notice should indicate the intention to sell or transfer ownership / control, the particulars of transferee and the reasons for such sale or transfer of ownership / control. The notice should be published in one leading national and another in leading local (covering the place of registered office) vernacular language newspaper.

(h) Change in management and mergers/amalgamation

The following changes are effected in the above instructions in January 2006:

- (i) Merger and amalgamation in terms of the High Court Order.
 - (a) Where merger and amalgamation takes place in terms of the High Court order in pursuance of

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Sections 391 and 394 of the Companies Act 1956, the company shall inform the Bank about merger or amalgamation along with Court's order approving the same within a period of one month from the date of the order. As the public notice is given by the companies under the Companies Act 1956 and Rules made thereunder, no further public notice is required to be given by the companies in terms of the Bank's Circular as mentioned above.

- (b) However there will be no change in other instructions contained in paragraph 5(iii) (b) of the Company Circular DNBS (PD) .CC No.12/02.01/99-2000 dated January 13, 2000.

(i) The Non-Banking Financial Companies (Deposit Accepting) (Approval of Acquisition or Transfer of Control) Directions, 2009.

Short title and commencement of the Directions

- 1. (1) These Directions shall be known as the Non-Banking Financial Companies (Deposit Accepting) (Approval of Acquisition or Transfer of Control) Directions, 2009.
- (2) These Directions shall come into force with immediate effect.

Definitions

- 2. For the purpose of these Directions, unless the context otherwise requires,-
 - (a) "control" shall have the same meaning as is assigned to it under clause (c) of sub-regulation (1) of regulation 2 of Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 1997.
 - (b) "NBFC" means non-banking financial company as defined in clause (xi) of sub-paragraph (1) of Paragraph 2 of Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998.

Prior approval of RBI in cases of acquisition or transfer of control of deposit taking NBFCs

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Any takeover or acquisition of control of a deposit taking NBFC, whether by acquisition of shares or otherwise, or any merger/amalgamation of a deposit taking NBFC with another entity, or any merger/amalgamation of an entity with a deposit taking NBFC, shall require prior written approval of Reserve Bank of India.

Application of other laws not barred

The provisions of these Directions shall be in addition to, and not in derogation of the provisions of any other law, rules, regulations or directions, for the time being in force.

Exemptions

The Reserve Bank of India may, if it considers necessary for avoiding any hardship or for any other just and sufficient reason, exempt any NBFC or class of NBFCs, from all or any of the provisions of these Directions either generally or for any specified period, subject to such conditions as the Reserve Bank of India may impose.

(Details are in Notification No. DNBS.(PD) 208/ CGM(ANR)-2009 dated September 17, 2009))

(ii) Other cases

Where merger and amalgamation or change in the management of the company takes place upon sale / transfer otherwise than as stated in sub-paragraph (i) above, the NBFCs (including RNBCs)(deposit taking and non-deposit taking companies) should give prior public notice of 30 days.

[Details in Company Circular DNBS (PD) CC.No.11/02.01/99-2000 dated November 15, 1999, DNBS (PD) CC No.12/02.01./99-2000 dated January 13, 2000, DNBS (PD) CC No. 63 / 02.02 / 2005-06 dated January 24, 2006 and DNBS (PD) CC No. 82 / 03.02.02 / 2006-07 dated October 27, 2006]

(j) Cover for public deposits – creation of floating charge on Liquid Assets by deposit taking NBFCs

NBFCs raise funds for their operations from various sources like public deposits, bank borrowings, inter-corporate deposits, secured/unsecured debentures, etc.

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In order to ensure protection of depositors interest, NBFCs should ensure that at all times there is full cover available for public deposits accepted by them. While calculating this cover the value of all debentures (secured and unsecured) and outside liabilities other than the aggregate liabilities to depositors may be deducted from the total assets. Further, the assets should be evaluated at their book value or realizable/market value whichever is lower for this purpose. It shall be incumbent upon the NBFC concerned to inform the Regional Office of the Reserve Bank in case the asset cover calculated as above falls short of the liability on account of public deposits.

[Details in DNBS (PD) C.C No. 47/ 02.01/ 2004-05 dated February 07, 2005 and DNBS (PD) C.C No. 87 /03.02.004/2006-07 dated January 4, 2007]

(k) Unsolicited Commercial Communications - National Do Not Call Registry

NBFCs are advised

- (i) not to engage Telemarketers (DSAs/DMAAs) who do not have any valid registration certificate from DoT, Govt of India, as telemarketers;
- (ii) to furnish the list of Telemarketers (DSAs/DMAAs) engaged by them along with the registered telephone numbers being used by them for making telemarketing calls to TRAI; and
- (iii) to ensure that all agents presently engaged by them register themselves with DoT as telemarketers .

[Details in DNBS.PD/ C.C No. 109/ 03.10.001/2007-08 dated November 26, 2007]

(l) Requirement of minimum NOF of Rs. 200 lakh for all deposit taking NBFCs

[DNBS (PD) C.C. No. 114 /03. 02.059 / 2007-08 dated June 17, 2008]

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(m) Reclassification of NBFCs

In terms of Company Circular DNBS.PD. CC No. 85 / 03.02.089 /2006-07 dated December 06, 2006 it was advised that NBFCs financing real / physical assets for productive / economic activity will be classified as Asset Finance Company (AFC) as per the criteria given under paragraph 4 of that circular. Consequent upon re-classification of NBFCs, in the proposed structure the following categories of NBFCs will emerge:

- (i) Asset Finance Company
- (ii) Investment Company
- (iii) Loan Company
- (iv) Infrastructure Finance Company
- (v) Core Investment Companies-ND-SI

[Details in DNBS.PD. CC No. 85 / 03.02.089 /2006-07 dated December 06, 2006 and DNBS.PD. CC No. 128 / 03.02.059 /2008-09 dated September 15, 2008]

(n) Monitoring Framework for non-deposit taking NBFCs with asset size of Rs 50 crore and above but less than Rs 100 crore

[Details in DNBS.PD/ CC.No. 130 / 03.05.002 /2008-09 dated September 24, 2008 and DNBS.PD/ CC.No. 137 / 03.05.002 /2008-09 dated March 02, 2009]

(o) Accounting for taxes on income- Accounting Standard 22- Treatment of deferred tax assets (DTA) and deferred tax liabilities (DTL) for computation of capital

As creation of DTA or DTL would give rise to certain issues impacting the balance sheet of the company, it is clarified that the regulatory treatment to be given to these issues are as under:-

- The balance in DTL account will not be eligible for inclusion in Tier I or Tier II capital for capital adequacy purpose as it is not an eligible item of capital.
- DTA will be treated as an intangible asset and should be deducted from Tier I Capital.

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- NBFCs may keep the above clarifications in mind for all regulatory requirements including computation of CRAR and ensure compliance with effect from the accounting year ending March 31, 2009.

In this connection it is further clarified that

DTL created by debit to opening balance of Revenue Reserves or to Profit and Loss Account for the current year should be included under 'others' of "Other Liabilities and Provisions."

DTA created by credit to opening balance of Revenue Reserves or to Profit and Loss account for the current year should be included under item 'others' of "Other Assets."

Intangible assets and losses in the current period and those brought forward from previous periods should be deducted from Tier I capital.

DTA computed as under should be deducted from Tier I capital:

- (i) DTA associated with accumulated losses; and
- (ii) The DTA (excluding DTA associated with accumulated losses) net of DTL. Where the DTL is in excess of the DTA (excluding DTA associated with accumulated losses), the excess shall neither be adjusted against item (i) nor added to Tier I capital."

[Details in DNBS (PD) C.C. No. 124/ 03.05.002/ 2008-09 dated July 31, 2008 and DNBS.PD/ CC. No. 142/ 03.05.002 /2008-09 dated June 9, 2009]

(p) Introduction of Interest Rate Futures- NBFCs

It has been decided that NBFCs may participate in the designated interest rate futures exchanges recognized by SEBI, as clients, subject to RBI / SEBI guidelines in the matter, for the purpose of hedging their underlying exposures.

NBFCs participating in IRF exchanges may submit the data in this regard half yearly, in the format enclosed, to the Regional office of the Department of Non-Banking Supervision in whose jurisdiction their company is registered, within a period of one month from the close of the half year.

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(Details are in DNBS.PD.CC.No.161 /3.10.01/ 2009-10 dated September 18, 2009)

(q) Compliance with FDI norms-Half yearly certificate from Statutory Auditors of NBFCs

NBFCs are required to submit a certificate from their Statutory Auditors on half yearly basis (half year ending September and March) certifying compliance with the existing terms and conditions of FDI. Such certificate may be submitted not later than one month from the close of the half year to which the certificate pertains, to the Regional Office in whose jurisdiction the head office of the company is registered.

(Details are in DNBS (PD).CC. No 167 /03.10.01 /2009-10 dated February 04, 2010)

(r) Finance for Housing Projects – Incorporating clause in the terms and conditions to disclose in pamphlets/brochures/ advertisements, information regarding mortgage of property to the NBFC

(Details are in DNBS (PD) C.C No. 174 /03.10.001/2009-10 dated May 6, 2010)

(s) Loan facilities to the physically / visually challenged by NBFCs

(DNBS.CC.PD.No. 191 /03.10.01/2010-11 dated July 27, 2010)

(t) Services to persons with Disability –Training Programme for Employees

(DNBS.CC.PD.No.208 /03.10.01/2010-11 dated January 27, 2011)

(u) Submission of data to Credit Information Companies - Format of data to be submitted by Credit Institutions

(DNBS.(PD).CC. No. 200 /03.10.001/2010-11 dated September 17, 2010)

10. Master Circular - Miscellaneous Instructions to NBFC- ND-SI
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Master Circular: RBI/2011-12/29 DNBS (PD) CC No.235/03.10.001/2011-12 dated July 1, 2011

Link : http://rbi.org.in/scripts/BS_ViewMasCirculardetails.aspx?id=6593

1. Financial Regulation of Systemically Important NBFCs and Banks' Relationship with them

The Reserve Bank of India had set up an Internal Group to examine the issues relating to level playing field, regulatory convergence and regulatory arbitrage in the financial sector. Based on the recommendations of the Internal Group and on the basis of the feedback received, final guidelines were issued for implementation on December 12, 2006.

Modifications to the Regulatory Framework

In the light of the concerns that arise out of the divergent regulatory requirements for various aspects of functioning of banks and NBFCs and keeping in view the broad principles for the proposed revision, the following modifications were made in the regulatory framework for NBFCs.

A. Regulatory Framework for Systemically Important NBFCs – ND (NBFC – ND – SI)

(i) Determination of NBFC – ND – SI

All NBFCs – ND with an asset size of Rs. 100 crore and more as per the last audited balance sheet will be considered as a systemically important NBFC – ND (NBFC-ND-SI).

(ii) Capital Adequacy Ratio for NBFCs – ND – SI

NBFCs – ND – SI shall maintain a minimum Capital to Risk-weighted Assets Ratio (CRAR) of 10% which was changed to 12% as on March 31, 2010 and 15% as on March 31, 2011. The present minimum CRAR stipulation at 12 % or 15%, as the case may be, for NBFCs – D shall continue to be applicable.

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(iii) Single/Group Exposure norms for NBFCs – ND – SI

Exposure norms were laid down for NBFC-ND-SIs.

Further, the NBFCs – ND – SI were advised to have a policy in respect of exposures to a single entity / group. NBFCs-ND-SI not accessing public funds both directly and indirectly can apply to the Reserve Bank for an appropriate dispensation consistent with the spirit of the exposure limits.

B. Additional Single Exposure norms for Asset Finance Companies

(iv) In terms of circular DNBS.PD.CC.No.85/03.02.089/2006-2007 dated December 6, 2006, companies financing real/physical assets for productive /economic activity will be classified as Asset Finance Companies (AFCs) as per the criteria prescribed therein.

In addition to the single party and single group of parties exposure norms prescribed for NBFCs-D and NBFCs-ND-SI, AFCs are permitted to exceed the exposure to a single party and single group of parties up to a further 5 percent of their owned fund in exceptional circumstances with the approval of their Boards.

C. Expansion of activities of NBFCs through automatic route

(v) NBFCs set up under the automatic route will be permitted to undertake only those 18 activities which are permitted under the automatic route. Diversification into any other activity would require the prior approval of FIPB. Similarly a company which has entered into an area permitted under the FDI policy (such as software) and seeks to diversify into NBFC sector subsequently would also have to ensure compliance with the minimum capitalization norms and other regulations as applicable.

Effective date and transition

Taking into account the likelihood that some of the NBFCs may not be in compliance with some of the elements of the revised regulatory framework a transition period up to end March 2007 was provided. Accordingly, NBFCs had to comply with all

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elements of the revised framework with effect from April 1, 2007. In case any NBFC – ND – SI needed more time for compliance, it had to apply to DNBS before the close of business on January 31, 2007 clearly indicating the reasons for which it is not able to ensure compliance within the above period and the time frame within which it would be able to comply with all the relevant elements.

Scope of application to certain categories

The guidelines contained in this circular are applicable to the NBFCs as specified in the relevant paragraphs except the categories mentioned below:

- (i). The Residuary Non Banking Companies (RNBCs) and Primary Dealers (PDs) as they are subjected to a separate set of regulations.
- (ii). Government owned companies, as defined under Section 617 of the Companies Act, which are registered with the Reserve Bank of India as NBFCs, are exempted from certain provisions of Non-Banking Financial Companies Prudential Norms (Reserve Bank) Directions, 1998, at present. It is proposed to bring all deposit taking and systemically important government owned companies under the provisions of the said Directions which will be in conformity with the existing guidelines, including those contained in this circular. However, the date from which they are to fully comply with the regulatory framework will be decided later. These companies, were therefore, required to prepare a roadmap for compliance with the various elements of the NBFC regulations, in consultation with the Government, and submit the same to the Reserve Bank (Department of Non Banking Supervision – (DNBS)), by March 31, 2007.

2. Supervisory Framework for Systemically Important non-deposit taking/holding NBFCs (NBFC-ND-SI)

To ensure adherence to compliance with the regulatory framework for Systemically Important NBFCs – ND such companies were advised to put in place a system for

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submission of an annual statement of capital funds, risk asset ratio etc., as at end of March every year in form NBS-7 as per prescribed format. The first such return was to be submitted for the year ending March 31, 2007. The return may be submitted within a period of three months from the close of the financial year, every year.

Such returns are to be submitted electronically and for the purpose, NBFC-ND-SI has to approach the Information Division of Central Office of this Department for assignment of user-id and password for web-enabled submission of the return. A hard copy of the return duly signed by the designated authority may be filed with the Regional Office of the Department of Non-Banking Supervision in whose jurisdiction the company is registered.

3. Guidelines for NBFC-ND-SI as regards capital adequacy, liquidity and disclosure norms

On a review of the experience with the regulatory framework since April 2007, it was felt desirable to enhance the capital adequacy requirement and put in place guidelines for liquidity management and reporting, as also norms for disclosures. Accordingly, the Bank placed on its web-site on June 2, 2008, the draft guidelines for NBFCs-ND-SI as regards the above aspects for receiving the comments of the public. These guidelines were finalized and issued as Non-Banking Financial (Non- Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007.

(i) Capital adequacy

The Capital adequacy for NBFC-ND-SI was enhanced to 12% as on March 31, 2010 and 15% as on March 31, 2011.

(ii) Disclosure in the Balance Sheet

The disclosure norms in respect of NBFCs-ND-SI have been reviewed and it has been decided that such Systemically Important NBFCs-ND shall make additional disclosures in their Balance Sheet from the year ending March 31, 2009 relating to:

Capital to Risk Assets Ratio (CRAR)

Exposure to real estate sector, both direct and indirect; and

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Maturity pattern of assets and liabilities

The format of disclosure of this additional information is furnished in Company Circular DNBS (PD). CC. No.125/03.05.002 / 2008-2009 dated August 1, 2008.

4. Asset Liability Management (ALM) – Reporting

NBFC-ND-Sis are required to submit three ALM returns i.e. ALM 1, ALM-2 and ALM-The periodicity of the Statement of short term dynamic liquidity [NBS-ALM1] shall be monthly and that of Statement of structural liquidity [NBS-ALM2] half-yearly. The frequency of Statement of Interest Rate Sensitivity [NBS-ALM3] would be half yearly, The Bank has since hosted the format of the ALM Returns (I, II and III) on the Bank's following website (<https://cosmos.rbi.org.in>).

(Details are given in DNBS (PD).CC.No.125/03.05.002/2008-2009 dated August 1, 2008 and in DNBS.PD.CC.No.169 /22.05.02/2009-10 dated April 22, 2010)

5. Enhancement of NBFCs' capital raising option for capital adequacy purposes

Taking into consideration, the need for enhanced funds for increasing business and meeting regulatory requirements, it has been decided that Systemically Important Non-Deposit taking Non-Banking Financial Companies (NBFCs-ND-SI) may augment their capital funds by issue of Perpetual Debt Instruments (PDI) in accordance with the guidelines contained in the circular. Such PDI shall be eligible for inclusion as Tier I Capital to the extent of 15% of total Tier I capital as on March 31 of the previous accounting year.

(Details are given in DNBS (PD) CC.No.131 /03.05.002 /2008-2009 dated October 29, 2008)

6. Ratings of NBFCs

NBFCs also issue financial products like Commercial Paper, Debentures etc. to which rating is assigned by rating agencies. The ratings assigned to such products may undergo changes for various reasons ascribed to by the rating agencies. It has

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therefore been decided that all NBFCs (both deposit taking and non-deposit taking) with asset size of Rs 100 crore and above shall furnish the information about downgrading / upgrading of assigned rating of any financial product issued by them, within fifteen days of such a change in rating, to the Regional Office of the Bank under whose jurisdiction their registered office is functioning.

[DNBS (PD) CC.No.134/03.10.001 /2008-2009 dated February 04, 2009]

7. Criteria for deciding NBFC-ND-SI status

A non-deposit taking NBFC with an asset size of less than Rs. 100 crore as on balance sheet date might subsequently add on assets before the next balance sheet date due to several reasons including business expansion plan. It is clarified that once an NBFC reaches an asset size of Rs. 100 crore or above, it shall come under the regulatory requirement for NBFCs-ND-SI as stated above, despite not having such assets as on the date of last balance sheet. Therefore, it is advised that all such non-deposit taking NBFCs may comply with RBI regulations issued to NBFC-ND-SI from time to time, as and when they attain an asset size of Rs. 100 crore, irrespective of the date on which such size is attained.

It is further observed that in a dynamic environment, the asset size of a company can fall below Rs 100 crore in a given month, which may be due to temporary fluctuations and not due to actual downsizing. It is clarified that in such a case the company may continue to submit the Monthly return on Important Financial Parameters to Reserve Bank of India and to comply with the extant directions as applicable to NBFC-ND-SI, till the submission of their next audited balance sheet to Reserve Bank of India and a specific dispensation is received from the Bank in this regard.

(Details are given in DNBS (PD) CC.No.141/03.10.001/2008-09 dated June 4, 2009)

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Ready Forward Contracts in Corporate Debt Securities

1. In terms of 'Repo in Corporate Debt Securities (Reserve Bank) Directions, 2010' dated January 08, 2010 issued by Internal Debt Management Department (IDMD) of RBI, NBFCs registered with RBI (other than Govt companies as defined in Section 617 of the Companies Act, 1956) are eligible to participate in repo transactions in corporate debt securities. IDMD has also issued revised guidelines on uniform accounting for repo / reverse repo transactions on March 23, 2010.

2. NBFCs participating in such repo transactions shall comply with the Directions and accounting guidelines issued by IDMD. Certain clarifications are being made in this regard as given below.

Eligible participants

- (i) NBFCs-ND with asset size of Rs. 100 crore and above (i.e. NBFCs-ND-SI).

Capital Adequacy

- (ii) Risk weights for credit risk for assets that are the collateral for such transactions as well as risk weights for the counterparty credit risk shall be as applicable to the issuer / counterparty in the NBFC (non-deposit accepting or holding) Prudential Norms Directions, 2007 as amended from time to time.

Classification of balances in the accounts

- (iii) Classification of balances in the various accounts viz; repo account, reverse repo account etc. shall be done in the relevant schedules similar to that of banks.

3. In all other matters related to such repo transactions, NBFCs-ND-SI shall follow the Directions and accounting guidelines issued by IDMD viz; Repo in Corporate Debt Securities (Reserve Bank) Directions, 2010 dated January 08, 2010 and Revised Guidelines on Uniform Accounting for Repo / Reverse repo transactions on March 23, 2010 respectively.

(DNBS.PD/ CC.No.196/ 03.05.002 /2010-11 dated August 11, 2010)

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Participation in Currency Options

1. Reserve Bank had issued guidelines to banks on trading in currency options in recognised stock/new exchanges on July 30, 2010.
2. Accordingly, it has been decided that NBFCs may participate in the designated currency options exchanges recognized by SEBI as clients, subject to RBI (Foreign Exchange Department) guidelines in the matter, only for the purpose of hedging their underlying forex exposures. Appropriate disclosures may be made regarding transactions undertaken in the Balance sheet.

(DNBS (PD) CC No.199 / 03.10.001/ 2010-11 dated September 16, 2010)

11. Introduction of New Category of NBFCs - 'Non Banking Financial Company-Micro Finance Institutions' (NBFC-MFIs) – Directions

RBI/2011-12/290 DNBS.CC.PD.No. 250/03.10.01/2011-12 dated December 02, 2011

Link: http://rbi.org.in/scripts/BS_CircularIndexDisplay.aspx?id=6857

Creation of a Separate Category of NBFC-MFI

It has been decided to create a separate category of NBFCs viz; Non Banking Financial Company-Micro Finance Institution (NBFC-MFI). Consequently there would be following categories of NBFCs:

- i. Asset Finance Company (AFC)
- ii. Investment Company (IC)
- iii. Loan Company (LC)
- iv. Infrastructure Finance Company (IFC)
- v. Core Investment Company (CIC)
- vi. Infrastructure Debt Fund- Non- Banking Financial Company (IDF-NBFC)

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- vii. Non-Banking Financial Company - Micro Finance Institution (NBFC-MFI).

Notification DNBS. PD.No.234 / CGM(US)-2011 dated December 02, 2011

These Directions shall be known as the Non-Banking Financial Company -Micro Finance Institutions (Reserve Bank) Directions, 2011.

- ii. These Directions shall come into force with immediate effect.

2. Extent of the Directions

These Directions shall apply to every Non Banking Financial Company-Micro Finance Institution (NBFC-MFI) as defined in these Directions.

3. Definition of NBFC-MFI

An NBFC-MFI is defined as a non-deposit taking NBFC(other than a company licensed under Section 25 of the Indian Companies Act, 1956) that fulfils the following conditions:

- i. Minimum Net Owned Funds of Rs.5 crore. (For NBFC-MFIs registered in the North Eastern Region of the country, the minimum NOF requirement shall stand at Rs. 2 crore).
- ii. Not less than 85% of its net assets are in the nature of “qualifying assets.”

For the purpose of ii. above,

“Net assets” are defined as total assets other than cash and bank balances and money market instruments.

“Qualifying asset” shall mean a loan which satisfies the following criteria:-

- a. *loan disbursed by an NBFC-MFI to a borrower with a rural household annual income not exceeding Rs. 60,000 or urban and semi-urban household income not exceeding Rs. 1,20,000;*
- b. *loan amount does not exceed Rs. 35,000 in the first cycle and Rs. 50,000 in subsequent cycles;*

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- c. *total indebtedness of the borrower does not exceed Rs. 50,000;*
 - d. *tenure of the loan not to be less than 24 months for loan amount in excess of Rs. 15,000 with prepayment without penalty;*
 - e. *loan to be extended without collateral;*
 - f. *aggregate amount of loans, given for income generation, is not less than 75 per cent of the total loans given by the MFIs;*
 - g. *loan is repayable on weekly, fortnightly or monthly instalments at the choice of the borrower*
- iii. Further the income an NBFC-MFI derives from the remaining 15 percent of assets shall be in accordance with the regulations specified in that behalf.
 - iv. An NBFC which does not qualify as an NBFC-MFI shall not extend loans to micro finance sector, which in aggregate exceed 10% of its total assets.

4. Regulatory Framework for NBFC-MFIs

A. Entry Point Norm

As stated above, all new NBFC-MFIs except those in the North Eastern Region of the country should have a minimum Net Owned Funds(NoF) of Rs 5 crore; those located in the North eastern region should have a minimum NoF of Rs. 2 crore for purposes of registration. The existing NBFCs to be classified as NBFC-MFIs will be required to comply with this norm w.e.f April 01, 2012.

B. Prudential Norms

a. Capital Requirement

All new NBFC-MFIs shall maintain a capital adequacy ratio consisting of Tier I and Tier II Capital which shall not be less than 15 percent of its aggregate risk weighted assets. The total of Tier II Capital at any point of time, shall not exceed 100 percent of Tier I Capital. The risk weights for on-balance sheet assets and the credit conversion factor for off-balance sheet items will be as provided in para 16 of the Non-Banking

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Financial (Non-Deposit Accepting or Holding) Companies Prudential Norms (Reserve bank) Directions 2007.

Note:

- i. Among the existing NBFCs to be classified as NBFC-MFIs, those with asset size less than Rs. 100 crore will be required to comply with this norm w.e.f April 01, 2012. Those with asset size of Rs. 100 crore and above are already required to maintain minimum CRAR of 15%.*
- ii. The CRAR for NBFC-MFIs which have more than 25% loan portfolio in the state of Andhra Pradesh will be at 12% for the year 2011-2012 only. Thereafter they have to maintain CRAR at 15%.*

b. Asset Classification and Provisioning Norms:

With effect from April 01, 2012 all NBFC-MFIs shall adopt the following norms(till then they shall follow the asset classification and provisioning norms as given in the Non-Banking Financial (Non-Deposit accepting or holding) Companies Prudential Norms (Reserve Bank) Directions, 2007).

Asset Classification Norms:

- i.** Standard asset means the asset in respect of which, no default in repayment of principal or payment of interest is perceived and which does not disclose any problem nor carry more than normal risk attached to the business;
- ii.** Nonperforming asset means an asset for which, interest/principal payment has remained overdue for a period of 90 days or more.

Provisioning Norms:

The aggregate loan provision to be maintained by NBFC-MFIs at any point of time shall not be less than the higher of a) 1% of the outstanding loan portfolio or b) 50% of the aggregate loan instalments which are overdue for more than 90 days and less than 180 days and 100% of the aggregate loan instalments which are overdue for 180 days or more.

- c.** All other provisions of the Non-Banking Financial (Non-Deposit accepting or holding) Companies Prudential Norms

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(Reserve Bank) Directions, 2007 will be applicable to NBFC-MFIs except as indicated therein.

C. Other Regulations

a. Pricing of Credit

- i. All NBFC-MFIs shall maintain an aggregate margin cap of not more than 12%. The interest cost will be calculated on average fortnightly balances of outstanding borrowings and interest income is to be calculated on average fortnightly balances of outstanding loan portfolio of qualifying assets.
- ii. Interest on individual loans will not exceed 26% per annum and calculated on a reducing balance basis.
- iii. Processing charges shall not be more than 1 % of gross loan amount. Processing charges need not be included in the margin cap or the interest cap.
- iv. NBFC-MFIs shall recover only the actual cost of insurance for group, or livestock, life, health for borrower and spouse. Administrative charges where recovered, shall be as per IRDA guidelines.

12. Non Banking Financial Company-Micro Finance Institutions (NBFC-MFIs) - Provisioning Norms- Extension of time

RBI/2011-12/463 DNBS.PD/ CC.No.263 / 03.10.038 /2011-12 dated March 20, 2012

Link: <http://www.rbi.org.in/scripts/NotificationUser.aspx?Mode=0&Id=7081>

A new category of NBFCs namely 'Non Banking Financial Company-Micro Finance Institutions' (NBFC-MFIs) was introduced vide DNBS.CC.PD.No.250/03.10.01/2011-12 dated December 02, 2011, which also contained guidelines on asset classification and provisioning norms to be adhered to by the MFIs with effect from April 01, 2012. Taking into account the difficulties faced by MFI sector and the representation received by the Bank from them, it has been decided to defer the implementation of asset classification and provisioning norms for NBFC-MFIs to April 01, 2013.

13. Mortgage Guarantee Companies Investment (Reserve Bank) Directions, 2008
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Master Circular: RBI/2011-12/34 DNBS (PD-MGC) C.C. No.10/23.11.01/2011-12 dated **July 1, 2011**

Link: http://www.rbi.org.in/scripts/BS_ViewMasCirculardetails.aspx?id=6566

This Master circular contains the directions relating to the prudential norms relating to investment policy, pattern of investments, income recognition and accounting for investments.

The mortgage companies are required to make investments only in specified securities with a minimum of 25% investment in government securities. The remaining investments may be in corporate bonds, debentures and debt oriented mutual funds with a ceiling of 25% in each category. Further sub limits may be fixed by the Board of the company. The Investments in securities other than the government securities should have a minimum credit rating as assigned by SEBI registered rating agencies. However, a mortgage guarantee company may hold investments in equity shares of any company which may be quoted or unquoted or other unquoted investments acquired in satisfaction of its debts which shall be disposed of by the mortgage guarantee company within a period of three years or within such period as extended by the Bank, from the date of such acquisition.

Accounting:

- (i) Mortgage Guarantee Companies may book income on accrual basis on securities of corporate bodies/public sector undertakings in respect of which the payment of interest and repayment of principal have been guaranteed by the Central Government or a State Government, provided interest is serviced regularly and as such is not in arrears.
- (ii) Mortgage Guarantee Companies may book income from dividend on shares of corporate bodies on accrual basis provided dividend on the shares has been declared by

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the corporate body in its Annual General Meeting and the owner's right to receive payments is established.

- (iii) Mortgage Guarantee Companies may book income from Government securities and bonds and debentures of corporate bodies on accrual basis, where interest rates on these instruments are pre-determined and provided interest is serviced regularly and as such is not in arrears.
- (iv) Mortgage Guarantee Companies should book income from units of mutual funds on cash basis.

Accounting of investments

- (1) All investments shall be marked to market;

Quoted investments shall, for the purposes of valuation, be grouped into the following categories, viz.,

- (a) Government securities including treasury bills,
- (b) Government guaranteed bonds/securities;
- (c) Bonds of banks/ PFIs;
- (d) Debentures/bonds of corporates; and
- (e) Units of mutual fund.

Quoted investments for each category shall be valued at cost or market value whichever is lower. For this purpose, the investments in each category shall be considered scrip-wise and the cost and market value aggregated for all investments in each category. If the aggregate market value for the category is less than the aggregate cost for that category, the net depreciation shall be provided for or charged to the profit and loss account. If the aggregate market value for the category exceeds the aggregate cost for the category, the net appreciation shall be ignored. Depreciation in one category of investments shall not be set off against appreciation in another category.

- (2) Investments in unquoted Government securities or Government guaranteed bonds shall be valued at carrying cost.
- (3) Unquoted investments acquired in satisfaction of its debts shall be valued as under:

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- (a) Unquoted investments in the units of mutual funds shall be valued at the net asset value declared by the mutual fund in respect of each particular scheme;
- (b) Unquoted equity shares shall be valued at cost or break up value, whichever is lower. However, mortgage guarantee companies may substitute fair value for the break up value of the shares, if considered necessary. Where the balance sheet of the investee company is not available for two years, such shares shall be valued at Rupee one per company;
- (c) Unquoted preference shares shall be valued at cost or face value, whichever is lower.

Note: Unquoted debentures shall be treated as term loans or other type of credit facilities depending upon the tenure of such debentures for the purpose of income recognition and asset classification.

The investment policy of the Mortgage guarantee company should be in tune with these directions and approval of the Board.

14. Notification as amended up to June 30, 2011 – “Mortgage Guarantee Company (Reserve Bank) Guidelines, 2008”

Master Circular: RBI/2011-12/32 DNBS (PD-MGC) C.C. No. 8/23.11.01/2011-12 dated July 1, 2011

Link: http://www.rbi.org.in/scripts/BS_ViewMasCirculardetails.aspx?id=6591

The guidelines include guidelines on Registration and Operations of Mortgage Guarantee Company under Section 45L(1)(b) of the Reserve Bank of India Act, 1934 for the formation, registration of mortgage companies, capital structure, Board composition etc.

A mortgage company shall have a capital adequacy ratio of 10% of the risk weighted assets.

A mortgage guarantee company shall maintain at least six percent (6%) of its aggregate risk weighted assets of on

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balance sheet and of risk adjusted value of off-balance sheet items as Tier I capital.

The mortgage guarantee company shall also comply with all the relevant Accounting Standards and Guidance Notes issued by the Institute of Chartered Accountants of India from time to time.

No single guarantee shall exceed 10% of the company's Tier I and Tier II capital.

Mortgage guarantee companies shall not accept public deposits.

Mortgage guarantee companies shall not avail External Commercial Borrowings.

Creation and maintenance of Reserves

Contingency Reserves

A mortgage guarantee company shall create and maintain a "Contingency Reserve" on an ongoing basis. The mortgage guarantee company:

- (a) Shall appropriate each year **at least** forty percent (40%) of the premium or fee earned during that accounting year or twenty five percent (25%) of the profit (after provisions and tax), whichever is higher, to the Contingency Reserve;
- (b) In case of inadequate profits, such appropriation shall either result in or increase the amount of carry forward loss;
- (c) May appropriate a lower percentage of the premium or fee earned during any accounting year when the provisions made each year towards losses on account of settlement of mortgage guarantee claims exceeds thirty-five percent (35%) of the premium or fee earned during that accounting year;
- (d) Shall ensure that the Contingency Reserve is built up to **at least five percent** (5%) of the total outstanding mortgage guarantee commitments;

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- (e) Shall retain the amounts appropriated each year to the Contingency Reserve for a minimum period of seven (7) subsequent years which shall be eligible for reversal only in the eighth year subject to the condition in (d) above;
- (f) Shall utilize the Contingency Reserve only with the prior approval of the Reserve Bank of India;
- (g) Shall show the amount of 'Contingency Reserve' as a separate line item on the liability side of the balance sheet; however, Contingency Reserve may be treated as 'free reserve' for the purpose of net owned fund.

Accounting of Unearned Premium

A mortgage guarantee company shall account the premium or fee on the mortgage guarantee contracts as an income in the profit and loss account in accordance with the Accounting Standards issued by the Institute of Chartered Accountants of India. The amount of unearned premium shall be shown as a separate line on the liability side of the balance sheet.

Provision for losses on invoked guarantees

A mortgage guarantee company is exposed to a potential loss when its guarantee is invoked. Mortgage guarantee companies shall hold provisions for losses in respect of such invoked guarantees pending recovery of assets. The amount of provisions required to be held shall be equal to the contract-wise aggregate of 'amount of invocation' after adjusting the realisable value of the assets held by the company in respect of each housing loan where the guarantee has been invoked. In case the realisable value of the assets held in respect of any invoked guarantee is more than the amount of invocation, the excess shall not be adjusted against the shortfall in other invoked guarantees. In case the amount of provisions already held is in excess of the amount as computed above, the excess shall not be reversed. The amount of provisions made each year shall be shown as a separate line item in the Profit and Loss Account. The amount of provision held for losses on settlement of invoked guarantees shall be shown as a separate line item on the liability side of the balance sheet.

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Provision for 'Incurred But-Not-Reported (IBNR) losses'

A mortgage guarantee company is exposed to a potential loss when there is a default in a housing loan guaranteed by it. Mortgage guarantee companies shall hold provisions in respect of such defaulted housing loans where the trigger event is yet to occur or the guarantee is yet to be invoked. The potential loss to which the guarantee company is exposed to is referred to as 'Incurred-But-Not-Reported (IBNR) losses'. The amount of provisions required to be held shall be arrived at on an actuarial basis depending upon the estimates of loss frequency and loss severity for incurred but not reported losses which are derived from historic data, trends, economic factors and other statistical data in relation to paid claims, the provisions held for claims settled, risk statistics, etc. In case the amount of provisions already held is in excess of the amount as computed above, the excess shall not be reversed. The amount of provisions made each year shall be shown as a separate line item in the Profit and Loss Account. The amount of provision held for Incurred But-Not-Reported (IBNR) losses shall be shown as a separate line item on the liability side of the balance sheet.

A mortgage guarantee company is required to maintain Register of guarantees containing details of borrower

A mortgage guarantee company shall not pay commissions, rebates, or other inducements for referral of mortgage guarantee business to any person.

A mortgage guarantee company shall constitute an Audit Committee consisting of not less than three non-executive Directors of the Board of the company, at least one of whom will be a Chartered Accountant.

15. Mortgage Guarantee Companies Prudential Norms (Reserve Bank) Directions, 2008
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Master Circular: RBI/2011-12/33 DNBS (PD-MGC) C.C. No. 9/23.11.01/2011-12 dated July 1, 2011

Link: http://rbi.org.in/scripts/BS_ViewMasCirculardetails.aspx?id=5844

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Short title, commencement and applicability of the directions

1. (i) These directions shall be known as the "Mortgage Guarantee Companies Prudential Norms (Reserve Bank) Directions, 2008".

(ii) These directions shall come into force with immediate effect and shall apply to every Mortgage Guarantee Company which has been granted Certificate of Registration under the scheme of Registration of Mortgage Guarantee Companies by the Reserve Bank of India.

Definitions

2. (1) For the purpose of these directions, unless the context otherwise requires:

- (i) "doubtful asset" means an asset which remains a sub-standard asset for a period exceeding 12 months;
- (ii) "hybrid debt capital instrument" means capital instrument which possesses certain characteristics of equity as well as of debt;
- (iii) "loss asset" means:
 - (a) an asset which has been identified as loss asset by the mortgage guarantee company or its internal or external auditor or by the Reserve Bank of India, to the extent it is not written off by the mortgage guarantee company; and
 - (b) an asset which is adversely affected by a potential threat of non-recoverability for reasons like erosion in the value of security or non availability of security or due to any fraudulent act or omission on the part of the borrower, etc.;
- (iv) "Mortgage Guarantee Company" means as defined in paragraph 2(1)(i) of the Mortgage Guarantee Company (Reserve Bank) Guidelines, 2008;
- (v) (i) For the purpose of these directions 'net owned fund' means:

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- (a) the aggregate of the paid-up equity capital and free reserves as disclosed in the latest balance sheet of the company after deducting therefrom-
 - (i) accumulated balance of loss;
 - (ii) deferred revenue expenditure; and
 - (iii) other intangible assets; and
- (b) further reduced by the amounts representing-
 - (1) investments of such company in shares of-
 - (i) its subsidiaries;
 - (ii) companies in the same group;
 - (iii) all other non-banking financial companies; and (2) the book value of debentures, bonds, outstanding loans and advances (including hire-purchase and lease finance) made to, and deposits with-
 - (i) subsidiaries of such company; and
 - (ii) companies in the same group, to the extent such amount exceeds ten per cent, of (a) above.
 - (II) "subsidiaries" and "companies in the same group" shall have the same meanings assigned to them in the Companies Act, 1956 (1 of 1956).]
- (vi) 'non-performing asset' (NPA) in respect of mortgage guarantee asset means, an asset acquired from the credit institution on the happening of trigger event which is straight away classified as non-performing asset and shall thereafter be classified according to the age of NPA;
- (vii) "owned fund" means paid up equity capital, free reserves including contingency reserves maintained as per paragraph 18 of the Guidelines on Registration and Operations of Mortgage Guarantee Company, balance in share premium account and capital reserves representing surplus arising out of sale proceeds of asset, excluding reserves created by revaluation of asset, as reduced by accumulated loss balance, book value of intangible assets and deferred revenue expenditure, if any;

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- (viii) “standard asset” means the asset in respect of which, no default in repayment of principal or payment of interest is perceived and which does not disclose any problem nor carry more than normal risk attached to the business;
- (ix) “sub-standard asset in respect of mortgage guarantee asset” means an asset which has been classified as non-performing asset for a period not exceeding 12 months;
- (x) "subordinated debt" means an instrument, which is fully paid up, is unsecured and is subordinated to the claims of other creditors and is free from restrictive clauses and is not redeemable at the instance of the holder or without the consent of the supervisory authority of the mortgage guarantee company. The book value of such instrument shall be subjected to discounting as provided hereunder:

Remaining Maturity of the instruments	Rate of discount
(a) Upto one year	100%
(b) More than one year but upto two years	80%
(c) More than two years but upto three years	60%
(d) More than three years but upto four years	40%
(e) More than four years but upto five years	20%

to the extent such discounted value does not exceed fifty per cent of Tier I capital;
- (xi) “substantial interest” means holding of a beneficial interest by an individual or his spouse or minor child, whether singly or taken together in the shares of a company, the amount paid up on which exceeds ten per cent of the paid up capital of the company; or the capital subscribed by all the partners of a partnership firm;
- (xii) “Tier I Capital” means owned fund as reduced by investment in shares of other non-banking financial companies and in shares, debentures, bonds, outstanding loans and advances including hire purchase and lease finance made to and deposits with subsidiaries and companies in the same group exceeding, in aggregate, ten per cent of the owned fund;

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Note;- Investment in shares of subsidiaries, companies in the same group and other NBFCs refers to that which has been acquired by the mortgage guarantee company in satisfaction of debt;

(xiii) "Tier II Capital" includes the following:-

- (a) preference shares;
- (b) revaluation reserves at discounted rate of fifty five percent;
- (c) general provisions and loss reserves to the extent these are not attributable to actual diminution in value or identifiable potential loss in any specific asset and are available to meet unexpected losses and provisions made on standard assets, to the extent of one and one fourth percent of risk weighted assets;
- (d) hybrid debt capital instruments; and
- (e) subordinated debt,

to the extent the aggregate does not exceed Tier I capital;

(xiv) 'Turnover or business turnover' means the total mortgage guarantee contracts entered during the year together with the volume of business arising out of other activities undertaken during the year;

(2) Other words or expressions used but not defined herein and defined in the Reserve Bank of India Act, 1934 (2 of 1934) or Mortgage Guarantee Company (Reserve Bank) Guidelines, 2008 contained in Notification DNBS(PD)MGC)No.3 /CGM (PK) - 2008 dated February 15, 2008 shall have the same meaning as assigned to them under that Act or that Directions. Any other words or expressions not defined in that Act or that Directions, shall have the same meaning assigned to them in the Companies Act, 1956 (1 of 1956).

Income recognition

3. (i) Income including interest/discount or any other charges on an asset which is NPA or on an asset which is NPA and is

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taken over from creditor institution on happening of trigger event shall be recognised only on cash basis.

(ii) A mortgage guarantee company shall account the premium or fee on the mortgage guarantee contracts as an income in the profit and loss account in accordance with the Accounting Standards issued by the Institute of Chartered Accountants of India. The amount of unearned premium shall be shown as a separate line on the liability side of the balance sheet.

(iii) In respect of any other business undertaken by the mortgage guarantee company as specified in Section 45 I (c) of the RBI Act, 1934 within the permitted limit, income shall be recognised as per income recognition norms prescribed for such assets as contained in the "Non-Banking Financial (Non - Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007".

Accounting standards

4. Accounting Standards and Guidance Notes issued by the Institute of Chartered Accountants of India (referred to in these directions as "ICAI") shall be followed insofar as they are not inconsistent with any of the provisions of these directions.

Asset Classification

5. (1) Every mortgage guarantee company shall, after taking into account the degree of well defined credit weaknesses and extent of dependence on collateral security for realisation, classify its assets, loans and advances and any other forms of credit into the following classes, namely:

- (i) Standard assets*;
- (ii) Sub-standard assets;
- (iii) Doubtful assets; and
- (iv) Loss assets.

* Assets acquired under guarantee obligations will not be classified as standard assets.

(2) The class of assets referred to above shall not be upgraded merely as a result of rescheduling, unless it satisfies

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the conditions as stipulated by the Bank from time to time, required for the upgradation.

Provisioning requirements

6. (1) Provision for losses on invoked guarantees: A mortgage guarantee company is exposed to a potential loss when its guarantee is invoked. Mortgage guarantee companies shall hold provisions for losses in respect of such invoked guarantees pending recovery of assets. The amount of provisions required to be held shall be equal to the contract-wise aggregate of 'amount of invocation' after adjusting the realisable value of the assets held by the company in respect of each housing loan where the guarantee has been invoked. In case the realisable value of the assets held in respect of any invoked guarantee is more than the amount of invocation, the excess shall not be adjusted against the shortfall in other invoked guarantees. In case the amount of provisions already held is in excess of the amount as computed above, the excess shall not be reversed. The amount of provisions made each year shall be shown as a separate line item in the Profit and Loss Account. The amount of provision held for losses on settlement of invoked guarantees shall be shown as a separate line item on the liability side of the balance sheet.

(2) Provision for 'Incurred But-Not-Reported (IBNR) losses': A mortgage guarantee company is exposed to a potential loss when there is a default in a housing loan guaranteed by it. Mortgage guarantee companies shall hold provisions in respect of such defaulted housing loans where the trigger event is yet to occur or the guarantee is yet to be invoked. The potential loss to which the guarantee company is exposed to is referred to as 'Incurred-But-Not-Reported (IBNR) losses'. The amount of provisions required to be held shall be arrived at on an actuarial basis depending upon the estimates of loss frequency and loss severity for incurred but not reported losses which are derived from historic data, trends, economic factors and other statistical data in relation to paid claims, the provisions held for claims settled, risk statistics, etc. In case the amount of provisions already held is in excess of the amount as computed above, the excess shall not be reversed. The amount

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of provisions made each year shall be shown as a separate line item in the Profit and Loss Account. The amount of provision held for Incurred But-Not-Reported (IBNR) losses shall be shown as a separate line item on the liability side of the balance sheet.

(3) Subject to what has been mentioned above, every mortgage guarantee company shall, after taking into account the time lag between an account becoming non-performing, its recognition as such, the realisation of the security and the erosion over time in the value of security charged, make provision against each class as provided hereunder :-

(4) Mortgage guarantee assets

The provisioning requirement in respect of mortgage guarantee assets shall be as under:

(i) Loss Assets	The entire asset shall be written off. If the assets are permitted to remain in the books for any reason, 100% of the outstanding should be provided for;
(ii) Doubtful Assets	<p>(a) 100% provision to the extent to which the advance is not covered by the realisable value of the security to which the mortgage guarantee company has a valid recourse shall be made. The realisable value is to be estimated on a realistic basis;</p> <p>(b) In regard to the secured portion, provision is to be made on the following basis to the extent of 20% to 100% of the secured portion depending upon the period for which the asset has remained doubtful: Period for which the asset has</p>

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	remained in doubtful category % of provision Up to one year 20 % One to three years 30% More than three years 100 %
(iii) Sub-standard assets	A general provision of 10% of total outstanding shall be made.
For Standard Assets Standard asset	Mortgage guarantee companies should make general provisions for standard asset on the following basis; (a) Guarantee cover for residential housing loans beyond Rs. 20 lakhs at 1%; (b) All other guarantee cover at 0.40%

Notes:

- (1) The provisions on standard asset should not be reckoned for arriving at net NPAs.
- (2) The provisions towards standard assets need not be netted from gross advances but shown separately as 'Contingent Provisions against Standard Assets' under 'Other Liabilities and Provisions Others' in the balance sheet.
- (3) It is clarified that income recognition on and provisioning against NPAs are two different aspects of prudential norms and provisions as per the norms are required to be made on NPAs on total outstanding balances. The fact that income on an NPA has not been recognised cannot be taken as reason for not making provision.

Other Activities

7. A mortgage guarantee company can take up any activity up to 10% of its total assets. If a mortgage guarantee company undertakes any other business as specified in 45I(c) of the RBI

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Act 1934 within the permitted limit, for which Prudential Norms are already prescribed and the same is contained in Notification No. DNBS. 193 DG(VL)-2007 dated February 22, 2007, as amended from time to time, the said norms for valuation of investments, asset classification and provisioning should be followed.

Accounting year

8. Every mortgage guarantee company shall prepare its balance sheet and profit and loss account as on March 31 every year. Whenever a mortgage guarantee company intends to extend the date of its balance sheet as per provisions of the Companies Act, it should take prior approval of the Reserve Bank of India before approaching the Registrar of Companies for this purpose.

Further, even in cases where the Bank and the Registrar of Companies grant extension of time, the mortgage guarantee company shall furnish to the Bank a proforma balance sheet (unaudited) as on March 31 of the year and the statutory returns due on the said date.

Disclosure in the balance sheet

9. (1) Every mortgage guarantee company shall separately disclose in its balance sheet the provisions made as per paragraph 6 above without netting them from the income or against the value of assets.

(2) The provisions shall be distinctly indicated under separate heads of account separately for mortgage guarantee business and others and individually for each type of assets as under :-

- (i) provisions for bad and doubtful debts; and
- (ii) provisions for depreciation in investments.

(3) Such provisions for each year shall be made from the profit and loss account.

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Constitution of Audit Committee by mortgage guarantee company

10. Every mortgage guarantee company shall constitute an Audit Committee, consisting of not less than three non-executive Directors of the Board of its company, at least one of whom will be Chartered Accountant.

Explanation I: The Audit Committee constituted by a mortgage guarantee company as required under Section 292A of the Companies Act, 1956 (1 of 1956) shall be the Audit Committee for the purposes of this paragraph.

Explanation II: The Audit Committee constituted under this paragraph shall have the same powers, functions and duties as laid down in Section 292A of the Companies Act, 1956 (1 of 1956).

Transactions in Government securities

11. Every mortgage guarantee company may undertake transactions in Government securities through its CSDL account or its demat account:

Provided that no mortgage guarantee company shall undertake any transaction in government security in physical form through any broker.

Requirement as to capital adequacy

12. (1) Every mortgage guarantee company subject to the condition that the net owned fund shall be a minimum of 100 crore rupees or such other amount that Reserve Bank of India may specify from time to time, shall maintain, a minimum capital ratio consisting of Tier I and Tier II capital which shall not be less than ten per cent of its aggregate risk weighted assets of its on balance sheet and of risk adjusted value of off-balance sheet items. Of the required capital ratio, it shall maintain at least 6% of its aggregate risk weighted assets as Tier I.

(2) The total of Tier II capital, at any point of time, shall not exceed one hundred per cent of Tier I capital.

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Explanations:

On balance sheet assets

(1) In these Directions, degrees of credit risk expressed as percentage weightages have been assigned to balance sheet assets. Hence, the value of each asset/item requires to be multiplied by the relevant risk weights to arrive at risk adjusted value of assets. The aggregate shall be taken into account for reckoning the minimum capital ratio. The risk weighted asset shall be calculated as the weighted aggregate of funded items as detailed hereunder:

Items of assets – On-Balance Sheet items	Risk weight %age
(i) Cash	0
(ii) Bank balances and claims on banks including fixed deposits and certificates of deposits.	20
(iii) Investments	
(a) Central Government and State Government Securities	0
(b) Bonds of banks	20
(c) Fixed deposits/certificates of deposits/bonds of public financial institutions	100
(d) Shares of all companies *and debentures/bonds/commercial papers of all companies and units of debt oriented/money market mutual funds	100
(*As per paragraph 3(ii) of Mortgage Guarantee Companies Investment (Reserve Bank) Directions, 2008 shares of corporates can be acquired only in satisfaction of debt)	
(iv) Current assets	
(a) Loans and advances	100
(b) Loans to staff, if fully covered by superannuities, benefits & mortgage of flats/houses	20
(c) Other loans to staff	100
(d) Other secured loans and advances	100
(e) Others (including net stock on hire, bills	100

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purchased and discounted, etc.)

(v) Fixed Assets (net of depreciation)

(a) Assets leased out (net book value) 100

(b) Premises 100

(c) Furniture & Fixtures 100

(d) Other fixed assets 100

(vi) Other assets

(a) Income tax deducted at source (net of provision) 0

(b) Advance tax paid (net of provision) 0

(c) Interest due on Government securities 0

(d) Others 100

Notes:

- (1) Netting may be done only in respect of assets where provisions for depreciation or for bad and doubtful debts have been made.
- (2) Assets which have been deducted from owned fund to arrive at net owned fund shall have a weightage of 'zero'.
- (3) While calculating the aggregate of funded exposure of a borrower for the purpose of assignment of risk weight, mortgage guarantee companies may net off the amount of cash margin/caution money/security deposits (against which right to set-off is available) held as collateral against the advances out of the total outstanding exposure of the borrower.

Off-balance sheet items

(2) In these Directions, degrees of credit risk exposure attached to off-balance sheet items have been expressed as percentage of credit conversion factor. Hence, the face value of each item requires to be first multiplied by the relevant conversion factor to arrive at credit equivalent value of off-balance sheet item. The credit equivalent value of each item shall have to be again multiplied by the risk weight as applicable to the respective counterparties. The aggregate risk weighted value shall be taken into account for reckoning the minimum capital ratio. The credit equivalent value of the off-

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balance sheet items shall be calculated as per the credit conversion factors for non-funded items as detailed hereunder:

Nature of item	Credit conversion factor – Percentage
i) Financial & other guarantees	100
ii) Underwriting obligations in r/o capital investment such as shares/ debentures, etc	50
iii) Partly-paid shares/debentures	100
iv) Lease contracts entered into but yet to be executed	100
v) Other contingent liabilities	50

Note: Cash margins/deposits shall be deducted before applying the conversion factor.

Loans against Mortgage Guarantee Company's own shares prohibited

13. (1) No mortgage guarantee company shall lend against its own shares.

(2) Any outstanding loan against its own shares shall be recovered by the mortgage guarantee company as per the repayment schedule before grant of Certificate of Registration to it.

Concentration of credit/investment

14. (1) No mortgage guarantee company shall lend to

- (a) any single borrower exceeding fifteen per cent of its owned fund; and
- (b) any single group of borrowers exceeding twenty five per cent of its owned fund.

(2) Every mortgage guarantee company shall formulate a policy in respect of exposures to a single party / a single group of parties.

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Notes :

- (1) For determining the limits, off-balance sheet exposures shall be converted into credit risk by applying the conversion factors as explained above.
- (2) The investments in debentures for the purposes specified in this paragraph shall be treated as credit and not investment.
- (3) These ceilings shall be applicable to credit exposure by such a mortgage guarantee company to companies/firms in its own group as well as to the borrower company's group.

Information in regard to change of address, directors, auditors, etc. to be submitted

15. Every mortgage guarantee company shall communicate to Reserve Bank of India, not later than one month from the occurrence of any change in:

- (a) the complete postal address, telephone number/s and fax number/s of the registered/corporate office;
- (b) the names and residential addresses of the directors of the company;
- (c) the names and the official designations of its principal officers;
- (d) the names and office address of the auditors of the company; and
- (e) the specimen signatures of the officers authorised to sign on behalf of the company.

Exemptions

16. The Reserve Bank of India may, if it considers it necessary for avoiding any hardship or for any other just and sufficient reason, grant extension of time to comply with or exempt any mortgage guarantee company or class of mortgage guarantee companies, from all or any of the provisions of these instructions either generally or for any specified period, subject to such conditions as the Reserve Bank of India may impose.

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Interpretations

17. For the purpose of giving effect to the provisions of these directions, the Reserve Bank of India may, if it considers necessary, issue necessary clarifications in respect of any matter covered herein and the interpretation of any provision of these directions given by the Reserve Bank of India shall be final and binding on all the parties concerned.

16. Directions/instructions issued to the Securitisation Companies/ Reconstruction Companies

Master Circular: RBI/2011-2012/16 DNBS (PD) CC. No. 27/SCRC/26.03.001/ 2011-2012 dated July 1, 2011

Link: http://www.rbi.org.in/scripts/BS_ViewMasCircularDetails.aspx?id=6564

This Master circular contains the gist of all the circulars issued by RBI to Securitisation/ Reconstruction Companies. It includes

- (1) Submission of application for a Certificate of Registration to commence/carry on the business of a Securitisation Company or Reconstruction Company
- (2) Maintenance of minimum owned fund for carrying out the business of securitisation or asset reconstruction
- (3) Commencement of business by Securitisation Companies/Reconstruction Companies within 6 months of registration.
- (4) Submission of quarterly statements by Securitisation Companies/ Reconstruction Companies
- (5) Regulation of SCs/RCs-submission of returns and audited balance sheet by SCs/RCs within one month from the date of annual general meeting. in which the audited results are adopted.
- (6) Investment in Security Receipts issued by the trusts floated by Securitisation Companies/Reconstruction Companies

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- (7) Guidelines on Declaration of Net Asset Value of Security Receipts issued by Securitisation Company/Reconstruction Company
- (8) Regulation of SCs/RCs-disclosure while issuing Security Receipts (SRs)
- (9). Quarterly Statement to be submitted by Securitisation Companies/Reconstruction Companies registered with the Reserve Bank of India under Section 3(4) of the SARFAESI Act
- (10). 'Restructuring of loans by SC/RC' is one of the measures allowed to be undertaken by SC/RCs for realisation of their dues.
- (11) Resolution of acquired assets - Extension in time frame for redemption of security receipts (SRs) issued
- (12). Guidelines on Change in or Take Over of the Management of the Business of the Borrower by Securitisation Companies and Reconstruction Companies (Reserve Bank) Guidelines, 2010
- (13) The Securitisation Companies and Reconstruction Companies (Reserve Bank) Guidelines and Directions, 2003
- (14) Securitisation Company or Reconstruction Company shall continue to hold a minimum of 5% of the Security Receipts of each class issued by the SC/RC under each scheme on an ongoing basis till the redemption of all the Security Receipts issued under such scheme.
- (15) All SC/RCs being 'credit institutions' are required to become a member of at least one credit information company as per the statute.
- (16) Setting up of Central Electronic Registry under the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002

17. The Securitisation Companies and Reconstruction Companies (Reserve Bank) Guidelines and Directions, 2003

Master Circular: RBI/2011-2012/35 DNBS (PD) CC. No. 25/SCRC / 26.03.001/ 2011-2012 dated July 1, 2011

Link: http://rbi.org.in/scripts/BS_ViewMasCirculardetails.aspx?id=6592

The provisions of these guidelines and directions shall apply to Securitisation companies or Reconstruction Companies registered with the Reserve Bank of India under Section 3 of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002.

- Every Securitisation Company or Reconstruction Company shall apply for registration in the form of application specified vide Notification No.DNBS.1/CGM(CSM)-2003, dated March 7, 2003 and obtain a certificate of registration from the Bank
- A Securitisation Company or Reconstruction Company shall commence business within six months from the date of grant of Certificate of Registration by the Bank;
Provided that on the application by the Securitisation Company or Reconstruction Company, the Bank may grant extension for such further period, not exceeding one year in aggregate from the date of grant of Certificate of Registration.
- Provisions of section 45 -IA, 45-IB and 45-IC of RBI Act,1934 shall not apply to non banking financial company, which is a securitisation company or reconstruction company registered with the Bank under section 3 of the SARFAESI Act,2002].
- A Securitisation Company or Reconstruction Company shall not raise monies by way of deposit.
- Every such company shall have a 'Financial Asset Acquisition Policy' and 'rescheduling of Debts' approved by its Board.

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- Every Securitisation Company or Reconstruction Company shall maintain, on an ongoing basis, a capital adequacy ratio, which shall not be less than fifteen percent of its total risk weighted assets

18. Regulatory Framework for Core Investment Company (CICs)

RBI/2011-12/31 DNBS (PD) CC No.237/03.02.001/2011-12 dated July 1, 2011

Link : http://www.rbi.org.in/scripts/BS_ViewMasCirculardetails.aspx?id=6589

Core Investment companies are companies which have their assets predominantly as investments in shares for holding stake in group companies but not for trading, and also do not carry on any other financial activity

The regulatory framework for the Core Investment Companies can be accessed at the above link or at

http://www.rbi.org.in/scripts/BS_NBFCNotificationView.aspx?Id=5944

In the case of Non Deposit taking Systematically Important Core Investment Companies, the above referred Regulatory framework requires an annual certificate from their statutory auditors regarding compliance with the above guidelines within one month from the date of finalisation of the balance sheet.

19. Infrastructure Finance Companies

RBI/2009-10/316 DNBS.PD. CC No.168/03.02.089 /2009-10 dt February 12, 2010.

Link: <http://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=5503&Mode=0>

Reserve Bank has classified NBFCs under three categories, viz., Asset Finance Companies, Loan companies and Investment Companies and have recently introduced a fourth category of NBFCs as "Infrastructure Finance Companies"(IFCs). An IFC is defined as non deposit taking NBFC that fulfils the criteria mentioned below:

- (i) a minimum of 75 per cent of its total assets should be deployed in infrastructure loans as defined in Para 2(viii) of the Non Banking Financial (Non Deposit Accepting or

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Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007;

- (ii) Net owned funds of Rs. 300 crore or above;
- (iii) minimum credit rating 'A' or equivalent of CRISIL, FITCH, CARE, ICRA or equivalent rating by any other accrediting rating agencies
- (iv) CRAR of 15 percent (with a minimum Tier I capital of 10 percent)

20. 'Know Your Customer' (KYC) Guidelines – Anti Money Laundering Standards (AML) - 'Prevention of Money Laundering Act, 2002 - Obligations of NBFCs in terms of Rules notified there under'

Master Circular : RBI/2011-12/25 DNBS (PD) CC No.231/03.10.42/2011-12 dated July 1, 2011

Link: http://www.rbi.org.in/scripts/BS_ViewMasCirculardetails.aspx?id=6575

NBFCs are required to put in place a KYC policy with the approval of the Board. The information collected from the client should be kept confidential.

The guidelines are to be adhered by the brokers / agents etc. of the NBFC.

As an extension of the KYC Guidelines, NBFCs should put in place a process of due diligence in respect of persons authorised by NBFCs including brokers/agents etc. collecting deposits on behalf of the company through a uniform policy for appointment and detailed verification.

All deposit receipts should bear the name and Registered Office address of the NBFC and must invariably indicate the name and other details of the persons authorised by NBFCs including brokers/agents etc.

There may be relaxation in the KYC procedures for a depositor if the total balance in all their accounts does not exceed Rs 50000 and the total credit in all the accounts would not exceed Rs 100000 in a year.

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It may be appreciated that KYC norms/AML standards/CFT measures have been prescribed to ensure that criminals are not allowed to misuse the banking/financial channels. It would, therefore, be necessary that adequate screening mechanism is put in place by NBFCs as an integral part of their recruitment/hiring process of personnel.

21. Corporate Governance

Master circular - RBI/2011-12/28 - DNBS (PD) CC No. 234 / 03.10.001 / 2011-12 July 1, 2011

Link: http://www.rbi.org.in/scripts/BS_ViewMasCircularDetails.aspx?id=6584

(a) Rotation of partners of the statutory auditors audit firm - with public deposits/ deposits of Rs 50 crore and above.

The partner/s of the Chartered Accountant firm conducting the audit could be rotated every three years so that same partner does not conduct audit of the company continuously for more than a period of three years. However, the partner so rotated will be eligible for conducting the audit of the NBFC after an interval of three years, if the NBFC, so decides. Companies may incorporate appropriate terms in the letter of appointment of the firm of auditors and ensure its compliance.

Circular reference RBI/2005-06/ 232 DNBS (PD).CC. No. 61 / 02.82 / 2005-06 dt December 12, 2005.

Link: <http://www.rbi.org.in/scripts/NotificationUser.aspx?Id=2661&Mode=0>

(b) Guidelines on Corporate Governance

NBFCs are essentially corporate entities. Listed NBFCs which are required to adhere to listing agreement and rules framed by SEBI on Corporate Governance are already required to comply with SEBI prescriptions on Corporate Governance. . In order to enable NBFCs to adopt best practices and greater transparency in their operations following guidelines are proposed for consideration of the Board of Directors of all Deposit taking NBFCs with deposit size of Rs 20 crore and above and all non-deposit taking NBFCs with asset size of Rs 100 crore and above (NBFC-ND-SI).

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Constitution of Audit Committee

- (i) In terms of extant instructions, an NBFC having assets of Rs. 50 crore and above as per its last audited balance sheet is already required to constitute an Audit Committee, consisting of not less than three members of its Board of Directors, the instructions shall remain valid.
- (ii) In addition, NBFC-D with deposit size of Rs 20 crore may also consider constituting an Audit Committee on similar lines.

Constitution of Nomination Committee

The importance of appointment of directors with 'fit and proper' credentials is well recognised in the financial sector. In terms of Section 45-IA (4) (c) of the RBI Act, 1934, while considering the application for grant of Certificate of Registration to undertake the business of non-banking financial institution it is necessary to ensure that the general character of the management or the proposed management of the non-banking financial company shall not be prejudicial to the interest of its present and future depositors. In view of the interest evinced by various entities in this segment, it would be desirable that NBFC-D with deposit size of Rs 20 crore and above and NBFC-ND-SI may form a Nomination Committee to ensure 'fit and proper' status of proposed/existing Directors.

Constitution of Risk Management Committee

The market risk for NBFCs with Public Deposit of Rs.20 crore and above or having an asset size of Rs.100 crore or above as on the date of last audited balance sheet is addressed by the Asset Liability Management Committee (ALCO) constituted to monitor the asset liability gap and strategize action to mitigate the risk associated. To manage the integrated risk, a risk management committee may be formed, in addition to the ALCO in case of the above category of NBFCs.

Disclosure and transparency

The following information should be put up by the NBFC to the Board of Directors at regular intervals as may be prescribed by the Board in this regard:

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- progress made in putting in place a progressive risk management system, and risk management policy and strategy followed
- conformity with corporate governance standards viz. in composition of various committees, their role and functions, periodicity of the meetings and compliance with coverage and review functions, etc.

Connected Lending

RBI has received suggestions in the matter with reference to paragraph 2(vi) of the circular dated May 28, 2007 containing instructions on connected lending. The suggestions are being studied and the instructions contained in paragraph 2 (vi) of the said circular will become operational after final evaluation of the suggestions and modifications, if any considered necessary.

NBFCs shall frame their internal guidelines on corporate governance, enhancing the scope of the guidelines without sacrificing the spirit underlying the above guidelines and it shall be published on the company's web-site, if any, for the information of various stakeholders.

Details in DNBS.PD/ CC 94 / 03.10.042 /2006-07 dated May 8, 2007 read with

(Link : <http://www.rbi.org.in/scripts/NotificationUser.aspx?Id=3499&Mode=0>)

DNBS.PD/ CC 104 / 03.10.042 /2007-08 dated July 11, 2007

Link : <http://www.rbi.org.in/scripts/NotificationUser.aspx?Id=3706&Mode=0>

22. Fair Practice Code

Master Circular : RBI/2011-12/26 DNBS (PD) CC No. 232/03.10.042/2011-12 dated July 1, 2011

Link: http://www.rbi.org.in/scripts/BS_ViewMasCirculardetails.aspx?id=6583

The Reserve Bank of India, being satisfied that for the purpose of enabling it to regulate the credit system of the country to its advantage, it is necessary to do, hereby, in exercise of powers conferred under Section 45 L of the Reserve Bank of India Act, 1934 (Act 2 of 1934) and of all the powers enabling it in this behalf, hereby prescribes the broad guidelines on fair practices that are to be framed and approved by the Board of Directors of

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all Non- Banking Financial Companies (including RNBCs). The fair practices code so framed and approved by the Board of Directors should be published and disseminated on the web-site of the company, if any, for the information of the public. The Fair Practices Code based on guidelines given below were to be put in place by all NBFCs with the approval of their Boards within one month from the date of issue of the circular dated September 28, 2006.

The guidelines include the following

- (i) Requirements in the applications for loans and their processing
- (ii) Loan appraisal and terms/conditions- The NBFCs should convey in writing to the borrower by means of sanction letter or otherwise, the amount of loan sanctioned along with the terms and conditions including annualised rate of interest and method of application thereof and keep the acceptance of these terms and conditions by the borrower on its record.
- (iii) Disbursement of loans including changes in terms and conditions
- (iv) General guidelines like- NBFC to refrain from interference in the affairs of the borrower
- (v) Creating a grievance redressal mechanism to resolve disputes
- (vi) Keep a track on interest charged and to refrain from charging excessive interest rate
- (vii) Boards of NBFCs are advised to lay out appropriate internal principles and procedures in determining interest rates and processing and other charges.

The Board of each NBFC shall adopt an interest rate model taking into account relevant factors such as, cost of funds, margin and risk premium, etc and determine the rate of interest to be charged for loans and advances

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The rate of interest should be annualised rates so that the borrower is aware of the exact rates that would be charged to the account.

- (viii) Clarification regarding repossession of vehicles financed by the NBFCs- repossession clause should be built in the loan/ borrowing agreement.

23. Frauds – Future approach towards monitoring of frauds in NBFCs

Master Circular: RBI/2011-12/23 DNBS.PD.CC.
No.229/03.10.042/2011-12 July 1, 2011

Link: http://rbi.org.in/scripts/BS_ViewMasCirculardetails.aspx?id=6586

Applicable to All Deposit taking NBFCs (including RNBCs)

1. Introduction

1.1 Incidence of frauds in NBFCs is a matter of concern. While the primary responsibility for preventing frauds lies with NBFCs themselves, a reporting system for frauds is prescribed in the following paragraphs, which may be adopted by NBFCs.

1.2 It is possible that frauds are, at times, detected in NBFCs long after their perpetration. NBFCs should, therefore, ensure that a reporting system is in place so that frauds are reported without any delay. NBFCs should fix staff accountability in respect of delays in reporting of fraud cases to the Reserve Bank.

1.3 Delay in reporting of frauds and the consequent delay in alerting other NBFCs about the modus operandi and issue of caution advices against unscrupulous borrowers could result in similar frauds being perpetrated elsewhere. NBFCs may, therefore, strictly adhere to the timeframe fixed in this circular for reporting fraud cases to the Reserve Bank failing which NBFCs would be liable for penal action as prescribed under the provisions of Chapter V of the RBI Act, 1934.

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1.4 NBFCs should specifically nominate an official of the rank of General Manager or equivalent who will be responsible for submitting all the returns referred to in this circular.

1.5 It may be noted that NBFCs are not required to submit 'Nil' reports to Frauds Monitoring Cell/Regional Offices of Department of Non-Banking Supervision. At the same time enough precautions may be taken by deposit-taking NBFCs to ensure that the cases reported by them are duly received by Frauds Monitoring Cell/Regional Offices of Department of Non-Banking Supervision as the case may be.

2. Classification of Frauds

2.1 In order to have uniformity in reporting, frauds have been classified as under based mainly on the provisions of the Indian Penal Code :

- (a) Misappropriation and criminal breach of trust.
- (b) Fraudulent encashment through forged instruments, manipulation of books of account or through fictitious accounts and conversion of property.
- (c) Unauthorised credit facilities extended for reward or for illegal gratification.
- (d) Negligence and cash shortages.
- (e) Cheating and forgery.
- (f) Irregularities in foreign exchange transactions.
- (g) Any other type of fraud not coming under the specific heads as above.

2.2 Cases of 'negligence and cash shortages' and 'irregularities in foreign exchange transactions' referred to in items (d) and (f) above are to be reported as fraud if the intention to cheat / defraud is suspected / proved. However, the following cases where fraudulent intention is not suspected / proved, at the time of detection, will be treated as fraud and reported accordingly :

- (a) cases of cash shortages more than Rs.10,000/- and

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- (b) cases of cash shortages more than Rs. 5000/- if detected by management /auditor / inspecting officer and not reported on the occurrence by the persons handling cash.

2.3 NBFCs having overseas branches/offices should report all frauds perpetrated at such branches/offices also to the Reserve Bank as per the format and procedure detailed under Paragraph 3 below.

3. Reporting of Frauds to Reserve Bank of India

3.1 Frauds involving Rs. 1 lakh and above

3.1.1 Fraud reports should be submitted in all cases of fraud of Rs. 1 lakh and above perpetrated through misrepresentation, breach of trust, manipulation of books of account, fraudulent encashment of FDRs unauthorised handling of securities charged to the NBFC, misfeasance, embezzlement, misappropriation of funds, conversion of property, cheating, shortages, irregularities, etc.

3.1.2 Fraud reports should also be submitted in cases where central investigating agencies have initiated criminal proceedings suo moto and/or where the Reserve Bank has directed that they be reported as frauds.

3.1.3 NBFCs may also report frauds perpetrated in their subsidiaries and affiliates/joint ventures. Such frauds should, however, not be included in the report on outstanding frauds and the quarterly progress reports referred to in paragraph 4 below. (DNBS PD CC No 127/03.10.42/2008-09 dated August 14, 2008)

3.1.4 The fraud reports in the prescribed format should be sent to the Central Office (CO) of the Reserve Bank of India, Department of Banking Supervision, Frauds Monitoring Cell where the amount involved in fraud is Rs 25 lakhs and above and to Regional Office of the Reserve Bank of India, Department of Non-Banking Supervision under whose jurisdiction the Registered Office of the NBFC falls where the fraud amount involved in fraud is less than Rs 25 lakh, in the format given in FMR – 1, within three weeks from the date of detection.

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A copy of FMR-1 where the amount involved in the Fraud is Rs 25 lakhs and above should also be submitted to the Regional Office of the Department of Non-Banking Supervision of Reserve Bank of India under whose jurisdiction the Registered Office of the NBFC falls.

3.2 Frauds committed by unscrupulous borrowers

3.2.1 It is observed that a large number of frauds are committed by unscrupulous borrowers including companies, partnership firms/proprietary concerns and/or their directors/partners by various methods including the following:

- (i) Fraudulent discount of instruments.
- (ii) Fraudulent removal of pledged stocks/disposing of hypothecated stocks without the NBFC's knowledge/inflating the value of stocks in the stock statement and drawing excess finance.
- (iii) Diversion of funds outside the borrowing units, lack of interest or criminal neglect on the part of borrowers, their partners, etc. and also due to managerial failure leading to the unit becoming sick and due to laxity in effective supervision over the operations in borrowal accounts on the part of the NBFC functionaries rendering the advance difficult of recovery.

3.2.2 In respect of frauds in borrowal accounts, additional information as prescribed under Part B of FMR-1 should also be furnished. (DNBS.PD.CC. No 127 /03.10.42/2008-09 dated August 14, 2008)

3.3 Frauds involving Rs. 25 lakh and above

In respect of frauds involving Rs. 25 lakh and above, in addition to the requirements given at paragraphs 3.1 and 3.2 and above, NBFCs may report the fraud by means of a D.O. letter addressed to the Chief General Manager-in-charge of the Department of Banking Supervision, Reserve Bank of India, Frauds Monitoring Cell, Central Office and a copy endorsed to the Chief General Manager-in-charge of the Department of Non-Banking Supervision, Reserve Bank of India, Central Office within a week of such frauds coming to the notice of the NBFC. The letter may contain brief particulars of the fraud such

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as amount involved, nature of fraud, modus operandi in brief, name of the branch/office, names of parties involved (if they are proprietorship/ partnership concerns or private limited companies, the names of proprietors, partners and directors), names of officials involved, and whether the complaint has been lodged with the Police. A copy of the D.O. letter should also be endorsed to the Regional Office of Reserve Bank, Department of Non-Banking Supervision under whose jurisdiction the Registered Office of the NBFC is functioning.

3.4 Cases of attempted fraud

Cases of attempted fraud, where the likely loss would have been Rs. 25 lakh or more, had the fraud taken place, should be reported to the Central Office of the Reserve Bank, Department of Banking Supervision, Frauds Monitoring Cell and a copy endorsed to Central Office of the Reserve Bank, Department of Non-Banking Supervision indicating the modus operandi and how the fraud was detected. Such cases should not be included in the other returns to be submitted to the Reserve Bank.

4. Quarterly Returns

4.1 Report on Frauds Outstanding

4.1.1 NBFCs should submit a copy of the Quarterly Report on Frauds Outstanding in the format given in FMR – 2 to the Regional Office of the Reserve Bank of India, Department of Non-Banking Supervision under whose jurisdiction the Registered Office of the NBFC falls irrespective of amount within 15 days of the end of the quarter to which it relates.

4.1.2 Part A of the report covers details of frauds outstanding as at the end of the quarter. Parts B and C of the report give category-wise and perpetrator-wise details of frauds reported during the quarter respectively. The total number and amount of fraud cases reported during the quarter as shown in Parts B and C should tally with the totals of columns 4 and 5 in Part – A of the report.

4.1.3 NBFCs should furnish a certificate, as part of the above report, to the effect that all individual fraud cases of Rs. 1 lakh and above reported to the Reserve Bank in FMR – 1 during the quarter have also been put up to the NBFC's Board and have

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been incorporated in Part – A (columns 4 and 5) and Parts B and C of FMR – 2.

4.2 Progress Report on Frauds

4.2.1 NBFCs should furnish case-wise quarterly progress reports on frauds involving Rs. 1 lakh and above in the format given in FMR – 3 to the Central Office (CO) of the Reserve Bank of India, Department of Banking Supervision, Frauds Monitoring Cell where the amount involved in fraud is Rs 25 lakhs and above and to Regional Office of the Reserve Bank of India, Department of Non-Banking Supervision under whose jurisdiction the Registered Office of the NBFC falls where the fraud amount involved in fraud is less than Rs 25 lakh within 15 days of the end of the quarter to which it relates.

4.2.2 In the case of frauds where there are no developments during a quarter, a list of such cases with a brief description including name of branch and date of reporting may be furnished as per FMR – 3.

5. Reports to the Board

5.1 Reporting of Frauds

5.1.1 NBFCs should ensure that all frauds of Rs. 1 lakh and above are reported to their Boards promptly on their detection.

5.1.2 Such reports should, among other things, take note of the failure on the part of the concerned officials, and consider initiation of appropriate action against the officials responsible for the fraud.

5.2 Quarterly Review of Frauds

5.2.1 Information relating to frauds for the quarters ending March, June and September may be placed before the Board of Directors during the month following the quarter to which it pertains.

5.2.2 These should be accompanied by supplementary material analysing statistical information and details of each fraud so that the Board would have adequate material to contribute effectively in regard to the punitive or preventive aspects of frauds.

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5.2.3 All the frauds involving an amount of Rs 25 lakh and above should be monitored and reviewed by the Audit Committee of the Board (ACB) or if ACB is not there, other Committee of the Board of NBFCs. The periodicity of the meetings of the Committee may be decided according to the number of cases involved. However, the Committee should meet and review as and when a fraud involving an amount of Rs 25 lakh and above comes to light.

5.3 Annual Review of Frauds

5.3.1 NBFCs should conduct an annual review of the frauds and place a note before the Board of Directors for information. The reviews for the year-ended December may be put up to the Board before the end of March the following year. Such reviews need not be sent to RBI. These may be preserved for verification by the Reserve Bank's inspecting officers.

5.3.2 The main aspects which may be taken into account while making such a review may include the following :

- (a) Whether the systems in the NBFC are adequate to detect frauds, once they have taken place, within the shortest possible time.
- (b) Whether frauds are examined from staff angle.
- (c) Whether deterrent punishment is meted out, wherever warranted, to the persons found responsible.
- (d) Whether frauds have taken place because of laxity in following the systems and procedures and, if so, whether effective action has been taken to ensure that the systems and procedures are scrupulously followed by the staff concerned.
- (e) Whether frauds are reported to local Police, as the case may be, for investigation.

5.3.3 The annual reviews should also, among other things, include the following details:

- (a) Total number of frauds detected during the year and the amount involved as compared to the previous two years.

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- (b) Analysis of frauds according to different categories detailed in Paragraph 2.1 and also the different business areas indicated in the Quarterly Report on Frauds Outstanding (vide FMR – 2).
- (c) Modus operandi of major frauds reported during the year along with their present position.
- (d) Detailed analyses of frauds of Rs. 1 lakh and above.
- (e) Estimated loss to the NBFC during the year on account of frauds, amount recovered and provisions made.
- (f) Number of cases (with amounts) where staff are involved and the action taken against staff.
- (g) Time taken to detect frauds (number of cases detected within three months, six months and one year of their taking place).
- (h) Position with regard to frauds reported to Police.
- (i) Number of frauds where final action has been taken by the NBFC and cases disposed of.
- (j) Preventive/punitive steps taken by the NBFC during the year to reduce/minimise the incidence of frauds.

6. Guidelines for Reporting Frauds to Police

NBFCs should follow the following guidelines for reporting of frauds such as unauthorised credit facilities extended by the NBFC for illegal gratification, negligence and cash shortages, cheating, forgery, etc. to the State Police authorities :

- (a) In dealing with cases of fraud/embezzlement, NBFCs should not merely be actuated by the necessity of recovering expeditiously the amount involved, but should also be motivated by public interest and the need for ensuring that the guilty persons do not go unpunished.
- (b) Therefore, as a general rule, the following cases should invariably be referred to the State Police :
 - (i) Cases of fraud involving an amount of Rs. 1 lakh and above, committed by outsiders on their own and/or with the connivance of NBFC staff/officers.

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- (ii) Cases of fraud committed by NBFC employees, when it involves NBFC funds exceeding Rs. 10,000/-.

24. Exemptions from RBI Act, 1934

Master Circular : RBI/2011-12/22 DNBS.PD. CC.No.228 /03.02.004 / 2011-12 dated July 1, 2011

Link: http://www.rbi.org.in/scripts/BS_ViewMasCirculardetails.aspx?id=6573

1. Introduction

The Bank has issued notifications from time to time exempting some entities from the requirements of Chapter III B of the RBI Act, 1934 or part thereof. While the Master Circular has been prepared to enable the users to have the benefit of a consolidated circular for the purpose of operations, they should refer to the instructions / directions contained in the relevant notifications. The Master Circular is based on notifications listed in the Annex.

2 (i) Exemption from provisions of Chapter III B of the RBI Act, 1934 – Housing Finance Institutions.

The Bank has exempted a non-banking financial company which is a housing finance institution as defined in Section 2(d) of the National Housing Bank Act, 1987 from the provisions of Chapter III B of the RBI Act, 1934.

(Notification DFC(COC) No 112 ED(SG)/97 read with circular DFC(COC) No. 4438/02.04/96-97 dated June 18, 1997)

2(ii) Merchant Banking Company

(Notification No. DFC 123/ED(G)-98, dated February 3, 1998,

Notification DFC(COC) No 118 DG(SPT)-98 dated January 31, 1998

Notification DFC(COC) No 119 DG(SPT)-98 dated January 31, 1998)

A merchant banking company has been exempted from the provisions of Section 45-IA [Requirement of registration and net owned fund], Section 45-IB [Maintenance of liquid assets] and 45-IC [Creation of Reserve Fund] of the RBI Act, 1934 , Non-

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Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998 and Non-Banking Financial Companies Prudential Norms (Reserve Bank) Directions, 1998 subject to compliance with the following conditions:

- (a) It is registered with the Securities and Exchange Board of India as a Merchant Banker under Section 12 of the Securities and Exchange Board of India Act, 1992 and is carrying on the business of merchant Banker in accordance with the Securities and Exchange Board of India Merchant Banking (Rules) 1992 and Securities and Exchange Board of India Merchant Banking (Regulations) 1992;
- (b) acquires securities only as a part of its merchant banking business;
- (c) does not carry on any other financial activity referred to in Section 45I(c) of the RBI Act, 1934; and
- (d) does not accept or hold public deposits as defined in paragraph 2(1)(xii) of the Notification No. DFC 118/DG(SPT)-98 dated January 31, 1998.

2 (iii) Micro Finance Companies

Sections 45-IA, 45-IB and 45-IC of the Reserve Bank of India Act, 1934 (2 of 1934) shall not apply to any non-banking financial company, which is

- (a) engaged in micro financing activities, providing credit not exceeding Rs. 50,000 for a business enterprise and Rs. 1,25,000 for meeting the cost of a dwelling unit to any poor person for enabling him to raise his level of income and standard of living; and
- (b) licensed under Section 25 of the Companies Act, 1956; and
- (c) not accepting public deposits as defined in paragraph 2(1)(xii) of Notification No. 118 /DG(SPT)-98 dated January 31, 1998.

{Microfinancing activities - Notification No.DNBS.138/CGM(VSNM)-2000 read with DNBS.(PD).CC.No. 12 /02.01/99-2000dated January 13, 2000}

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Mutual Benefit Companies

Sections 45-IA, 45-IB and 45-IC of the Reserve Bank of India Act, 1934 (2 of 1934) shall not apply to any non-banking financial company which being a mutual benefit company as defined in paragraph 2(1) (ixa) of the Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998 contained in Notification No. DFC.118/DG(SPT)-98 dated January 31, 1998). A “mutual benefit company” means a company not notified under section 620A of the Companies Act, 1956 (1 of 1956) and carrying on the business of a non-banking financial institution, -

- (a) on 9th January 1997; and
- (b) having the aggregate of net owned funds and preferential share capital of not less than ten lakhs of rupees; and
- (c) has applied for issue of certificate of registration to the Bank on or before 9th July 1997; and
- (d) is complying with the requirements contained in the relevant provisions of the Directions issued under Section 637A of the Companies Act, 1956 to Nidhi Companies by the Central Government.

2(iv) Government Companies

Sections 45-IB and 45-IC of the Reserve Bank of India Act, 1934 (2 of 1934), paragraphs 4 to 7 of the Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998 and Non-Banking Financial Companies Prudential Norms (Reserve Bank) Directions, 1998 (since repealed by Prudential Norms Directions Notification No 192 dated February 22, 2007), except paragraph 13 A of the said directions relating to submission of information to Reserve Bank in regard to change of address, directors, auditors, etc. shall not apply to any non-banking financial company as defined in section 45-I(f) of the Reserve Bank of India Act, 1934 (2 of 1934) being a Government company as defined in section 617 of the Companies Act, 1956. A Government Company is a company in which not less than 51% of the paid up capital is held by the Central Government, or by any State Government or Governments or partly by the Central Government and partly

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by one or more State Governments and includes a company which is subsidiary of a Government Company as thus defined.

(Notification No.DNBS.134, 135, 138/CGM(VSNM)-2000 read with DNBS.(PD).CC.No. 12 /02.01/99-2000dated January 13, 2000)

2(v) Venture Capital Fund Companies

(Notification No.DNBS.163/CGM(CSM)-2002 read with DNBS(PD)CC No.22 /02.59/ 2002-03 dated November 28, 2002)

Section 45-IA and Section 45-IC of the Reserve Bank of India Act, 1934 (2 of 1934); Notification No. DFC.118/DG(SPT)-98 dated January 31, 1998; and Notification No. DFC.119 / DG(SPT)-98 dated January 31, 1998 shall not apply to a non-banking financial company, which is a venture capital fund company holding a certificate of registration obtained under Section 12 of the Securities and Exchange Board of India Act, 1992 (15 of 1992) and not holding or accepting public deposit as defined in paragraph 2(1)(xii) of the Notification No. DFC.118/DG(SPT)-98 dated January 31, 1998.

2(vi) Insurance/Stock Exchange/Stock Broker/Sub-Broker

The provisions of Section 45-IA, 45-IB, 45-IC, 45MB and 45MC of the Reserve Bank of India Act, 1934 (2 of 1934) and provisions of Non-Banking Financial Companies Acceptance of Public Deposit (Reserve Bank) Directions contained in Notification No. DFC.118 / DG(SPT)-98 dated January 31, 1998, "Non-Banking Financial (Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007" shall not apply to any non-banking financial company not holding or accepting public deposit as defined in paragraph 2(1)(xii) of the Notification No. DFC.118/DG(SPT)-98 dated January 31, 1998, and -

- (a) doing the business of insurance, holding a valid certificate of registration issued under Section 3 of the Insurance Act, 1938 (IV of 1938);
- (b) being a stock exchange, recognised under Section 4 of the Securities Contracts (Regulation) Act, 1956 (42 of 1956) ; and

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- (c) doing the business of a stock-broker or sub-broker holding a valid certificate of registration obtained under Section 12 of the Securities and Exchange Board of India Act, 1992 (15 of 1992)

(Insurance - Notification No.DNBS.164/CGM(CSM)-2003 read with DNBS (PD) CC No. 23 / 01.18 / 2002-03 dated January 8, 2003)

2(vii) Nidhi Companies

(Notification No.DNBS.164/CGM(CSM)-2003 read with DNBS (PD) CC No. 23 / 01.18 / 2002-03 dated January 8, 2003)

The provisions of Sections 45-IA, 45-IB and 45-IC of the Reserve Bank of India Act, 1934 (2 of 1934) shall not apply to any non-banking financial company

- (a) Notified under Section 620A of the Companies Act, 1956 (1 of 1956), known as Nidhi Companies;

And

[“The provisions contained in Non-Banking Financial Companies Acceptance of Company; Public Deposits (Reserve Bank) Directions, 1998 shall not apply to a Mutual Benefit Financial Company or a Mutual Benefit company

Provided that the application of Mutual Benefit Company is not rejected by Government of India under the provisions of the Companies Act, 1956(Act 1 of 1956).”]

Chit Companies

- (b) doing the business of chits, as defined in clause (b) of Section 2 of the Chit Funds Act, 1982 (No. 40 of 1982).

Securitisation and Reconstruction Companies

(Notification No.DNBS. 3/CGM(OPA)-2003 dated August 28, 2003)

- (c) Securitisation company or Reconstruction company registered with the Reserve Bank of India under Section 3 of the Securitisation and Reconsruction of Financial Assets and Enforcement of Security Interest Act, 2002.

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Mortgage Guarantee Companies

(Notification No.DNBS.(MGC) 2/CGM(PK)-2008 read with DNBS (PD)(MGC) CC No. 111 / 03.11.001 / 2007-08 dated January 15, 2008)

(d) Mortgage Guarantee Companies notified as non-banking financial company in terms of Section 45 I (f)(iii) of the Reserve Bank of India Act, 1934 (2 of 1934) with the prior approval of the Central Government, and a company registered with the Bank under the scheme for registration of Mortgage Guarantee Companies.

25. Notification of change in or take over of management of the business of the borrower by securitisation and reconstruction companies (Reserve Bank) Guidelines, 2010
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Master Circular: RBI/2011-2012/36 DNBS (PD) CC. No. 26/SCRC /26.03.001/ 2011-2012 dated July 1, 2011.

Link: http://www.rbi.org.in/scripts/BS_ViewMasCirculardetails.aspx?id=6587

RBI has notified the above said guidelines, framed under Section 9(a) of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI Act) to provide for the proper management of the business of the borrower to enable the Securitisation Company or Reconstruction Company (SC/RC) to realise their dues from the borrowers, by effecting change in or take over of the management of the business of the borrower and related matters.

SC/RCs shall report to the Bank all cases where they have taken action to cause change in or take over the management of the business of the borrower for realization of its dues from the borrower in terms of circular DNBS (PD) CC. No.12 / SCRC/ 10.30.000/ 2008-2009 dated September 26, 2008.

26. Allied activities- entry into insurance business, issue of credit card and marketing and distribution of certain products

Master Circular : RBI/2011-12/27 DNBS (PD) CC No. 233/03.10.001/2011-12 dated July 1, 2011

Link : http://www.rbi.org.in/scripts/BS_ViewMasCircularDetails.aspx?id=6577

- (a) NBFCs registered with Reserve Bank of India may take up insurance agency business on fee basis and without risk participation, without the approval of Reserve Bank of India subject to the certain conditions; Statutory auditor certificate is required while filing the application with RBI.

[Details in DNBS.(PD).CC. No. 13 /02.01/99-2000 dated June 30, 2000, DNBS(PD).CC.No.18/02.01/2001-02 dated January 1, 2002 read with DNBS (PD) C.C. No. 35 / 10.24 / 2003-04 dated February 10, 2004]

- (b) NBFCs are allowed to take up credit card business with RBI approval subject to compliance with terms and conditions. However NBFCs are not permitted to issue debit cards, smart cards, stored value cards, charge cards, etc.

[Details in DNBS (PD) C.C. No. 41/10.27/2004-05 dated July 7, 2004, DBOD.FSD.BC. 49/ 24.01.011/ 2005-06 dated November 21, 2005]

[Details in DNBS (PD) CC No. 83/03.10.27/ 2006-07 dated December 04, 2006]

- (b) NBFCs are allowed to market mutual fund products.

[Details in DNBS (PD) CC No. 84/ 03.10.27/2006-07 dated December 04, 2006]

27. NBFCs-ND-SI issuing guarantees - Applicability of exemption from Concentration norms

RBI/2010-11/110 DNBS.PD/ CC.No.190 /03.02.002/2010-11 dated July 9, 2010

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Link : http://www.rbi.org.in/scripts/BS_NBFCNotificationView.aspx?Id=5867

Non deposit taking, systematically important NBFCs can make an application to RBI for modifications in the prescribed ceilings with regard to Concentration of credit / investment norms.

28. Opening of Branch-Subsidiary-Joint Venture-Representative office or Undertaking Investment Abroad by NBFCs

Master Circular : RBI/2011-12/101 DNBS (PD) CC No. 238/03.02.001/2011-12 dated July 1, 2011

Link: http://www.rbi.org.in/scripts/BS_ViewMasCircularDetails.aspx?id=6563

1. No NBFC shall open subsidiaries/joint ventures/representative office abroad or shall make investment in any foreign entities without obtaining prior approval in writing from the Reserve Bank of India. The application from the NBFC seeking No Objection would be considered subject to these directions.

2. These directions are in addition to those prescribed by Foreign Exchange Department for opening of branches abroad or for investments in Joint Venture/Wholly Owned Subsidiary.

29. Implementation of Green Initiative of the Government

RBI/2011-12/237 DNBS(PD).CC. No 248/03.10.01 /2011-12 dated October 28 , 2011

Link : http://rbi.org.in/scripts/BS_CircularIndexDisplay.aspx?Id=6783

For better utilisation of resources and better delivery of services, NBFCs are requested to take proactive steps to increase the use of electronic payment systems, elimination of post-dated cheques and gradual phase-out of cheques in their day to day business transactions. These will result in more cost-effective transactions and faster and accurate settlements.

30. NBFCs - Infrastructure Debt Funds (IDFs)

RBI/2011-12/268 DNBS.PD.CC.No.249/03.02.089/2011-12 dated November 21, 2011

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Link: http://rbi.org.in/scripts/BS_CircularIndexDisplay.aspx?Id=6830

The Finance Minister had in his budget speech for the year 2011-2012 announced the setting up of The Reserve Bank had vide its Press Release dated September 23, 2011, issued broad parameters for banks and NBFCs to set up IDFs. Detailed guidelines are set out in the following paragraphs prescribing the regulatory framework for Non Banking Financial Companies (NBFCs) to sponsor IDFs which are to be set up as Mutual Funds (MFs) and NBFCs. Such entities would be designated as “Infrastructure Debt Fund – Mutual Funds (IDF-MF) and “Infrastructure Debt Fund – Non-Banking Financial Company (IDF-NBFC)”. All NBFCs, including Infrastructure Finance Companies (IFCs) registered with the Bank may sponsor IDFs to be set up as Mutual Funds. However, only IFCs can sponsor IDF-NBFCs.

Eligibility Parameters for NBFCs as Sponsors of IDF-MFs

3. All NBFCs would be eligible to sponsor (sponsorship as defined by SEBI Regulations for Mutual Funds) IDFs as Mutual Funds with prior approval of RBI subject to the following conditions, in addition to those prescribed by SEBI, in the newly inserted Chapter VI B to the MF Regulations :

- i. The NBFC should have a minimum Net Owned Funds (NOF) of Rs. 300 crore and Capital to Risk Weighted Assets (CRAR) of 15%;
- ii. Its net NPAs should be less than 3% of net advances;
- iii. It should have been in existence for at least 5 years.
- iv. It should be earning profits for the last three years and its performance should be satisfactory;
- v. The CRAR of the NBFC post investment in the IDF-MF should not be less than the regulatory minimum prescribed for it;
- vi. The NBFC should continue to maintain the required level of NOF after accounting for investment in the proposed IDF and

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- vii. There should be no supervisory concerns with respect to the NBFC.

Eligibility Parameters for IFCs setting up IDF-NBFCs

- 4. Only NBFC-IFCs can sponsor IDF-NBFC with prior approval of the Reserve Bank and subject to the following conditions.
 - i. Sponsor IFCs would be allowed to contribute a maximum of 49 percent to the equity of the IDF-NBFCs with a minimum equity holding of 30 percent of the equity of IDF-NBFCs,;
 - ii. Post investment in the IDF-NBFC, the sponsor NBFC-IFC must maintain minimum CRAR and NOF prescribed for IFCs
 - iii. There are no supervisory concerns with respect to the IFC.

Tripartite Agreement

- 5. IDF-NBFCs will enter into Tripartite Agreements to which, the Concessionaire, the Project Authority and IDF-NBFC shall be parties. Tripartite Agreement binds all the parties thereto to the terms and conditions of the other Agreements referred to therein also and which collectively provide, inter alia, for the following:-
 - i. take over a portion of the debt of the Concessionaire availed from Senior Lenders,
 - ii. a default by the Concessionaire, shall trigger the process for termination of the agreement between Project Authority and Concessionaire,
 - iii. the Project Authority shall redeem the bonds issued by the Concessionaire which have been purchased by IDF-NBFC, from out of the termination payment as per the Tripartite Agreement and other Agreements referred to therein (compulsory buyout),
 - iv. the fee payable by IDF-NBFC to the Project Authority as mutually agreed upon between the two.
- 6. NBFC and IFCs that fulfill the eligibility criteria as above may approach the Central Office of the Department of Non-

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Banking Supervision, Reserve Bank of India, Centre I, World Trade Centre, Cuffe Parade, Mumbai – 400 005 for sponsoring IDFs as MFs and NBFCs, as applicable.

Investment by NBFCs and IFCs in IDFs

7. The exposure of sponsor NBFCs / IFCs and non-sponsor NBFCs / IFCs to the equity and debt of the IDFs would be governed by the extant credit concentration norms as given in para 18 of the Non-Banking Financial (Non-Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007.

8. Notification containing the detailed guidelines issued with regard to regulation of IDF-NBFCs viz; DNBS.PD.No.233/CGM (US)-2011, dated November 21, 2011 are enclosed for meticulous compliance. As regards foreign exchange related aspects of the functioning of IDF-NBFCs, a separate circular is being issued.

b. Fair Practices in Lending

I. Transparency in Interest Rates

- a. There shall be only three components in the pricing of the loan viz., the interest charge, the processing charge and the insurance premium (which includes the administrative charges in respect thereof).
- b. There will be no penalty charged on delayed payment.
- c. NBFC-MFIs shall not collect any Security Deposit/ Margin from the borrower.
- d. There should be a standard form of loan agreement.
- e. Every NBFC-MFI should provide to the borrower a loan card reflecting
 - (i) the effective rate of interest charged
 - (ii) all other terms and conditions attached to the loan
 - (iii) information which adequately identifies the borrower and

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- (iv) acknowledgements by the NBFC-MFI of all repayments including instalments received and the final discharge.
- (v) all entries in the Loan Card should be in the vernacular language.
- f. The effective rate of interest charged by the NBFC-MFI should be prominently displayed in all its offices and in the literature issued by it and on its website.

II. Multiple-lending, Over-borrowing and Ghost-borrowers

- a. NBFC-MFIs can lend to individual borrowers who are not member of Joint Liability Group(JLG)/Self Help Group(SHG) or to borrowers that are members of JLG/SHG.
- b. a borrower cannot be a member of more than one SHG/JLG.
- c. not more than two NBFC-MFIs should lend to the same borrower.
- d. there must be a minimum period of moratorium between the grant of the loan and the due date of the repayment of the first instalment. The moratorium shall not be less than the frequency of repayment. For eg: in the case of weekly repayment, the moratorium shall not be less than one week.
- e. recovery of loan given in violation of the regulations should be deferred till all prior existing loans are fully repaid.
- f. All sanctioning and disbursement of loans should be done only at a central location and more than one individual should be involved in this function. In addition, there should be close supervision of the disbursement function.

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III. Non- Coercive Methods of Recovery

- NBFC-MFIs shall ensure that a Code of Conduct and systems are in place for recruitment, training and supervision of field staff. The Code of Conduct should also incorporate the Guidelines on Fair Practices Code issued for NBFCs vide circular CC No.80 dated September 28, 2006 as amended from time to time.
- Recovery should normally be made only at a central designated place. Field staff shall be allowed to make recovery at the place of residence or work of the borrower only if borrower fails to appear at central designated place on 2 or more successive occasions.
- All other elements of the Fair Practices Code issued for NBFCs vide CC No 80 dated September 28, 2006 as amended from time to time shall be adhered to.

c. Corporate Governance

The Master Circular issued for NBFCs on Corporate Governance vide CC No. 187 dated July 01, 2011 shall be applicable to NBFC-MFIs also.

d. Improvement of Efficiency

NBFC-MFIs shall review their back office operations and make the necessary investments in Information Technology and systems to achieve better control, simplify procedures and reduce costs.

e. Others

All NBFCs may refer to the circular RPCD.CO.Plan BC. 66 /04.09.01/2010-11 dated May 3, 2011 issued by the Rural Planning and Credit Department of RBI titled "Bank loans to

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Micro Finance Institutions (MFIs) – Priority Sector status” issued to banks with regard to guidelines on priority sector.

5. Existing NBFCs that satisfy the above conditions may approach the Regional Office in the jurisdiction of which their Registered Office is located, along with the original Certificate of Registration (CoR) issued by the Bank for change in their classification as NBFC-MFIs. Their request must be supported by their Statutory Auditor's certificate indicating the asset (loan) pattern as on March 31, 2011. The onus of including only eligible assets for the purpose of classification as NBFC-MFI shall be that of the company concerned. The change in classification would be incorporated in the Certificate of Registration issued by the Bank as NBFC-MFI.

6. In terms of paragraph 15 of the Non-Banking Financial (Non-Deposit accepting or holding) Companies Prudential Norms (Reserve Bank) Directions, 2007 all NBFCs are required to submit Statutory Auditors Certificate with reference to the position of the company as at end of the financial year ended March 31 every year. For an NBFC-MFI, such Certificate will also indicate that the company fulfils all conditions stipulated to be classified as an NBFC-MFI in this circular.

7. Non-compliance with these Directions shall invite penal provisions under the RBI Act, 1934.

31. Revised Capital Adequacy Framework for Off-Balance Sheet Items for NBFCs

RBI/2011-12/316 DNBS.CC.PD.No.252/03.10.01/2011-12 dated December 26, 2011

Link: <http://www.rbi.org.in/scripts/NotificationUser.aspx?Mode=0&Id=6892>

To introduce greater granularity in the risk weights and credit conversion factors for different types of off balance sheet items, NBFCs will need to calculate the total risk weighted off-balance sheet credit exposure as the sum of the risk-weighted amount of the market related and non-market related off-balance sheet

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items. The risk-weighted amount of an off-balance sheet item that gives rise to credit exposure will be calculated by means of a two-step process:

- a. the notional amount of the transaction is converted into a credit equivalent amount, by multiplying the amount by the specified credit conversion factor or by applying the current exposure method; and
- b. the resulting credit equivalent amount is multiplied by the applicable risk weight.

For the off-balance sheet items already contracted by NBFCs, the risk weights shall be applicable with effect from the Financial Year beginning April 01, 2012. For all new contracts undertaken including CDS, the new risk weights shall be applicable from the date of the circular.

The amending Notifications DNBS.PD.No.237/ CGM (US) 2011 and DNBS.PD.No. 238/CGM (US) 2011 both dated December 26, 2011 amending the Non-Banking Financial (Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) directions, 2007 and the Non-Banking Financial (Non-Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007 respectively are enclosed with the circular.

32. Revised Capital Adequacy Framework for Off-Balance Sheet Items for NBFCs-Clarification

RBI/2011-12/333 DNBS.CC.PD.No.254/03.10.01/2011-12 dated December 30, 2011

Link: <http://www.rbi.org.in/scripts/NotificationUser.aspx?Mode=0&Id=6914>

Paragraph 16(2) of Non-Banking Financial (Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007(hereinafter referred to as the said Directions),

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contained in Notification No. DNBS. 192/DG(VL)-2007 dated February 22, 2007 has been replaced with the following:

“E. Credit conversion factors for Credit Default Swaps (CDS):

NBFCs are only permitted to buy credit protection to hedge their credit risk on corporate bonds they hold. The bonds may be held in current category or permanent category. The capital charge for these exposures will be as under:

- (i) For corporate bonds held in current category and hedged by CDS where there is no mismatch between the CDS and the hedged bond, the credit protection will be permitted to be recognised to a maximum of 80% of the exposure hedged. Therefore, the NBFC will continue to maintain capital charge for the corporate bond to the extent of 20% of the applicable capital charge. This can be achieved by taking the exposure value at 20% of the market value of the bond and then multiplying that with the risk weight of the issuing entity. In addition to this, the bought CDS position will attract a capital charge for counterparty risk which will be calculated by applying a credit conversion factor of 100 percent and a risk weight as applicable to the protection seller i.e. 20 per cent for banks and 100 per cent for others.
- (ii) For corporate bonds held in permanent category and hedged by CDS where there is no mismatch between the CDS and the hedged bond, NBFCs can recognise full credit protection for the underlying asset and no capital will be required to be maintained thereon. The exposure will stand fully substituted by the exposure to the protection seller and attract risk weight as applicable to the protection seller i.e. 20 per cent for banks and 100 per cent for others.

The Notifications DNBS.PD.No.239/ CGM (US) 2011 and DNBS.PD.No. 240/CGM (US) 2011 both dated December 30, 2011 amending the Non-Banking Financial (Deposit Accepting

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or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007 and the Non-Banking Financial (Non-Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, (as amended vide Notifications.No.237 and No. 238 both dated December 26, 2011) are enclosed with this circular.

33. Monitoring of frauds- All Non-Deposit taking NBFCs with asset size of Rs.100 crore and above and Deposit taking NBFCs

RBI/2011-12/424 DNBS.PD.CC. No. 256 /03.10.042 / 2011-12 dated March 02, 2012

Link: <http://www.rbi.org.in/scripts/NotificationUser.aspx?Mode=0&Id=7037>

All NBFCs-ND-SI are advised to follow the Guidelines which inter alia, stipulate that individual cases of frauds involving amount less than Rs. 25 lakhs shall be reported to the respective Regional Offices(ROs) of DNBS in whose jurisdiction registered office of the company is located whereas individual cases of frauds involving amount of Rs. 25 lakhs and above may be reported to RBI.

Additionally, all non-deposit taking NBFCs with asset size of Rs.100 crore and above and deposit taking NBFCs shall disclose the amount related to fraud, reported in the company for the year in their balance sheets. As envisaged in the CC dated October 26, 2005, it is reiterated that NBFCs failing to report fraud cases to the Reserve Bank would be liable for penal action prescribed under the provisions of Chapter V of the RBI Act, 1934.

34. Non- Reckoning Fixed Deposits with Banks as Financial Assets

RBI/2011-12/446 DNBS (PD)CC.No.259 /03.02.59/2011-12 dated March 15, 2012

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Link: <http://www.rbi.org.in/scripts/NotificationUser.aspx?Mode=0&Id=7063>

1. In terms of Section 45IA (1) of the RBI Act 1934, no non-banking financial company shall commence business or carry on the business of a non-banking financial institution without (a) obtaining a certificate of registration (CoR) from the Reserve Bank and (b) having a net owned fund of twenty five lakh rupees, which was increased to Rs. 200 lakh with effect from April 21, 1999.

2. It has, however, come to the notice of the Reserve Bank that some NBFCs obtain registration from the Bank, park their funds in fixed deposits with commercial banks but do not commence NBFI activities for several years thereafter. The Auditors of the companies have in these cases also certified that the companies are conducting NBFI activities, justifying the continued holding of the CoR issued by the Bank.

3. It is clarified, that the Reserve Bank issues a Certificate of Registration for the specific purpose of conducting NBFI activities. Investments in fixed deposits cannot be treated as financial assets and receipt of interest income on fixed deposits with banks cannot be treated as income from financial assets as these are not covered under the activities mentioned in the definition of “financial Institution” in Section 45I(c) of the RBI Act 1934. Besides, bank deposits constitute near money and can be used only for temporary parking of idle funds, and/or in the above cases, till commencement of NBFI business.

4. In addition, the NBFC which is in receipt of a CoR from the Bank must necessarily commence NBFC business within six months of obtaining CoR. If the business of NBFC is not commenced by the company within the period of six months from the date of issue of CoR, the CoR will stand withdrawn automatically. Further, there can be no change in ownership of the NBFC prior to commencement of business and regularization of its CoR.

35. Lending Against Security of Single Product – Gold Jewellery

RBI/ 2011-12/467 DNBS.CC.PD.No.265/03.10.01/2011-12 dated March 21, 2012

Link: <http://www.rbi.org.in/scripts/NotificationUser.aspx?Mode=0&Id=7086>

All NBFCs shall maintain a Loan-to-Value(LTV) ratio not exceeding 60 percent for loans granted against the collateral of gold jewellery and disclose in their balance sheet the percentage of such loans to their total assets.

NBFCs primarily engaged in lending against gold jewellery (such loans comprising 50 percent or more of their financial assets) shall maintain a minimum Tier I capital of 12 percent by April 01, 2014.

NBFCs should not grant any advance against bullion / primary gold and gold coins.

36. Foreign investment in NBFC Sector under the FDI Scheme – Clarification

RBI/2011-12/562 A.P. (DIR Series) Circular No. 127 dated May 15, 2012

Link: <http://www.rbi.org.in/scripts/NotificationUser.aspx?Id=7216&Mode=0>

RBI has clarified that the activity 'leasing and finance', which is one among the eighteen NBFC activities wherein FDI up to 100 per cent is permitted under the automatic route, subject to minimum capitalisation norms, covers only 'financial leases' and not 'operating leases', in so far as the NBFC sector is concerned.

ICAI Announcement dated September 18, 2007

http://www.icai.org/resource_file/7945announ1158.pdf

TG on Audit of Non-Banking Financial Companies

ANNOUNCEMENT

For the Immediate Attention of the Members Audits of NBFCs

Non Banking Finance Companies (NBFCs) are playing a vital role as the financial resource mobilised in India given the country's geographical and population spread. However, having regard to the locations at which they generally operate, the type of clientele they serve and the some of instances of fraudulent/ mismanaged NBFCs, the Reserve Bank of India (RBI) established a strict regulatory framework for operation of NBFCs. Annual statutory audit of the NBFCs, including the NBFC Auditor's Report (Reserve Bank) Directions, 1998 constitutes important pillar of that framework. The aforesaid Directions include a number of reporting responsibilities, including making of exception reports, for the statutory auditors of NBFCs.

The Institute of Chartered Accountants of India has recently received a communication from the Department of Non Banking Supervision of the RBI in respect of audit of NBFCs. In its said communication the Reserve Bank of India has given an illustrative inclusive list of irregularities in NBFCs, required to be reported by the statutory auditors of NBFCs in terms of the requirements of the aforesaid Directions, but one or more of which have not been reported by some of the statutory auditors.

The abovementioned list is as follows:

- Net Owned Funds below the minimum required level not reported
- Item not eligible for inclusion in 'Free Reserve' for the purpose of calculation of Net Owned Fund not excluded nor reported e.g. Share Premium included in Free Reserve in case where the shares are redeemable at premium and the NBFC has not created any redemption reserve.

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- Company engaged in the business of Non-Banking Financial Institution without obtaining Certificate of Registration from the Reserve Bank of India.
- Failure to comply with the prudential in terms of the Non-Banking Financial (Non-Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007 and Non-Banking Financial (Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007.
- Non-reporting of downgrading of credit rating of deposit-taking NBFCs having bearing on the quantum of deposits permissible under the Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998.
- Failure to report passing of Board Resolution by NBFCs (Non Deposit Taking) that they shall not accept public deposits.
- Failure to report acceptance of deposit by the NBFCs in excess of the quantum of deposits permitted in terms of Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998.
- Failure to report adherence to conditions subject to which a company is classified as Core Investment Company.

Members are requested to take note of the above.

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Technical Guide to Audit in a Shared Service Centre Structure

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Foreword

‘Shared Service Centre Structure’ is an emerging concept in organizational structures these days. In this structure, service is provided by one part of a group of entities where that service was earlier scattered in more than one part of such group. The main purpose of this structure is the convergence and streamlining of functions of an organization to ensure that the services required of it are delivered as effectively and efficiently as possible to the organization.

Shared service centre structure provides an ideal bridge between centralized and decentralized administration. It provides several benefits to organization like clear separation of responsibilities, effective quality assurance, concentration on core operations in various business areas, standardized processes and reporting, company-wide utilisation of available knowledge, better information analysis and decision making, etc. Audit of shared service centres poses many typicalities and to resolve them, some of the members may need guidance.

I am happy that the Auditing and Assurance Standards Board has brought out this Technical Guide to Audit in a Shared Service Centre Structure. The Guide has been formulated in an easy to understand language and contains detailed guidance on the various intricacies involved in audit of shared service centres.

At this juncture, I wish to place on record my appreciation for CA. Abhijit Bandyopadhyay, Chairman, Auditing and Assurance Standards Board for his proactive initiatives to help members in conducting audits in various industries/sectors in the form of such industry/sector specific Technical Guides.

April 05, 2013
New Delhi

CA. Subodh K. Agrawal
President, ICAI

Preface

Shared services centre (SSC) is a dedicated unit (including people, processes and technologies) that is structured as a centralized point of service and is focused on defined business functions. Driven by technology, shared service centres are proving to be instrumental in achieving cost efficiency in large organisations by centralising back-office operations and eliminating redundancy. Today, many organisations employ a shared services model for finance, human resources management and information technology.

Given their peculiar structure and positioning in an organisation, audit of SSCs can pose typical challenges to their auditors. In this background, I am happy to place in your hands, the Technical Guide to Audit in a Shared Service Centre Structure. The Technical Guide covers aspects such as background information on origin of SSCs, planning and scoping, control testing, completion and reporting, etc. It also augments implementation of the Standard on Assurance Engagement (SAE) 3402, 'Assurance Reports on Controls at a Service Organisation' and Standard on Auditing (SA) 402, 'Audit Considerations Relating to an Entity Using a Service Organisation'.

At this juncture, I wish to place on record my deep gratitude to CA. Harinderjit Singh, Gurgaon and his team comprising CA. Sandeep Chaddha, CA. Ankur Motiwal and CA. Ridhima Dubey who, despite their extremely pressing professional and other preoccupations, volunteered to write this Technical Guide and share their valuable experience and knowledge for the benefit of the members, at large.

I am also thankful to CA. Subodh Kumar Agrawal, President, ICAI and CA. K Raghu, Vice President, ICAI for their support to the activities of the Auditing and Assurance Standards Board.

I also wish to place on record my gratitude for my colleagues on the Board during 2012-13 when the Technical Guide was

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envisioned as well as my colleagues at the Board for the current term 2013-14, viz., CA. Naveen ND Gupta, Vice Chairman, CA. Rajkumar S Adukia, CA. Jay Ajit Chhaira, CA. Shriniwas Y Joshi, CA. Sanjeev Maheshwari, CA. Dhinal A Shah, CA. Shiwaji B Zaware, CA. M. Devaraja Reddy, CA. S. Santhanakrishnan, CA. J. Venkateswarlu, CA. Manoj Fadnis, CA. Sanjiv K Chaudhary, CA. Vijay K Gupta, Shri Gautam Guha, Shri Bhaskar Chatterjee, CA. Niraj Kumar Jhunjhunwala, CA. Sanjay Vasudeva, CA. Ganesh Balakrishnan, CA. Charanjeet Surendra Attra and CA. Saunak Ray for their support and guidance to the Board. I also wish to place on record my thanks to the special invitees to the Board, viz., Prof. Manoj Anand, Shri Vijay Sachdeva and Shri Sunil Kadam for their support to the Board. I also wish to thank the Secretariat of the Auditing and Assurance Standards Board for their efforts in giving the Guide its final shape.

I am sure that the Technical Guide would be immensely useful to the members.

April 22, 2013
Kolkata

CA. Abhijit Bandyopadhyay
Chairman
Auditing and Assurance Standards Board

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Chapter 1

Overview

Introduction

The purpose of this Technical Guide to Audit in a Shared Service Centre Structure is to provide supplementary guidance to the members who are performing audit in shared service centre structure. The Guide should not be considered as replacement to the existing pronouncements of the Institute of Chartered Accountants of India (ICAI), i.e., Standard on Assurance Engagements (SAE) 3402, Assurance Reports on Controls at a Service Organisation. SAE 3402, deals with assurance engagements undertaken by a professional accountant in public practice to provide a report for use by user entities and their auditors on the controls at a service organisation that provides a service to user entities that is likely to be relevant to user entities' internal control as it relates to financial reporting. It complements Standard on Auditing (SA) 402*, Audit Considerations relating to an Entity Using a Service Organisation, in that reports prepared in accordance with this SAE are capable of providing appropriate evidence under SA 402.

1.1 History and Evolution of Shared Service Centre

In the global economies, international businesses are under pressure from ever-increasing and cut-throat competition.

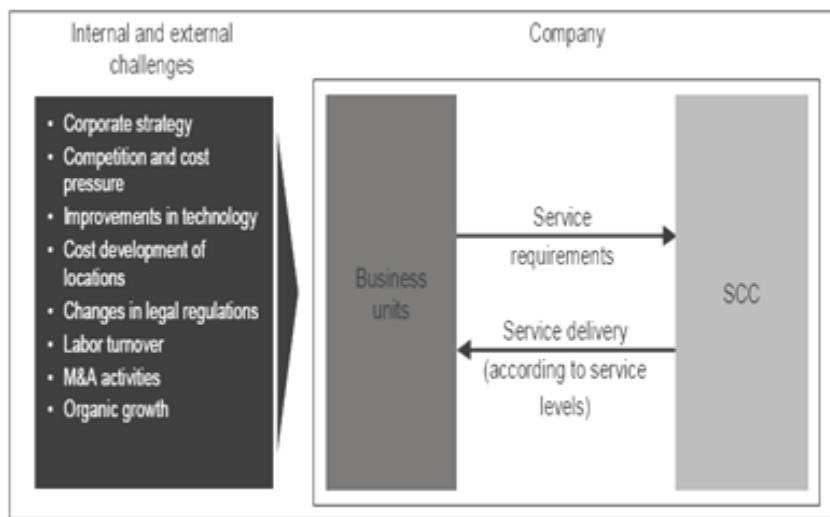
* This Standard on Auditing (SA) deals with the user auditor's responsibility to obtain sufficient appropriate audit evidence when a user entity uses the services of one or more service organisations. Specifically, it expands on how the user auditor applies SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment" and SA 330, "The Auditor's Responses to Assessed Risks" in obtaining an understanding of the user entity, including internal control relevant to the audit, sufficient to identify and assess the risks of material misstatement and in designing and performing further audit procedures responsive to those risks.

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Although consistent expansion along with diversified operations leads to greater profits and market share, an inefficient company structure, high administrative costs, and unclear information paths are often the side products.

General cost reductions coupled with steadily growing product quality are key mantras in establishing and sustaining in any competitive market. Many companies resort to restructuring their operations in order to create synergies and increase their performance.

Internal and external challenges led to the birth of the concept of shared services. As an internal services provider, the Shared Service Centre presents an ideal bridge between consolidated administration and decentralised responsibilities in order to master the challenges of modern-day business management.



1.2 What is a Shared Service Centre

Shared Services “Defined”

Shared services refer to an arrangement wherein service is provided by one part of a group of entities where that service had previously been scattered in more than one part of the group of entities. Under these arrangements, the funding and resourcing of

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the services are shared and the providing department could effectively be termed as an internal service provider. The arrangements can alternatively be entered with a third party service provider.

The above does not imply that a captive unit of an entity would be considered as a Shared Service provider.

Features of a Shared Service Centre

- Support of local operations for the improvement of customer services through better information and work methodology.
- Back office optimisation of process and support activities.
- Effective and efficient support of internal areas through application of standardised and consolidated processes.
- Organisationally and economically independent entity.
- Through focusing on internal needs, release of resources.

Key Note:

Features of the shared service centre entirely depend upon the nature and purpose of the shared service centre.

What cannot be termed as a Shared Service Centre

A Shared Service Centre leads to a restructuring of duties and responsibilities with defined evaluation periods and service levels. As a result, it can be arranged according to a centralised or decentralised organisational structure. Through a combination of the respective organisational forms, it is possible to utilise the advantages of synergy effects and eliminate existing deficiencies.

Following table highlights the key difference between SSC and centralised/decentralised organisation structure:

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SSC versus centralised/decentralised organisation		
Initial Situation		Option Shared Service Centre
Centralised	Decentralised	
• Inflexible	• Higher costs	• Efficient organisations culture
• Rigid structure	• Variable standards	• Economies of scale
• Too far away from the daily business	• Non-standardised quality Management	• Synergy effects
• Bureaucratic	• Similar costs in different business units	• Company-wide controlling
		• Bundled experience
		• Business areas maintain independence
		• Standardisation of best practices
		• Recognition of local priorities
		• Sensitive to customer needs

Shared Services is different from the diametrically opposite model of **Outsourcing**, which is where an external third party is paid to provide a service that was previously internal to the buying organisation.

What is a Shared Service Centre

For purpose of illustration, in a typical client structure for a Multinational Corporation (MNC), there will be a parent company in US or Europe and then there will be a number of legal

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subsidiaries (referred to as 'component' in the subsequent paragraphs) across the globe to service its customer base in those countries.

Many such clients have established Shared Service Centres ("SSCs"). SSCs generally provide centralised services ranging from specific tasks (such as processing of accounts receivable, accounts payable, payroll, intercompany accounting and reconciliations, etc) to complete functions or businesses processes (including, entire accounting cycle including preparation of management information reports and financial statements, information technology operations, customer relationships, procurement process, etc.). These SSCs could either be captive i.e., in-house or external i.e., a third-party SSC. The SSCs may also be established in different geographies primarily driven by language constraints. The SSCs in India provides support for those countries which have high degree of English speaking capabilities and the SSCs which are established in other countries such as Europe or in Greater China Region predominantly support those countries where the medium is dominated by local languages.

Key Note:

In case of a third party SSC, the group/component auditor needs to exercise judgment on the level of assurance/audit comfort required out of the processes/activities. Such decision/assessment would be influenced by nature of process/activities outsourced to the third party, auditor's risk assessment process, etc.

1.3 Importance/Role of Shared Service Centre

One purpose of Shared Services is the convergence and streamlining of an organisation's functions to ensure that they deliver to the organisation the services required of them as effectively and efficiently as possible. This often involves the centralising of back office functions such as HR and Finance but can also be applied to the middle or front offices. The application

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of a Shared Service Centre follows goals that are aimed at increasing profit and efficiency as well as quality improvements.

Other benefits at a glance:

- Clear separation of responsibilities.
- Effective quality assurance.
- Effectiveness and ease in adopting changes.
- Defined (quality) standards for input/processing/output.
- Establishment of internal customer and supplier relationship management.
- Concentration on core operation in the various business areas.
- Established performance production and control through service level agreements.
- Standardised processes and reporting.
- Company-wide utilisation of available knowledge.
- Higher information consistency.
- Better information analysis and decision making.

Types of Shared Service Centres

Shared Service Centres – Types	
Commercial Structure Variation	Location Variation
Unitary - A single organisation consolidating and centralising a business service	On-shore – Work is carried out in the same country but at a different location
Lead department - An organisation consolidating and centralising a business service that will be shared by other organisations	Near-shore – Work is carried out in a close location
Joint Initiatives – Agreement between two or more organisations to set up and operate Shared Services	Off-shore – Work is carried out anywhere in the world that is not on-shore or near-shore

TG to Audit in a Shared Service Centre Structure

The audit approach for each of these types of the Shared Service Centre would be different and would depend on the organisational set-up of the shared service centre. An auditor would have to adopt different audit strategy depending upon structure of the Shared Service Centre as well as risks and related controls.

Suggested audit strategies are discussed in detail in the next sections.

1.4 Services Offered by Shared Service Centre

Some of the common services offered by SSC include the following:

Finance	Procurement	HR	IT	Sales
<ul style="list-style-type: none">•Accounts Payable•Accounts Receivable•Credit and Collections•Treasury Operations•Financial Reporting•Fixed Asset Accounting•General Ledger Reconciliations•Inter-Company Transactions•Planning and Forecasting	<ul style="list-style-type: none">• Administrative Procurement• Contact Management• Logistics and Goods Management• Purchase Order Processing• Supplier Management	<ul style="list-style-type: none">• Application Data Administration• Payroll• Personnel Data Administration• Travel Accounting	<ul style="list-style-type: none">• Application Development• Hosting• Operating of Data Processing Centre, Data Collection and Data Filing• User Help Desk	<ul style="list-style-type: none">• Billing• Complaint Management• Customer Service• Order Management• Technical Support

1.5 Efficiencies and Economies Attained

There is two-fold benefit of centralising the accounting and other functions at one or more SSC viz., economies and efficiencies attained.

Reduction in Cost

The client benefits from the economies by moving the transactions processing and reporting, reconciliations and review, etc. to low

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cost countries like India, China, etc. and also because of the volume of transactions processed from one location rather than a number of locations globally it also gains economies of scale.

Efficiency from Standardisation

The client also attains significant efficiency by standardising the processes which ensures uniformity of reporting. The review mechanism also becomes more robust since all the reports and reviews are driven by one standardised process. The client is also in a better position to have a constant look at those processes and bring in further efficiencies in the same.

1.6 Homogeneous Process and Standardisation Attained

As discussed above, in a SSC model, the process will be homogeneous or consistent irrespective of the fact from where the transaction is originating. Taking an example, in case of Treasury Reconciliations, all the Bank Reconciliations for all the legal subsidiaries and parent company will be prepared at the SSC with same set of defined process, subject to same set of defined rigor of review and reporting of exceptions and performed by same set of people at SSC. This definitely helps the client in attaining standardisation in their processes. Reference should also be made to Chapter 3, in respect of third-party SSC handling processes of multiple groups.

1.7 Objective of Audit in a Shared Service Centre Structure

In case of both captive/third-party SSC, sending multiple audit engagement teams to perform audit work at SSC is likely to be neither efficient nor effective. A better approach is usually for the group audit team (responsible for audit of parent company and consolidation) to establish the level of audit comfort needed over the functions and processes at the SSC and to assign one audit team (the “SSC audit team”) to perform specified procedures designed to share audit comfort with In-Country/component audit teams to achieve both group and component and local statutory reporting objectives. Refer paragraph 2.1 for the role of

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corporate/group audit team, SSC audit team and In-Country/component audit teams.

In the remaining Chapters, we will look at an overview of the planning and scoping, execution, reporting and communication involved in an effective audit of a SSC. We will also look at some of the key messages from the experience of some of the engagement teams who have already implemented a SSC audit approach.

Key Note:

The technical guide should not be considered as substitute for the audit of the financial statements of the Shared Service Centre under the legal regulatory environment of the jurisdiction under which it operates. Depending upon the legal status of the SSC it would be subject to the audit requirements as per local laws. For example, a SSC incorporated as a company under Companies Act, 1956 (the 'Act'), would be subject to audit pursuant to the requirements of Section 227 of the Act.

To understand the relevance and scope of different audit teams involved in SSC audit engagement, reference should be made to Para 2.1 of Chapter 2.

Chapter 2


Planning and Scoping Phase

2.1 Areas of Audit Emphasis in a Shared Service Centre

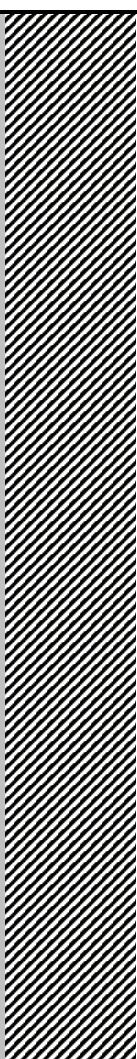
Typically, in a SSC audit structures, 3 types of audit teams are involved. These audit teams can be referred to as 'parent/group audit team', 'in-country/component audit team' and 'SSC audit team'. Depending upon the nature of engagement, key roles and responsibilities of these audit teams can be identified as under:

Audit Team	Component	Location	Role	Responsibilities
Parent/Group Audit Team	Group Financial Statements	Usually, the location where the consolidated financial statements of the group are filed.	<ul style="list-style-type: none"> • Maintaining relationship with the group's management / audit committee. • Drive relationship with component/ SSC audit teams. • Planning for audit of consolidated financials statements. • Issue inter firm instructions. 	<ul style="list-style-type: none"> • Ensure compliance with the local reporting requirement, practice regulations and oversight. • Review the work of the component/ SSC audit teams. • Perform the incremental required audit work locally. • Issue

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			<ul style="list-style-type: none"> • Ensure compliance with local risk management policies. 	<p>opinion on the group's consolidated financial statements.</p>
In-Country/ Component Audit Team	Component/ Subsidiary Financial Statements	Usually, the location where the component financial statements of the subsidiary Company are filed.	<ul style="list-style-type: none"> • Maintaining relationship with the subsidiary's management. • Drive relationship with SSC audit team. • Planning for audit of component financials statements. • Issue inter firm instructions. • Ensure compliance with local risk management policies. 	<ul style="list-style-type: none"> • Ensure compliance with the local reporting requirement, practice regulations and oversight. • Review the work of the SSC audit teams. • Perform the incremental required audit work locally. • Issue opinion on the component's financial statements.
Share Service Centre		Locations where the shared	<ul style="list-style-type: none"> • Maintaining relationship with the SSC 	<ul style="list-style-type: none"> • Ensure that the staff performing

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Audit Team		service centre is located.	<p>management.</p> <ul style="list-style-type: none"> • Ensure that nature and scope of the work to be performed in connections with group's/ component's financial statement is clearly agreed with the group/ component audit teams. • Receive inter firm instructions. • Ensure compliance with local risk management policies. 	<p>the work is appropriately trained – depending upon the nature of the engagement</p> <ul style="list-style-type: none"> • Ensure that the work performed is in accordance with the instructions. • Issue reports/ opinion in the format and timelines – agreed in the inter firm instructions.
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Key Note:

In the scenario where the shared service centre is a subsidiary of the group company, it is possible that the 'In-country/component' auditor and SSC auditor would be same in relation to SSC entity.

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The areas where audit support could be provided to Parent/Group Audit Team or In-Country/Component audit teams from the Shared Service Centre Facility include:

- a) Tests of manual and automated controls, including information technology general controls (ITGC) where systems reside at the Shared Service Centre, and IT support is provided by the SSC;
- b) Tests of monitoring controls or business performance reviews performed by personnel at the SSC;
- c) Detailed substantive audit procedures; and/or
- d) Substantive analytical procedures.

Key Note:

Competency level of the engagement team performing the audit at any SSC depends upon the nature of engagement and capacity under which engagement team is working. For e.g. where the engagement team performing work at SSC is an extension of the Parent/Group Audit Team, the SSC engagement team is not expected to exercise any judgment independently. SSC engagement team in such situations would generally perform their work strictly as per instructions received from the Parent/Group /in-country audit team.

In cases where the audit team at SSC is engaged to perform a full scope audit on behalf of the in-country/group audit team on a component's/group's financial statements and the inter firm instruction does not specify the detailed procedures to be performed by the SSC audit team, SSC audit team is expected to apply their judgment on the nature, timing and extent of audit procedures to be performed by them.

It is also important to note that the reporting structure in each of the above cases would be different and should be agreed between the audit teams and be part of the inter firm instructions.

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2.2 Role of Group Audit Team, SSC Audit Team and In-Country Audit Teams

Each of the Group audit team, SSC audit team and In-Country audit teams plays an important role in servicing the client.

For the reporting at Parent/Group office including consolidation, the Group audit team needs to work closely with SSC audit team (since most of the significant processes are at SSC) and in some cases with In-Country audit teams also (where some of the significant processes are still residing In-Country rather than at SSC). Similarly, to support local reporting by In-Country audit team for each legal subsidiary, all the three teams need to work collectively to divide the work amongst each of them so as to ensure sufficient audit comfort is obtained by the In-Country audit team and they can then sign-off the legal subsidiary's accounts as per applicable local GAAP and GAAS.

The role of each of these three teams is discussed in more details in the paragraphs below.

2.3 Independence and Competency

GAAS requirements in certain territories may necessitate the SSC engagement team providing confirmations to group and component/statutory audit teams (to all groups in case of a third-party SSC) regarding the independence and competency of the team performing the audit work. In order to manage this process in a timely fashion, the SSC team should enquire, during the planning phase, as to the nature of confirmations required. The SSC team should consider and coordinate centrally the full listing of these confirmations, and assign an appropriate administration assistant to collate, track and distribute appropriately required information for SSC engagement team members. Any issues of potential non-compliance should however be communicated and discussed with the respective group or component/in-country team immediately.

Group engagement teams should identify all SSC audit teams involved in the group audit including those that may not have a

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direct reporting responsibilities and it should ensure that those are in compliance with the independence requirements of the group audit.

Key Note:

Standard on Quality Control (SQC) establishes basic principles and essential procedures and to provide guidance regarding a firm's responsibilities for its system of quality control for audits and reviews of historical financial information, and for other assurance and related services engagements.

Appropriate consideration needs to be given by the audit firm in ensuring compliance with SQC in performing the audit engagements.

2.4 Understanding of the Processes

The audit in a SSC scenario needs to be planned to ensure that the desired level of audit comfort is available to each impacted audit team using the most effective and efficient overall audit approach.

The planning and scoping of the work to be performed at SSC will depend on a number of factors including the extent to which the SSC is performing transactions through standardised systems (as opposed to running different processes for each subsidiary or group in case of a third-party SSC) and the degree to which Parent/Group audit team is relying on the work in issuing an opinion on controls.

For example, in case provisions of the Sarbanes Oxley Act, 2002 (SOX) are also applicable to the Group(s), the Parent/Group audit team in conjunction with SSC audit team needs to do the following during the planning and scoping exercise:

- a) Understanding the strategy of the client as it relates to the SSC, the standing of the SSC within the group, its business rationale and objectives. This includes ensuring a thorough understanding of the roles, responsibilities, accountability for and ownership of the information to be

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processed by the SSC. This also involves understanding where the control and responsibility lies between the entities using the data from the SSC and the SSC itself, control activities that are performed at the SSC and how these are monitored by the Client.

- b) Understanding key risks, including fraud and business risks, related to the SSC. In doing this, audit teams need to understand both those risks the SSC is responsible for managing on behalf of the rest of the group, as well as the risks to which the SSC itself is exposed. Management's views and response to the assessed risks should also be considered by the relevant audit teams.
- c) Understanding both the legal and management control structure of the client.
- d) Understanding the audit and reporting requirements for the group and component entities that require stand-alone audits, including local statutory requirements, relevant GAAP and GAAS, and related materiality.
- e) Understanding those processes, systems (that is supporting the SSC, and where are these hosted) controls, personnel and accounting records employed (whether GL or Sub- Ledgers are maintained at SSC) and retained at the SSC which are relevant to financial reporting and how those relate to group and component and statutory audit financial reporting throughout the client.
- f) Evaluating what audit comfort can be obtained at the SSC.
- g) Determining what level of audit comfort is required by each of the group and component/statutory audit teams.
- h) Considering what procedures might need to be performed at the group or component location in support of the SSC team's work.
- i) Upfront and ongoing agreement with all group and component/statutory audit teams on the audit comfort to be obtained at the SSC, including the nature, timing and extent of specified procedures.

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- j) Determining who will perform the SSC audit work and when.
- k) Agreeing on the process for applicable review and oversight of work performed at the SSC.
- l) Establishing how the audit comfort will be documented and shared.
- m) Understand the processes, the activities and tasks that are transitioned.
- n) Understand the various reports that are provided by SSC.

The following activities should be considered by the auditor when determining what work to perform at SSC:

- i) Make inquiries of management at the group level and at the component/statutory and SSC entities, and review management's existing documentation of policies, procedures, processes, and controls.
- ii) Identify significant processes and sub-processes managed at the SSC relevant to authorising, initiating, processing, recording and/or reporting transactions for the relevant entities, including identifying activities that are common to multiple entities (for any given process which is determined to be in scope, the population of key controls is often the same whether the scoping were performed from a group audit perspective or a component/statutory audit entity perspective).
- iii) Identify the key inputs to, and outputs from, the SSC which are relevant from a financial accounting perspective (e.g., transaction flow, standing data, and accounting records).
- iv) Identify technologies and application instances that support the key SSC financial processes, inputs and outputs.
- v) Relate key SSC inputs/outputs and processes/sub-processes to control objectives, information processing objectives, and/or financial statement assertions relevant to the group audit and all component/statutory entity audits.

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- vi) Where comfort is being sought from tests of controls, identify key controls that operate both within and outside the SSC, to ensure a complete understanding of the end-to-end design of internal control and to clearly identify those controls to be tested by the SSC audit team versus those to be tested by the group or other component/statutory audit teams.
- vii) Obtain and review any Internal Audit work relating to the SSC and consider that work in developing the SSC audit plan.
- viii) Document the above information as part of the audit plan in a manner that facilitates sharing amongst the engagement teams and streamlines the inter firm instruction and reporting processes.

Good documentation practices include:

- 1) A matrix identifying SSC processes and sub-processes that are relevant to each entity.
- 2) Process flowcharts and narratives that enable a clear understanding of the SSC processes, inputs and outputs.
- 3) A "roadmap" or "mapping" that relates SSC input/outputs and processes/sub-processes to related control objectives and control activities - see sample template below:

	Processes/Sub-Processes			
	Accounts Payable		Inventory	Accounts Receivable
	Goods Receipt	Disbursement		
US	X			
UK	X			
Germany	X			
India		X		X
Malaysia	X		X	
<u>Key Note:</u> The extent of processes managed out of shared service centre				

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may vary from one organisation to another. However, this technical guide has been prepared keeping in view that the majority of the components entailed in the guide shall be applicable to the audit of all shared service centre irrespective of its size, complexity and volume of operations.

2.5 Understanding/ Building Integrated Audit Approach

The integrated audit approach implies using the controls work in conjunction with substantive work. This integrated audit approach may be more relevant to a client to which SOX is applicable. However, this approach can also be adopted for in-country statutory audit requirements since the controls will be homogenous across all components and a control based approach can be applied to support the component's audit.

The Parent/Group audit team, the in-country audit teams and SSC audit team should together determine the integrated audit approach as applicable in terms of controls reliance and substantive testing approach.

Under the integrated audit approach, the results of the controls testing work should be used for determining the nature, timing and extent of the substantive audit procedures by Group audit team/In-Country audit team and communicated to SSC audit team.

2.6 Understanding of Reporting Requirements in Local Countries

In order to make the SSC audit approach effective wherein In-Country audit teams can rely on the work done by SSC audit team at SSC, it is important for SSC audit team to understand the reporting requirements in local countries.

Although most of the countries across the globe have statutory audit requirements for companies, there could be few exceptions also like Brazil, Canada, etc. Further, in some countries like Netherlands, Switzerland, etc., the statutory audit is required for companies only if revenue is beyond a threshold, etc. Countries in scope for audit is communicated by the client to the group team,

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which then shares this with the in-country audit teams as well as the SSC audit team. Based on this information the audit teams need to closely co-ordinate with the in-country audit teams to understand audit and reporting requirements of respective countries.

2.7 Local GAAS Requirements Compliance to be Ensured

During the planning stage, the component audit teams should communicate additional audit requirements to the group audit team as required under the local GAAS. Accordingly, it is pertinent to note that the SSC audit team should have adequate understanding of local GAAS requirements. Such understanding is necessary to ensure determination of nature, timing and extent of substantive procedures to be performed by the component audit team in conjunction with In-Country audit team. For example, in some countries there is a local GAAS requirement to send accounts payable confirmation and in those cases the SSC audit team can centrally coordinate those accounts payable confirmations at the SSC rather than each In-Country audit team doing it locally.

In most instances, it is expected that the work would be conducted in accordance with International Standards on Auditing or applicable GAAS, but if additional statutory or local professional standard requirements exist they need to be identified during the planning phase by the Group/in-country audit team and appropriately included in the instructions and specify procedures to be performed by SSC audit team.

Key Notes:

- 1) The above guidance on Local GAAS will only be applicable if the SSC is handling processes of entities for a group located outside the country in which SSC audit team is conducting its audit procedures.
- 2) Usually, any specific GAAS requirement which requires a specific audit procedure to be performed by the SSC team, the in-country audit team would include that GAAS requirement

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and details of the related audit procedure in the inter firm instructions itself. Also it is important to note that the inter firm report/opinion by the SSC team to the in-country audit team would only refer to the specific audit procedure and would not make reference to compliance of any local GAAS.

2.8 Identification of Significant Risks

It is necessary to consider the extent to which the client exercises control over the effective operation of the SSC by means of certain key performance indicators. Accordingly, the extent to which a review of this information (e.g., account reconciliation statistics) may provide audit comfort to the SSC team has to be determined. This may require other teams to perform work on behalf of the SSC team.

The respective Parent/Group, component/statutory and SSC audit teams should collaborate on any risk factors that would require additional work to be performed at the SSC in connection with any specific group or component/statutory audit. This should be completed and documented at the planning stage of the audit to ensure appropriate scoping for all entity audits and to demonstrate the active involvement of all relevant parties to group audit/component audit planning decisions.

Further, the SSC audit team should also consider fraud risk in the scoping phase. In order to address the fraud risk, the SSC team may be requested by the respective Parent/Group auditor/component auditor to leverage the fraud risk assessment done by them and may be asked to perform procedures such as fraud related inquiries with SSC management, testing of manual journal vouchers, etc.

Reference should be made to paragraph 6.1 in respect of reliance to be placed on scanned documents and related risks.

Key Note:

Standard on Auditing (SA) 240, '*The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*' deals with the auditor's responsibilities relating to fraud in an audit of financial statements. Specifically, it expands on how SA 315, '*Identifying and Assessing the Risk of Material Misstatement*

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Through Understanding the Entity and Its Environment,” and SA 330, “The Auditor’s Responses to Assessed Risks,” are to be applied in relation to risks of material misstatement due to fraud.

2.9 Agreement of Scope of Audit Work between Teams

The respective Parent/Group or component/statutory audit teams may desire comfort from substantive tests of details at the SSC, whether contemplated in the initial audit plan or as a response to the results of other audit work. In most cases, substantive tests of details at the SSC will be limited to situations where the work can only be performed at the SSC due to the physical location of the accounting records or supporting documentation. Consideration should also be given, however, to procedures that can serve dual purpose as both tests of controls and tests of details. The SSC team should feel free to challenge instructions to perform work which in the view of the SSC team will not provide effective and efficient results.

However, the procedures to be performed are ultimately the responsibility of the group/ component teams.

Specified procedures to be performed by the SSC audit team should clearly distinguish between procedures that are ‘tests of controls’ versus ‘tests of details’. The SSC audit team may be able to provide controls comfort to multiple audit teams by sampling once from a single population of common control activities. A similar approach may be used for some substantive testing, particularly when using accept-reject or audit sampling techniques. For certain tests of details, however, the audit team might need to identify separate populations of transactions and balances related to each component entity and test a full sample from each to satisfy the needs of each respective audit team for substantive testing.

The timing of the audit work to be performed by the SSC audit team should be agreed upon at an early stage by all audit teams. Controls work should be performed to allow sufficient time for the teams to review the results, determine their conclusions on the design and operating effectiveness of the controls and consider the need to alter the nature, timing and extent of their planned

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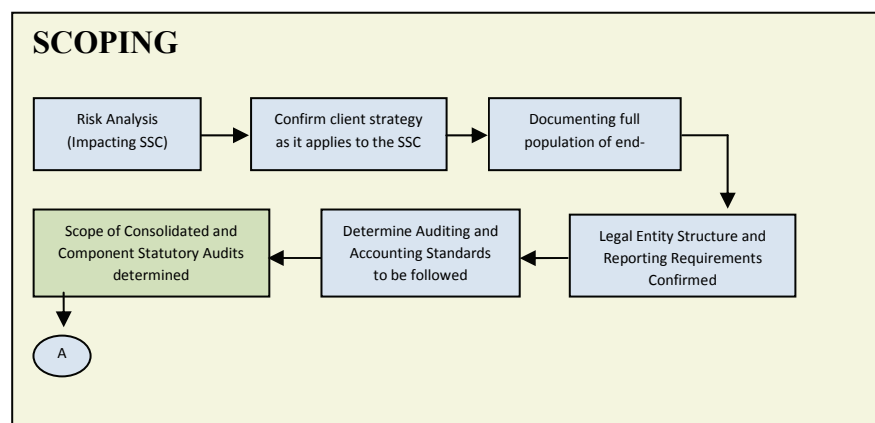
audit procedures or to request additional work at the SSC in response to any identified control weaknesses or other audit findings. Additional visits, such as those that might be required to update testing of controls or to perform subsequent events procedures, should be clearly outlined in planning.

The reporting GAAP for specified procedures also needs to be determined and agreed with respective Parent/Group audit team for consolidation reporting and with In-Country audit teams of the respective Group for statutory audits of subsidiaries. The SSC audit team needs to ensure that they have sufficient knowledge in reporting GAAP (to the extent applicable in understanding the process and procedures required to be performed).

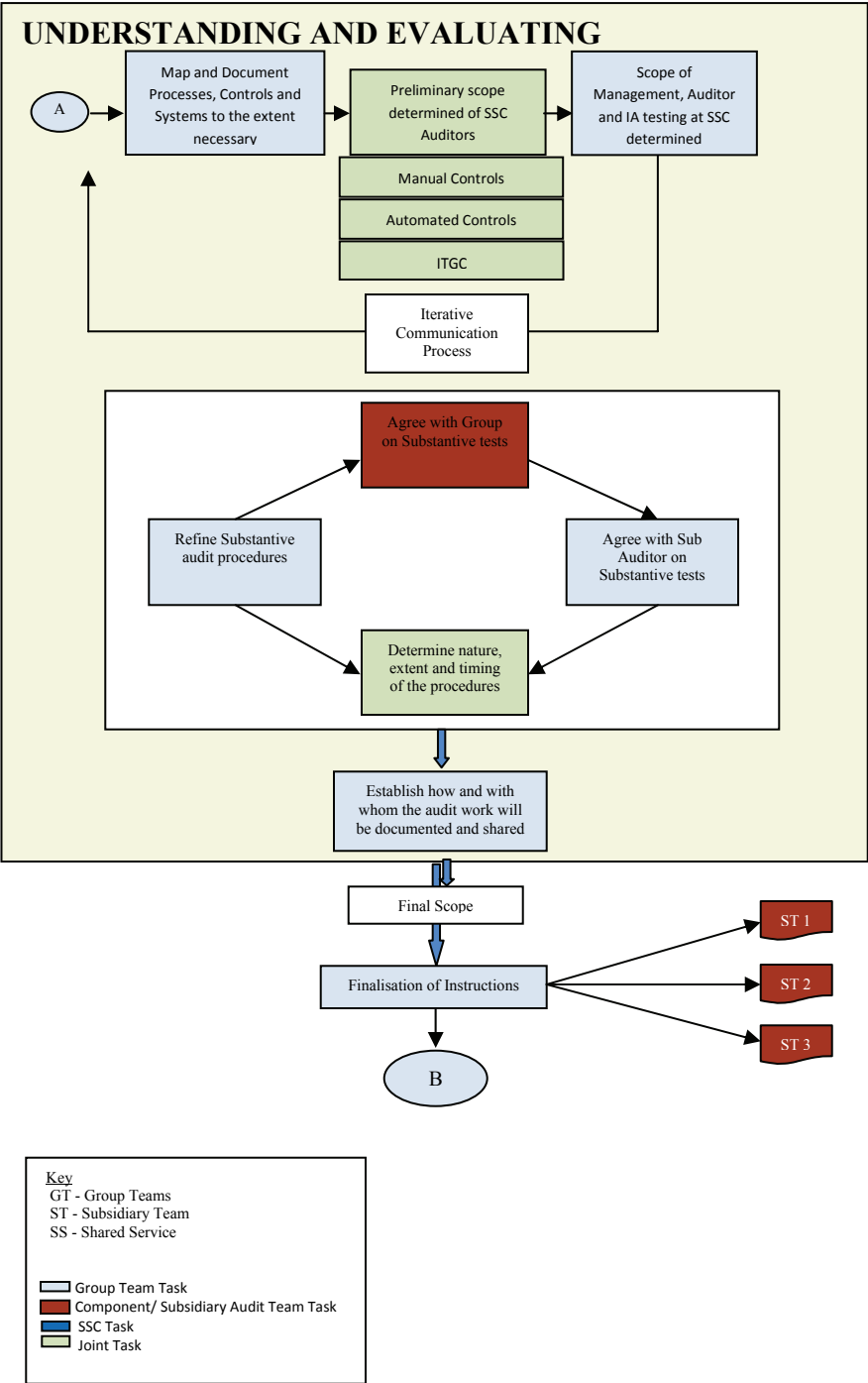
In some cases or for a particular group (in case of a third-party SSC), the client may have developed local GAAP expertise (including financial statements and disclosures also) at SSC like in case of IFRS reporting applicable in certain countries. In such cases, the SSC audit team can expand its scope of work to include full-scope IFRS financial statement opinion rather than only doing specified procedures. The SSC audit team needs to ensure that they have sufficient expertise in reporting GAAP viz. US GAAP, IFRS or otherwise before issuing inter firm reporting to In-Country audit team.

Good documentation practices includes use of “Split-of-work matrix” given in Appendix 1 clearly earmarking the controls and substantive testing scope of work to be done by Group audit team, SSC audit team and In-Country audit team.

Summary Flowchart for Scoping and Understanding and Evaluating Phase



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2.10 Materiality

Materiality needs to be separately determined for reporting by SSC audit team to Parent/Group audit team for consolidation purposes and to In-Country audit teams for statutory audits of subsidiaries (for all the Groups handled by a third-party SSC). These materiality thresholds need to be determined by Parent/Group audit team and In-Country audit teams for subsidiaries respectively and informed *via* Inter firm instructions to the SSC audit team so that it can perform the specified substantive procedures and report accordingly.

Key Note:

It is important to perform the audit at the SSC considering the materiality thresholds of all the countries on behalf of which the audit is performed by the SSC audit team. In particular, considering materiality limits of each country is also important in case where the SSC audit include substantive audit procedures. As the sample size in case of each country, for substantive testing, has to be determined on the basis of respective materiality limits.

Standard on Auditing (SA) 320, *Audit Materiality*, requires the auditor to consider materiality and its relationship with audit risk when conducting an audit.

2.11 Importance of Effective Communication between Teams

Effective communication has become the utmost important tool of the auditor to carry out an effective audit and issue an audit opinion under a SSC environment. One of the key challenges in conducting the audit under a shared service centre set-up is to get access to the information to plan, execute and conclude the audit. In case the audit is not carried out on the basis of right information, the auditor would not be able to plan the audit effectively as understanding the key components like assessment of the company's risk profile; understanding of the controls under

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the shared service environment and understanding the linkages of the process/transactions are keys to plan an effective audit.

Typically, for a company under shared service centre environment, it becomes difficult for the remote audit teams (i.e., the audit teams of entities whose processing and knowledge base has been transferred to the shared service centres) to have detailed insights to the changes effective/planned by the company. It is due to the fact that some of the key organisations like business finance, strategic planning and sales organisations also get concentrated in a particular geography. Most of the key plans/decisions for the group under this new environment are influenced by the overall objective of the group instead of focusing on operations in the individual countries. However, it does not mean that the group does not intend to have profitable operations in all the countries, what it essentially means is that all operations focus and contribute to the overall objectives of the group. Also, the objectives of individual units are aligned and linked to ones of the group in such a way that success/achievement of the group's objectives would mean success for the individual operations.

The above challenges mandate that effective channels of communication must be established which would enable audit teams in individual countries to have access to information they need to conduct an effective audit and have knowledge base to understand the company's business, strategies, operating styles, objectives etc., which they can link to the one's relating to their piece (country, branch, service organisation, etc.).

One of the suggested approaches in case of a Multi National Company is the process by which the auditor of the parent company who has the overall responsibilities of the consolidated financial statements and is in the best position to access the information in the company, to share a document with the other audit teams, who have limited access. This shall help both the company and the respective auditors to carry out an informed and effective audit. The contents on this document would be specific to company's structure, purpose and timing of the communication.

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As an example a document giving the understanding of Company's controls and environment would typically include the following:

- Listing and overview of the key business processes.
- Mapping of the risks with the controls at business process level.
- Overview of the control environment of the company.
- Analysis of the fraud risks.

Other similar communications could be following subjects, form and contents of which would again depend on Company's structure, agreement between the auditors keeping in view the local level compliances, timing of the communications and expectation between the client and auditors:

- Results of the work carried out by the parent company's auditors on the internal controls of the group, to the extent applicable to the local legal entities.
- Results of other Agreed-upon procedures (AUP) performed by any of the audit teams with other audit teams.
- Result of any other work carried out (as agreed between the auditors) by one of the audit team on the behalf of other auditors.

Key challenges in sharing documents would be:

- a) to define as to what level of information and form of information that the auditors of the parent company's auditor would be able to share with the auditors of the respective audit teams.
- b) to assess as to what level the local country audit teams would be able to place reliance on any such documents as there would be inherent limitation of level of information it would contain and local Indian GAAS requirements (like different year ends, specific procedures to be performed on the some of the components on which the auditor in India has to comment (CARO 2003) and other local legal and other regulatory compliances).

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- c) restrictions imposed by the policies (if any) of the individual audit firms and sometimes by the regulators like Institute of Chartered Accountants of India (ICAI) in respect of such forms of reporting.

Upfront collaboration and sharing of information during planning among the group, component/statutory and SSC audit teams facilitates the group auditor's ability to provide more detail on the exact nature, timing and extent of the specified procedures to be performed at the SSC. To the extent the details of this planning and scoping are documented in the formalised instructions, it may be possible to simplify the SSC audit report to include results and findings only.

For suggested contents of inter firm instructions to be issued by Group audit team or In-Country audit team to SSC audit team, refer the Appendix 2.

Besides Inter firm Instructions, as a best practice there could be ongoing sharing of information and results between the three teams via conference calls, e-mails, etc., at planning, execution and completion stages of the audit.

2.12 Controls Work Planning and Scoping

The key controls could exist at the following locations:

- 1) Corporate level controls for example, if IT server is based at corporate level then Information Technology General Controls (ITGCs) and most of the application controls will exist at corporate level. These should be tested by Group audit team.
- 2) There may be certain application level controls that could be tested at the SSC if there are certain applications being operated. SSC auditor may be required to test controls on key reports, spreadsheets, access restrictions, segregation of duty conflicts, etc.
- 3) At SSC, manual controls are around transactions processing, reconciliations preparation and review, etc, for

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the processes handled by SSC. These controls should be tested by SSC audit team.

- 4) In some cases, the controls continue to operate In-Country or locations other than corporate and SSC primarily because of language issues, proximity to customers, etc. For example, the controls around sales order processing, collections for non-English speaking countries, etc., may reside In-Country or locations other than corporate and SSC. These controls should be tested by In-Country teams or if it is more efficient for the Group audit team to test it centrally.

The suggested practice is that the Group audit team in conjunction with SSC audit team should decide the scope of work around controls (manual or automated) and determine the audit team who will be doing walkthroughs and testing for each of the sub-processes and key controls.

2.13 Substantive Testing Planning and Scoping

Like controls testing approach, the substantive testing approach also needs to be determined at the following locations:

- a) Substantive testing for Group consolidation reporting and Corporate level push-down entries (i.e., processes driven centrally from Corporate level like restructuring accruals, etc., and entries are then passed at local entity set of books level) for statutory audits should be covered by Group audit team.
- b) For the processes handled at SSC, the substantive procedures should be performed by SSC audit team.
- c) There could be some processes like local taxation, pension, etc., which for the reason that they require local laws and local GAAP knowledge may continue to be retained In-Country and accordingly substantive procedures for them will be covered by In-Country audit teams along with financial statements and disclosures for opinion on local statutory financials.

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Again, like controls testing approach, for reporting on consolidated financials by Group audit team, the Group audit team in conjunction with SSC audit team should determine the nature, timing and extent of the substantive audit procedures along with determining the team responsible for performing those procedures. For local statutory financials, the In-Country audit team should determine the substantive procedures and the team responsible for performing those procedures in conjunction with SSC audit team.

The planning stages of a SSC audit can be quite complex and will likely require iterative communication and information gathering amongst the group, component/statutory and SSC audit teams. The development of an effective overall audit approach is more likely to be achieved if the group audit, including work to be performed in the SSC, is planned on a coordinated team basis.

At an early stage, the group auditor and the SSC auditor will need to determine the most effective approach for coordinating audit work relating both to the group financial statements and component/statutory audit requirements. Often, the efficiency and effectiveness of the group audit is enhanced when the group audit team assumes responsibility for the SSC audit approach and related testing decisions and communicates appropriate details of such, including the specified procedures, to all relevant engagement teams. In this regard it should be noted that SSC audit work will always be performed and reported as specified procedures. Other approaches may be more appropriate when the data generated at the SSC is used for statutory, rather than group financial statements. The group, SSC and component/statutory audit teams will need to maintain adequate communication to ensure the specified procedures performed will satisfy all needs and expectations of the teams.

2.14 Linkages with IT Work

Usually the IT server will not be based out of the SSC (except in case of a third-party SSC where procedures around IT controls will have to be performed by SSC auditor) and may exist at Corporate or some other location of the group. In that scenario,

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the group/corporate audit team will be responsible for carrying out the IT environment of the group including Information Technology General Controls (ITGCs) and Application Controls. The SSC audit team relies on the work done by group audit team with regard to the IT controls testing. In cases, where SSC team assesses the need for doing any procedures related to IT environment at the SSC of the company, they need to perform such procedures in concurrence with the group audit team.

It is of paramount importance that there are proper linkages of the IT controls testing with manual controls testing and nature, timing and extent of substantive testing procedures. Any exception identified in ITGC testing will have a pervasive impact and should accordingly be assessed. Also, any exception identified in IT applications controls testing could have an impact on manual controls and therefore needs to be assessed accordingly. The result of IT testing to the extent that impacts the SSC controls should be appropriately addressed by the Group/in-country teams and communicated to SSC audit team before execution of the manual controls testing and final determination of nature, timing and extent of substantive procedures at SSC.

2.15 Review of Internal Audit Work

In order to leverage the work done by internal audit at SSC which may be only relevant in case of captive SSC, the Group audit team and SSC audit team needs to work together. In case the internal audit process is driven out of corporate, the Group audit team needs to assess the competency and objectivity of the internal audit team. In addition, the Group audit team may use a direct assistance or direct reliance model for the work to be done by internal audit team to support controls testing work. For example, the internal audit team may be used under direct assistance model to perform control walkthroughs or direct reliance could be placed on internal audit work for controls testing.

The Group audit team and SSC audit team also needs to review the Internal Audit reports relevant to SSC to determine the nature, timing and extent of procedures to be performed by them.

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Key Note:

It is also important for the in-country audit team to review the relevant internal audit reports issued from time to time. This review becomes important especially in cases where internal audit has raised any observation in relation to a specific location or has issued an observation that impacts a particular (or set of) locations.

Also, while relying on the work of Internal Auditor, reference needs to be made to SA 610 on 'Using the Work of Internal Auditors'.

2.16 Effective Work Practices Tools

The teams may use work practices tools like sub-process mapping, key controls mapping, split-of work (refer Appendix 1), etc. to ensure that there are no issues in the SSC audit approach and responsibilities are clearly defined between the teams.

2.17 Agreement on Timings of Audit

As part of the planning phase, there should be an agreement between the teams on the reporting timelines and this should be agreed in the Inter firm Instructions. The local reporting deadlines of respective countries should be discussed and agreed among the in-country audit team, SSC audit team and SSC personnel and client personnel too before finalising the timings of planning, execution and reporting between Group audit team or In-Country audit team and SSC audit team. Also refer paragraph 2.10.

Key Note:

Due emphasis should be given to the timing of update testing (roll forward testing at year end, where majority of the audit procedures are performed before the year end), as there might be subsidiary companies/components in the group, which operate with a different financial year as compared to one of the ultimate parent company.

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2.18 Risk Management Considerations

The SSC team would also need to consider the ICAI's pronouncements such as Code of Ethics, etc., Risk Management policies before accepting any inter firm reporting assignment under a SSC audit approach including for the form of reporting, reporting GAAS and GAAP, sharing of work papers, etc.

2.19 Structure of the Audit Team

At SSC, the structure of the audit team will depend on the complexity of the processes handled at SSC. In case, complex processes like revenue, payroll, etc., are handled from SSC, it becomes important that the audit team has adequate experience in auditing those areas and require more senior level team involvement. Use of specialists in the audit team like IT, etc., may also be warranted again depending on the processes handled at the SSC. The involvement of the specialists should also be agreed upfront with the Group audit team and In-Country audit teams *via* Inter firm Instructions.

2.20 Engagement Letter

Standard on Auditing (SA) 210 (Revised), 'Agreeing the Terms of Audit Engagements' lays down the requirements in respect of engagement letter and should be taken into consideration while agreeing the scope of the engagement.

Chapter 3

Execution Phase

Typically, the audit approach for an audit would be divided in the following stages viz., understanding, evaluating and testing of operating effectiveness of controls, substantive analytics and substantive tests of detail. The nature, extent and timing of the procedures to be performed in each of these stages would depend upon the auditor's judgement and local GAAS requirements.

Further, auditing in the shared service environment also requires consideration of the appropriate definition of populations and selection of samples. It should be noted that there is a clear distinction between controls testing and substantive tests of details performed by the SSC auditor with respect to these matters. Audit team should follow the relevant guidance/pronouncement applicable in the territory considering the aspects discussed in the following paragraphs.

3.1 Controls Testing

Auditing in the shared service environment also requires consideration of the appropriate definition of populations and selection of samples. It should be noted that there is a clear distinction between controls testing and substantive tests of details performed by the SSC auditor with respect to these matters.

The decision on the number of items to test requires a determination as to whether the population subject to testing is sufficiently homogeneous to permit it to be treated as one population and, therefore, permit the results of testing to be appropriately projected to that entire population. Therefore, in a situation where a SSC is processing transactions for multiple geographies and/or entities following the same or substantively similar procedures on a common accounting IT application, it is often appropriate to define the population to test as being all

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transactions for all geographies and/or entities processed at the SSC. Conversely, in situations where the SSC follows different procedures or processes transactions on different systems, it would generally not be appropriate to combine populations of transactions for sample selection.

For example, in case of third-party SSC handling processes for multiple groups, and the processes are homogeneous, selection of a single sample from the entire population should be sufficient to give assurance on controls at the SSC for all the groups. Where the processes are not homogeneous, then separate samples needs to be selected for each group covered by SSC.

Key Note:

SAE 3402 on '*Assurance Reports on Controls At a Service Organisation*' issued by ICAI should be referred for reliance on controls where third party SSC is handling processes of multiple groups.

3.2 IT Controls Testing

In case of IT controls testing, testing of even a few transactions for IT application controls and IT reports could suffice in case of a common accounting IT application. In case the client is using different IT accounting applications, then such IT controls testing have to be performed for all the significant applications. As already stated above, the results of IT Controls Testing may impact Manual Controls reliance on the nature, timing and extent of substantive procedures.

Key Notes:

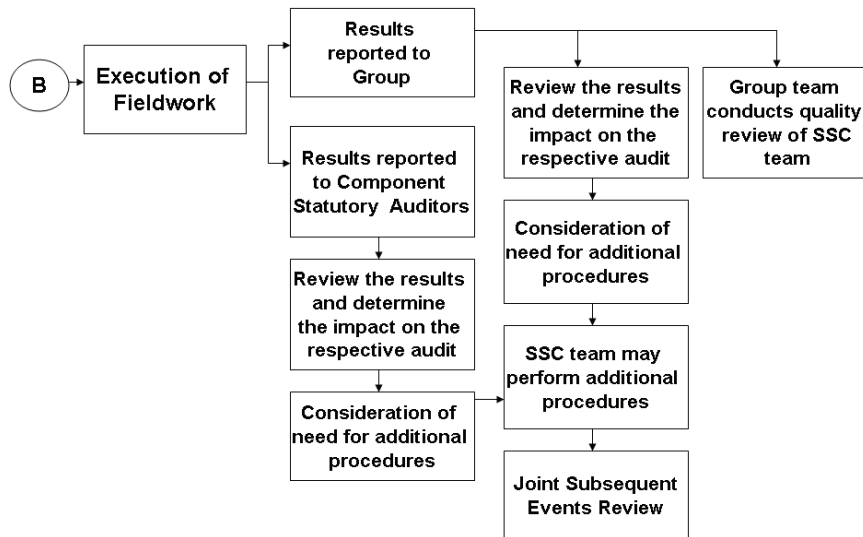
1. Reference should be made to paragraph 3.1 above, for third-party SSC, where the IT Controls are not homogeneous across processes for all the Groups.
2. Importance of Information Technology has been recognised across all Standards on Auditing.

3.3 Substantive Testing

The definition of population when performing substantive tests of detail will differ based upon the type of test. Audit sampling lends itself to extrapolation of results to a full population and as such this type of test might be applied to the complete population of transactions processed in the SSC. Accept-reject testing also allows the auditor to either accept or reject certain characteristics of an entire population based on an appropriately selected sample. This may generate efficiencies through performing a substantive test once with one sample to draw conclusions on account balances for many locations processed in the SSC. Conversely, for targeted testing, it may be more appropriate to separate transactions by entity in a Group for the purposes of defining populations and selecting samples.

Process Flow for Shared Services Centre Audits

EXECUTION & REVIEW



Chapter 4

Completion and Reporting

Reporting is a critical part of any audit. In an SSC audit, it is even more important as the reporting between the SSC audit team and group/component audit team forms the basis of handing over of the work performed at the shared service centre. On completion of the SSC audit, the SSC auditor needs to issue a report to the group/component audit team as agreed at the time of finalising the scope of the work between the two audit teams. The paragraphs below summarise the form of reporting, including the illustrative templates for the same.

4.1 Form of Reporting

Reporting to the group and component/statutory teams for an SSC will generally take the form of a report on specified procedures and findings. See the illustrative template in Appendix 3. The report will document the procedures performed, the results of applying those procedures, and restrictions on the use of the report.

Whether by reference to the specified procedures included in the audit instructions (or a separate communication issued by the SSC team) or by directly listing the procedures performed, the report needs to provide sufficient information to enable all teams to clearly understand the level of work that was done and conclude on the design and operating effectiveness of the controls tested. The detail provided in the report should ideally include:

- a) the specific control objectives that were considered through the evaluation and testing of controls, including the nature, timing and extent of the controls work. If the relationship between financial statement assertions and in-scope control objectives is described in the planning and scoping documentation, the same may be attached to the inter firm specified procedures report;

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- b) substantive tests of details performed, including the nature, timing and extent of the testing;
- c) the extent to which reliance has been placed on the work of others and the procedures performed to justify it; and
- d) exceptions should be reported clearly, indicating the test performed and details of the exception, including population subject to testing, and sampling approach.

Much of the information to be included in the report should be readily available from the audit working papers of the SSC auditor. The report will provide sufficient detailed information for the user of the report to understand the nature, extent and results of the work performed. Providing this detail in a report which can be appended to the receiving office's working papers will eliminate the need for group and component/statutory auditors to duplicate documentation prepared by the SSC auditor. The efficiency of sharing comfort across multiple locations serviced by the SSC should more than offset any incremental time required to prepare the report.

The planning and scoping of audit work in a SSC environment is best executed as a collaborative effort. A key element of this process will be to ensure that testing requested by the group or component/statutory audit teams is warranted, i.e., it either addresses identified significant risks for the group or entity, or is a required procedure under applicable GAAS. Scrutiny should be applied in any situation where neither of the above criteria applies, and the requesting party should be asked to justify the need for the procedure to be performed.

A report on SSC procedures should also explicitly state that the work performed at the SSC and the report issued thereon do not restrict the scope of either the group or component/statutory audit.

For situations where another office of the SSC audit firm is not the statutory auditor and another firm plans to place reliance on the work of the SSC team, the Specified Procedures report will not be appropriate as it is for inter firm reporting only. Rather, an Agreed-Upon Procedures report might be issued in accordance with applicable GAAS. See the illustrative template at Appendix 4.

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Engagement teams should carefully consider the appropriate reporting in these circumstances.

In case Inter firm's opinion is being issued by SSC audit team rather than a specified procedures report, then see the illustrative template at Appendix 5.

4.2 Access to Working Papers

The responsible parties (i.e. group/component/SSC audit teams) should enter into a memorandum of understanding on access to audit work papers. On the assumption that the SSC work is performed properly, and that there is a sufficiently detailed and clear report, it is anticipated that access to working papers would only rarely be necessary. Where applicable, consultation with local Firm's Risk Management team may be required by SSC team with respect to granting access of working papers.

Key Note:

1. Importance of documentation in audit cannot be ignored. Standard on Auditing (SA) 230, Audit Documentation deals with the auditors responsibility to prepare audit documentation for an audit of financial statements.
2. The local laws of the countries may restrict the access of audit work paper and thus necessary compliance should be ensured. In India, the Chartered Accountants Act, 1949 per se prohibits sharing of work papers by the auditors.

4.3 Work Papers Review by Group or In-Country Audit Team and Evaluation of Findings

Consideration should also be given to the appropriate level of quality control review required over the SSC auditor. The group team, on behalf of all teams using the results of the SSC team's work, should obtain representation from the SSC team as to their possession of the appropriate skills, knowledge of group accounting policies and of applicable GAAPs and GAASs to execute the assigned audit work. Agreement should also be

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reached and documented at the planning stage as to the form of any oversight and review to be performed on the SSC team's work, in accordance with the requirements of applicable regulations. This may involve one or more visits by the group team to meet the SSC team.

Key Notes:

- 1) Significant consideration needs to be given to the risk management policies/issues applicable in the respective territories under which the SSC team and in-country audit team operates – in cases where access to work paper is extended. Also refer paragraph 2.18.
- 2) Reference should be made to SA 600, *Using the Work of Another Auditor*, issued by ICAI, if the SSC audit engagement team and Group/Component audit team are operating within the jurisdiction of India. Pursuant to this Standard on Auditing, there is no requirement to assess the professional competence of the other auditor(s) where the latter is/are also the members of ICAI. Requirement to assess the professional competence of other auditors members would be required if the audit is being carried in accordance with ISAs or any other GAAS which has similar requirement.

For specified procedures reporting also, the In-Country teams will be required to review the work papers of SSC audit team.

Group and component/statutory teams should use the SSC specified procedures report to enable them to conclude upon the work performed by the SSC team like design and operating effectiveness of the population of key controls operating in the SSC in case where the work performed by the SSC team is primarily controls testing. The information appended to the report should be incorporated into the group or component/statutory work papers as required documentation as per applicable requirements.

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Key Note:

Some countries/jurisdictions have additional responsibilities imposed on the central/group audit team to perform certain procedures on review of work performed in relation to the audit of group's financial statements by the component/shared service centre teams. For instance, in case the ultimate holding company is based out of United States of America and registered with Securities Exchange Commission (SEC), these requirements are prescribed under Auditing Standard 3 – "Audit Documentation" issued by Public Company Accounting Oversight Board (PCAOB).

4.4 Representation Letter

In the same way as procedures for engagement letters should not change when auditing in a SSC environment, in general there is no need to alter the approach to obtaining representation letters, unless the engagement team deems it necessary to obtain a separate representation letter from management of the SSC.

In other words, where the SSC auditor is doing the work in accordance with the group's/component's engagement letter, i.e., there is no separate engagement letter exchanged by the SSC auditor with SSC management. However, the SSC auditor should assess the form and content of any additional representations required by them from the SSC management (over and above what group/component audit teams would obtain from group/component's management).

Key Note:

Standard on Auditing (SA) 580, Written Representations, identifies that representation are necessary information that the auditor requires in connection with the audit of the entity's financial statements. Accordingly, similar to responses to inquiries, written representations are audit evidence.

It further acknowledges that although the written representations provide necessary audit evidence, they do not provide sufficient appropriate audit evidence on their own about any of the matters which they deal.

Chapter 5

Key Messages

5.1 Planning and Scoping

One challenge, and a key to success in implementing the sharing of comfort in a shared services environment, is ensuring all participating parties are committed to the scoping process, and that the exercise is conducted in sufficient detail to facilitate execution of fieldwork. As with all audit work, and especially in the first year, detailed planning is essential to avoid misunderstanding, inefficiencies and exposure to the gathering of insufficient audit evidence. Time devoted to detailed scoping of controls work and substantive tests of detail in the first year can be significantly leveraged in subsequent years.

Key Note:

Through the planning phase the auditor should give cognizance to the requirements of Standard on Auditing (SA) 300, 'Planning an Audit of Financial Statements'.

5.2 Effective and Timely Communication

Another critical factor is effective communication amongst all parties involved in the audits. Preliminary discussions, documentation and correspondence should be clear on the definition of responsibilities and requirements of all parties. During the implementation phase of shared service centre work, teams might consider workshops with representatives of the group, component and SSC audit teams to monitor progress, and to reinforce the need to effectively leverage results of work performed centrally in the SSC.

In many instances, it is just as important to prepare and educate the client as it is to prepare the audit teams. As the clients evolve to a centralised processing and accounting structure, engagement

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teams should engage in timely dialogue with the client to clearly understand the details of the timetable for migration of work to the SSC. This will enable engagement teams to plan their own approach effectively and mitigate the risk of misunderstanding with the client later in the audit cycle.

5.3 Quality of Documentation

Given the number of end users, the quality of documentation in the work product provided by the SSC team is critical. Engagement teams should consider real-time participation from group, component and SSC audit teams (for example, through timely conference calls to walk through results of testing) to evaluate the progress of work.

Key Note:

Group/Component/SSC auditor should ensure compliance with the relevant standard/s dealing with using the work of the other auditors as also audit documentation, to the extent possible.

5.4 Evaluation of Findings

Results of testing may have different impacts for group and component audit teams, respectively, depending on the materiality level to which they are auditing. It is recommended that the SSC team ensures that sufficient details are provided regarding any findings, e.g. magnitude of errors, existence and degree of precision of any compensating control (and results of testing that control), mitigating factors, to enable all teams to interpret and evaluate the results for their own purposes.

5.5 Coordination between Teams

Coordination between teams is another factor relevant to all audit work, not just in a shared service environment. However, it is all the more critical in a shared service environment audit.

5.6 Substantive Analytics - Challenges Faced

In case the auditor is required to perform analytical procedures under substantive procedures, a challenge regularly faced by component/statutory audit teams is to identify the appropriate client contacts for analysis to support the team's substantive analytics, when some or all of the entity's transactions are processed in an SSC. This is an example of why it is important for audit team to align the audit engagement team and efforts along the management control structure, as management has primary responsibility for understanding and explaining results of operations. The group, component/statutory and SSC audit teams should discuss with the client and collaborate with each other during planning to identify those client individuals who will be responsible as primary contacts for providing analyses to the auditors for the financial results of component entities that have transactions processed through a SSC. It may be that the SSC team will need to perform the substantive analytics, depending on whether SSC management is responsible for financial statement assertions or not. Special attention should be paid to the challenges associated with designing and documenting the audit approach for the first year of auditing a client and/or the specific SSC, and heavier involvement of the group audit team in planning may be needed.

Key Note:

Standard on Auditing (SA) 520, 'Analytical Procedures', requires the auditor (a) to obtain relevant and reliable audit evidence when using substantive analytical procedures; and (b) to design and perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion as to whether the financial statements are consistent with the auditor's understanding of the entity.

Chapter 6

Other Considerations

6.1 Reliance on Scanned Documents and Risk Management

In a SSC audit, the SSC audit team has to rely heavily on auditing the scanned documents since most of the original documentation will be typically retained in the originating country like for example, third-party service provider invoices will be received at client's locations across the globe and the accounting is done by SSC based on the scanned images of those invoices sent by the originating locations. In most cases, it will not be cost effective for SSC to get all the original documents at SSC and therefore, the SSC audit team may not be able to verify those original documents for the samples selected by them. Further, the SSC audit team is also unlikely to have knowledge about the attributes of such documentation originating from foreign jurisdictions that may hamper the ability of the engagement team to place reliance on these documents.

The engagement team performing audit for the SSC unit may discharge its reporting responsibility in the following manner:

- Expressing an audit opinion.
- Performing an Agreed Upon Procedure (AUP) as per the group reporting instruction.

While discharging its reporting responsibility SSC audit teams may consider including certain wording to draw reference to its concern, disclaiming its opinion.

Key Note:

SA 500 on Audit Evidence states:

Para 9 – “Audit evidence provided by original documents is more reliable than audit evidence provided by photocopies or

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facsimiles.”

Para 10 – “.....,the auditor considers the reliability of the information to be used as audit evidence, for example, photocopies, facsimiles, filmed, digitized or other electronic documents, including consideration of controls over their preparation and maintenance where relevant.”

SSC auditor may consider performing relevant additional procedures on the controls over maintenance of these scanned documents in cases where the audit procedures are based on verification of scanned/digitized documents.

Audit opinion

We have audited in accordance withauditing standards, except that the scope of our audit has been limited by the inability to scrutinize original documentation and by not having the level of knowledge of laws, custom, language and practice in relation to documentation that apparently emanates from other countries, to identify any obvious signs that such documentation may not be valid.

Except for the possible effects if any of the limitation in scope referred to above in our opinion.....

Specified/Agreed upon procedures report

For the avoidance of doubt, our procedures did not include reference to original documentation but only to scanned copies of documentation. In addition, our knowledge of laws, custom language and practice is not sufficient to enable us to identify any obvious signs that such documentation may not be valid.

The only relief to the above reporting requirement could be under the following conditions:

- 1) If all documentation is in English and if appropriate steps have been taken to translate documentation not in English so that the SSC audit team may understand the

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documentation, then the reference to 'language' in the reports may be deleted.

2) If either:

- the business of the entity is straightforward, e.g., a cost plus company, and the documentation is simple such that the SSC audit team is satisfied that they have sufficient knowledge to scrutinise the documents appropriately as audit evidence, then the reference given in italics below may be omitted, or
- if with the help of the audit engagement teams of the users of the SSC, adequate steps are taken such that the SSC audit team is satisfied that they have the requisite level of knowledge and skill to scrutinise the documents appropriately as audit evidence then the reference in italics below may be omitted . It may be possible to consult with the user auditor to determine whether they believe that an appropriate sample of documentation can be sent to them for their review so that they are able to confirm that it meets their expectations as audit evidence. If this is agreed then this wording may be omitted. An appropriate sample should relate only to documentation about which the user auditor should be in a better position than the SSC audit team to form a view. Other documentation should be reviewed by the SSC audit team who should have the relevant skill to conclude without the need for any qualification by these words and so they should be omitted in such cases.

".....and by not having the level of knowledge of laws, custom, language and practice in relation to documentation that apparently emanates from other countries,"

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- 3) For specified/agreed upon procedures engagements, if the instructing auditor issues instructions as follows, then no reference in the note as set out in italics below may be required.

'In connection with your agreed upon procedures, we understand and agree that, where applicable, you will accept the scanned/faxed/electronic documentation available at the SSC and not original documentation as sufficient and appropriate audit evidence on which to perform the procedures requested.'

".....our procedures did not include reference to original documentation but only to scanned copies of documentation."

The considerations given and actions taken in relation to the above relief should be documented on the audit file at the planning stage and may be referred to again in the reporting section of the file.

Key Note:

It is the responsibility of the In-Country Team to perform procedures to ensure that the control over scanned documents is adequate. As such, they can also perform incremental procedure of looking at the original documents (on a sample basis) of the scanned documents verified/relied-upon by the SSC audit team.

As a best practice approach, this step should be included in the inter firm instructions and in-country team and SSC audit team can agree on the exchange of relevant information (as part of the work papers) to ensure that this test is performed.

Chapter 7

Way Forward

7.1 Future of Business Process Outsourcing in India

According to the study conducted by Gartner, Inc. in April 2011, Indian business process outsourcing market will grow by 23.2 percent in 2011.

According to Gartner, Inc. the business process outsourcing (BPO) market in India totaled \$1.139 billion in 2010, a 28.6 percent increase from 2009 revenue of \$885.6 million. The market's growth was driven primarily by increasing volumes in existing BPO engagements, clients expanding the scope of existing BPO relationships, and a number of new BPO deals in 2010 were from pent-up demand from 2009.

Gartner estimates the Indian domestic BPO market reach \$1.4 billion in 2011, up 23.2 percent from 2010. The market will grow into a \$1.69 billion market by 2012 and increase to \$2.47 billion by 2014.

The study further states that the BPO services market in Asia/Pacific and Japan is made up of a good mix of multinationals, regional and local pure-play BPO service providers; IT services providers with BPO assets and capabilities; and telecom vendors. Though the BPO market is dominated by global and India-based service providers, there are also a number of fast-growing regional and niche BPO service providers.

According to Gartner, Inc. –

“Changing demographics, increasing affluence and economic growth in Asia/Pacific continues to drive shared services and BPO

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adoption, especially in Australia, India, Southeast Asia and China,” and

“There is growing demand for multi country shared services and BPO services within Asia/Pacific. Buyers continue to invest in services that deliver scalable, high quality and consistent services across their geographical presence. There was significant consolidation in the global and regional BPO market in 2009 and 2010 with some large merger and acquisition (M&A) deals impacting the regional BPO service provider landscape.”

As per the study –

The BPO services market in Asia/Pacific (excluding Japan) reached \$8.6 billion in 2010, a 21.5 percent increase from 2009 revenue of \$7.0 billion. The largest BPO country market in the region is Australia, which is more than three times larger than India, the second-largest consumer of BPO services. By vertical industry, banking and financial services, communications, government (both local and federal), technology and travel and transportation were the largest consumers of BPO services in the region.

India is one of the fastest-growing BPO market in Asia/Pacific. This segment was earlier dominated by small service providers with some local companies, such as Magus Customer Dialogue, Infovision, Andromeda.

Over the past three years, many established India-based BPO service providers and U.S. and Europe-based multinational BPO services providers have started focusing on the Indian domestic market. In the past, these providers were focused primarily on the international or offshore market. Some of the local providers include Omnia, Kenkei, Andromeda, Genpact, Magus, Mphasis, Intelenet Global Services, Tech Mahindra, Aegis, Spanco and HTMT.

7.2 Moving up from Supporting the Financial Statement to Drafting Them

Most finance directors and finance professionals recognise that a shared service centre is a document factory, a transaction processing plant. It takes raw materials of invoices, receipts, etc. and processes them through an agreed and established procedure.

Not all agree that the SSC should go a step further and produce the management accounts – but without that next step management accounting remains a cottage industry. And in the 21st century it needs to match the scale and sophistication of the whole organisation.

An SSC should be responsible for all the mechanical, routine and predictable activities of the finance function – right up to the production of the first draft of the monthly financial statements. These activities are generally susceptible to clear rules that can be adhered to and will prevent the SSC seeking clarification from other parts of the business on a frequent basis.

7.3 Building Expertise to Support Full Scope Audits - move Towards IFRS

With the emergence of IFRS in Europe, Asia-Pacific and other geographies, there is a potential for building IFRS expertise in teams at SSC by clients. The SSC therefore, can assume more responsibilities once the option to prepare IFRS financials is available for legal subsidiaries instead of local GAAP financials. With this emerging trend, SSC audit teams can also assume more work by issuing full-scope IFRS financials opinion for the legal subsidiaries instead of Specified/Agreed upon procedures report or Inter firm's Opinion on specified balances.

7.4 Benefits to Public Sector

Governments around the world are poised to benefit from adoption of a shared services business framework provided that lessons learned from the commercial sector are applied. Shared

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services frameworks bring together functions that are common to multiple business units under a single delivery organisation. The result is increased efficiency and quality of service and decreased cost. This Guide identifies four models for shared services as well as several factors common to all successful shared services initiatives. It also provides government policy makers with factors to consider in choosing a model, an overview of challenges to maximise benefits from shared services and a pathway to realise the framework's full potential.

Appendix 1

Split-of-work Matrix (Illustrative)

Split-of-work matrix for Inter firm Opinion audit by SSC audit team to support statutory audit by In-Country audit team of a subsidiary

Particulars of Task	Group audit team	SSC audit team	In-Country audit team
Planning and Controls Work			
Acceptance and Continuance Assessment			X
Engagement Letter			X
Independence Considerations		X	X
Inter firm Instructions		X	X
Understanding the Business		X	X
Review minutes of meetings		X	X
Review new/significant contracts		X	X
Assess fraud risk		X	X
Opening balances		X	X

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Risk Assessment - Significant and Elevated Risks assessment		X	X
Materiality			X
Communicate with the client		X	X
Assess control environment	X	X	X
Controls Testing	X	X	X
Controls Opinion - Consolidated	X		
Evaluate results of Controls Opinion		X	X
Summary of Comfort		X	X
Substantive Analytics and Testing			
Property, plant and equipment		X	
Intangible assets		X	
Inventory		X	
Accounts receivable		X	
Prepayments and other current assets		X	
Cash		X	
Accounts payable		X	

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Accruals, provisions and other liabilities		X	
Revenue- Analytics and Test of Details for Significant risk		X	
Cost of Sales		X	
Payroll except pension		X	
Operating expenses		X	
Other income and expenses		X	
Corporate Push Down Entries	X		
Other Substantive Testing			
Capital and other equity accounts		X	
Intercompany accounts		X	
Other Fieldwork Procedures			
Review of SSC audit team's work			X
Legal letters			X
Bank confirmation letters		X	
Accounts receivable confirmation letters		X	

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Statutory accounts procedures			
Audit of detailed note disclosures			X
US GAAP and ISA Inter firm Opinion		X	
US Local GAAP conversion			X
Audit of pensions			X
Audit of tax			X
Completion procedures			
Detailed review of statutory accounts			X
Completion procedures and sign off			X

Appendix 2

Suggested Contents of Inter Firm Instructions (Illustrative)

Inter firm Instructions for Inter firm Opinion audit by SSC audit team to support statutory audit by In-Country audit team of a subsidiary

Table of Contents

1. General Audit Information

- a. Introduction.
- b. Entity information and scope of work.
- c. Auditing and accounting standards.

2. Audit Scope and Procedures

- a. Audit scoping and materiality levels.
- b. Relevant comments on internal control structure.
- c. Risk assessment, including fraud.
- d. Independence and other confirmations.
- e. Laws and regulations.
- f. Related parties.
- g. Subsequent events review.
- h. Communication during the audit.
- i. Sharing audit comfort.
- j. Reliance on the work of the client's Internal Audit department or others.
- k. Going concern assessment.

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3. Reporting Requirements and Timings

- a. Communicating results.
- b. Communication protocols.
- c. Acceptance and Continuance assessment.
- d. Engagement Letter requirements.
- e. Fees.
- f. Management Representation Letter requirements.
- g. Local statutory audit opinion requirements.
- h. Timetable and due dates.
- i. Archiving and record retention requirements.

4. Appendices

- a. Acknowledgment of receipt of Inter firm Instructions template.
- b. Allocation of work between Group, In-Country and SSC audit teams.
- c. Materiality levels determined by Group/In-Country audit team.
- d. Timetable and due dates.
- e. Significant risks identified by Group/In-Country audit team.
- f. Memorandum of work to be performed by SSC audit team.
- g. List of key Group/In-Country audit team's contacts.
- h. List of key Client's contacts.
- i. Memorandum of Examination template.
- j. Inter firm Opinion template.
- k. Subsequent events procedures report template.
- l. Independence confirmation template.
- m. Archiving/Retention confirmation template.

Appendix 3

Specified Procedures Report Template (Illustrative)

Inter firm Report -

Specified Audit Procedures - Financial Information or Internal Controls (year-end)

[SSC audit team's office Letterhead]

To the [name of Group/In-Country audit team's office] [name of parent company] Group/In-Country Engagement Team

We have performed the procedures agreed with you^{*} as set forth in your instructions dated [date of instruction letter] with respect to [identify the financial statements/special purpose financial information] of [name of component].

During the course of applying these procedures, no matters requiring comment to you were found [*include when there are exceptions to report: except as follows*^{**}:].

Because the procedures performed do not constitute either an audit or a review conducted in accordance with [the standards of the Public Company Accounting Oversight Board (United States) OR auditing standards generally accepted in the United States of America] or standards for accounting and review services in the United States of America, respectively OR applicable review standard, we do not express any assurance on [identify financial statements/special purpose financial information]. [*Include when relevant in the circumstances*: This report relates only to the [financial information] specified above and does not extend to the

^{*} As an alternative, refer to "the following procedures" and list the specific procedures performed following the paragraph.

^{**} Internal control deficiencies noted during the engagement should be listed here or included in an attachment.

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[financial statements/special purpose financial information] of
[name of component] taken as a whole.]

This report is intended solely for the use of [name of Group/In-country audit team's office] [name of parent company] Group/In-Country Engagement Team in connection with the [audit/review] of the consolidated financial statements of [name of parent company] and should not be used for any other purpose.

[Name of SSC audit team's office (signed)]

[Date]

Appendix 4

Agreed Upon Procedures Report Template (Illustrative)

**(For work performed on the basis of International Standards
on Related Services)**

Agreed Upon Procedures - Financial Information or Internal Controls (year-end)

[SSC audit team's office Letterhead]

To the [name and address of Group/In-Country audit team's office]

We have performed the procedures agreed with you¹ as set forth in your instructions dated [date of instruction letter] with respect to [identify the financial statements/special purpose financial information] of [name of component]. Our engagement was performed in accordance with International Standards on Related Services (ISRS 4400 – Engagements to Perform Agreed Upon Procedures Regarding Financial Information)

During the course of applying these procedures, no matters requiring comment to you were found [*include when there are exceptions to report: except as follows*².]

Because the procedures performed do not constitute either an audit or a review conducted in accordance with [the standards of the Public Company Accounting Oversight Board (United States) OR auditing standards generally accepted in the United States of America] or standards for accounting and review services in the United States of America, respectively, OR applicable review standard we do not express any assurance on [identify financial statements/special purpose financial information]. [*Include when*

¹ As an alternative, refer to "the following procedures" and list the specific procedures performed following the paragraph.

² Internal control deficiencies noted during the engagement should be listed here or included in an attachment.

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relevant in the circumstances] This report relates only to the [financial information] specified above and does not extend to the [financial statements/special purpose financial information] of [name of component] taken as a whole.]

This report is intended solely for the use of [name of Group/In-country audit team's office] [name of parent company] Group/In-Country Engagement Team in connection with the [audit/review] of the consolidated financial statements of [name of parent company] and should not be used for any other purpose.

[Name of SSC audit team's office (signed)]

[Date]

Appendix 5

Inter Firm Opinion Report Template (Illustrative)

Inter firm opinion

(For work performed on the basis of ISA's)

[SSC audit team's reporting office letterhead]

To [Group audit team's office]

As requested in your Inter firm Audit Instructions dated [insert date] ("instructions"), we have audited the accompanying special purpose financial information of [name of component] expressed in [currency] as of [year-end] and for the year then ended.

1. Management's Responsibility for the Special Purpose Financial information

Management is responsible for the preparation and presentation of this special purpose financial information in accordance with policies and instructions contained in the [name of parent company]'s accounting manual. This special purpose financial information has been prepared solely to enable [name of component] to prepare statutory financial statements.

2. Auditor's Responsibility

Our responsibility is to express an opinion on the special purpose financial information based on our audit. Except as explained in paragraph 4 below, we conducted our audit in accordance with International Standards on Auditing (ISAs). [As requested, our audit procedures also included the procedures identified in your instructions, which the instructions indicate are required by the auditing standards generally accepted in country where component is located]. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the special purpose financial information is free from material misstatement.

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3. Restriction in Scope

As requested, the scope of our audit was restricted by the overall materiality level of [XXXX] specified in your instructions. [Include if relevant in the circumstances: As requested, we used the materiality level(s) of [XXXX] for [identify the particular class(es) of transactions, account balance(s) or disclosure(s), if applicable]].

4. Basis for [Qualified/Adverse/Disclaimer of] Opinion

[Include if giving a qualified/adverse/disclaimer of opinion: Provide a clear description of all of the substantive reasons and, unless impracticable, a quantification of the possible effect(s) on the financial information.]

5. Opinion

Because of the restriction described in the paragraph 4 above, the scope of our work was not sufficient to enable us to express, and we do not express, an unrestricted opinion on this financial information. However, in our opinion, based on our audit performed within the limits of materiality described in the paragraph 3 above, [add if the opinion is qualified: and except for the effect on the special purpose financial information of the matter[s] referred to in the paragraph 4 above], the accompanying special purpose financial information for [name of component] as of [date] and for the year then ended has been prepared, in all material respects, to give the information required to be shown in accordance with the policies and instructions contained in the [name of parent company]'s accounting manual.

6. Emphasis of Matter - Basis of Preparation

Without qualifying our opinion, we draw attention to the fact that the accompanying special purpose financial information is not presented in accordance with and does not include all the information required to be disclosed by (name of the country) Generally Accepted Accounting Practice. Accordingly, the accompanying information is not intended to give a true and fair view of the financial position of [name of component] as of

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[date], and of its financial performance and its cash flows for the year then ended in accordance with(name of the country) Generally Accepted Accounting Practice.

7. Restriction on Distribution or Use

Our report is intended solely for [name of component Audit Firm] in connection with the audit of the statutory financial statements of [name of component] and for no other purpose.

[Signature/Name of SSC audit team Firm]

[Date]

[Address]

Appendix 6

Additional Considerations for Indian Entities Operating in a Shared Service Centre Environment

The concern of auditors for the main entity, that is using the services of the SSC increases manifold under Indian context because of certain special considerations applicable to them. These considerations can broadly be classified as below.

6.1 Compliance with Indian Generally Accepted Accounting Practices (IGAAPs)

GAAP requirement vary across jurisdiction and certain adjustments may be necessitated to ensure compliance with the local GAAP requirements. These adjustments are carried out by the Indian entities accounting team, as these adjustments require knowledge of Indian GAAP for which necessary expertise may not be available at SSC.

Considering above, adjustments made to the financial statements to comply with the local GAAP requirements needs to be audited by the main auditor and thus additional work needs to be performed to get a corroborative evidence.

Examples of IGAAP adjustments:

- Accounting Standard 2, Valuation of Inventories.
- Accounting Standard 9, Revenue Recognition.
- Accounting Standard 11, The Effects of Changes in Foreign Exchange Rates.
- Accounting Standard 15, Employee Benefits.
- Accounting Standard 19, Leases.
- Accounting Standard 26, Intangible Assets.
- Accounting Standard 28, Impairment of Assets.

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- Accounting Standard 29, Provisions, Contingent Liabilities and Contingent Assets.

6.2 Indian Generally Accepted Auditing Standards (IGAAS)

The Indian audit team also needs to ensure compliance with various IGAAS requirements while auditing the Indian entity. Although, India has substantially harmonised with the International Standards on Auditing (hereinafter referred to as the “ISAs”), certain other pronouncements like Statement on the Companies (Auditor’s Report) Order, 2003, Guidance Notes, General Clarification etc, have been issued by the professional regulatory body (Institute of Chartered Accountants of India) for the guidance of the members and same has to be considered by the members of the Institute.

Most of the IGAAS are similar to ISAs with certain key differences that may require Indian entity to perform certain additional procedures to comply with the audit quality norms and these could be over and above the ISAs.

6.3 Compliance with Laws and Regulations in India

Following are the examples of major laws for which compliance needs to be ensured by the Indian entity and thus by the reporting auditor.

- Taxation laws.
- Companies Act, 1956.
- Labour laws.
- Software Technology Parks of India (STPI).
- Other relevant laws and regulations.

Regulatory requirements have to be considered by the Indian entity and therefore, the same needs to be audited by the Indian audit team only.

6.3 (a) Compliance with Companies Act, 1956

- (i) *Preparation of financial statements:* The Companies Act, 1956 specifies the format under Revised Schedule VI for

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Balance Sheet and lays down the general principles for preparation of Statement of Profit and Loss.

(ii) ***Statutory Reporting Requirement under section 227 of the Companies Act, 1956***

In addition to general reporting requirement, the auditor is required to report specifically on the following:

- The Balance Sheet, Statement of Profit and Loss and Cash Flow Statement dealt with by this report comply with the accounting standards referred to in sub-section (3C) of Section 211 of the Act;
- None of the directors is disqualified as on [balance sheet date] from being appointed as a director in terms of clause (g) of sub-section (1) of Section 274 of the Act;

(iii) ***Auditors reporting requirement under Companies (Auditor's Report) Order (CARO) 2003***

CARO reporting requirements include for example specific reporting on fixed assets and inventory records, physical verification of fixed assets and inventory, etc. In order to address these specific reporting requirements, the Indian audit team needs to ensure that adequate samples are selected for Indian entity rather than only relying on the work done by SSC auditor. Sample selection at SSC level may be representative of Indian entities population. This is important to ensure that the Indian audit team has done sufficient work on a standalone basis to address all the CARO reporting requirements.

Illustrative report on CARO 2003 reporting requirements

1. (a) The Company is maintaining proper records showing full particulars, including quantitative details and situation, of fixed assets.
- (b) The fixed assets of the Company have been physically verified by the Management during the year and no

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material discrepancies between the book records and the physical inventory have been noticed. In our opinion, the frequency of verification is reasonable.

(c) In our opinion and according to the information and explanations given to us, a substantial part of fixed assets has not been disposed of by the Company during the year.

2. (a) The inventory (excluding stocks with third parties) has been physically verified by the Management during the year. In respect of inventory lying with third parties, these have substantially been confirmed by them. In our opinion, the frequency of verification is reasonable.

(b) In our opinion, the procedures of physical verification of inventory followed by the Management are reasonable and adequate in relation to the size of the Company and the nature of its business.

(c) On the basis of our examination of the inventory records, in our opinion, the Company is maintaining proper records of inventory. The discrepancies noticed on physical verification of inventory as compared to book records were not material.

3. (a) The Company has not granted any loans, secured or unsecured, to companies, firms or other parties covered in the register maintained under Section 301 of the Act.

(b) In our opinion, the rate of interest and other terms and conditions of such loans are not prima facie prejudicial to the interest of the Company.

(c) In respect of the aforesaid loans, the parties are repaying the principal amounts as stipulated and are also regular in payment of interest, where applicable.

(d) In respect of the aforesaid loans, there is no overdue amount more than Rupees One Lakh.

(e) The Company has not taken any loans, secured or unsecured, from companies, firms or other parties covered

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in the register maintained under Section 301 of the Act.

(f) In our opinion, the rate of interest and other terms and conditions of such loans are not prima facie prejudicial to the interest of the Company.

(g) In respect of the aforesaid loans, the Company is regular in repaying the principal amounts as stipulated and is also regular in payment of interest, where applicable.

4. In our opinion and according to the information and explanations given to us, there is an adequate internal control system commensurate with the size of the Company and the nature of its business for the purchase of inventory, fixed assets and for the sale of goods and services. Further, on the basis of our examination of the books and records of the Company, and according to the information and explanations given to us, we have neither come across nor have been informed of any continuing failure to correct major weaknesses in the aforesaid internal control system.

5. (a) According to the information and explanations given to us, there have been no contracts or arrangements referred to in Section 301 of the Act during the year to be entered in the register required to be maintained under that Section. Accordingly, the question of commenting on transactions made in pursuance of such contracts or arrangements does not arise.

(b) In our opinion and according to the information and explanations given to us, the transactions made in pursuance of such contracts or arrangements and exceeding the value of Rupees Five Lakhs in respect of any party during the year have been made at prices which are reasonable having regard to the prevailing market prices at the relevant time.

6. In our opinion and according to the information and explanations given to us, the Company has complied with the provisions of Sections 58A and 58AA or any other

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relevant provisions of the Act and the Companies (Acceptance of Deposits) Rules, 1975 with regard to the deposits accepted from the public. According to the information and explanations given to us, no Order has been passed by the Company Law Board or National Company Law Tribunal or Reserve Bank of India or any Court or any other Tribunal on the Company in respect of the aforesaid deposits.

7. In our opinion, the Company has an internal audit system commensurate with its size and nature of its business.

8. We have broadly reviewed the books of account maintained by the Company in respect of products where, pursuant to the Rules made by the Central Government of India, the maintenance of cost records has been prescribed under clause (d) of sub-section (1) of Section 209 of the Act, and are of the opinion that prima facie, the prescribed accounts and records have been made and maintained. We have not, however, made a detailed examination of the records with a view to determine whether they are accurate or complete.

9. (a) According to the information and explanations given to us and the records of the Company examined by us, in our opinion, the Company is regular in depositing the undisputed statutory dues including provident fund, investor education and protection fund, employees' state insurance, income-tax, sales-tax, wealth tax, service tax, customs duty, excise duty, cess and other material statutory dues as applicable with the appropriate authorities. .

(b) According to the information and explanations given to us and the records of the Company examined by us, the particulars of dues of income-tax, sales-tax, wealth-tax, service-tax, customs duty, excise duty and cess as at [balance sheet date] which have not been deposited on

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account of a dispute, are as follows:

Name of the statute	Nature of dues	Amount (Rs.)	Period to which the amount relates	Due date	Date of Payment

10. The Company has no accumulated losses as at [balance sheet date] and it has not incurred any cash losses in the financial year ended on that date or in the immediately preceding financial year.

11. According to the records of the Company examined by us and the information and explanation given to us, the Company has not defaulted in repayment of dues to any financial institution or bank or debenture holders as at the balance sheet date.

12. In our opinion, the Company has maintained adequate documents and records in the cases where the Company has granted loans and advances on the basis of security by way of pledge of shares, debentures and other securities.

13. The provisions of any special statute applicable to chit fund / nidhi / mutual benefit fund/ societies are not applicable to the Company.

14. In our opinion, the Company has maintained proper records of transactions and contracts relating to dealing or trading in shares, securities, debentures and other investments during the year and timely entries have been made therein. Further, such securities have been held by the Company in its own name or are in the process of transfer in its name, except to the extent of the exemption granted under Section 49 of the Act.

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15. In our opinion and according to the information and explanations given to us, the terms and conditions of the guarantees given by the Company, for loans taken by others from banks or financial institutions during the year, are not prejudicial to the interest of the Company.

16. In our opinion, and according to the information and explanations given to us, on an overall basis, the term loans have been applied for the purposes for which they were obtained.

17. On the basis of an overall examination of the balance sheet of the Company, in our opinion and according to the information and explanations given to us, there are no funds raised on a short-term basis which have been used for long-term investment.

18. The Company has made preferential allotment of shares to parties and companies covered in the register maintained under Section 301 of the Act during the year. In our opinion and according to the information and explanations given to us, the price at which such shares have been issued is not prejudicial to the interest of the Company.

19. The Company has created security or charge in respect of debentures issued and outstanding at the year-end.

20. The Management has disclosed the end use of money raised by public issues (Refer Note [] on Schedule) which has been verified by us.

21. During the course of our examination of the books and records of the Company, carried out in accordance with the generally accepted auditing practices in India, and according to the information and explanations given to us, we have neither come across any instance of fraud on or by the Company, noticed or reported during the year, nor have we been informed of such case by the Management.

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22. [The other clauses, of paragraph 4 of the Companies (Auditor's Report) Order 2003, as amended by the Companies (Auditor's Report) (Amendment) Order, 2004, are not applicable in the case of the Company for the year, since in our opinion there is no matter which arises to be reported in the aforesaid Order.]

However, it would be pertinent to note that just by relying on the control report of the service entity auditor, the auditor of the Indian entity would not be able to conclude appropriately on the above, neither would he be able to demonstrate the fact that adequate audit evidence has been obtained. For an instance, as part of its audit procedure the Indian audit team needs to select sufficient samples for additions and retirements to fixed assets to demonstrate, that sufficient work has been carried out. Similarly, for inventories, the Indian audit team would require to report on the adequacy of physical verification of inventory and inventory records. Indian audit team needs to attend the physical verification of inventory done by the Indian entity and also verify sufficient samples of inventory items to its records in order to ensure the adequacy of the physical verification process of inventory and inventory records. In relation to internal controls, the Indian team would require to specifically report on the adequacy of internal controls in relation to inventory, fixed assets and sale of goods and services. In this regard also, the Indian team needs to ensure that sufficient work has been done by ensuring that adequate samples have been tested for the standalone Indian entity so that the Indian team can comment on the adequacy of internal controls. In relation to internal audit the Indian team would require to report on the adequacy of internal audit system. In some cases, the Indian entity may appoint an Internal Auditor locally to cover all such areas which are not covered by SSC internal audit. In respect of compliance with statutory requirement in Clause 9, the Indian audit team would need to consider appropriateness of legal compliance. Thus, there has to be adequate coverage in these areas.

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6.3 (b) Taxation Laws

Compliance with relevant tax laws like Direct Taxes, Indirect Taxes, Transfer Pricing issues have to be ensured at the local entity level as the nature of compliance is complex and requires adequate understanding of compliance norms.

6.4 Institute of Chartered Accountants of India (ICAI):

6.4(a) Mandatory compliance with Standards of Auditing

The mandate for compliance with the auditing standards also flows explicitly/ implicitly from the following requirements of the Chartered Accountants Act, 1949:

- Clause 5 of Part I of the Second Schedule to the Chartered Accountants Act, 1949, requires that a chartered accountant in practice shall be deemed to be guilty of professional misconduct, if he fails to disclose a material fact known to him which is not disclosed in a financial statement, but disclosure of which is necessary in making such financial statement where he is concerned with that financial statement in a professional capacity.
- Clause 7 of Part I of the Second Schedule to the Chartered Accountants Act, 1949 states that a chartered accountant in practice shall be deemed to be guilty of professional misconduct, if he does not exercise due diligence, or is grossly negligent in the conduct of his professional duties.
- Clause 9 of Part I of the Second Schedule to the Chartered Accountants Act, 1949 holds a member guilty of professional misconduct if he fails to invite attention to material departure from the generally accepted procedures of audit applicable to the circumstances.

6.4 (b) Peer Review under the Chartered Accountants Act, 1949

The audit process in India is subject to Peer Review under the Chartered Accountants Act, 1949. The examination and review of a practice unit would be carried out by a "reviewer", i.e., a

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member, selected from a panel of reviewers maintained by the Peer Review Board of ICAI. The Peer Review process provides guidance to members to improve their performance and adherence to various statutory and regulatory requirements.

It is therefore necessary for the India engagement team to ensure that sufficient work has been done and documented by them for the standalone Indian entity considering the requirements of IGAAP, IGAAS, CARO 2003, Code of Ethics and Chartered Accountants Act, 1949, etc.