Compendium of Industry Specific Internal Audit Guides

(*As on January 1, 2015*)

Volume II

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

In past several decades, rapid changes amplified by technology have made the overall business environment more complex. This dynamic environment has given rise to new types of risks. Internal audit function has the potential to help manage the increasingly sophisticated risk factors faced by today's organizations, and drive efficiency and sustainability. Internal audit function needs to focus on providing business insights, becoming a strategic advisor, balancing assurance and advisory thereby meeting increased stakeholder's expectations.

The Internal Audit Standards Board of the Institute of Chartered Accountants of India (ICAI) has been bringing out high quality technical literature on internal audit and risk management to upgrade the skill sets of the members. With a view to provide guidance to the members on internal audit of different industries, the Board has brought out a number of industry specific internal audit guides highlighting the peculiar aspects of these industries. I am pleased that this "Compendium of Industry Specific Internal Audit Guides" would consolidate all these industry specific internal audit guides and will be a one stop referencer for the benefits of the members.

At this juncture, I would like to congratulate CA. Charanjot Singh Nanda Chairman, Internal Audit Standards Board and all the other members of the Board for their initiatives in developing technical literature on internal audit.

I am sure that this Compendium would prove to be a useful technical resource for the members.

February 4, 2015 **CA. K. Raghu**
New Delhi President, ICAI

Preface

Globalization, advances in technology, complex regulatory environment have led to an increased focus on risk management, fraud prevention and corporate governance. It is more important than ever for internal audit to be seen as a credible business partner, able to identify control weaknesses that may undermine business drivers or breach regulatory requirements. Internal audit function should overcome these challenges of higher expectations by thinking and acting strategically, building partnership of trust with all stakeholders, remaining aligned with the organization's strategy and business objectives and by delivering high quality reports that are clear and forward looking.

The Institute of Chartered Accountants of India through Internal Audit Standards Board has been working relentlessly, to reinforce the primacy of the Institute as a promoter, source and purveyor of knowledge relating to internal audit and other aspects related to it, so as to enable it's members to provide more effective and efficient value added services. The Board has been bringing out Standards on Internal Audit, Technical Guides of both generic and industry specific nature for the guidance of the members. In 2011, the Board had issued "Compendium of Technical Guides on Internal Audit" which contained text of all the Industry Specific and Generic Guides issued by the Board till June, 2011 and further issued revised edition of the same in 2013.

In 2015, the Board is bringing out separate Compendiums for Industry Specific Internal Audit Guides and Generic Internal Audit Guides. This *Compendium of Industry Specific Internal Audit Guides (As on January 1, 2015)* is divided into five volumes. The first volume contains industry specific Guides on Aluminium Industry, Upstream Oil and Gas Companies, Telecommunication Industry, Stock Brokers, Sugar Industry. The second volumes comprises of Guides on Educational Institutions, BPO Industry, Retail Industry and Life Insurance Companies. The third volume includes Mutual Fund, Infrastructure, Stock and Receivables Audit, Mining and

Extractive Industry and Not-for-Profit Organizations Guides. The fourth volume Guides are on Construction Sector, Textile Industry, Pharmaceutical Industry and Petrochemical Industry. The fifth volume contains Oil and Gas Refining & Marketing (Downstream) Enterprise, Waste Management, Beverages and IT Software Industry. In addition to this, the text of all these Guides have also been published as a separate publication of the Institute.

I would like to express my gratitude to CA. K. Raghu, President, ICAI and CA. Manoj Fadnis, Vice President, ICAI for their continuous support and encouragement to the initiatives of the Board. I must also thank my colleagues from the Council at the Internal Audit Standards Board, *viz.*, CA. Shriniwas Yeshwant Joshi, Vice Chairman, IASB, CA. Rajkumar S. Adukia, CA. Prafulla Premsukh Chhajed, CA. Sanjeev K. Maheshwari, CA. Dhinal Ashvinbhai Shah, CA. Shiwaji Bhikaji Zaware, CA. V. Murali, CA. S. Santhanakrishnan, CA. Abhijit Bandyopadhyay, CA. Sanjiv Kumar Chaudhary, CA. Atul Kumar Gupta, CA. Naveen N.D. Gupta, Shri Manoj Kumar, Shri P. Sesh Kumar and Shri R.K. Jain for their vision and support. I also wish to place on record my gratitude for the co-opted members on the Board, *viz.*, CA. R. Balakrishnan, CA. N. S. Ayyanagoudar, CA. Sunil H. Talati, CA. J. Vedantha Ramanujam and CA. Milind Vijayvargia and special invitees, CA. Nagesh D. Pinge and CA. Hardik Chokshi for their invaluable guidance as also their dedication and support to various initiatives of the Board. I also wish to express my thanks to CA. Jyoti Singh, Secretary, Internal Audit Standards Board, CA. Arti Bansal, Asst. Secretary and CA. Pallavi Aggarwal, Management Trainee in giving final shape to the Compendium.

I am sure that this publication would be warmly received by the interested readers.

February 3, 2015 **CA. Charanjot Singh Nanda**
New Delhi Chairman, IASB

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Volume V

Note : Detailed contents of each of these Guides is given at the beginning of the respective Guide.

I-6
TECHNICAL GUIDE ON INTERNAL AUDIT OF EDUCATIONAL INSTITUTIONS

Foreword

Education is the starting point of every successful human activity. Education makes a person right thinker and a correct decision maker. The role played by educational institutions in the process of growth and persistent advancement of countries is accepted by everybody and education is regarded as a main base of advancement and progress. In a way the educational institutions at various levels constitute the foundation of the technological, administrative, civic, legal and other domains of a country.

In India education is rendered both by the government institutions and private institutions, partly aided or unaided, at primary, secondary and higher levels. In order to ensure sustainable growth of this sector of national importance, adherence to the fundamental principles of efficient management, governance and accountability of financial resources assumes significant importance.

Internal audit has emerged as an important tool to assist the educational institutions in achieving their goals and maximising value to the society as a whole. I am happy to note that Internal Audit Standards Board of the Institute is issuing this "Technical Guide on Internal Audit of Educational Institutions" that primarily deals with the operational as well as internal audit aspects relevant for various types of educational institutions.

At this juncture, I congratulate CA. Shantilal Daga, Chairman, Internal Audit Standards Board and other members of the Board for bringing out publication on such an important topic of national relevance.

I am sure that this Technical Guide, like other publications of the Board, would be warmly received and appreciated by the members and other interested readers.

February 3, 2010
New Delhi

CA. Uttam Prakash Agarwal
President, ICAI

Preface

Education plays vital role in building up a strong nation. Education refers to any act or experience that has a formative effect on the mind, character, or physical ability of an individual. It is the process by which society, through schools, colleges, universities, and other institutions, deliberately transmits its cultural heritage – its accumulated knowledge, values, and skills – from one generation to another. Indian constitution provides directives regarding the development of education throughout the country. The Government of India has identified areas in which the respective Central and State Governments have domain as the Central list, State list and concurrent list.

An effective internal audit function in educational institutions is undoubtedly a fundamental component of good governance. Internal audit assists in achieving efficiency and effectiveness in educational institutions, ensuring that processes and systems produce results that meet the needs of society while making the best use of resources at their disposal. Keeping this in view, the Internal Audit Standards Board is issuing "Technical Guide on Internal Audit of Educational Institutions" that would help the internal auditors to better understand the intricacies of this sector and discharge their onerous responsibilities with utmost efficiency.

The Technical Guide is divided into four chapters. The first chapter deals with the scope and objective of the Guide and overview of education in India. The second chapter of the Guide explains the technical aspects of the educational institutions in the country. It gives an overview on various aspects like, evolution of education in post independence period, types of management, stages of education, organisational structure of the educational institutions. It also covers the regulatory framework, technical and operational aspects, finance and accounting features, sources of income and expenditure of educational institutions. The third chapter of the Guide deals with the overall approach of internal audit with reference to Standards on Internal Audit issued by the Board, and the procedures to be undertaken by the internal auditors with regard to peculiar aspects related to educational institutions. The fourth chapter of the Guide provides guidance regarding internal audit of special aspects such as corporate governance, frauds, transactions with related parties, statutory and legal compliances, etc. It also provides in-depth understanding of internal audit in information technology environment and internal audit using computer assisted audit techniques. For better understanding of the readers, the Guide also contains Appendix which includes organisational structure of Ministry of Human Resource Development as well as of educational institution, illustrative reporting format under Bombay Trust Rules, Internal Control Checklist, etc.

At this juncture, I express my thanks to CA. Verendra Kalra, member of the Internal Audit Standards Board and convenor of the study group and its members, *viz.*, CA. Ajay Khattak, CA. Vimal Kishore and CA. Deepak Jain for squeezing time out of their pressing preoccupations to share their wealth of knowledge and experience with us and preparing the basic draft of the Guide.

I also wish to thank CA. Uttam Prakash Agarwal, President and CA. Amarjit Chopra, Vice President for their continuous support and encouragement to the initiatives of the Board. I must also thank my colleagues from the Council at the Internal Audit Standards Board, *viz.*, CA. Rajkumar S. Adukia, CA. Ved Jain, CA. Abhijit Bandyopadhyay, CA. Bhavna G. Doshi, CA. Pankaj I. Jain, CA. Sanjeev K. Maheshwari, CA. Mahesh P. Sarda, CA. S. Santhanakrishnan, CA. Vijay K. Garg, Shri Krishna Kant, Shri Manoj K. Sarkar and Shri K. P. Sasidharan for their vision and support. I also wish to place on record my gratitude for the co-opted members on the Board, *viz.,* CA. N. K. Aneja, CA. M. Guruprasad, CA. Dilip Kumar Vadilal Shah and CA. K. S. Sundara Raman as also special invitees on the Board, *viz.*, CA. K. P. Khandelwal, CA. S. Sundarraman, CA. Ravi H. Iyer, CA. Rajiv Dave, CA. Pawan Chagti, CA. Ram Mohan Johri and CA. Arindam Guha for their devotion in terms of time as well as views and opinions to the cause of the professional development. I also wish to place on record the efforts put in by CA. Jyoti Singh, Secretary, Internal Audit Standards

Board and her team of officers, *viz.*, CA. Arti Aggarwal and CA. Gurpreet Singh, Senior Executive Officers, for their inputs in giving final shape to the publication.

I am sure that the readers would find the Technical Guide extremely useful.

February 8, 2010
Hyderabad

CA. Shantilal Daga
Chairman
Internal Audit Standards Board

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Chapter 1
Introduction

1.1 An old Sanskrit adage states, *"That is education which leads to liberation – liberation from ignorance which shrouds the mind; liberation from superstition which paralyzes effort, liberation from prejudices which blind the vision of the truth."*

Objective and Scope of the Technical Guide

1.2 The objective of the technical guide is to provide guidance to members to carry out the internal audit of educational institutions in India. These institutions are providing education from the primary level to the higher level and depending upon the level, operate as schools, colleges, universities, and other places of learning. This technical guide attempts to provide information about the structure of education in India, the environment in which it operates, the technical and operational details related to the functioning of educational institutions, and the internal audit aspects to be kept in mind by the members of the Institute of Chartered Accountants of India in conducting internal audit of such institutions.

1.3 The size, structure of management, the governing legislations, manner of functioning and nature of activities may vary from one educational institution to another. This technical guide cannot cover all the intricacies that might be involved in different practical situations. Therefore, the various aspects and principles enunciated in this guide should be applied *mutatis mutandis*, exercising professional judgement.

1.4 This guide is not intended to dwell on the basic internal audit procedures, which are common to all types of organisations/ industries. It purports to provide insight into peculiar aspects of the educational sector for internal audit purpose. The guide also discusses special areas of compliance peculiar to this sector that call for internal auditor's scrutiny.

Overview of Education in India

1.5 Education holds the key to development for any nation. It lays the foundation for a continuous and equitable growth of any country. In India, at the time of independence, less than one-fifth of the population was literate. After independence, many efforts were made to provide access to education to the general public. However, due to lack of educational institutions and teachers as well as poverty, customs and social barriers, there was not much development in education sector. As of today, significant progress has been made by the Government to develop and maintain the education system in the country. From time to time the Government of India has introduced various measures to provide quality education to all.

1.6 Today, education in India has expanded many folds, bringing a significant increase in the schools, universities, colleges, teaching staff and strength of students. India has made considerable achievement in 'Green Revolution', 'Space Technology', 'Nuclear Energy', 'Information Technology', etc. due to the development of higher education. The success of the Indian education system is nowhere more visible than in the important positions held by Indian professionals, managers and entrepreneurs worldwide in cutting edge sectors such as those driven with the support of information technology, biotechnology and medical sciences.

Chapter 2
Technical Aspects

Evolution of Education in Post Independence India

Education and Constitution of India

2.1 The citizens of India have a fundamental right to education. The said right flows from Article 21A of Part III of Fundamental Rights of the Constitution of India, which was inserted by the Constitution (Eighty-sixth) Amendment Act in 2002[1]. Article 21A states that *"The State shall provide free and compulsory education to all children of the age of six to fourteen years in such manner as the State may, by law, determine".* Subsequently, to enforce this right, The Right of Children to Free and Compulsory Education Act, 2009 was legislated in August, 2009.

2.2 The right to education is also mentioned in the Directive Principles contained in Part IV of the Constitution under Article 45. The Constitution (Eighty-sixth) Amendment Act, 2002, also amended Article 45 to state that *"The State shall endeavour to provide early childhood care and education for all children until they complete the age of six years.*"

Hence, the Constitution gives right to each citizen to free compulsory education up to the age of 14 years. However, thereafter, the right is not so absolute and it is circumscribed by Article 41 that reads as follows:

"State shall, within the limits of its economic capacity and development, make effective provisions for securing the right to work, to education *and to public assistance in cases of unemployment, old age, sickness and disablement, and in other cases of undeserved want."*

[1] It shall come into force on such date as the Central Government may, by notification in the Official Gazette, appoint. The notification is yet to be done.

2.3 '*Education*' earlier was only in the State List. The Constitution (42nd Amendment) Act of 1976 has included education in the concurrent list. Para 25 of List 3 of Schedule VII to the Constitution reads as under:

"Education including technical education, medical education and Universities, subject to the provisions of Entries 63, 64, 65 and 66 of List 1: Vocation and Technical Training of Labour"

Regulatory Framework[2]

2.4 The origin of the Indian Education Department dates back to pre-independence days when for the first time a separate department was created in 1910 to look after education. However, soon after India achieved its independence on 15th August, 1947, a full-fledged Ministry of Education was established on 29th August, 1947. The nomenclature and responsibilities of the Education Department has undergone changes from time to time since Independence. At present, the Ministry of Human Resource and Development (MHRD) regulates education in India and it operates mainly through two departments namely:

(i) ***Department of School Education and Literacy -*** It is responsible for making policies on Elementary Education, Basic Education, Bal Bhawan Children's Museum, Social Education, Adult Education, Audio Visual Education, Books, Educational Research, Teachers Training and National Council for Teacher Education.

(ii) ***Department of Higher Education –*** The Central Government is responsible for major policy relating to higher education in the country. It provides grants to University Grant Commission (UGC) and establishes Central Universities in the country. The Central Government is also responsible for declaration of educational institutions as 'Deemed to be University' on the recommendation of the UGC. The Central Government has also been empowered by Entry 66 of Union subject list of the Constitution[3] to maintain a particular standard

[2] *Source: http://india.gov.in/sectors/education/index.php*
[3] *Source: http://www.education.nic.in/Higedu.asp*

conducive to the educational health of the country. The Central Government lays special emphasis on research and development carried out in technical as well as other institutions. The organisation chart of Department of Higher Education has been enclosed as ***Appendix 1 to*** this Guide.

The State Governments are responsible for establishment of State Universities and Colleges, and provide plan grants for their development and non-plan grants for their maintenance.

National Policy of Education

2.5 The Central Government has reviewed educational policy and progress from time to time. In its resolution in the National Policy on Education in 1968, an emphasis on quality improvement and a planned, more equitable expansion of educational facilities and the need to focus on the education of girls was stressed. About a decade ago and a half later, the National Policy on Education (NPE-1986) was formulated which was further updated in 1992. The NPE 1986 provided for a comprehensive policy framework for the development of education up to the end of the century. The Plan of Action (POA) 1992, assigned specific responsibilities for organising, implementing and financing the proposals contained in the 1986 policy.

Education and Charity

2.6 Though the Constitution of India enjoins upon the state to provide education compulsorily up to the age of 14, the private sector today is playing a vibrant role in the field of education.

2.7 In India, the concept of education has always been synonymous with charity. It was stated in the judgment delivered in *The State of Bombay v. RMD Chamarbaugwala [(1957) SCR 874; AIR (1957) SC 699], that "Education is per se regarded as an activity that is charitable in nature".* As a result, the regulatory framework has always striven to ensure that the educational institutions, even though being run by the private sector and despite their autonomous management status partake the character of non-profit institutions such as, public trusts or societies registered under the Societies Registration Act, 1860. This objective is achieved in the following ways:

(i) Institutions receiving grant in aid from the Government have to follow the guidelines laid down for being eligible for such grants and inter alia such conditions require that such institutions be run on charitable basis.

(ii) Institutions, even though not dependent on Government grants but seeking affiliation/recognition have to follow the guidelines laid down for being eligible for recognition and inter alia such conditions require that such institutions are run on charitable basis. Registration authorities constituted by the Government for this purpose are the Inspector of Schools, the Central Board of Secondary Education, UGC, etc.

2.8 The role of the Government in the functioning of private educational institutions has been the subject of perennial litigation. However, following two landmark judgments of the Supreme Court have been instrumental in defining this role:

(i) The first judgment was delivered in the case of *Unni Krishnan J.P. vs. State of AP [(1993) 1 SCC 645]* in which it was held that private unaided recognised/affiliated educational institutions running professional courses could not charge a fee that exceeded the maximum limit fixed by the State and the manner of admissions could also be regulated. About private aided recognised/affiliated institutions, the Court went a step further and upheld the power of the Government to regulate matters of recruitment and conditions of service of teachers and staff as well.

(ii) In the recent judgment the Apex Court in *TMA Pai Foundation and Others v. State of Karnataka and others [(2002) 8 SCC 481],* has partially reversed the aforesaid judgment. The Court held that the decision in the Unni Krishnan's case, in so far as it framed the scheme relating to the grant of admission and the fixing of the fee, was not correct, and to that extent, the said decision and the consequent directions given to UGC, Medical Council of India, Central and State

Governments, etc., are overruled. The Court further held that the decision on the fees to be charged must necessarily be left to the private educational institutions that does not seek or is not dependent on any funds from the Government and a reasonable revenue surplus, may be generated for the purpose of development of education and expansion of the institutions. In respect of the aided institutions, the court was of the view that the Government can make rules and regulations that promote good administration and management of the institution.

2.9 The recent judgment, by concluding that the object to run such an institution should not be to make a profit, continues to uphold the necessity for maintaining the charitable nature of the educational institutions. Yet, at the same time, it has removed a number of restrictions on such institutions, resulting in dilution of Government interference in the functioning of educational institutions.

Statutes Applicable to Educational Institutions

Statutes Governing Creation of the Institutions

Societies Registration Act, 1860

2.10 The educational institutions are generally registered as societies under the Societies Registration Act, 1860. In addition to the Central Act, various states have framed their respective Acts and Rules for example, The West Bengal Societies Registration Act 1961, The Andhra Pradesh Societies Registration (Validation) Act,1959, The Karnataka Societies Registration Act,1960, etc. Registration is as such done both under the Central Act as well as State enactments and in cases where the State Act exists registration is done by the State Governments in whose territories the society is located. The societies to be registered must have been established for literary, scientific or charitable purposes. Section 20 further elaborates to include for this *purpose "Societies established for the promotion of science, literature or the fine arts, for instruction, the diffusion of useful knowledge…".*

Public Trusts Act [State enactment]

2.11 The institutions may also be established as Public Charitable Trusts. To create a trust, there must be few essential elements present. These are namely an author, the trustees, property to be held under the trust, purpose of the trust, beneficiaries and objects with which the trust is to be administered. The Charitable Endowment Act, 1890 defines charitable purpose as a purpose for *"relief of the poor, education, medical relief and advancement of any object of general public utility"* but excludes a purpose exclusively to religious teachings. The Central legislation governing trusts is the Indian Trust Act, 1882. It, however, does not govern public trusts.

2.12 Registration of a Trust is made as per the provisions of the Indian Trust Act, 1882 and the trust deed (and not the trust) has to be registered with the registration department of the respective State Governments. In some of the states, such as state of Maharashtra and Gujarat, where public trust acts have been passed, all the societies registered under the Societies Registration Acts, are required to be simultaneously registered under the Public Trusts Act.

Companies Act, 1956

2.13 The educational institutions may also be incorporated as a Company under section 25 of the Companies Act, 1956. Such institutions may be given a license by the Central Government when it is incorporated as a company with the limited liability. Section 13(1)(a) makes it necessary that the name of a limited company must end with the word '*limited*' in the case of a public company and with the words '*private limited*' in the case of private company. However, section 25 permits the registration under a license granted by the Central Government to all '*associations not for profit with limited liability*' without being required to use the word '*limited*' or the words '*private limited*' at the end of their names. Such license may be granted, if the Central Government is satisfied that the company is to be formed for promoting commerce, art, science, religion, charity or any other useful object and it intends to apply its profit, if any, or other income in promoting its objects and to prohibit the payment of any dividend to its members. Such a company is registered without payment of any stamp duty on its Memorandum or Articles. Further, such companies are also allowed numerous exemptions from the provisions of the Companies Act, 1956.

Statutes Regulating Education in India

Central and State Enactments

2.14 Both Central and State Government are responsible to make policies to provide for the planned development of educational institutions, inculcation of healthy educational practice, maintenance and improvement in the standards of education and better organisation, discipline and control over educational institutions with a view to fostering the harmonious development of the mental and physical faculties of students and cultivating a scientific and secular outlook through education.

2.15 Some examples of Central/Constitutional Enactments are as follows[4]:

S.No.	Bureau	Acts and Subordinate Legislation	Purpose
(i)	Distance Learning	➢ Indira Gandhi National Open University Act, 1985	An Act to establish and incorporate an Open University at the national level for the introduction and promotion of open university and distance education systems in the educational pattern of the country and for the co-ordination and determination of standards in such systems.
(ii)	University and Higher Education	➢ The Central Educational Institutions	An Act to provide for the reservation in admission of the students belonging

4 *Source: www.education.nic.in/Acts/actssubleg.asp*

S.No.	Bureau	Acts and Subordinate Legislation	Purpose
		(Reservation in Admission) Act, 2006	to the Scheduled Castes, the Scheduled Tribes and the Other Backward Classes of citizens, to certain Educational Institutions established, maintained or aided by the Central Government, and for matters connected therewith or incidental thereto.
		➢ The University Grants Commission Act, 1956	An Act to make provision for the co-ordination and determination of standards in Universities and for that purpose, to establish a University Grants Commission.
		➢ The National Council for Minority Educational Institutions Act, 2004	An Act to constitute a National Commission for Minority Education Institutions and to provide for matters connected therewith or incidental therto.
iii)	Technical Education	➢ The All India Council for Technical Education Act, 1987	An Act to provide for the establishment of an All India Council for Technical Education with a view to ensure proper planning and co-ordinated development of the technical education system throughout the country, the promotion of qualitative growth and the regulation and proper maintenance of norms and standards in the

S.No.	Bureau	Acts and Subordinate Legislation	Purpose
			technical education system and for matters connected therewith.
		The Institutes of Technology Act, 1961	An Act to declare certain institutions of technology to be institutions of national importance and to provide for certain matters connected with such institutions.
		➢ National Institutes of Technology Act, 2007	An Act to declare certain institutions of technology to be institutions of national importance and to provide for instructions and research in branches of engineering, technology, management, education, sciences and arts and for the advancement of learning and dissemination of knowledge in such branches and for certain other matters connected with such institutions.
		➢ The Architects Act, 1972	An Act to provide for the registration of architects and for matters connected therewith.
		➢ The Apprentices Act, 1961	An Act to provide for the regulation and control of training of apprentices and for matters connected therewith.

S.No.	Bureau	Acts and Subordinate Legislation	Purpose
(iv)	Book Promotion and Copyright	➢ The Copyright Act, 1957	An Act to amend and consolidate the law relating to copyright.
(v)	Languages	➢ The English and Foreign Languages University Act, 2006	An Act to establish and incorporate a teaching University for promotion and development of English and other Foreign Languages and their Literature, and to provide for matters connected therewith or incidental thereto.

2.16 Some examples of State Enactments[5] are as follows:

S.No.	State	Acts
(i)	Gujarat	The Ganpat University Act, 2005
(ii)	Haryana	The Punjab University Act, 1947
(iii)	Uttarakhand	Doon University Act, 2005
(iv)	Himachal Pradesh	The Himachal Pradesh Compulsory Education Act, 1992
(v)	Tamil Nadu	The Tamil Nadu State Council for Higher Education Act, 1992
(vi)	Rajasthan	The Rajasthan Private University Act, 2005
(vii)	Uttar Pradesh	UP Act No. 1248(2)XVII-V-I-I-19-2000 Uttar Pradesh Adhiniyam Sankhya 23, 2000
(viii)	Punjab	Punjab Technical University Act 1996

5 *Source: http://india.gov.in/govt/acts.php*

2.17 Since the State Governments establish and plan for the colleges and universities in the states and the Central Government does it for the Central Universities, it is essential that there is adequate co-operation between the State Governments and the Central Government in the field of higher education. The *Central Advisory Board of Education (CABE)* has, therefore, been constituted to assist in the functioning of the two Governments and ensure that parity is maintained.

Other Enactments - An Illustrative List

2.18 The educational institutions imparting higher education have to comply with laws of the concerned Statutory Professional Councils, for example an engineering college has to comply with the rules and regulations of *All India Council for Technical Education (AICTE)*, a hospital has to follow rules and regulations of *Medical Council of India (MCI)* for setting up a medical college, etc. In cases where the educational institutions are in receipt of donations from foreign sources, statutory reporting compliances will have to be made under the *Foreign Contribution (Regulation) Act, 1976*; for example, application for registration under the Foreign Contribution (Regulation) Act, 1976 for the acceptance of foreign contribution has to be filed in Form FC-8. The format of Form FC-8 has been enclosed as **Appendix 2** to this Guide.

2.19 Educational institutions will also have to comply with *Prevention of Food Adulteration Act and Rules, 1954*, local *Shop and Establishment Acts* and the *State VAT Acts* in case of establishment of a canteen. The educational institutions, like any other establishments are governed by all the relevant labour laws such as *Employees' Provident Fund and Miscellaneous Provisions Act, 1952, The Payment of Bonus Act, 1965, Payment of Gratuity Act, 1972, Minimum Wages Act, 1948,* etc.

Laws Governing Tax Exemptions

Income Tax Act, 1961

2.20 The income of an educational institution is subject to income tax, except where the provisions for grant of exemption are applicable. Such provisions are contained in Chapter III of the Income Tax Act, 1961. A special set of provisions governing the taxability of income from property held under trust for charitable purpose is contained in Section 11 to 13 of the Income Tax Act, 1961. Section 10(23C) also provides exemption to educational institutions under certain circumstances, not necessarily being trusts or societies, provided however that such institution exists solely for the purpose of education and not for the purpose of profit. Institutions having receipts more than the prescribed limits have to specifically apply for such exemption.

2.21 Section 2(15) of the Income Tax Act, 1961 defines charitable purpose to include '*education*'. It was held by the Supreme Court in the case of *Sole trustee; Loka Shikshana Trust V. CIT (1975) 101 ITR 234* that term '*education*', for the purpose of Income Tax Act, 1961 should be in the nature of systematic instruction, schooling or training given to the young in preparation for the work of life. It also connotes the whole course of scholastic instruction that a person has received. Similar view has been taken in the following two cases:

- *CIT Vs. Oxford University Press (Bom) (1996) 221 ITR 77*
- *Samaj Kalyan Parishad Vs. ITO (2007) 107 TTJ 302*

2.22 Approved charitable institutions whose income is not liable to be taxable under the provisions of section 11 to 12 or 10(23C) are also eligible for further benefits in the shape of deduction available to donors to such societies. The donors upon making donations to such institutions can claim deductions from their income at the prescribed rates, from their taxable incomes, subject to other provisions contained in section 80G. The donee institutions have to apply for this benefit to the Commissioner of Income Tax. The approval granted by the Commissioner of Income Tax shall continue to be valid in perpetuity from 1st October, 2009. This facilitates the receipt of donations by such institutions from individual, corporate donors, etc.

2.23 The benefits given are, however, subject to certain restrictions, so as to ensure that the institutions spend their funds on charitable causes only. As per Section 13 of *Income Tax Act, 1961*, the following incomes of the charitable/ religious trusts/ institutions will not qualify for exemption under section 11:

(i) Any part of the income from property held under a trust for private religious purposes which does not ensure for the benefit of the public. *[Section 13(1)(a)]*

(ii) Entire income of a charitable trust/institution (established on or after 1st April, 1962) created for the benefit of the any particular religious community or caste. *[Section 13(1)(b)]*

(iii) Entire income of a charitable trust/ institution (established on or after 1st April, 1962) if it enures directly or indirectly any part of its income for the benefit of any interested person, or if the income/property is used/applied for the direct/indirect benefit of interested person. *[Section 13(1)(c)]*

2.24 Under section 13(3), following are considered as interested persons:

(i) The author of the trust or the founder of the institution,

(ii) Any person who has made a total contribution of an amount exceeding Rs. 50,000 to the trust or institution,

(iii) A member of HUF, where such author or founder or substantial contributor is a Hindu Undivided Family,

(iv) Any trustee of the trust or manager (by whatever name called) of the institution,

(v) Any relative of any such author, founder, substantial contributor, member, trustee or manager, and

(vi) Any concern in which any of the persons referred above has a substantial interest.

Wealth Tax Act, 1957

2.25 Similarly, the Wealth Tax Act, 1957 is equally applicable to any charitable or religious trust as to any other assessee. However, Section 5 of the Act allows exemption from wealth tax to such trusts subject to certain conditions. These conditions are identical to the conditions prescribed under section 11 to 13 of the Income Tax Act, 1961.

Customs Duty

2.26 The Government is empowered under section 25(2) of the Customs Act, 1962[6] to allow exemption to charitable institutions that are providing their services free or on *'no profit no loss'* basis. Such institutions include educational institutions. The exemption is granted subject to the condition that the institution should be certified by the concerned district authorities. Further, the imported goods should not be put to any commercial use and the same should be available for charitable purposes without any distinction on account of caste, creed, religion, race or gender. The exemption is not available on the items of general use and the imported goods should not be sold, gifted or exchanged without prior permission of the Ministry of Finance.

Service Tax

2.27 Service Tax exemption for providing training or coaching under section 65(105)(zzc) is available for pre-school coaching and training centers and those awarding legally recognised certificates/diploma/degree or any educational qualification, i.e., the certificates/diploma/degree should be '*recognised by the law for the time being in force*'.[7]

2.28 Further, the vocational training institutions are exempted from service tax[8]. The exemption is available only to such institutions that impart training to enable the trainee to seek employment or self-employment. The institutions offering general course on improving communication skills, personality development, how to be effective in group discussions or personal interviews, general grooming and finishing, etc., are not covered under the said exemption.

6 *Source: Customs Circular No. 81/2001, dated 12th December, 2001*

7 *Source: www.servicetax.gov.in [Circular No. 107/01/2009-ST dated: 28th January, 2009]*

8 *Source: Notification No. 24/2004-ST, dated: 10th September, 2004*

Exemptions from Local Taxes

2.29 Registered charitable societies are also eligible for exemptions/relief from payment of local taxes such as to municipal authorities, development authorities depending upon the policy of the state in which such societies operate.

Applicability of Accounting Standards issued by ICAI

Overview of Accounting Standards

2.30 The accounting principles and practices, in India, are governed, *inter alia*, by the Accounting Standards, Guidance Notes, etc., issued from time to time by the Institute of Chartered Accountants of India (ICAI). Para 6.1 of *"Preface to the Statements of Accounting Standards"*, lays down that *the Accounting Standards will be mandatory from the respective date(s) mentioned in the Accounting Standard(s). The mandatory status of an Accounting Standard implies that while discharging their attest functions, it will be the duty of the members of the Institute to examine whether the Accounting Standard is complied with in the presentation of financial statements covered by their audit. In the event of any deviation from the Accounting Standard, it will be their duty to make adequate disclosures in their audit reports so that the users of financial statements may be aware of such deviation. Ensuring compliance with the Accounting Standards while preparing the financial statements is the responsibility of the management of the enterprise.*

2.31 Sound accounting principles under accrual basis of accounting, albeit in the context of business, industrial and commercial enterprises, have been laid down in the Accounting Standards issued by the Institute of Chartered Accountants of India. With respect to applicability of Accounting Standards to various types of enterprises paragraph 3.3 of *"Preface to the Statements of Accounting Standards"* states as follows:

"3.3 Accounting Standards are designed to apply to the general purpose financial statements and other financial reporting, which

are subject to the attest function of the members of the ICAI. Accounting Standards apply in respect of any enterprise (whether organised in corporate, co-operative[9] *or other forms) engaged in commercial, industrial or business activities, irrespective of whether it is profit oriented or it is established for charitable or religious purposes. Accounting Standards will not, however, apply to enterprises only carrying on the activities which are not of commercial, industrial or business nature, (e.g., an activity of collecting donations and giving them to flood affected people). Exclusion of an enterprise from the applicability of the Accounting Standards would be permissible only if no part of the activity of such enterprise is commercial, industrial or business in nature. Even if a very small proportion of the activities of an enterprise is considered to be commercial, industrial or business in nature, the Accounting Standards would apply to all its activities including those which are not commercial, industrial or business in nature*[10]*."*

2.32 Since in most cases, an educational institution is normally run for charitable purposes by a society or a trust, unless the circumstances warrant otherwise, the Accounting Standards would not apply to such educational institution. However, if the society/ trust is also undertaking business activity, the Accounting Standards would apply to all its activities, including charitable activities.

For detailed guidance on these aspects reference may be made to *"Guidance Note on Accounting by Schools"* issued by the Institute of Chartered Accountants of India.

Applicability of Accounting Standards to Educational Institutions Registered under Section 25 of the Companies Act 1956

2.33 Educational Institutions registered under Section 25 of the Companies Act, 1956, are required to comply with Accounting

[9] With the issuance of this revised Preface, General Clarification (GC) – 12/ 2002, Applicability of Accounting Standards to Co-operative Societies, issued by the Accounting Standards Board in October 2002, stands superseded.

[10] With the issuance of this revised Preface, Announcement of 'Applicability of Accounting Standards to Charitable and/or Religious Organisations", approved by the Council (published in 'The Chartered Accountant', September 1995 (page 79)), stands superseded.

Standards by virtue of sub-section (3A) of Section 211 of the Companies Act, 1956. Further, Section 211(3B) requires that where the profit and loss account (income and expenditure account in the case of educational institutions) do not comply with the Accounting Standards, the company shall disclose the fact of such deviations from the accounting standards, the reasons thereof and the financial effect, if any, arising due to such deviation.

2.34 Section 227(3)(d) also requires the auditor to state whether profit and loss account and balance sheet comply with Accounting Standards referred to in sub-section (3C) of section 211. Sub-section (3C) of Section 211 provides that for the purposes of this section, the expression *'Accounting Standards'* means the standards of accounting recommended by the ICAI constituted under The Chartered Accountants Act, 1949 (38 of 1949), as may be prescribed by the Central Government in consultation with the National Advisory Committee on Accounting Standards (NACAS) established under sub-section (1) of section 210A. Proviso to Sub-section (3C) of the section provides that the standards of accounting specified by the ICAI shall be deemed to be the Accounting Standards until the Accounting Standards are prescribed by the Central Government under this sub-section. It may also be noted that on the recommendation of NACAS, the Ministry of Corporate Affairs, has issued a Notification dated 7th December, 2006, whereby it has prescribed Accounting Standards 1 to 7 and 9 to 29 as recommended by the ICAI which are included in the said Notification.

Standards on Internal Audit (SIAs)

2.35 Internal Audit Standards Board of the Institute of Chartered Accountants of India has, till date, issued seventeen Standards on Internal Audit (SIAs) which are as follows:

- SIA 1, Planning an Internal Audit
- SIA 2, Basic Principles Governing Internal Audit
- SIA 3, Documentation
- SIA 4, Reporting

- SIA 5, Sampling
- SIA 6, Analytical Procedures
- SIA 7, Quality Assurance in Internal Audit
- SIA 8, Terms of Internal Audit Engagement
- SIA 9, Communication with Management
- SIA 10, Internal Audit Evidence
- SIA 11, Consideration of Fraud in an Internal Audit
- SIA 12, Internal Control Evaluation
- SIA 13, Enterprise Risk Management
- SIA 14, Internal Audit in an Information Technology Environment
- SIA 15, Knowledge of the Entity and its Environment
- SIA 16, Using the Work of an Expert
- SIA 17, Consideration of Laws and Regulations in an Internal Audit

These Standards codify the best practices in the field of internal audit. *"Framework for Standards on Internal Audit"* provides a frame of reference for the internal audit standards being issued by the Institute.

2.36 Paragraph 3 of the *'Preface to the Standards on Internal Audit'* deals with the scope of the SIAs. It reads as under:

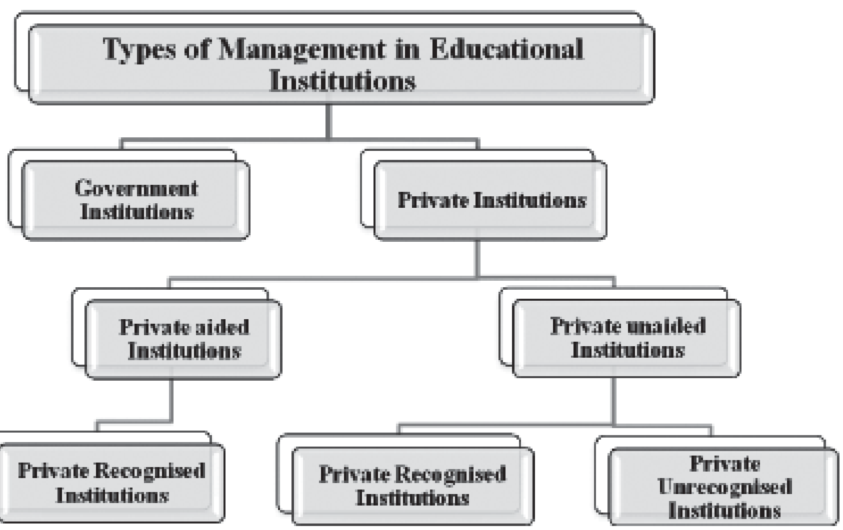
"The Standards on Internal Audit shall apply whenever an internal audit is carried out. Internal audit is an independent management function, which involves a continuous and critical appraisal of the functioning of an entity with a view to suggest improvements thereto and add value to and strengthen the overall governance mechanism of the entity, including the entity's strategic risk management and internal control system. Internal audit, therefore, provides assurance

that there is transparency in reporting, as a part of good governance."

Presently, the Standards on Internal Audit issued by the ICAI are recommendatory in nature.

Types of Management in Educational Institutions

2.37 The different types of management in educational institutions is as follows:



(a) Government Institutions – Government institutions are also known as state institutions or public institutions. These institutions are run by the Central or State Government or Local Government bodies like, Municipality Council. These types of institutions are 100% funded and managed by some level of Government, state or local. In these institutions, the respective state board syllabus is adopted.

(b) Private Institutions – These types of institutions are not run by the Central Government, State Government, a local authority or any other authority designed or sponsored by the Central Government, State Government or a local authority.

(c) Private Aided Institutions – These types of institutions are in receipt of recurring financial aid or assistance in the form of maintenance grant from the Central Government, State Government, a local authority or any other authority designed or sponsored by the Central Government, State Government, or a local authority. Though, these institutions are privately managed, they are funded by the government. They are entitled to financial aid only if they are recognised by the appropriate authorities.

(d) Private Unaided Institutions – These institutions do not receive any aid and are entirely privately managed and privately funded. Private unaided institutions are of two types, recognised and unrecognised.

(i) ***Recognised Institutions*** – These are those institutions which are recognised by the appropriate authority. The appropriate authority is the Central Government or State Government or a local authority. These institutions have to meet the regulatory requirements of the Central or State Government.

(ii) ***Unrecognised Institutions*** **–** These are those institutions which are not recognised by any appropriate authority. They are in effect operating in the informal sector of the economy. Unrecognised institutions can offer only certificate and diploma courses, unlike recognised institutions, which in appropriate cases, can also be authorised to grant degrees.

Stages of Education in India

2.38 The present education system in India mainly comprises of primary/elementary education, secondary education, senior secondary education and higher education. Elementary education consists of eight years of education. Each of secondary and senior secondary education consists of two years of education. Higher education in India starts after passing the higher secondary education or the 12th standard. Graduation courses can take three to five years depending on the stream. Post graduate courses are, generally, of two to three years of duration.

2.39 The table[11] below highlights the stages of education in India with the corresponding age group of students in each stage.

S. No.	Stages	Classes/ Duration	Corresponding age group of students
I	**School Education**		
I.1	***Elementary Education***		
I.1.1	Primary Education	I – V	6 - 11 years
I.1.2	Upper Primary Education	V – VIII	11 - 14 years
I.2	***Secondary Education***		
I.2.1	High School	IX – X	14 - 16 years
I.2.2	Higher/ Senior Secondary School	XI - XII	16 - 18 years
II	**Higher/University Education**		
II.1	***Non-professional Degree Courses***		18 - 24 years[12]
II.1.1	Undergraduate	3 years	
II.1.2	Post-Graduate	2 years	
II.2	***Technical Education***	As per nature of course	

School Education System

2.40 The Indian education system is based upon 12 years of schooling (10+2), which includes primary and secondary education. Secondary Schools are affiliated with Central or States boards for conduct of examination. Most of the private schools as well as many Government schools are affiliated with the Central Board of Secondary Education (CBSE). All the Indian universities and other institutions of higher education recognise the various 10+2 qualifications from different states as well as All India Boards like the CBSE and CISCE.

11 *Source: www.education.nic.in/sector.asp*

12 *18-24 years are usually taken as the age group of students corresponding to university education.*

Elementary Education[13]

2.41 Elementary education is the foundation on which the development of every citizen and the nation as a whole hinges. According to the Constitution of India, elementary education is a fundamental right. The Government has made elementary education compulsory and free. The Government has rolled out many plans to increase the penetration of elementary education such as, Sarva Siksha Abhiyan (SSA), District Primary Education Program (DPEP), Operation Blackboard, Mid Day Meal, etc.

Secondary Education

2.42 Secondary Education[14] serves as a link between the elementary and higher education. A significant feature of India's secondary school system is the emphasis on inclusion of the disadvantaged sections of the society. Professionals from established institutions are often called to support in vocational training. Another feature of India's secondary school system is its emphasis on profession based vocational training to help students attain skills for finding a vocation of his/her choice. The secondary level of education includes children between the age group of 14-18 years, studying in classes 9-10th leading to higher secondary classes of 11th and 12th. A host of programmes and organisations that support Secondary Education under the administrative control of the Union Department of Education are:[15]

(a) National Council of Educational Research and Training (NCERT)

(b) Central Institute of Education Technology (CIET)

(c) Central Board of Secondary Education (CBSE)

(d) National Institute of Open Schooling (NIOS)

(e) Kendriya Vidyalaya Sangathan (KVS)

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13 *Source: www.india.gov.in/citizen/primary_education.php*
14 *Source: www.india.gov.in/citizen/secondary_education.php*
15 *Source: www.india.gov.in/citizen/secondary_education.php*

(f) Navodaya Vidyalaya Samiti (NVS)

(g) Central Tibetan Schools Administration (CTSA)

2.43 The following types of school curricula are available in India:

(I) International Curricula:

a) International Baccalaureate (IB) curriculum from International Baccalaureate Organisation is an internationally recognised school system made up of three educational programs:

- PYP - The Primary Years Program (Kindergarten to Grade 5).
- MYP - The Middle Years Program (Grade 6 to Grade 10).
- DP - The Diploma Program (Grade 11 to Grade 12).

b) International General Certificate of Secondary Education (IGCSE) is an internationally recognised qualification, taken at the Grade 10 level, similar to the Grade 10 examinations of the CBSE and ICSE or the middle years program of the IB. IGCSE assessment is conducted by two UK assessment bodies, Edexcel (*formerly known as London Examinations*) and Cambridge International Examinations (CIE).

(II) Central/ National Curricula:

a) Central Board of Secondary Education, Government of India (CBSE) is the most prominent and central board of school in India. The CBSE prepares the syllabus for Class 1 to Class 12 for schools affiliated to it. It also conducts all India level entrance examinations for higher studies.

b) Council for Indian School Certificate Examinations, New Delhi (CICSE) is a private, non-governmental board for Anglo Indian Studies in India. It conducts two examinations *'Indian Certificate of Secondary Education'* and *'Indian School Certificate'*.

c) The National Open Schools are known as National Institute of Open Schooling. It was established by the Government of India in 1989 for those students who cannot attend formal schools.

(III) State Curricula:

a) Apart from CBSE and CISCE, each state in India has its own State Board of Education, which looks after the educational issues.

- SSC - Secondary School Certificate for 10th Grade.
- HSC - Higher Secondary Certificate for 12th Grade.

b) Islamic Madrasah Schools, whose boards are controlled by the Local State Governments, or are autonomous, or affiliated with Darul Uloom Deoband.

Higher Education

Key Players in the Higher Education System in India[16]

2.44 The University Grant Commission (UGC), a national body, is not only the lone grant agency, but also co-ordinates and looks after the maintenance of standard of university education in India. Apart from the UGC there are various statutory professional councils that are responsible for recognising courses, promoting professional institutions and providing grants and various awards to undergraduate programmes. Some of them are as follows:

(a) All India Council for Technical Education (AICTE)

(b) Distance Education Council (DEC)

(c) Indian Council for Agriculture Research (ICAR)

(d) Bar Council of India (BCI)

[16] *Source: http://india.gov.in/citizen/higher_education.php*

(e) National Council for Teacher Education (NCTE)

(f) Rehabilitation Council of India (RCI)

(g) Medical Council of India (MCI)

(h) Pharmacy Council of India (PCI)

(i) Dental Council of India (DCI)

(j) Central Council of Homeopathy (CCH)

(k) Central Council of Indian Medicine (CCIM)

Academic Courses

2.45 India's higher education system is the third largest in the world, after China and the United States.[17] As of 2009, India has 20 central universities, 215 state universities, 100 deemed universities, 5 institutions established and functioning under the State Act, and 13 institutions which are of national importance.[18] Other institutions include 17000 colleges, including 1800 exclusive women's colleges, functioning under these universities and institutions. Though State Governments are responsible for establishment of State Universities and running them, Government of India is primarily responsible for framing major policies relating to higher education in the country. Higher education in India starts after the higher Secondary or 12th standard. The university education in India starts with undergraduate courses. Depending upon the nature of course pursued its duration may vary from three to five years.

2.46 The academic degree courses are, principally, divided into three levels namely:

(a) ***Undergraduate or Bachelor's Level (e.g., B.Sc., B.A., B.E., M.B.B.S., L.L.B., etc.)*** – The undergraduate course in India is of three years' duration. After completing this course, students get a Bachelor's degree in the subject studied such as Bachelor of Arts,

17 *"India Country Summary of Higher Education". World Bank.*
18 *India 2009: A Reference Annual (53rd edition), 237*

Bachelor of Commerce or Bachelor of Science. Bachelor's degrees in science, arts and commerce take three years of study but in vocational subjects like pharmacy, dentistry, architecture, medicine and technology the duration may vary between four to five years (with six months of additional compulsory internship).

(b) ***Postgraduate or Master's Level (e.g. M.Sc., M.A., M.Tech, M.S., LL. M., etc.)*** – Postgraduate courses, generally, are of two-three years of duration. The Postgraduate programme could either be course or research based.

(c) ***Doctoral (Ph. D)*** - Entrance examinations are held for almost all the universities for admission to doctoral level degrees. Some universities also consider undergraduate degrees for entrance to doctorate level degrees. The duration of the coursework and thesis for award of the degree is about 5 years. The most commonly awarded doctoral level degree is Ph.D. There are some other doctoral level degrees such as D.B.A. (Doctorate of Business Administration), LL.D (Doctorate in Laws) and D.Sc. (Doctorate in Science).

Technical Education

2.47 The history of imparting formal technical education in India can be traced back to mid 19th century, although it got momentum in 20th century with the set up of Constitution of Technical Education Committee of the Central University Board of Education (CABE) in 1943; preparation of Sergeant Report in 1944 and formation of All India Council of Technical Education (AICTE) in 1945. The setting up of Indian Institutes of Technology, Indian Institutes of Management and Indian Institutes of Science was a major step in the development of technical education in India. In order to maintain the standard of technical education, a statutory authority, The All India Council for Technical Education (AICTE), was set up. AICTE is responsible for planning, formulation and maintenance of norms and standards, quality assurance through accreditation, funding in priority areas, monitoring and evaluation, maintaining parity of certification and awards and ensuring coordinated and integrated development and management of technical education in the country.

2.48 The courses, which are known as '*technical*' in India and, therefore, come under the purview of AICTE, are:

(a) Degree and Diploma courses in Engineering

(b) Master Degree courses in Engineering

(c) Master of Computer Application (MCA)

(d) Master of Business Administration (MBA)

(e) Pharmacy Courses

(f) Courses in Architecture and Applied Arts

(g) Hotel Management and Catering Technology Courses.

Foreign Institutions/ Universities

2.49 AICTE also regulates the entry and the operations of the foreign educational institutions imparting technical education in India. Foreign institutions already offering Technical programmes in India at Diploma, Undergraduate, Postgraduate and Doctoral level directly or through collaborative arrangements with Indian institutions will have to seek approval from AICTE before commencement of ensuing academic session. AICTE carries out the necessary inquiries and inspection of the foreign educational institutions in India and then grants approval by approving the courses to be offered, the maximum intake of students in the course and the period of validity of the approval.

Other Diploma and Certificate Courses

2.50 A diploma is a specific academic award usually awarded in professional/ vocational courses for example, Engineering, Pharmacy, Designing, etc. A diploma is lower in rank than a specific Bachelor's degree of that discipline but equivalent to general degree in that discipline. Diploma courses are offered by the educational institutions at the undergraduate level and the duration of their study may vary from 1 to 3 years. Postgraduate level diploma courses are also offered which are generally of one year duration.

Distance Education in India

2.51 Indian Education system offers distance education to those who cannot join regular schools or colleges. Not only students, but working professionals are also enrolling for various distance learning degree or diploma programs in order to enhance their qualifications and skills. National Institute of Open Schooling offers school education to students all over the country through distance learning. The Distance Learning Courses offered at institutions can be categorised under the several disciplines, namely Arts, Science and Commerce. Students can opt for both undergraduate and post graduate degree as well as diploma courses.

Organisational Structure of an Educational Institution

2.52 Generally, the educational institutions are registered as public trust or societies. The trust is created through endowment of property by the founder trustee and is managed by a Board of Trustees, out of which some trustees may be designated as office bearers. Societies are autonomous bodies, generally, incorporated with minimum of seven founder members, out of which typically four members may be appointed as office bearers such as President, Vice President, Secretary and Treasurer. They together with other three members normally constitute the first executive committee. Subsequently, more members may be inducted in the general body of the society and such general body shall be comprised of all the members of the society. The executive committee may also take members from the general body from time to time and shall be responsible for managing day-to-day affairs of the society. The executive committee of the society is empowered to appoint separate governing bodies for managing the affairs of each school, college etc. run by it. Normally, the academic head/senior teachers of such educational institutions are inducted as members of the governing body. The governing body is entrusted with the responsibility of managing the affairs of each such individual educational institution. Such governing bodies are in themselves supported in their functioning by various committees, such as the finance committee, sports committee, academics committee, building committee, etc. The composition of these committees consists of members from the governing body, teaching faculty and administrative staff as well as students.

Technical and Operational Features

Departments and Organisational Structure

2.53 The following is an illustrative list of departments in educational institutions:

(a) Principals/ Dean's/ Academic Department

(b) Admission Department

(c) Billing/ Fees Collection Department

(d) Examination Department

(e) Hostel Management Department

(f) Canteen/ Mess Management Department

(g) Transport Management Department

(h) Infirmary Department

(i) Library Management Department

(j) Human Resources Department

(k) Payroll Department

(l) Accounts Department

(m) Administration Department

(n) Purchase / Assets Procurement Department

(o) Inventory Management Department

(p) Estate Management Department

(q) Information Technology Department.

Usually, the activities in most educational institutions fall under two clear cut verticals, i.e., academics and administration. The organisational structure is, thus, built around these two verticals, which may be headed by separate authorities. The organisation structure of educational institution has been enclosed as **Appendix 3.**

Students

2.54 There are normally following types of students:

(a) ***General/ Normal/ Ordinary Students* –** Those students who do not fall under any of the other categories mentioned hereunder are considered as general category students.

(b) ***Concessional Students* –** The educational institutions may allow concession to certain students based on certain criteria like, sibling concession, staff concession, meritorious students concession, need based concession, concession for the disabled, armed forces concession, management concession, etc.

(c) ***SC/ ST/ OBC Students* –** This category normally comprises of students that are to be admitted based on certain quotas fixed by the State or Central Government. Apart from the preference to the vacancies, such students are also allowed concessions by certain institutions.

(d) ***Donor/ HNI Students* –** Under this category, fall such students whose family members have been contributing to the development of the infrastructure of the educational institution or fall under a prospective list of such family members.

(e) ***Sports Quota Students* –** Under this category are mainly students who are admitted due to certain statutory regulations.

2.55 All the above type of students can be further classified as follows:

(a) Day Scholars are students who normally attend the educational institution during the normal academic hours but do not live in its premises.

(b) Day Boarders are students whose timings are extended as compared to the day scholars and who have their afternoon meals in the educational institution, and stay back for extended coaching hours, games, etc. The fees paid by them covers the cost of these items as well. However, such students do not stay in the hostel at night.

(c) Boarders are students who avail the hostel facilities of the educational institutions for residential purposes. The fee paid by them includes their boarding as well as lodging costs. The accounting in respect of such students has to be more detailed as the educational institutions are supposed to keep track of various expenses incurred on them throughout the year on heads such as uniform, housekeeping, medical expenses, pocket money, etc.

(d) Staff Wards are those who attend the educational institutions like day scholars and enjoy boarding and lodging facilities at the institution's premises with their parents.

Admission Procedure

2.56 On submission of admission form, birth certificate, transfer certificate, previous academic records and other necessary documents, a student becomes eligible to appear for an entrance examination and/or interview. Immediately after a student clears the entrance examination and/or interview or fulfills the criteria for admission under any other scheme promulgated by the institution such as, cut-off marks of the qualifying examination, he is required to deposit the admission fees. Generally, to keep track of the students opting for admission, the educational institution accepts the admission fees (either directly or through authorised collecting bank) only after allotting a unique ID in a register maintained for that purpose by the admission department. This ID is then forwarded to the accounting department/collecting banker for controlling all accounting entries related to that student. This ID is also forwarded internally to all other departments such as, the class teachers, sports in charge, hostel in charge, library, logistics, etc.

Billing Procedure

2.57 Once a student has been granted admission and has been allotted an ID, the wards of the student are intimated the fee to be deposited by them. The fee is normally collected in advance for the term, which might be monthly, quarterly, half yearly or yearly. Intimation of fee due may be done in various manners such as, printed fee schedules for that academic term, fee bills, fee cards, etc. Fee bills are made term wise and contain details of all fees due from that student. Fee Cards are printed for the entire academic year and are updated term wise for the fees due under various heads. The detail of fee deposited such as, amount, date and mode of payment are also recorded in these cards. Some institutions retain these cards as part of their records whereas others allow the wards of the students to retain them as acknowledgement of the fee deposited by them. A duplicate card or other record may in such cases be kept by the institution to keep track of fees due.

2.58 In case of boarding institutions, the procedure becomes more elaborate and, normally, takes shape of bills raised in the beginning of the term. These bills contain two types of amounts due. One is the advance fee due for the following term and the second part consists of the imprest to be deposited for the expenses which may have to be incurred during the following term such as on uniform, infirmary, housekeeping, etc. A lump-sum amount of the imprest is normally fixed on the basis of expenses estimated to be incurred during the term. The imprest takes the shape of a revolving fund and the amount charged in each term bill is calculated to maintain the imprest at the fixed amount at the beginning of each term. A single imprest account may be maintained for all expenses or different imprest accounts may be maintained for expenses such as infirmary, uniform, pocket money, etc. Receipts are issued for the amount received from the students where such receipt are collected in-house and not outsourced to a collection agency.

Procedure for Fee Collection

2.59 With the rapid advent of technology, most of the large institutions prefer to outsource the collection and accounting of the fees through their designated bankers. This results in considerable reduction of risks and documentation on the part of the institution. The collection may be limited to a single branch of the agent. In such a case, generally the bank opens its extension counter within the institution's premises to provide dedicated services. However, with rapid inroads of the foreign and private banks, a new dimension to banking has been added with constant up gradation of the facilities with use of the latest technology. Now, the concept of '*anywhere'* banking is the in-thing. This facility has revolutionised the concept of the fees collection through authorised banks. Now institutions of middle to large scale, prefer to appoint collection banks having branches all over the country with the facility of anywhere banking. Under this facility, the students/parents may remit the fees at any of the bank's branch anywhere in the country or at the designated branches. The fee is credited to the centralized account of the institution instantly or after the realisation of the cheques/demand draft as the mutually agreed terms may be. The information as to the remittance is available to the institution in '*real time'*. The procedure, generally, followed by the institution for outsourcing the fees collection is given hereunder:

(a) A collection agent is identified. The choice of the banker to act as a collection agent, generally, depends on a number of factors such as the network of the banker, the service charges (generally, these services are provided free of cost, with a rider that the institution shall maintain a predetermined minimum balance with the bank), the reporting procedure, the scale of the institution, etc.

(b) Designated bank accounts are opened. These accounts may be different for different types of fees receipts. For example, separate bank accounts may be opened for the caution money, tuition fees, hostel fees, miscellaneous fees, etc.

(c) Each student who is granted admission to the institution is allotted enrollment number that is a unique student identification number.

(d) The pay-in-slip (which is, generally, customised for the institution) bears this unique student identification number mandatorily and the same is used for remitting the fees into the bank account of the institution.

(e) Generally, the pay-in-slip has three copies, one each for the student, the bank and the institution. The institution's and the banker's copy is retained by the bank and it is handed over to the institution after appropriate intervals. However, with the concept of the paper less offices catching the imagination in today's high-tech world, the pay-in-slip methodology is getting outdated and now the fees can even be remitted through the ATMs of the banks in which no such physical documentation is generated except for acknowledgment to the remitter.

(f) The bank reports the collection on daily basis to the institution through conventional methods or online.

Charge Out of Expenses to the Students

2.60 As discussed above, a number of expenses are incurred by the institution for the students such as, cost of uniform, stationery, medical expenses, picnic expenses, housekeeping items, cost of tokens, etc. In all such cases, the expenses, which can be identified directly to a particular student account, are charged to that student based on charge slips, which contain the description of such expenses, the amount of expenses, and the name and ID no. of the students on whose behalf this expenditure was incurred. The charge slips are also countersigned by the concerned in-charge, under whose authority such expense was incurred. The original bills for expenses incurred together with the charge slips are forwarded to the accounts section, which debits the account of the student with that amount. At times, certain recoverable expenses are incurred for example expenses on picnic for a class. The recoverability of such expenses is worked out by distributing the cost on to the number of students on whom it was incurred and charging it to their individual accounts. Sometimes, a lump sum estimated amount is recovered from each student for the expense incurred on their account. In such cases, the total cost is first debited to the expenditure account of the institution. Subsequently, the recoveries on that account are credited to the income account by passing a corresponding debit to the individual accounts of the students, for example, in case of supply of books to the students, the institution may debit the total cost of the books supplied to the expenditure account and the amount recovered from the students to the income account.

2.61 To ensure integrity of the matching principle, it must be ensured that the expense must be charged to the income and expenditure account in the period in which such expenditure is incurred. Given these peculiar characteristics of an educational institution, special precautions needs to be taken at the end of the financial period while preparing the financial statements.

Mess Facilities

2.62 This facility is provided either to the boarders or day borders. The mess is an integral part of the residential or day-residential institutions. The mess operations may be handled in-house or may be outsourced to an outside contractor. The trend now is on outsourcing these services to outside specialised agencies. The diet served in the mess is evaluated by doctors, nutritionists, etc., after taking into account the average calorie consumption of a particular age group of students.

2.63 The pattern and menu of food to be served on different days of the week is normally fixed in advance, such as non-vegetarian food may be served on alternative days. The day boarders are normally provided their afternoon meals in the institution itself. The in house running of mess substantially increases the workload of the institution. Apart from the infrastructure required in the shape of kitchen equipment, crockery and cutlery, staff will have to be hired for jobs of cooks, mess in-charge, for purchasing daily rations, for store keeping, etc. A number of accounting records will have to be correspondingly maintained such as, stock registers for cutlery, crockery, consumables, dry rations, etc. Often the food is also consumed by the staff of the institution and such consumption is charged and deducted from the salary of such persons on per meal basis. In such cases, to calculate such deductions, records will have to be maintained for keeping track of the consumptions.

In case the kitchen is outsourced, then the terms usually take shape of per head charges for breakfast, lunch, evening tea and evening meals. The outsourcing may require the contractor to set up his own kitchen equipment or the institution may provide the equipment. The count of students and staff who consume the food is kept by the staff of the contractor, who raises the bill accordingly at end of each month. In such cases, the institution must have a system of cross verifying the number of persons specified in the bill of the contractor.

Hostel Facilities

2.64 The residential institutions charge fees from the students for providing them residential accommodation in the premises of the institution. This fee charged is, normally, not demarcated separately in the fee structure and the coaching, boarding and hostel fee is charged as a consolidated amount. The residential facilities may be in the premises of the institution or may be hired near the premises. In case they are hired by the institution, the institution will charge the fees directly from the students and in turn pay to the lessor of the premises on monthly basis as a lump sum amount or calculated on per head basis of the students who reside in the accommodation provided by that lessor. In case the hostel is run in-house, then the appointment of staff such as, hostel in charge, housekeepers and cleaning staff is required. Infrastructure in the shape of furniture such as beds, study tables, bedding, linen, etc. will have to be procured. The residential facility may take shape of a dormitory, twin sharing rooms, etc.

Centralised Purchase Department

2.65 Depending upon the nature and spread of activities, the purchasing activities of an institution can range from items of daily consumption in the hostel, mess, administrative office, educational aids to capital items like, furniture, equipment, building material, etc. In all large institutions, this purchasing activity is normally centralised and formally structured and documented to ensure adequate internal control and prevention of leakages.

2.66 Setting up an educational institution today involves substantial amount of funds and this is also true for the running expenditure to be incurred to maintain the same. Constant up-gradation of infrastructure takes place in the shape of more buildings to house the classes, provide residential accommodation, etc. as well as other items of fixed assets such as, furniture, equipment, teaching aids, buses, expansion of library, games equipment, etc. Normally, the purchase activity is controlled through an independent Purchase Manager. The control and maintenance of the infrastructure and property is done by an Estate Manager.

Capital Expenditure in an Educational Institution

2.67 Fixed Assets in an educational institution primarily consists of:

(a) Land

(b) Buildings/ Building Renovations (Classrooms, Hostels, Cafeterias, Labs, Administrative Building, Staff Quarters, etc.)

(c) Infrastructure (Roads, Parking Lots, Outside Lighting, Sidewalks, etc.)

(d) Plant and Machinery (Office Equipment, ACs, Power backup units, etc.)

(e) Furniture and Fixture

(f) Computers, printers, servers, etc.

(g) Vehicles.

Fixed assets may further be grouped into movable and immovable assets. With regard to the movable assets, assets should be capitalised as soon it is installed at the premises. All incidental costs incurred with respect to put the asset ready to use should be capitalised.

2.68 With regard to the immovable assets, the cost of asset and initial acquisition shall include all expenses related directly to the acquisition or construction. Construction costs include materials, labor, overhead directly related to the construction, interest on loans, building permits, and fees, i.e. attorney and architecture. The amount of borrowing costs eligible for capitalisation should be determined in accordance with Accounting Standard (AS) 16, "*Borrowing Costs*".

2.69 A separate Capital Work in Progress (CWIP) account for each project should be opened to track the cost incurred in a specific project. Further, this account should be segregated to track the cost of assets in the block of assets as specified. For example, construction of a student lab will involve civil and sanitary work, electrical fittings, furniture and fixture, installation of computers, wires and servers, etc. Different ledger accounts should be opened to segregate the costs under a group account Student Lab-CWIP so that it is easy to capitalise the value of total assets on a given date. Accounting Standard (AS) 10, "*Accounting for Fixed Assets* and *Guidance Note on Accounting by Schools*" should be referred for accounting and disclosure requirements of the fixed assets. In case any grant is received for the fixed asset acquired, Then Accounting Standard (AS) 12, "*Accounting for Government Grants*" should be referred.

2.70 The educational institution is responsible for maintaining appropriate records of control and accountability of its capital assets. All records in regard to additions and deletions of fixed assets should be maintained. Further, the institution must perform a periodic physical verification of fixed assets and reconcile any differences to the fixed asset records. Generally, the storekeeper maintains stock registers of the construction material containing the details of receipts of material and issues of material to construction sites. The item-wise details of materials are recorded in the stock registers. The consumption of materials made by various departments/ construction sites is assessed through these stock registers. Then, the store keeper periodically submits the consumption of materials to the accounts department.

Canteen/ Tuck Shops

2.71 The educational institution, normally, allows a tuck shop to operate on its premises to sell stationery, refreshments, etc., for its students. The tuck shop may be operated by the institution or may be given on contract/lease to an outside party. Tokens of various denominations are issued by the institution to the students for making payments to the tuck shop. The accounts of the students are debited with the value of the tokens so issued. The tuck shop in-charge at the end of a fixed period, submits the tokens collected by him to the accounts section and collects the payment against them. The accounts section reconciles the same with its issue records and destroys the tokens. The students at any time before leaving the institution may return the unused tokens and get a credit against them in their accounts. The use of tokens facilitates control of the institution on the tuck shop, as well as ensures that the students do not handle any cash that may be used for making purchases from any other unauthorised source.

2.72 If the institution has a centralised computerised accounting system, the use of the token may be eliminated. The tuck shop is provided with an online terminal and the student is allowed to make purchase within the preset limits. Any purchase is instantly debited to his account. This system obviously mitigates the internal control risks of the manual environment; moreover, it also reduces the administrative costs.

Library

2.73 A library is an integral part of any educational institution. Generally, a qualified librarian, who might be assisted by helper staff, runs the library. Library books are systemised on two types of classification Dewey Decimal Classification (DDC) and Universal Decimal Classification (UDC). DDC is a proprietary system of library classification. This system organises books on library shelves in a specific and repeatable order that makes it easy to find any book and return it to its proper place. UDC is a system of library classification, based on the DDC, but which uses auxiliary signs to indicate various special aspects of a subject and relationships between subjects.

2.74 Library security deposit may be charged separately from the students apart from the caution money deposit. The institution may follow a policy of making this security deposit a part of the fees structure and as such make it compulsory for all students. On the other hand, some institutions allow use of these library facilities only to students who opt to deposit the security money and become members thereof. Apart from the security deposit, library fees may be charged along with other fees from the students. Fines are also recovered from the students for returning the books after the expiry of the loaning period or for damage to books.

Refund of Caution Money Deposits and Other Fees

2.75 The educational institutions collect a fixed amount as caution/ security money from the students at the time of admission. This security is refundable immediately at the time the students leave the institution. The caution money by its very nature has to be repaid on demand any time the student takes a transfer from the institution. It should not be considered as income but as a current liability in the financial statements. Students are entitled to refund of the caution money deposits as well as any credit balance standing in their favour at the time of leaving the educational institution. A deduction for any loss or payment due to the institution is made from the security. Normally, the institutions follow a policy restricting the claim of such fees to a specific period say up to 3 years from the date of leaving the institution. Such terms and conditions are printed on the admission receipts, etc.

2.76 Care should be taken to grant such refunds only after ascertaining that no dues with regard to fees, charge out of expenses, fines, recoveries on account of lost library books, breakages in laboratories, damage to property of the institution, etc., stand recoverable from that student. Since all this information has to be communicated by different agencies operating within the institution, to the accounts department, necessary internal controls should be implemented to ensure that there is no loss of revenue due to non-communication. This would effectively mean that the refund should be granted only after the student furnishes no dues certificate from all the departments, wherever so prescribed. In case, the institution does not have such a system, the accounts department should communicate with all the agencies to ascertain the dues of the students and grant the refund only thereafter. In case, the system of charge out of expenses, billing, etc., is computerised, then it will facilitate immediate settlement of the account of the student to a great extent.

Fund Flow Management of an Educational Institution

2.77 The fund flow of the educational institution may often be much skewed owing to the fact that the institution may be collecting the fees in advance in the beginning of the year and the expenditure have to be incurred throughout the year. To overcome this polarisation, the institutions manage their funds by deploying them in short-term investments/ deposits whereby the maturity of the same matches the expected expenditure. In such cases, the interest income may be appropriately accounted for keeping in view the fund accounting concept. Hence, the income on investment of special funds may be credited to the respective fund and similarly the interest on revenue fund investments may be booked under the revenue fund account.

Management Information System in an Educational Institution

2.78 Of late with the onset of the computerisation, the number of manual records maintained by an educational institution like any other enterprise has reduced considerably. Now, a number of registers and ledgers have outlived their utility and, generally, common software is used in an online environment to control activities as diverse as admission procedures, issue of I-cards, maintenance of academic records and other background details of students, generation of results as well as accounting records. The integrated features ensure that there is no duplicity in respect of crucial issues such as, number of students enrolled. Now days, educational institutions are equipped with Management Information System (MIS) which helps in control of the management of the institution as well as integration of all departmental jobs.

2.79 The Management Information System (MIS) is usually divided into the following modules:

(a) ***Student Registration Module –*** This module manages the student registration class-wise or batch-wise. The module features the interview details, registration status, results, and auto transfer of selected student details from Registration Module to Admission Module.

(b) ***Student Admission Module –*** The student admission module manages the admission process of both new and the old students. It is usually fully integrated with the accounts section, and helps in managing the entire procedure. One of the main feature of this module is multi-option of student search with respect to name, parent's name, subject, receipt number, qualifications, etc. The module generates reports regarding the total number of students (class/ batch/ subject wise).

(c) ***Fees Collection Module –*** The fees collection module automatically calculates the pending fees, last fee payment details, advance fees paid, deductions and concessions, if any, applicable to the selected student. The fee module is useful in automatic generation and printing of receipts as well as automatic generation of fees collection register as required i.e., head wise, receipt wise, class wise, section wise, or division wise reports. There is separate provision for collection of miscellaneous fees, boarding fees, etc.

(d) ***Time Table Management –*** This module helps in generating time tables on the input of basic information regarding allocation of subject to the teachers, teacher to the classes and number of lectures for each subject to each class. The time table can easily be modified as per changing requirements. The time table report displays the reports regarding time table.

(e) ***Attendance Module –*** The attendance module is used to keep track of presence of students as well as employees. Student's attendance details are used to identify irregularities in the academic interests of the students, whereas employee's attendances are used to keep track of leaves taken and automatically update the payroll department. The daily attendance register is maintained by this module which helps in reporting attendance status month/term wise.

(f) ***Examinations Management Module*** **–** Besides helping in allotment of examination roll numbers; this module processes the final result on a formula basis which helps in analyzing the students' performance. The module generates reports of toppers, failures, analysis of results, etc.

(g) ***Hostel Management Module*** **–** It is used to manage the allotment of rooms to students, hostel clearance and administrative expenses incurred.

(h) ***Mess Management Module*** **–** It is a fully functional mess management tool for managing direct purchases by mess, details of provisions and other consumables, list of suppliers, number of students availing mess facilities, preparation of mess menu, eligible diner list, issue of mess slips, daily attendance management, daily consumption pattern, mess facilities availed by guests and staff, preparation of list of outstanding dues and defaulters, etc.

(i) ***Transport Module*** **–** It is used to manage the transport infrastructure of the institution. The module has facilities to report the fuel consumption, route details, number of vehicles, maintenance overdue, profile of drivers, insurance information and permit information management. It is also integrated in to the fee structure and accounts so that the transport charges are automatically charged from the students. To the management, the system provides vital information regarding the expiration of insurance, renewal of permits, details of fuel consumption and fuel economy of the vehicle, etc.

(j) ***Infirmary Management Module*** **–** It is used to manage the infirmary in an educational institution. The module helps in managing the registration of patient, scheduling of appointments, bed management, reporting duties of doctors and nurses, stock management of medicines and blood, electronic medical records, patients' dietary records, housekeeping/laundry services, management of insurance of students, patient's billing, details of discharged patients, etc.

(k) ***Library Module –*** It is a fully functional library management tool containing detailed options for entering information about the books, periodicals and electronic media. Barcode enabled library system manages issues and returns of books without any user intervention. It includes advanced search software for finding and tracking status of the books. The system is capable of calculating automatically, the fines due from students on the late return of books.

(l) ***HR Management Module –*** It manages the generation of recruitment advertisement, search the data bank for the appropriate applicant, short listing of candidates, detail particulars of employees (their education, training records, etc.), results of interview and generation of appointment letter along with the terms and conditions.

(m) ***Payroll Module –*** Usually a fully functional payroll management system is available, which is fully compliant with the rules as laid down by various laws. Various calculation parameters and the allowances are also configurable as per the user requirements. The payroll module is capable of calculating the working days, payable amount, deductions, etc. The payroll module helps to keep workflow costs in check and ensure that all employees are paid on time in any circumstances. Various reports are also available to assist the management in calculating the expenses on salary as well as reports needed for departmental processes like, provident fund forms.

(n) ***Financial Accounts Module –*** The Integrated Accounting Package allows comprehensive management of accounts without the need of cumbersome posting of vouchers. It is used to maintain books of account on computers. The software can be used to record transactions, maintain account balances, and prepare financial statements and reports. Integrated with fee module, the accounts module automatically manages posting of fees into appropriate accounts heads. There is availability of many financial reports that provide a detailed snapshot of various financial activities. One can view the ledger statements, fee collection, balance sheet, drill down reports leading to individual transactions, voucher reports and various management level reports to provide a more abstract view of the institution's financial position.

(o) ***Administration Module –*** This tool helps in overall administration of an educational institution. It helps in making managerial decision by making available useful information from the large database as well as helps in staying up to date with the current status of institution's activities. The module generates two different types of reports; first regarding student's personal and academic details and other employee personal details.

(p) ***Asset Management and Procurement Module –*** Asset management module is used in controlling the assets by providing the total list of assets, their total costs and their details of physical presence. The Asset management module is helpful in better management of assets while providing the feature of grouping and item classification, multiple supplier support, multiple department transaction support, generation of purchase order, etc.

(q) ***Inventory Module –*** It is helpful in managing and sorting all the consumables as well as durables. Reports regarding the issue of the stock items to the employees are available to the management. Periodical consumption summary with respective costs records can be deduced and efforts may be made for improvement.

(r) ***I-Cards System –*** ID card system allows creating photo ID Cards, membership badges and employee ID cards.

(s) ***Web Modules –*** Web Modules enable educational institutions to become more organised, improve communications, streamline processes, and track common happenings. Some of the features available to students are:

(i) Attendance Records

(ii) Status of Homework

(iii) Fees Details

(iv) Time Table for classes and examination

(v) Events and scheduling

(vi) List of Holidays

(vii) Discussion Forum

(viii) Notice Board

(ix) Online Results

(x) E-mail/E-chat facility

(xi) Photo Album

(xii) Alumni Information

(xiii) Placement information

(t) ***User Rights –*** User rights administration allows full control on delegation of authority to the various employees so that their domain of operation may be restricted to their own department only. No employee is able to see/edit/modify the information that is not pertinent to his/her role in the institution. The information is provided on need to know basis. This acts as a great management tool and allows authorities to have direct control over the employees' access to the software and to the institution's information resources in general.

An illustrative list of modules of MIS in an educational institution is enclosed as **Appendix 4**.

Chapter 3
Finance and Accounting Features

Typical Flow of Transactions in Case of an Educational Institution

3.1 As the educational institutions are not akin to manufacturing or trading organisations, much of the processes are simple and linear. Thus, the primary flow of transactions may involve the following processes:

(a) Student Admission → Up gradation → Suspension/ Graduation → Alumni

(b) Staff Recruitment → Hiring → Maintenance → Promotion à Golden Handshake

(c) Inventory Procurement → Issues/ Consumption

(d) Fixed Assets → Purchase/ Construction → Utilisation → Maintenance à Disposal

3.2 If these processes are converted into financial transactions, they may result into the following:

(i) Student Process Flow – Primary Source of Revenue

(a) Security D`eposit/ Caution Money

(b) Levy of various types of Fees as per the Fees Chart

(c) Student Fee Matrix (Grade-Wise and Student-Wise)

(d) Collection/ Dues/ Penalty/ Fines levied from time to time

(e) Promotion of Student may involve change of Fee Structure

(f) While leaving the institution, a student is required to clear all the dues

(g) Refund of Security Deposit/ Caution Money.

(ii) Human Resource Process

(a) Advertisement/Recruitment Agency expenses

(b) Staff Induction and Continuous Training

(c) Salaries, Allowances, Perquisites and Deductions as per Staff Service Rules

(d) Statutory Compliances – Income Tax on Salaries, PF, ESIC, Gratuity, etc

(e) Promotion/Retirement Schemes/Staff Advances

(f) Leave Encashment/ Gratuity/ Ex-Gratia Payments/ PF/ Recovery.

(iii) Inventory

(a) Approval of Budget

(b) Obtaining Quotations and Bids

(c) Selection of Supplier

(d) Preparation of Purchase Order

(e) Sanction of Purchase Order

(f) Procurement as per requirement

(g) ABC Analysis/ Level Setting

(h) Sale/ Issue to Students/ Consumption in the Institution.

(iv) Fixed Assets

(a) Purchase of Furniture/ Fixture/ Vehicles/ Machinery

(b) Fixed Asset Register/ Marking of Assets/ Asset Movement

(c) Construction of Building and premises

(d) Involvement of Contractors

- Bidding/ Allotment
- Capital Work-in-Progress
- Advances

(e) Completion/Retention of Caution Deposit.

Principal Books of Accounts Maintained by an Educational Institution

3.3 An educational institution, normally, maintains the books of accounts similar to those maintained by other enterprises. However, some additional records to address its specific requirements are also maintained, and to this end, the conventional accounting records may also be appropriately modified. The type of students may also dictate the requirements. The accounting records for residential institutions are more elaborate than those that provide education only to day scholars. The following is an illustrative list of books of accounts/ records, normally, maintained by an educational institution:

- General Ledger
- Day books such as cash books, bank books, expense register, cheques in hand register
- Journal (if the books are maintained on accrual basis)
- Creditors Ledger
- Stock Register (for stationery, books, uniform, eatables, prospectus, etc.)
- Payroll Summaries
- Fixed Assets Register
- Investments Register

- Minutes Book
- Library Registers
- Vehicle Log Records

The books/ records typically maintained only by an educational institution has been discussed in the following paragraphs:

Students Ledger (to record outstanding of students)

3.4 This record is, normally, maintained to keep track of the fees and other dues to be received from the boarders/residential students. An account/ ledger folio is allotted to each student immediately after admission. The admission fees, tuition fee for the ensuing academic session, the expenses incurred from time to time such as uniform, stationery, and infirmary are debited to this account and the fee received together with imprest is credited to this account. The student accounts are, normally, expected to have a credit balance in the shape of unutilised imprest received for making expenses.

3.5 In a computerised environment, normally, the billing as well as accounting record is integrated through single software. Once a bill is generated through the software, it automatically results in debit to the account of the student and a corresponding credit to the various revenue accounts of the institution. In institutions where manual records are maintained, control on all transactions relating to a student is kept in the shape of columnar ledger, with columns on the left hand side recording receipts of fees and columns allocated on the right hand side recording different expense heads. Column for balance outstanding is also included to keep track of the amounts due from or payable to the student. This register is usually called as '*Charging Register' or 'Students Register'* and is, normally, made to keep track of the financial transactions pertaining to residential students, such as fee due, charge out of various expenses incurred or items issued from stores, etc., during the stay of such students in the institution. For day scholars, the control is normally exercised through fee collection register.

3.6 The institutions often follow an accounting system where a control account is opened in the main ledger for the receivable/ dues to the students and a subsidiary ledger is maintained for individual accounts of the students. The reconciliation of both these records on periodic basis is essential to determine the accuracy of the accounting transactions.

Fees Collection Registers (for keeping track of fee collection)

3.7 This register is used for recording the names and roll numbers of the non-residential students and against their names, columns are allocated for the period for which fees is to be received (monthly, quarterly, etc.). The fees received for a particular month is entered under that column and the blank entries enable the accountant to keep track of the outstanding dues.

Caution Money Registers (for recording security deposit from students)

3.8 This is a ledger in which an individual account is opened for security received from each student including details of cheque no. and date of receipt, etc. Similarly, when the security is refunded, the full details of refund are entered in that account.

Fund Ledgers (for keeping track of fund balances)

3.9 This ledger is used for recording fund balances of building, library, laboratory, games, furniture, equipment, endowment, provident fund, poor students fund, etc.

Financial Reporting Requirements

Financial Statements

3.10 As discussed in detail earlier, educational institutions are expected to provide education on charitable basis. As such, the provisions discussed here are in the context of not-for-profit institutions. In view of the absence of the profit motive, the trusts/

society are not supposed to draw up financial statements such as profit and loss account normally prepared by a commercial enterprise. However, absence of profit motive does not mean absence of deficit or surplus. It has been upheld in a number of judgments delivered by various high courts and the apex court that the charitable institutions have a right to earn surplus, so long as such surplus is utilised for the charitable purpose for which such institution exists and has not been distributed to the trustees or members of the trust/society. Further, no charitable institution can ever continue to exist solely on its dependence on grants and donations and should, therefore, generate enough surpluses so as to sustain its organisational objectives. Thus, as a measure of accountability and performance, they will be preparing an Income and Expenditure account and a Balance Sheet. This Income and Expenditure account is essential to calculate the deficit/surplus resulting from the activities carried out by the trust/society during a financial year. The balance sheet will reflect the state of asset and liabilities as on the date of balance sheet.

3.11 Such financial statements should be accompanied with notes to accounts, significant accounting policies and other statements and explanatory material that are an integral part of the financial statements. Such statements should disclose every material transaction of an exceptional and extraordinary nature. The financial statements should be prepared in conformity with relevant statutory requirements, the accounting standards and other recognised accounting principles and practices, the basic objective being to give a true and fair view of the surplus or deficit in the case of income and expenditure account and the state of affairs in the case of balance sheet.

Reporting Requirements Dictated by Law

3.12 At times, financial reporting requirements may be dictated by law, or even by donors such as in the case of Government aided institutions. For e.g., the financial year can be a period other than ending on 31st of March each year, but in view of the income tax provisions, for tax purposes, the accounts in such a case, will have to be prepared for a period of 12 months ending 31st March every year. Another example is the case of educational institutions incorporated under Section 25 of the *Companies Act, 1956*. In such cases, the reporting has to comply with the formats set out in Schedule VI, to the extent possible. Similar reporting requirements are prescribed by the *Bombay Trusts Rules, 1951*, as well as the *Gujarat Grants in Aid Code*. To illustrate, the reporting format under the *Bombay Trusts Rules, 1951* is enclosed as **Appendix 5**.

3.13 Apart from serving as a tool of measurement of performance, such statements serve another very important objective, i.e., to verify as to whether the institution utilised its funds for the charitable objective for which it exists and that no part of its funds were distributed for the personal benefit of members or trustees, etc. The donors of endowment funds scrutinize them to verify as to whether the funds were spent for the purposes for which they were granted or donated. Often such donors or government agencies prescribe additional reporting formats that need to be certified by auditors with a view to being assured about the utilisation of funds. Such reporting may be annual or for periods less than that. In case of a society registered under the *Societies Registration Act, 1860*, it is mandatory to submit annually, the audited financial statements and list of governing bodies along with the requisite fees. Under the *Foreign Contribution (Regulation) Act, 1976*, if the educational institutions are in receipt of donations from foreign sources, Form FC-3, Yearly account of foreign contribution received and utilised has to be submitted every year. The format of Form FC-3 has been enclosed as **Appendix 6**.

3.14 The educational institutions are also required to submit audited financial statements and other reports in the prescribed format every year, within the due date, to the *Fee Regulatory Committee of State Governments* to whom it is affiliated for renewal of registration, regulation of admission and fixation of fees. Special reporting requirements are also prescribed for Government approved technical institutions, for example, AICTE approved institutions are required to submit every year and display on their websites, mandatory disclosures of information regarding affiliated university, governance, fees structure, number of admission seats, admission procedures, results, details of infrastructure facilities, etc. This information can be useful for the internal auditor for the purpose of his work.

3.15 The illustrative cases in respect of which disclosure as per Accounting Standard (AS) 1, "*Disclosure of Accounting Policies"*, is required for accounting policies in case of educational institutions will be in respect of recognition of income such as, endowment grants, various fees from students, treatment of deferred expenses, valuation of inventories, investments, fixed assets, classification of liabilities such as endowment funds, capital reserves, treatment of contingent liabilities, etc.

Basis of Accounting

3.16 The societies/ trusts can follow a method of accounting of their choice. Normally, the cash system is adopted by smaller trusts/societies in view of the simplicity involved in maintaining the accounts. Under cash basis of accounting, transactions are recorded when the cash receipts or cash payments take place. At the end of a period, a statement of receipt and payment is drawn, which reflects the total receipts and payments under different heads during that period with opening and closing balances of funds such as cash and bank balances.

3.17 Under accrual basis of accounting, also known as '*mercantile'* basis of accounting, the transactions relating to assets, liabilities, revenues and costs are recorded and reflected in the accounts in the period in which they accrue. However, at times this choice is not available to the assessee and may be dictated by legal requirements as may be applicable to the institution.

3.18 The Income Tax Act, 1961, restricts the method of accounting to be employed to mercantile or cash basis in all cases. As a result, institutions required to file returns under the Income Tax Act, 1961 will have to prepare their accounts for income tax purposes keeping this in mind. Further, in case of educational institutions registered under Section 25 of the Companies Act, 1956, the books of accounts of the companies are required to be maintained by following accrual basis of accounting only.

3.19 The entities to which Accounting Standards are applicable are also required to maintain accounts on accrual basis. The Accounting Standards issued by ICAI are based on the fundamental assumption of accrual. These standards, thus, reflect what can be construed as the appropriate application of accrual accounting to different types of transactions and events. In application of the accrual basis of accounting, it is extremely important for the educational institutions to follow the guidelines laid down in Accounting Standard (AS) 9, "*Revenue Recognition*" issued by ICAI which deals with issues relating to revenue recognition for items such as, income from other sources, *viz.,* interest, sale of products, franchisee and affiliation fees, etc.

Fund Accounting

3.20 The educational institution, generally, follow fund accounting concept while preparing the financial statements. Fund Accounting is a method of accounting and presentation whereby assets and liabilities are grouped according to the purpose for which they are to be used. A fund is either created by law or by management or by donor. Funds are represented by the assets whether in the form of Fixed Assets, Investments, Inventory, Bank account, etc. Fund Accounting does not necessarily involve opening of a new bank account for its operations. Funds are just the restriction imposed for utilisation of asset.

3.21 Fund based accounting essentially involves preparation of financial statements fund-wise and consolidation of those statements to represent the financial results/position of the institution as a whole. This is quite similar to the fund accounting for government institutions. The basic difference between the fund accounting for the government and private institutions is that in the case of the government institutions, most of the funds are earmarked, and as compared to this, in a private institution the funds may be restricted or free depending upon the source.

3.22 The educational institution may maintain separate ledgers for each fund. An educational institution may receive funds the use of which is unrestricted, i.e., these funds can be used for the general purposes of the institution or the use of which is subject to the restrictions imposed by the contributors, i.e., the funds can only be used for specific purposes. An educational institution may, on their own, earmark certain funds for specific purposes. The different types of fund are as under:

(a) Restricted Funds - When the donor or the governing body restrict the usage of the funds or income earned from the funds or both and the funds can be used only as per the instruction of the donor, then those funds are known as restricted funds.

(b) Endowment Funds – They are a form of restricted funds which have been received from the donor with a stipulation that the amount received should not be used for any purpose and only the income earned from investments of these funds can be utilised for general or specific purposes. There may be two types of endowments – perpetual endowment and term endowment. In the first case, such endowments are given in perpetuity and the fund principal is never spent or repaid. Interest earned on Perpetual Endowment Fund may be transferred directly to the Endowment fund, if specified. Term endowments are gifts for which the donor has specified a date or event after which the funds may be spent.

(c) Unrestricted Funds - It refers to funds contributed to an institution with no specific restrictions. The unrestricted fund is augmented by the income from the operations of the institution, such as tuition fees, income from investments, besides unrestricted donations/gifts/grants from individuals/government or income from auxiliary services such as, canteen, bookstores, etc. The Unrestricted funds are utilised for the day-to-day operations of the institution. The Unrestricted funds are further classified into following two categories:

(i) Designated Funds – These are unrestricted funds which have been set aside by the institutions for specific purposes or to meet future commitments e.g., library fund for purchase of books, Development funds for acquiring building and equipment, etc. The designated funds are self imposed and not legally binding.

(ii) ***General Fund -*** Unrestricted funds other than the designated funds are a part of the General fund. It represents the Corpus of the Society and is not subject to any restrictions on its utilisation.

Inter-Fund Transfers

3.23 Educational institutions may make inter-fund transfers subject to certain conditions. The legal agreements or grant agreements may force the institutions to make transfers from the revenue funds mandatorily. Similarly, the Governing Body also transfers funds from revenue fund to special funds to undertake some specific activities. There is a peculiar practice on the treatment of capital expenditure in case the educational institution's income is exempt under Section 11(1) of Income Tax Act, 1961. As per this practice, many societies and trusts transfer from the income and expenditure account, an amount equal to the cost of fixed asset purchased during the year, to the fixed asset fund account. Income Tax Act, 1961 requires that the society should utilise a minimum prescribed percentage of income during the year so as to fulfill conditions for exemption of income from income tax. Purchase of fixed assets is also considered as one of the modes of utilisation of funds. The practice of transferring the amount from the income and expenditure account to the fixed asset fund account is often followed to ensure that the end surplus reflected in the accounts is arrived at after reflecting such utilisation. Even though this practice is followed, the concept of fund accounting requires earmarking of the funds with the objective of identifying funds as may be required for specified purposes or projects. In such cases, the underlying idea is to park these funds in investments/specific bank accounts for subsequent utilisation for the earmarked purposes.

3.24 In transferring the amount from the Income and Expenditure account to fund accounts, whether to fixed asset fund or other earmarked funds, the correct method is to do it from the income and expenditure appropriation account, i.e., below the line and not above the line. In cases where the practice of transferring to the fixed asset fund account, an amount equal to the amount of addition to the fixed assets during the period is followed, the following procedure is followed for ensuring that the balance of the fixed asset fund matches with the value of the fixed assets. Where the institution is following the procedure of reducing the value of depreciation from the gross value of the fixed assets, an amount corresponding to the depreciation charged during the year is credited to the income and expenditure appropriation account by debiting the fixed asset fund account with the same amount. In case the institution is following the procedure of crediting the depreciation charged during the period to the depreciation fund account, then no adjustment is required.

3.25 It is hereby apprised that, accounting is governed by the Accounting Standards and the expenses in the nature of capital expenditure need to be capitalised under fixed assets and not charged to the revenue accounts. To comply with the requirements of Income Tax Act, 1961, for working out the utilisation of income for charitable purposes, a separate working sheet may be attached with the computation of income in which the cost of fixed assets purchased may be reduced for working out the end surpluses left after making such utilisation. The balances of earmarked funds should always tally with the balances of bank accounts in which such funds are retained or with the value of fixed assets/investments that have been acquired against such funds.

Sources of Income and Expenditure

Sources of Income from Students

Tuition Fees

3.26 The major source of revenue of the educational institution is the tuition fees. Tuition fees is recognised on the due date for the receipt of fees and apportioned over the term of the student on a time proportion basis. Generally, tuition fees are received on a periodic basis, i.e. monthly, quarterly, half yearly or annually, in advance as per the semester period followed by the institution. In case of day scholars, it may be received on monthly basis, while in the case of boarders, it may be received half yearly. Therefore, at the end of the financial year, there is always a portion of the fees, which may pertain to the period falling in the next financial year. The fees pertaining to the next financial year should not be booked as income during the year, but should be shown as Advance Fees received from students under the head *'Current liabilities'* and should be charged off to Income and Expenditure Account in the next financial year.

Hostel Fees

3.27 The educational institutions charge fees from the students for the hostel facility in addition to the tuition and other fees. It is quite possible that the hostel fees will exceed the tuition fees many fold. Hence, the hostel fee takes a very important pie in the total revenue. The hostel may be run by the educational institution itself or on contract basis by an outside party. Normally, a consolidated fee is charged from the students for hostel as well as tuition fee. The hostel fee, whether separately charged or not, is collected in advance from the students along with the tuition and other fees.

3.28 In case the hostel is run in-house, separate set of books of account may be maintained for the hostel. The expenditure for running the hostel is booked as and when incurred. In cases where the hostel fee is charged separately, it will be possible to identify the income from running of the hostel. In such a case, at the year-end, a separate set of financial statements may be prepared to ascertain the total surplus/deficit from such activities. Care should be taken while auditing such financial statements that the matching concept has been consistently followed.

Boarding Fees

3.29 The charges for the boarding are not segregated from the tuition and hostel fees and are recovered as a lump sum charge at the beginning of term. In such cases, it will not be possible to ascertain the revenues against the boarding facilities provided by the institution. The educational institutions also separately earn income in the form of mess charges and laundry charges from the students who avail these facilities.

One Time Charges

3.30 The following are one time charges received from the students:

(i) Registration Fees - Registration fees is received from the students who wish to apply for admission in the institution and is generally charged to cover the costs involved in taking admission, examinations, etc. It is booked as income in the year in which it is received.

(ii) Admission Fees - The admission fee is paid by the students at the time of initial admission to the institution. Generally, admission fees is booked as an income of the year in which it received, since it does not pertain to a specific academic year, but is in the nature of one time fee paid at the time of admission into the institution.

(iii) Affiliation and Development Fees - The educational institutions may be charging the students affiliation and development fees, which may have to be paid to the University/ Affiliation body. Such fees is generally collected on actual basis and paid in full to such authorities. The fees collected must be reconciled with the fees paid/payable to such authorities.

Other Periodic Charges

3.31 The following are other periodic charges received from the students:

(i) *Examination Fees* - The examination fee is, generally, collected in advance for the year. This fee has to be paid to the exam conducting authority in parts at the time of conducting exams or before that. Hence, the fees collected can easily be reconciled with the fees paid/payable to such authority. The examination roll list may prove to be a reliable record for the verification of fees paid/ payable.

(ii) *Sports Fees* – It is received from the students for the purpose of making expenditure on sports material, practice schedules, safety, medical facilities, team meetings, etc.

(iii) Income from Transportation Facility - Transportation income may be received by the educational institution by one of the following methods:

- Transportation fees received from students where the transportation facility is provided by the institution itself,
- Contract charges where the contract of providing transportation facility has been given to an outside party.

Fines

3.32 Another source of income for an educational institution is from the collection of fines from the students. List of fines due from students is made by each Department-in-charge and communicated to the Accounts Department for charging the fines to the respective student's account. The fines are booked in the income and expenditure account on accrual basis. An illustrative list of fines imposed on the students is as under:

- Fees Fine – for non-deposit or deposit of fees after the prescribed due date.
- Library Fine – for non-return or late return of books and periodicals.
- Laboratory Fine – for breakage or mis-utilisation of laboratory equipment.
- Dress Fine – for non-adherence to dress code of the institution.
- Fine for non-submission of leave application by students.
- Fine for ragging students.
- Fine for use of mobile phones in the institution's premises.

Sources of Income from Ancillary Activities

Canteen Income

3.33 Canteen income may be received by the educational institution by one of the following methods:

(a) Sale of products where the canteen is owned and run by the institution itself.

(b) Contract charges, where the contract of running the canteen has been given to an outside party.

(c) Mess charges received from the students living in the hostel.

Bookstores

3.34 Educational institution may also be running the bookstores where the books, notebooks, and other stationery items are sold to the students. The bookstores may sometimes be given on contract basis. In such a case, there are no complicated accounting issues. However, if the books store is run by the institution itself, separate books of account for such activity may be maintained following the generally accepted accounting principles and standards issued by the ICAI. Further, inventory registers, may also be maintained, with periodic verification of the same by the management.

Publications

3.35 Some of the large educational institutions are also engaged in publication of books and periodicals, case studies, curriculum material, research paper, etc. The publication may be done through in-house printing press or the services may be outsourced. An honorarium/royalty may also be paid to the authors. It should be ensured that the provision of such payments which are based on the terms of agreement entered with such parties, be done following the matching concept. The magazines and newsletter may carry advertisement of various outside parties. The charges recovered from the outside parties form the income of the institution. Further, the inventory registers reflecting the sales, production and stock in hand at any point of time may also be maintained. The identification of books in various stages of printing as work in progress will have to be done to facilitate the valuation thereof in accordance with Accounting Standard (AS) 2, *"Valuation of Inventories"*.

Income from Seminars, Workshops, Consultancies and Management Development Programmes

3.36 Educational institutions, imparting higher and technical education, engage in conducting seminars, workshops, on-the-spot events, competitions, exhibitionsmanagement development programs, technical festivals and also undertake industrial and other consultancies. For example, IIMs actively carry out research and consultancy for various industries, including the needs of non-corporate and under-managed sectors such as agriculture, rural development, public systems management, energy, health education, habitat, etc. These may form significant part of revenue of the institution.

3.37 These activities are essentially in the nature of services rendered by the institution and the revenue there from is to be recognised accordingly. In case performance consists of the execution of more than one act, revenue should be recognised proportionately by reference to the performance of each act. If performance consists of the execution of a single act, or if it consists of performance of more than one act and the acts yet to be performed are very significant in relation to the transaction as a whole, revenue should be recognised only on the completion of the performance of the sole or the final act.

3.38 If an educational institution provides service in relation to the 'Intellectual Property Service', it will be liable to charge service tax on the value of taxable service. The educational institution may also get covered under the 'Consulting Engineer Services' or 'Management Consultants Services'.

Revenue from Franchisee Fees

3.39 Franchising has emerged as a very important model for business expansion. Under the franchise arrangement, the owner of the business model (known as the franchisor) permits the use of business rights comprised in brand, processes, products, etc., to the other person (known as the franchisee) against pre-agreed monetary consideration (known as franchisee fee). The franchisor benefits from business expansion without having to invest in infrastructure and establishment at off locations. At the same time franchisee derives the advantage of using an established brand and tested business techniques which eventually helps him to weather crisis easily.

3.40 Franchising is widely used as a business model in the education sector. In respect of educational institutions, who give franchisees of their courses, the revenue from such activities is to be recognised. The educational institutions will be required to charge service tax on the '*Franchise Services'* provided. The franchisee fee generally comprise of a product fee, i.e. a one-time fee payable by the franchisee at the time of signing of the franchisee agreement, and a regular fee payable as a percentage share in the revenue by the franchisee. The revenue recognition criteria for the two type of fee by the franchisor could be as follows:

(a) *Product fee -* This is the lump sum fee paid as an initial sign up amount and is valid for a stated period of time. The same should be recognised as deferred income and should be systematically recognised in the Income Statement over the period for which the product fee has been received.

(b) *Share in revenue -* The share in revenue is regularly received by the franchisor as a percentage of total revenues earned by the franchisee. The revenue on account of share in gross receipts of the franchisee is to be recognised for period to which receipts pertain.

Revenue from Placement Services

3.41 A Placement Cell for students publicises information about employment opportunities. The educational institutions provide career guidance, pre-placement training and personality development programmes to graduates to enable them to achieve their career growth. The placement cell conducts various value based programs, guest lectures, mock interviews, orientation and strategy meetings, etc. In addition to that, the Placement Cell provides direct placement services by Multinational Companies and National companies. Placement talks and campus interviews are arranged for students. These companies provisionally select the candidates and wait for them to join them after the completion of their courses.

3.42 For rendering the placement services, the educational institution charge fees from the corporate recruiting candidates through campus interviews. The educational institutions will be liable for service tax for placement fee under the *"Manpower Recruitment or Supply Service"*. The Central Board of Excise and Customs clarified that educational institutions, even though they are not a commercial concern, are liable to pay service tax under the category of *"Manpower Recruitment or Supply Service"* on the fees charged from prospective employers like corporate, who come to these institutions for recruiting candidates through campus interview[19].

Sponsorship Fees

3.43 Sponsorship fees is received by an educational institution from the outside parties for sponsoring the institution's functions or display of banners. The educational institutions will be liable for service tax for sponsorship fees received under the *"Sponsorship Services".*

Other Miscellaneous Receipts

3.44 The following are other miscellaneous receipts of an educational institution:

(a) *Sale of Prospectus* **-** The sale proceeds of the prospectus are booked as income of the year in which it is received. Some of the prospectus are also distributed free of cost as promotional material by the institution.

(b) *Premises given on rent to outside parties* - Income of the

[19] *Source: Circular No. 86/4/2006-ST, dated 1st November, 2006.*

educational institutions may arise from renting of premises to outside parties for holding examinations, functions, running coaching institutions on part-time basis, etc. The educational institution, in such cases, will be liable for service tax on the services of *'Event Management'* and *'Renting of Property Services'*. The educational institutions may also earn income for providing Guest House accommodation to the parents or relatives of staff.

(c) Other sources of income for an educational institution may arise from sale of handicraft items, paintings, drawings, etc., made by the students. Educational Institutions may earn income from sale of scrap which should be accounted on the actual receipt basis.

Recognition of Other Receipts

Grant in Aid

3.45 It will be pertinent to refer to Accounting Standard (AS) 12, *"Accounting for Government Grants"* issued by the Institute. Since there are a number of educational institutions that are substantially or partially dependent on government grants and from other agencies, it is desirable even in cases where the AS 12 is not mandatory that they should follow the Standard. Even though the Standard refers only to government grants, the principles enunciated therein can serve as a guide for grants from other donor agencies as well.

3.46 AS 12 states that the donee should not recognise the grant until there is reasonable assurance that the donee will comply with the conditions attached thereto and that the donations and grants will be received, as ascertained on the basis of all available evidence in that respect. In case such reasonable assurance is attained only when cash is received, then recognition in such case on cash basis will not vitiate the accrual basis of accounting.

3.47 AS 12 states that grants received to meet the cost of non-depreciable fixed assets should be credited to capital reserve. In case of depreciable assets, it requires the grant to be treated as deferred income, which should be recognised in the profit and loss account by allocating it over the periods and in proportions in which depreciation on the asset concerned is charged. AS 12 states that grants in the form of non-monetary assets should be recorded based on their acquisition cost (in case received at concessional rates) and at a nominal value (e.g. rupee one) in case of assets received free of cost.

3.48 The grant-in-aid may be received from the Central or State Government or from any other non-profit organisation. If the educational institution receives grant from foreign sources; it will be treated as 'foreign contribution' under the *Foreign Contribution (Regulation) Act, 1976* and the educational institution will be required to comply with the statutory provisions of the said Act. The grant-in-aid, whether capital or revenue in nature, is always granted for certain earmarked purposes. Examples of revenue grants could be for salary of staff, or special literacy projects, etc. Usually such grant comes with a number of conditions attached, which need to be fulfilled by the institution.

3.49 The concept of fund accounting comes into play in case of such grants. The unutilised grants are shown as liabilities in the balance sheet of the institution. Unutilised grants often have to be refunded back in case the conditions for utilisation have not been met by the grantee. At times, the grants are released according to a specific period of the project. In such cases, there might be a difference between the amount of grant actually released according to the project timeframe and the actual execution of the project activities. In such cases, for example, if the project has been completed for 9 months, but the grant has been released only for 6 months, then to follow the matching concept, 3 months grant shall have to be booked as receivable in the balance sheet. It is important that the grants are recognised as receivable and consequently as income only on the fulfillment of the conditions with which the donors sanction them. Voluntary contribution may be received in either cash or kind. Such contributions, unless earmarked for a specific purpose are taken to the income account of the institution.

Expenditures

Educational and Academic Expenditure

3.50 An educational institution incurs expenditure on educational and academic expenditure which includes all costs of providing the faculty with the physical supplies for imparting education to students, such as stationery, teaching aids, computer rentals, laptops, travelling, field trips, laboratories, equipment repair and maintenance, scholarships, medical facilities, fees to visiting faculties and consultants, sports expenses, recreational facilities, celebration expenses for Founder's Day, Annual Day, etc.

Mess Expenses

3.51 As far as mess expenses are concerned, as mentioned earlier, the boarding facilities may be run in-house or it may be outsourced to a contractor. In the first case, the expenses incurred in the shape of dry rations, food articles, fuel and gas, etc., may be recorded under the main head of *'Mess Expenses'*. At the year-end, an exercise may be carried out to ascertain the surplus or deficit for the year from such activities, in cases where the boarding fees is charged separately from the tuition and other fees. Deduction made from the staff for the meals consumed by them in the hostel is normally credited to the *'Mess Income'* and should not be netted off against the salary paid to the employees or the *'Mess Expenses'*. Accounting records will have to be maintained to keep a track of meals consumed by the staff during a particular period, which may be monthly so as to facilitate deduction from the salary disbursements.

Boarding Expenses

3.52 Boarding expenses in an educational institution includes the costs of providing residential facilities to the students. If the residential facilities are hired by the institution, then the institution will have to pay lump sum monthly charges to the lessor. In cases where the hostel is run in-house, then they are managed by the hostel in charge, housemasters, housemistress and residential advisors supported by matrons and house tutors. Besides the accommodation facility, the educational institutions are required to maintain dormitories, dining room, library, study rooms, computer rooms, common rooms for recreation, etc. The institutions will also have to incur expenses on providing furniture like beds, study tables, cupboards, bedding, linen, etc., to the students.

Laundry Expenses

3.53 Educational institutions incur laundry expenses on behalf of the students who avail the facility of laundry. The laundry services can be provided in-house or are contracted to a third party. In case the laundry service is contracted, the institution will have to pay monthly charges to the third party.

Library

3.54 An educational institution incurs heavy expenditure on the library for purchase of books, magazines, journals, periodicals, CD-Rom, etc. It may also install the library software for managing issue and returns of books, advance search options, automatic creation of dues, etc., as the library is required to be constantly maintained and updated. Educational institutions are required to purchase new books every year and pay annual subscriptions for periodicals. An educational institution may also receive a library grant for setting up library for a particular course.

Discount and Scholarships

3.55 The fees waiver and scholarships to the students should be booked under separate head in the Income and Expenditure account and should not be netted off against the Fee receipts. This method of accounting will be beneficial as a control tool in two ways. Firstly, it will enable the accountant to generate the percentage of fee waivers granted against the total fee receipts during the year, which in turn will highlight any excessive expenditure incurred on this account. Secondly, it will enable the gross fees receipts to be recorded without any distortions. These gross fee receipts then can be cross verified by analytical procedures such as by dividing the gross fees with the per head fees to arrive at the number of students and then comparing the same with the muster roll.

Extra Coaching

3.56 Accounting records by way of registers will have to be maintained to keep track of the extra hours/classes taken by the teachers so as to arrive at the remuneration to be given to them on this account.

Salary and Allowances to Staff

3.57 A substantial portion of the revenue of an educational institution is applied towards the payment of salaries, allowances, etc., to staff. The institution may also be allowing its employees to take advances/loans against salary. The advances/loans/ reimbursements are generally paid based on the standard operating policies formulated by the HRD department of the institution and approved by the Governing Body. The revenue items such as, salaries/ allowances/ reimbursement must be booked as expenditure in the period in which the employee renders service. Further, the payments to the employees may be subject to various statutory/voluntary deductions such as Provident Fund, Income Tax deducted at Source, Professional Tax, Loan repayment installment, etc. Usually, the educational institutions prefer to use the payroll bank account for making the payment of remuneration to the employees, whereby standing/monthly instructions are given to the bank to credit the employees with the monthly remuneration.

Retirement Benefits to Staff

3.58 For the accounting treatment, valuation and disclosure of the retirement benefits, an educational institution should follow Accounting Standard (AS) 15, "*Employee Benefits*". Similarly, the advances/loans etc., should be reflected as Loans and Advances in the Balance Sheet. In case of claiming deduction of expenses incurred on the retirement benefits under Section 36(1)(iv) of Income Tax Act, 1961, the employer must contribute to the recognised provident fund or an approved superannuation fund. Similarly, under Section 36(1)(v), employer's contribution is an allowable deduction only if the contribution is made to the approved gratuity fund created exclusively for the benefit of employees under an irrevocable trust. Therefore, an educational institution must create a trust for providing retirement benefits to the employees and get it recognised from the Income Tax department for claiming deduction of expenses.

Other Staff - Related Expenses

3.59 Other staff-related expenditure in an educational expenditure may comprise of:

(i) Expenditure on staff uniforms

(ii) Laundry expenditure

(iii) Staff recruitment expenses.

Utilities

3.60 The educational institution may incur expenditure on utilities in nature of electricity charges, power, fuel, generator running and maintenance, telephone expenses, etc. The purposes for which the expenditure of this nature is incurred may be multiple and the classification of expenses in the income and expenditure account is often done in accordance with the purpose for which it was incurred. For example, fuel consumption may be reflected under the head Mess Expenses. Similarly, power consumption for academic block and administrative block may be reflected under the group head *'Educational Expenses'* and *'Administrative Expenses'* respectively.

Promotional Expenses

3.61 The educational institutions, normally, incurs heavy expenditure during the initial years of set-up in order to promote themselves which can take shape of road shows, advertisements in print and electronic medias, etc.

Repair and Maintenance

3.62 The running of an educational institution involves substantial investment in infrastructure such as, buildings, equipment, vehicles, etc. All these items are subject to constant wear and tear and as such expenditure on repair and maintenance constitutes a major outflow of funds. The estate maintenance forms a huge expenditure for an educational institution. The repair and maintenance expenditure may be classified under various group heads in the income and expenditure account in accordance with the functional purpose of the asset in respect of which such expenditure was incurred.

3.63 Expenditure incurred in replacement of capital assets and which do not result in any incremental benefit may be classified under this head and should not be capitalised. An example could be replacement of damaged roof of the institution's gym. Estate maintenance in an educational institution comprises of the following types of expenses:

- Maintenance of school campus
- Maintenance of equipment
- Landscaping
- All maintenance expenses pertaining to civil, electrical, plumbing work, effluent treatment plant, water treatment plant, generators, swimming pools, carpentry work, etc.
- Pest Control expenses.

Financial Expenses

3.64 As the educational institution incurs a huge amount of expenditure on the acquisition and construction of fixed assets, it obtains the required funds from the construction of fixed assets from the financial institutions. The borrowing costs that are directly attributable to the acquisition or construction of the asset should be capitalised as part of the cost of that asset, and other borrowing costs should be recognised as an expense in the income and expenditure account in the period in which they are incurred. The amount of borrowing costs eligible for capitalisation as well as to be recognised as an expense should be determined in accordance with Accounting Standard (AS) 16, "*Borrowing Costs*".

Research and Development

3.65 Educational institutions imparting technical educations like, IITs usually set up research and development units for carrying out research project activities in subjects of national importance, for example, Atmospheric and Ocean Studies, Industrial Textiles, Biotechnology, Fly-ash Management, Optical Communication, Transportation, Microprocessor Applications, Signal Processing, Condition Monitoring, Artificial Intelligence and Robotics, etc. These are usually sponsored research from Government, International Bodies or collaborative research from an industry. For carrying out the research, the institutions are required to make a heavy expenditure to set up modern laboratories with the supporting infrastructure facilities. Students are encouraged to take part in the research activities while pursuing studies. They are also required to submit research proposals. Though, the research is usually funded from outside funding agencies, the educational institution may provide consultancy services or develop an intangible asset in the form of designs, software, patents, etc.

Depreciation

3.66 Accounting Standard (AS) 6, *"Depreciation Accounting"* enunciate principles, which can also serve as a useful guide in cases of not-for-profit organisations. It is often seen that the charitable institutions do not charge depreciation in their accounts, when the capital expenditure has been considered as application of income. As per section 11(2), in order to claim full tax exemption, a charitable trust or institution has to apply at least 85% of the income to charitable or religious purposes. The application of income can be for revenue as capital expenditure. The income of the trust has to be understood in its commercial sense. Depreciation on assets is allowed even if the costs of the assets have been fully allowed as application of income under section 11.

3.67 As per the "*Guidance Note on Audit of Public Charitable Institutions under the Income Tax Act, 1961*" issued by the ICAI, even when the whole of the capital expenditure may be treated as an application of income towards charitable or religious purposes for the purposes of section 11, the depreciation is allowed in respect of the assets used by it for its purposes on the basis of normal commercial principles. Merely because the cost of acquisition of an asset has been applied as an application of income for charitable purposes in the year of acquisition, a charitable trust cannot be denied depreciation in respect of such asset. The expenditure should be understood as necessary outgoing. The depreciation is nothing but decrease in value of property through wear, deterioration or obsolescence and allowance is made for the purpose in book-keeping and accountancy.

3.68 The educational institutions may calculate the cost of depreciable asset over its useful life and accordingly charge depreciation to the income and expenditure account. The depreciation rates to be applied may be taken as those specified under the Income Tax Act 1961 or that under the *Companies Act, 1956*. Section 349(4)(k) read with Section 350 of the *Companies Act 1956* requires public limited company and private limited company being a subsidiary of a public company to follow rates not less than those prescribed in Schedule XIV of the *Companies Act, 1956*. The rates prescribed under the *Income Tax Act, 1961* are in the nature of allowances available to a person while computing taxable income under that Act. Since, the charitable organisations are also expected to calculate their income and expenditure based on normal commercial principles, they may adopt rates specified in schedule XIV of the *Companies Act 1956* as a general guide to depreciate their fixed assets, in absence of any exercise carried out by them to calculate the useful life of the assets independently. It is important to note that the *"Guidance Note on Accounting by Schools"* published by the ICAI prescribes the depreciation rates to be charged in case of the schools.

Utilisation of Grant in Aid

3.69 The Grant-in-aid received from the Government Bodies or other agencies has conditions attached for the utilisation of the same. The Grant-in-aid may be for specific purpose or for meeting the regular expenditure of the educational institution. The grant-in-aid received for the specific purpose would have to be reflected as liability till such time the conditions attached at the time of sanction are fulfilled. The correct procedure for accounting of utilisation of grants is to charge the expenditure incurred against the grant to the appropriate head for which the grant was sanctioned in the Income and Expenditure account. A corresponding amount should be transferred from the grant received account to the credit of the Income and Expenditure account being grant utilised. It must be recognised that there is no possibility of earning any surplus out of funds received on account of restricted grants. This is because the balance left in the grant account will have to be reflected as unutilised grant in the balance sheet. On the other hand, the possibility of incurring a deficit is very much there on account of excess expenditure incurred by the recipient out of own resources for the purpose for which the grant was sanctioned.

Donations Given to Other Societies/ Trusts

3.70 Sometimes, an educational institution makes donation to a trust having the same set of objectives. The donations made are to be utilised for specific purposes. These donations are to be recognised as an expense in the Income and Expenditure account of the educational institutions. If the donation has not been fully utilised, then it is to be shown as advances in the Balance Sheet.

Chapter 4
Internal Auditing Aspects

Overall Approach of Internal Audit of an Educational Institution with reference to Standards on Internal Audit

4.1 Internal audit is a management function having the high level objective of serving management's needs through constructive recommendations in areas such as, internal control, risk, utilisation of resources, compliance with laws, management information system, etc. An effective and continuous internal audit function plays a key role in assisting the board to discharge its responsibilities of accomplishment of objectives and goals of the organisation through ethical and effective governance. Internal audit also plays an important role in providing assurance to management on the effectiveness of risk management.

4.2 A successful internal audit is based on sound planning and an environment of positive alliance and communication between the auditee and the internal auditor. The internal audit procedure is similar in most engagements. Auditee involvement is important at all stages of the internal audit process. The following paragraphs describe the steps to be followed for conducting internal audit of an educational institution.

Engagement Letter

4.3 Before the commencement of audit, the internal auditor must obtain an engagement letter from the auditee. The engagement letter should be approved by an appropriate level of management i.e., the Board of Directors or Board of Trustees or a relevant Committee thereof such as the Audit Committee, to ensure that the objective of independence of the internal auditor and corporate governance is met while carrying out the internal audit activity. Standard on Internal Audit (SIA) 8, *"Terms of Internal Audit*

Engagement" to provides guidance in respect of terms of engagement of the internal audit activity.

Specific Considerations while Planning Internal Audit of an Educational Institution

4.4 Standard on Internal Audit (SIA) 1, *"Planning an Internal Audit" e*xplains the planning process to be followed by an internal auditor before the start of internal audit. While preparing the internal audit programme of an educational institution, the internal auditor should give due consideration to the accounting system and the internal control system in place. The audit tests planned by the internal auditor will vary with the level of the accounting systems and the internal control systems deployed in the educational institutions.

4.5 In case of educational institutions run as not-for-profit organisations, honorary office bearers generally run such organisations. These office-bearers are usually pre-occupied with their own affairs and they do not have any pecuniary interest in the organisation as office bearers. Therefore, such institutions can be highly susceptible to frauds by the lower and middle level employees. While planning the audit the internal auditor must take into consideration these factors and apply the compliance and substantive procedures accordingly. It may, thus, be concluded that the internal auditor needs to exercise an extra bit of safeguard while planning and conducting the internal audit of an educational institution.

Knowledge of the Educational Institution and its Environment

4.6 As per Standard on Internal Audit (SIA) 15, "*Knowledge of the Entity and its Environment",* for reviewing key risks and entity-wide processes, systems, procedures and controls and determining the nature, timing and extent of internal audit procedures, an internal auditor must have knowledge of the economy, the entity's business and the entity's operating and regulatory environment.

4.7 An illustrative list of information required during the internal audit of an educational institution is as under:

(a) Legal form of the organisation and its Memorandum of Association, Articles of Association, Rules and Regulations.

(b) Laws, regulations, rules and standards that regulate an educational institution.

(c) Current industry developments.

(d) Organisational structure.

(e) Administrative and accounting personnel.

(f) Changes in nature of activities e.g., change in number and type of courses offered by the educational institution.

(g) Chart of accounts and accounting manual.

(h) Policy and procedures manual.

(i) Long term leases, contracts and commitments.

(j) License agreements and recognitions.

(k) Enrollment procedure.

(l) Physical facilities offered by the institution, e.g., library, canteens, playgrounds, furniture, computers, mess, workshops, laboratories, dormitories, staff quarters, etc.

(m) Placement and training programmes offered.

(n) Inspection reports of license authorities such as, AICTE, MCI, affiliating universities.

(o) Opinions in prior audit reports and other reports of statutory auditor e.g., report under section 10(23C) and 12 in Form 10B.

(p) Observations in external auditor's management report.

Risk Assessment and Internal Control in an Educational Institution

4.8 According to Standard on Internal Audit (SIA) 13, "*Enterprise Risk Management*", the role of the internal auditor in relation to risk management is to provide assurance to management on the effectiveness of risk management. The role of the internal auditor is to ascertain that risks are appropriately defined and managed. Some of the common risks recognised in an educational institution are as under:

(i) ***Regulatory Risks*** **-** Risks which affect the sector e.g., compulsory regulatory non-compliances under various statutes, changes in the Government policies, etc. The non-compliances can result into revocation of recognition leading to closure of institution, levy of penalties, loss of funding for expenditure incurred or loss of tax exemption benefits, etc.

(ii) ***Institution-wide risk*** **-** Risks which affect the institution, e.g., enrollment growth, additional capital requirement, additional requirement of funds for operating activities, non-availability of information, high turnover in key personnel, reputation risk with parents, major financial problems, competition, etc.

4.9 As per Standard on Internal Audit (SIA) 13, *"Enterprise Risk Management",* the scope of the internal auditor's work in assessing the effectiveness of the enterprise risk management would, normally, include:

(a) Assessing the risk maturity level both at the entity level as well as the auditable unit level;

(b) Assessing the adequacy of and compliance with the risk management policy and framework; and

(c) For the risks covered by the internal audit plan:

    (i) Assessing the efficiency and effectiveness of the risk response, and

    (ii) Assessing whether the score of the residual risk is within the risk appetite.

4.10 Standard on Internal Audit (SIA) 12, "*Internal Control Evaluation",* the onus of designing, maintaining, and documenting an internal control system is on the management. The internal auditor should examine the continued effectiveness of the internal control system through evaluation and make recommendations, if any, for improving that effectiveness.

4.11 As mentioned before, the educational institutions are generally susceptible to frauds more than other types of organisations. It is also generally observed that in such organisations the internal controls are either very weak or not in place due to lack of proper management and administration. It is very important that the internal auditor should obtain an understanding of the control environment in which the institution operates. As per Standard on Internal Audit (SIA) 12, "*Internal Control Evaluation",* the broad areas of review by the internal auditor in evaluating the internal control system, inter alia, are:

- Mission, vision, ethical and organisational value system of the entity;
- Personnel allocation, appraisal system, and development policies;
- Accounting and financial reporting policies and compliance with applicable legal and regulatory standards;
- Objective of measurement and key performance indicators;
- Documentation standards;
- Risk management structure;
- Operational framework;
- Processes and procedures followed;
- Degree of management supervision;
- Information systems, communication channels; and
- Business Continuity and Disaster Recovery Procedures.

4.12 Perhaps one control that has universal application in any environment and in any circumstances is segregation of duties. The flow of activities must be regulated in such a manner that no single person in the organisation is able to control all the activities in that chain and for this purpose, all non-compatible duties must be in different hands. Separate persons should be involved in issuing the receipt and receiving the cash, recording the transaction and maintaining the physical control over the cash/cheques in hand. The fees is the major source of income for the educational institutions, therefore, controls must be high in this area.

Management Control Aspects

Students Count is the Key Control Mechanism

4.13 The main source of revenue in an educational institution is from the students. The control on the student's records is the key control mechanism for ensuring that the revenue is recorded completely and correctly. Since various departments, *viz.*, accounts department, academic (daily attendance), registrar, examination department, etc. maintain separate records for the students on roll, it is imperative that all these records are reconciled to ensure that the student's strength is the same at all places.

4.14 The second important factor is the prompt charging of expenditures to the student accounts. As discussed earlier, expenses are incurred on the students continuously by various departments, such as the class teacher, the games section, the housekeeping section/the hostel warden, etc. All such expenses must be promptly charged to the account of the student, as sometimes the students may leave the educational institution in the middle of the term. Before handing over the transfer certificate and refunding the security, it must be ensured that the student has paid all his dues. The controls and procedures for forwarding of such details by the various departments to the centralised accounts section must be very clear, so that there is no loss on this account.

Budgetary Control

4.15 The financial management of the educational institution, like any other entity, may effectively be undertaken by resorting to budgeting. Apart from serving as a tool for forecasting and planning, it also serves as an important feedback tool at the end of the financial period through generation of variance analysis. Control on revenue items can be effectively exercised through budgets and periodic variance reporting serves as an important management information report.

4.16 Another crucial aspect, which may be taken into account in the preparation of budgets, are the provisions contained in Section 11 of the Income Tax Act, 1961, which require an institution to utilise a prescribed percentage of its funds for charitable purposes so as to be eligible for exemption from the income tax. It is essential that the management should be aware of the provisions of the Income Tax Act, 1961, so as to be able to gauge the impact of non-utilisation of funds in accordance therewith. Monthly track of the variances should be kept by the management so as to ensure that the application of the required percentage is done before the year-end. Non-utilisation of funds would entail tax liabilities on the unutilised portion. A sample computation of income with details of calculation of application of income under section 11 has been enclosed as **Appendix 7**.

4.17 The internal auditor may perform the following steps in checking the budgeted prepared by the institution:

(a) The internal auditor should study the reasons for variances between the budgeted and the actual figures periodically.

(b) The internal auditor should look out for significant variances.

(c) Detailed analysis should be made for significant variances by the internal auditor.

(d) The internal auditor should suggest appropriate actions for the variances so found.

(e) In case the budget is revised, the internal auditor should study the amendments made to the existing budget.

(f) The internal auditor should verify that both favourable and unfavourable variances were duly approved by the appropriate level of authority.

Internal Audit Evidence

4.18 Standard on Internal Audit (SIA) 10*, "Internal Audit Evidence"* lays down that the internal auditor obtains evidence by performing one or more of the following procedures:

- Inspection
- Observation
- Inquiry and confirmation
- Computation
- Analytical Review

4.19 The internal auditor should evaluate whether he has obtained sufficient appropriate audit evidence before he draws his conclusions therefrom. The internal audit evidence should enable the internal auditor to form an opinion on the scope of the terms of the engagement.

Sampling

4.20 In forming an opinion, the internal auditor may obtain internal audit evidence on a selective basis by way of statistical or non-statistical sampling methods, in accordance with the principles laid in Standard on Internal Audit (SIA) 5, "*Sampling"*. The internal auditor should design and select an audit sample, perform audit procedures thereon, and evaluate sample results so as to provide sufficient appropriate audit evidence to meet the objectives of the internal audit engagement.

Analytical Procedures

4.21 The Analytical Procedures have special significance in the internal audit of an educational institution. This is for the simple reason that most of the expenses incurred or revenue earned has direct correlation with a key statistic, i.e., the number of students on roll of the institution. Standard on Internal Audit (SIA) 6, "*Analytical Procedures",* deals with the nature and purpose of analytical procedures, analytical procedures as risk assessment procedures and in planning the internal audit, analytical procedures as substantive procedures, analytical procedures in the overall review at the end of the internal audit, extent of reliance on analytical procedures and investigating unusual items or trends.

4.22 At the planning stage, the analytical procedure may serve as a very important guide to obtain an understanding of the entity and its environment and in identifying specific risk areas. These procedures are meant to be used on the financial information in conjecture with the non-financial information. The internal auditor may use these procedures to establish relationship between variables such as, students and receipts, teachers and students, boarders and area of hostel, boarders and mess expenditure, etc.

4.23 In case, the significant fluctuations or relationships are inconsistent with other relevant information or that deviate from predicted amounts, the internal auditor should investigate and obtain adequate explanations and appropriate corroborative evidence. For example, the per head mess expenditure may have increased substantially despite no change in the prescribed diet by the management or the total fees receipts may not have increased in the same proportion as the increase in number of students, despite no significant increase in fees waiver given by the management during the current year. In all such cases, the internal auditor should investigate and document all such inconsistencies with all the corroborative evidence collected during the course of the internal audit. An illustrative list of Analytical Ratios for an educational institution has been given as **Appendix 8**.

Documentation

4.24 Standard on Internal Audit (SIA) 3, "*Documentation"* states that the internal auditor should document matters, which are important in providing evidence that the audit was carried out in accordance with the Standards on Internal Audit and support his findings or the report submitted by him. Internal audit documentation should also record the internal audit charter, the internal audit plan, the nature, timing and extent of audit procedures performed, and the conclusions drawn from the evidence obtained. The internal auditor retains the ownership of the internal audit documentation. Management and other designated personnel may seek access to the internal audit documentation of the internal audit department subject to the approval of the internal auditor and client or such other third party may seek access if there is any legal or regulatory requirement or as may be permitted by the client.

Reporting

4.25 As per Standard on Internal Audit (SIA) 4, "*Reporting*", after the performance of internal audit procedures, the internal auditor summarizes the audit findings, conclusions and suggestions and issues the report to the appointing authority. If there is a limitation on the scope of the internal auditor's work, the internal auditor's report should describe the limitation.

4.26 In case the educational institutions are being run as companies, the Board of Directors will constitute the persons who are charged with governance. Similarly, in the case of societies or trusts, the members of the Governing Body/Board of Trustees shall constitute such group. The internal auditor may find the possibility that some members of the management may be involved in the fraud or misappropriation of the institution's funds. In such cases, the internal auditor shall have to exercise his judgment in taking a decision regarding the person to whom such misdeeds may be communicated.

4.27 The internal auditor may also be required to report the audit findings to the donors of the grants to the educational institutions for verifying as to whether the institution utilised its funds for the charitable objective for which it exists and that no part of its funds were distributed for the personal benefit of members or trustees, etc. Chances of misutilisation of funds may be high in cases where the Board members are inter-related or from the same family. The donors of endowment funds scrutinize the audited statements to verify as to whether the funds were spent for the purposes for which they were granted or donated.

Often such donors or government agencies prescribe additional reporting formats that need to be certified by auditors with a view to being assured about the utilisation of funds. Such reporting may be annual or for periods less than that.

Follow-up Review and Report

4.28 Follow-up review is performed by the internal auditor to ensure that all internal audit issues mentioned in the internal audit report were resolved. The review will be concluded with a follow-up report with details of action taken by the auditee in resolving the original audit issues as well as unresolved audit issues. The follow-up report will then be issued to the auditee.

Internal Audit Procedures

4.29 The general procedures of an internal audit have not been purposely covered in the following paragraphs. The procedures are illustrative in nature and would require adequate modification to address internal audit requirements of a particular educational institution depending upon the nature, size and other factors.

Revenue

4.30 An internal auditor should study and evaluate the system of internal control relating to revenue in an educational institution, particularly the following aspects:

(i) The systems and procedures relating to generation of revenue including authority to fix fees structure, offer scholarships/ fees concessions and other terms of collection.

(ii) Accounting procedures relating to recognition of revenue.

Receipt Books

4.31 In a manual environment, a receipt is issued to the student in lieu of the payment received. It is imperative that a physical control over the receipt books is maintained. In case of most of the frauds, it has been observed that the cashier maintains parallel sets of receipt books to siphon off the money. The receipt books must be in the custody of the stores and it must be serially numbered. A new receipt book should be issued only when the old receipt book is exhausted. Cancelled receipts should be available in the receipt book with all copies. In no case, more than one receipt book should be used at one time. Another very effective control to manage the fees would be to compulsorily receive the fees through bank demand drafts, and fees should be received in cash only for petty amounts.

Billing Control

4.32 The system of billing being followed by the educational institution should be watertight and should ensure that bills are raised to each and every student at the end of the term. It must be also be ensured that accounts of all students are being debited with the fee that is to be recovered from them, and the cases wherever exceptions are found, are supported by appropriate management authorisations.

Discount/ Scholarships

4.33 The educational institution may sometimes conceive a policy of allowing discounts to poor students or scholarship to meritorious students. It should be ensured that any such discount/scholarship be allowed only with authorisation from the appropriate designated authority for this purpose.

Fee Waiver

4.34 The management, generally, has clear policy for the defaulters which encompasses imposing fine for late payment and more severe consequences by way of striking off the name from the roll for continuous default. It must be ensured that any relief from such penalties be allowed only with proper authorisation. The collection of the fine, therefore, in all the defaulting cases should be ensured unless relief has been granted in written.

4.35 It is imperative on the part of the internal auditor to invariably communicate internal control weaknesses to the management and his opinion on the possible effect of such weakness in institution's control environment. An illustrative Internal Control Checklist has been enclosed as **Appendix 9**.

Verification

Examination of Records

4.36 The internal auditor should examine the adequacy and efficacy of cut-off procedures to ensure that the transactions of receipt pertaining to the period under internal audit are recorded in that period and not in a preceding or subsequent period. The internal auditor may examine the admission documents and receipts pertaining to a few days immediately before the year-end and verify that the related receipts have been recorded as income of the period under internal audit.

4.37 The internal auditor should examine selected entries in the receipt records with reference to the related receipts, university roll sheets, other supporting documents such as the attendance registers and concession/scholarship approval notes, and admission records. He should compare the actual fees charged with authorised fees structure or with the authorisation by the appropriate official of the institution, as appropriate.

4.38 Selected entries in the fees refunded account should be examined with reference to the attendance register and authorisation from appropriate authority as per the terms and conditions governing the refund policies. Selected scholarship/ concession cases should be examined with reference to entries in the receipt records and authorisation from appropriate authority. It should be examined that in the case of provisional admissions, revenue is recognised only when the admission is regularised on compliance with the conditions prescribed. Where the fees is receivable in installments and includes an element of interest, the internal auditor should examine whether the interest element has been excluded from the amount recorded as fees income.

4.39 The internal auditor should also carry out the following additional procedures in the case of fees received in foreign currency:

(a) Examine that fees received in foreign currency is recorded at the exchange rates prevailing at the time of receipt.

(b) Obtain a written representation from the management to the effect that the institution has complied with the legal and regulatory requirements relating to FEMA/FCRA.

4.40 Revenue arising from services rendered (e.g., books provided, examination fees, library fees, lab charges, tuck shop, stationery, etc.) and from interest, dividends and royalties should be examined with reference to the related agreements and other supporting documents.

4.41 The internal auditor should verify realisations subsequent to the date of the balance sheet. This would help him in identifying cases of unrecorded revenue. If the fees collection is outsourced by the institution to a collection agent, the internal auditor should at regular intervals closely scrutinize fees collection records for any omission or erroneous collection of fees.

Analytical Procedures

4.42 The internal auditor may carry out the following analytical procedures in relation to revenue:

(a) Compare the amount of revenue for the current year, class-wise and batch-wise, with the corresponding figures for previous years with appropriate adjustments for the change in fees structure and new students/drop outs.

(b) Compare the ratio of concessions and scholarships to total receipts for the current year with the corresponding figures for previous years.

(c) Compare the amount of dividend/interest/royalty for the current year with the corresponding figures for previous years.

(d) Compare the ratio of income on investments to average investments for the current year (separately for each major type of investment) with the corresponding figures for previous years.

Procedures for Specific Areas

Tuition Fees

4.43 The major portion of the revenues of an educational institution is contributed by the tuition fees from the students. The analytical procedures may prove to be extremely effective and efficient method for auditing the total fees collected during the year. In order to verify the tuition fees collected from the students it is imperative that the number of students on the roll is first verified. Normally, these roll lists are available from a number of sources, *viz*., accounts department, registrar, university enrollment lists, teacher's attendance registers, examination roll lists, etc. Each of these records is prepared by different departments and, therefore, the reconciliation of all these records may serve as a check giving a very high degree of reliability.

4.44 The next important step in verification of the tuition fees would be to obtain the fees structure adopted by the institution which has been approved by the appropriate authority, for example Governing Body, Government/Approving authority, as applicable to the institution. The total fees collected may now be verified by using the above figures. A very useful method of checking the total fees is by multiplying the per head fees with the number of students and thus arriving at the gross figure. This gross figure may be verified with the total balance under that ledger account and if any variance is found, the investigation thereof may result in more information coming out before the internal auditor. There may be variance because of discount/scholarship or dropouts, etc. The internal auditor must verify whether the discount/scholarships have been given based on management approvals or guidelines prescribed for this purpose. Any other variance must also be reconciled keeping in mind the concept of materiality and risks involved. Other substantive procedure may be adopted after evaluating the results of the compliance procedures.

4.45 Similarly, other fees such as Admission fees, Affiliation and Development fees, Examination fees, Sports fees, Hostel fees, Boarding Charges, Mess Income, Transportation Income, etc. may be verified adhering to the above mentioned procedure.

Registration Fees/Sale of Prospectus

4.46 Unlike tuition fees, the registration charges/sale of prospectus cannot be verified with reference to the number of students. This is often a weak area where revenue leakage can occur. The management generally ignores the sale proceeds of prospectus, and other miscellaneous receipts. This in turn encourages malpractices in the recording and collection of such revenue. Further, it is observed in many of the educational institutions a large number of copies of prospectuses are distributed complimentary to attract students. The internal auditor therefore, cannot fully verify the revenue recorded under this head. Appropriate procedures to audit the revenue under this head would be to evaluate the total prospectus issued during the year with the prospectus issued free of cost. A variance with the results for the previous years may be significant and the internal auditor may evaluate it appropriately. Secondly, the internal auditor can compare the percentage of number of students who took admission during the year to the total number of students who paid the registration charges from last year.

Fines

4.47 The internal auditor may apply the following internal audit procedures to audit the income from fines:

(a) Check the procedure of identification of fines due and ensure that all fines are levied and collected as per policies laid down by the appropriate authority.

(b) Check the list of fines to be charged from students.

(c) Verify the number of students and the amount of fine due per student.

(d) Check the internal control procedures to ensure that there is no leakage of fines collected directly by the respective department.

(e) In case, fines are directly paid by students to the Head of department, verify the appropriateness of method of communication and deposit of funds to the Accounts Department.

Canteen Income

4.48 The internal auditor may apply the following internal audit procedures to audit the canteen income earned:

(a) Check the records maintained for the canteen operations to support all financial transactions.

(b) Verify the inventory controls and the physical counts.

(c) Verify and check the allocation of expenses, such as, equipment depreciation, rental charges, breakage, theft, spoilage and administrative expenses.

(d) Review the agreements and contracts in case the canteen is run by an outside party.

(e) Verify leakages that may take place, e.g., by way of non-deductions from staff or excessive consumption of food in the mess, despite fixed menus which are helpful in providing some measurement of the likely consumption of food articles.

(f) Review the approvals/disapprovals of the changes in the operation of the canteen, for example change in the price of goods, shift in responsibilities of the Canteen Staff, etc.

(g) Compliance with laws and regulations applicable for operation of canteen, for example, The Prevention of Food Adulteration Act & Rules, 1954, The Shops and Establishment Act, VAT Act, Service Tax, etc.

(h) Review of Inspection and Maintenance Reports

Revenue from Sale of In-House Publications

4.49 In respect of sale of publication material, the internal auditor should evaluate the system of recording sales, maintaining inventory of publications, MIS reports, if any, etc. The evidence in the form of publisher's statements, VAT returns, third party confirmations, etc. may be relied upon.

Revenue from Seminars, Workshops, Consultancies and Management Development Programmes

4.50 Revenue from seminars, workshops, consultancies and management development programmes should be verified by the internal auditor by charting the list of all the events organised department-wise during the relevant period. The internal auditor should also examine the attendance record of participants. The internal auditor should verify the entrance/ registration fees and the course fees charged from the participants. The registration fee will comprise of amount recovered from participants on account of seminar kit, beverages and lunch. The cost of accommodation, local travel, pre/post seminar tours are separately charged from the participants.

Revenue from Franchisee Fees

4.51 In respect of franchising revenue, the internal auditor should examine the basic records maintained by the franchisor in respect of the franchisee, the agreements entered into with them, the product fee and regular fee chargeable. The product fee from all franchisees should be tabulated and the amount attributable to the relevant period should be worked out. In respect of franchise fee in the form of percentage share in revenue, the internal auditor should examine the audited financial statements/certificates of the franchisees. The internal auditor should also examine the calculations and compliance with service tax regulations.

Grants/ Donations

4.52 The internal auditor may apply the following audit procedures to audit the donations/grants received:

(a) Check the donations received with the copies of receipts.

(b) Check sanction letters for any conditions attached with the donations.

(c) Verify the grants received from the Government or other authorities with reference to all the correspondences.

(d) Examine the statements submitted for utilisation of grant.

Expenses

Internal Control Evaluation

4.53 The internal auditor examines the internal controls over payments with reference to the following:

(a) Review of vision, mission, ethical and organisational value system of the institution;

(b) Segregation and rotation of duties;

(c) Procedures for authorisation;

(d) Maintenance of records and documents;

(e) Accountability for, and safeguarding of, assets; and

(f) Independent checks.

An illustrative Internal Control Checklist has been enclosed as **Appendix 9**.

Verification

4.54 The substantive procedure for verification of the expenses involves:

(a) Test of individual transactions which are often carried out on a sampling basis, depending on the internal auditor's assessment of the effectiveness of the internal controls.

(b) Examine the entries in the cash book/cash payments summary with reference to the related payment vouchers.

(c) In respect of payments by cheque, examine the numerical sequence of the cheques issued during the specified period, i.e., whether all the cheques issued during the period had been properly accounted for.

(d) Review the cash book or cash payment summary sheets for any unusual items and look into the same.

(e) Apply appropriate analytical procedures to judge the overall reasonableness of the recorded payments.

(f) Examine whether the payments have been properly classified and disclosed under appropriate account heads in the financial statements in accordance with the recognised accounting principles.

4.55 In case the statute governing the organisation lays down any guidelines in this behalf, also examine whether the disclosure of the payments in the financial statements complies with such requirements. For example, if the exemption is claimed under section 12A of the *Income Tax Act, 1961*, the internal auditor has to report all the payments made to the specified persons.

Verification of Expenses Based on Student Strength

4.56 A number of expenses also have correlation with the student strength. Such expenses can be verified by multiplying per student charges with the respective student strength. An example could be mess food bill paid to the catering contractor, which can be correlated with the number of students in the hostel. Another example could be of transport charges paid to a bus contractor, which could be correlated with the number of students using institution-arranged transport.

Procedures for Specific Areas

Payroll and Benefits

4.57 Some of the basic points to consider while auditing the payroll and benefits are:

(a) Review organisational structure, payroll operation procedures, and the sufficiency that there exists proper separation of duties and proper supervisory reviews in the organisation, to ensure that an effective payroll function has been established by the organisation.

(b) Obtain the list of current employee information relating to name, designation, unique employee number, payroll account number, and salary amount.

(c) Verify the documentation of rate of pay, rate of overtime, total input hours, authorisation policies, payroll deductions, preparation and approval of time sheets, leave tracking system (including approvals), termination procedures of employees.

(d) Check the employee data maintained in the information system for its accuracy and appropriateness as well as ensure that proper documentation is also maintained.

(e) Verify the procedure of periodically updating the employee data with the necessary approvals.

(f) Verify the procedure of maintaining the confidentiality of the employee data.

(g) Obtain an understanding of employee benefits and post-employment benefits like pension, provident fund, etc. offered to the employees by the institution.

(h) Verify the procedure of valuation and disclosure of employee benefits with reference to Accounting Standard (AS 15), *'Employee Benefits'*.

(i) Obtain a general understanding of the hiring and termination process and how payroll is affected.

(j) Review the personnel records maintained by HR and Payroll.

(k) Review the required hiring documents (for example, applications received, offers made, accepted and declined, personnel requisition, etc.) for employees hired.

(l) Ensure that any new employee related to the management or Board or owners is hired on the approval from the higher authority as well as disclosed as related party in the financial statements.

(m) Ensure all employees' current job descriptions are as per requirements of the institutions.

(n) Review the procedure of considering reference checks provided while recruitment of personnel.

(o) Review the personnel file maintained for work records (for example, hours worked, time reports, etc.)

(p) Review the contracts of the employees hired on part time basis and ensure that they are paid for the period they are employed as per the terms of their contract.

(q) Review the standard operating policy to ensure reporting of any work related grievances. (For example, stress, bias, etc.)

(r) Review the policy pertaining to payment of employees for overtime and test check the following:

  (i) Necessary prior approval from authorised supervisor is obtained.

  (ii) Proper documentation of overtime details is maintained.

  (iii) Determine and document how the payment of overtime is made.

(s) Examine the budget approved and reconcile the budgeted figures with actual payroll costs and where applicable, obtain the reasons for significant deviations. Check the reporting procedure of all significant deviations.

(t) Check the monthly reconciliations between financial records and payroll prepared by both the departments.

(u) Check the procedures for ensuring compliance with laws and regulations, for example, deduction of TDS.

(v) Scrutinize HR database (for hiring and firing of employee) and payroll database (for paying employee) to ensure that there are no ghost employees.

Other Expenditure

4.58 Other than payroll, an educational institution incurs Educational and Academic expenditure, Administrative expenditure, Occupancy expenditure and Promotional expenditure. The internal auditor should follow the following procedures while auditing these types of expenses:

(a) Compare the balances of each significant expense account with the comparable balance for the preceding period and with the budgeted balance for the current period. Examine unusual fluctuations.

(b) Compare current period relationships between accounts (e.g., total expenses as a percentage of revenue, etc.) with the comparable relationships for the prior period and with budgets. Examine unusual fluctuations.

(c) Analyze comparative expense calculations on a per unit basis (e.g., academic expenditure or cost of utilities per student, transportation expenses per student, space utilsation ratios, etc.). Examine unusual fluctuations.

(d) Review all expense accounts to determine whether year end accrual is appropriately recorded.

(e) Check expense account balances to the appropriate analyses of balance sheet accounts (e.g., rent expense to accrued rent, etc.).

(f) Check source documents (invoices) along with supporting forms and documents of all major expenses with amounts recorded in accounting records to ensure that all expenditures incurred during the period have been properly recorded.

(g) Ensure that the capital expenditure has not been booked as revenue expenses and vice-versa.

(h) Authorisation by appropriate authority to all the expenses should be confirmed.

(i) Check to ensure that no expenditure on personal account is debited as expenses.

Fund Balances

4.59 The fund balances of an institution may exist in various forms. The internal auditing aspects to be kept in mind in respect of each of these are elaborated as under:

Restricted Funds

4.60 Restricted Funds normally consist of donations received and grants sanctioned with conditions attached to the manner of the utilisation. This restriction may specify that the funds be spent only for specified purposes, whether revenue or capital in nature. The correspondence attached to each receipt as well as the sanction letters accompanying the grants need to be verified by the internal auditor to ascertain the restrictions and verify the utilisation of the grants in accordance therewith. Any misutilisation of funds may lead to claims against the institution, which may in extreme cases affect the financial viability of the institution.

Designated Funds

4.61 Designated Funds represents appropriation made by the institution with the purpose of accumulating funds for specific purposes. The internal auditor must evaluate evidences to establish the authority under which such appropriation was carried out as well as the purposes for which it was done. Extremely reliable evidence in respect thereof is the minutes of the meeting of the governing body of the institution in which the appropriation of the funds was approved. Normally, all such appropriations are recorded in the Board meetings called for approving the financial statements. The internal auditor must verify that the classification of funds appropriated has to be in accordance with the purposes and amounts approved in the Board meetings.

4.62 The internal auditor should also verify that the fund balances and the bank accounts in which the funds so appropriated are parked, reconcile with each other. Any discrepancy will mean that the accounting treatment has not been correctly followed or it may require verification of the actual utilisation of funds.

Liabilities

4.63 The internal auditor may employ the following procedures for verifying liabilities:

(a) Examination of records

(b) Direct confirmation procedure

(c) Examination of disclosure

(d) Analytical Procedures

(e) Obtaining management representations

Loans and Borrowings

4.64 For an educational institution, the major outflow of funds is for the capital expenditure. Therefore, the borrowings of an educational institution comprise of the term loans taken for construction of buildings, infrastructure facilities, acquisition of plant and machinery, furniture, etc.

4.65 The following points are important in internal audit of loans and borrowings:

(a) The internal auditor should verify that the loans obtained are within the borrowing powers of the institution and in accordance with the Memorandum and Articles of Association/ Rules/Bye-laws of the institution.

(b) The internal auditor should examine the relevant records to evaluate the validity and accuracy of the loans. The examination of minute books would constitute an important source of audit evidence for the same.

(c) The internal auditor should examine the reconciliation of the book balances with the statements of the lenders. Balance confirmation procedures should also be adopted.

(d) The internal auditor should examine the documents, if any, evidencing any charge created in respect of loans and borrowings. He should particularly examine compliance with the requirements of the applicable statute regarding creation and registration of charges in case of companies formed under section 25 of the Companies Act, 1956.

(e) In case the institution has accepted deposits, the internal auditor should examine whether the applicable directives issued by the Reserve Bank of India or other appropriate authorities are complied with.

(f) The internal auditor should examine whether the loan is classified as secured only when the same is secured against any asset belonging to the institution.

(g) In case the installments of long term loans falling due within the next twelve months have been disclosed in the financial statements, the internal auditor should verify the correctness of the amount of such installments.

(h) The internal auditor should examine the hire purchase agreements for the purchase of assets to verify the correctness of the outstanding amounts. The future installments under hire purchase agreements for the purchase of assets may be shown as secured loans.

(i) The deferred payment credits should be verified with the relevant agreements. The internal auditor should also verify the copies of hundies/bills accepted.

Creditors and Other Current Liabilities

4.66 The following points can be useful in internal audit of creditors and other liabilities:

(a) The internal auditor should carry out appropriate procedures to judge the adequacy of the relevant cut-off procedures e.g., he may examine the documents relating to goods received a few days immediately before the year end and check whether the related invoices have been recorded as purchase in the year under audit.

(b) The internal auditor should look into the difference, if any, between the total of the creditors balances as per creditor's ledger with the related control account.

(c) The internal auditor should examine the relevant correspondence /other documentary evidence to verify the validity, accuracy and completeness of creditors/ acceptances.

(d) The internal auditor should pay special attention to long outstanding items, unadjusted claims for short supplies, poor quality, discount, commission, etc., and liabilities not correlated/adjusted against related advances. He should also examine authorisation and correctness of transfers from one account to another.

(e) The internal auditor should examine any unusual payments around the year-end, especially if the entries have been reversed in the subsequent period.

(f) The internal auditor should review transactions in the immediately succeeding period to identify/ confirm material liabilities outstanding at the balance sheet date.

Fees Received in Advance

4.67 Usually an educational institution charges fees before the semester gets started. Such fees is received in advance from the students and as it does not relate to the period under internal audit, it should not be treated as income but shown as liability in the financial statements. Further, this fees should also be not shown in the respective student accounts because the amount is not required to be repaid back to the student but is to be disclosed in the Current Liabilities as 'Fees received in Advance'.

4.68 The following are important points in audit of fees received in advance:

(a) Obtain and examine the list of students from whom fees has been received in advance.

(b) Check the opening balance outstanding in the 'Fees received in Advance' account and ensure that the said amount is reversed and charged to income and expenses account.

(c) In case where the student at the time of admission has deposited fees for more than one year, obtain the detailed year wise list of students and examine the balance outstanding at the 'Fees received in Advance' account as well as year-wise income to be recognised.

(d) In case any student has left the institution, ensure the fees received in advance from that student have been transferred to his/her respective student's account.

Caution Money and Security Deposits

4.69 The following are important points can be useful in audit of caution money and security deposits:

(a) Confirm that caution money and other deposits paid by the students on admission have been shown as liability in the balance sheet and not transferred to revenue, unless they are not refundable.

(b) Examine the accounting procedure of caution money received from and paid to the students.

(c) Verify the caution money registers for entries made for receipts and payments and ensure that the registers reconcile with the financial records. Verify the details mentioned in the registers, like student's name, year of receipt, total amount, cheque details, due date of payment, etc.

(d) Check the documentation required to be maintained for the caution money paid to the students.

(e) Examine the communication procedure between various departments of the institution before the caution money is paid, for example, how does the library in-charge communicates with the accounts department regarding library fines.

(f) Verify whether the deposits, such as caution money, security, laboratory security, etc. are received from the students.

(g) Ensure that such deposits are not mixed up with the fees received account.

(h) Check the student's account to whom the caution money is being paid, to ensure that no dues like fees, fines, recoveries for on account of lost library books, etc. are recoverable. Verify that only net amount is being paid to the student.

(i) Check whether the No Dues Certificate has been obtained from all departments of the institution.

(j) Check that all the necessary approvals have been obtained from the appropriate authority before the payment of caution money.

Unutilised Grants

4.70 In case the grant received earlier was not utilised for the designated purpose, then the grant may become refundable. In such instance, the internal auditor should obtain the original donor letter and its specification. In case, the grant becomes refundable, the accounting treatment will depend upon the mode followed by the educational institution at the time of receipt of income. Accounting Standard (AS) 12 "*Accounting for Government Grants"*, issued by ICAI.

Assets

Fixed Assets

4.71 Fixed Assets in the shape of land, building, and equipment constitute a major chunk of the assets of an educational institution.

The audit procedures with respect to verification, valuation and disclosure are discussed in following paragraphs:

Verification

4.72 The verification of fixed assets consists of (a) examination of records, and (b) review of physical verification of such assets conducted by the management. The following are important procedures in this regard:

(a) The opening balances of fixed assets should be verified from relevant records e.g., schedule of fixed assets, ledger or register balances.

(b) Check whether the institution is in compliance with Accounting Standard (AS) 10, "*Accounting for Fixed Assets"*.

(c) Acquisition of fixed assets and improvements to the existing ones should be verified with reference to supporting documents such as, orders, invoices, receiving reports and title deeds.

(d) Review of the lease agreements, valuation and disclosure of fixed assets acquired on lease with respect to Accounting Standard (AS) 19, "*Leases*".

(e) Self constructed fixed assets, improvements and capital work-in-progress should be verified with reference to the supporting documents such as contractor's bills, work-order records and independent confirmation of the work performed. All incidental costs incurred with respect to use should be capitalised.

(f) Expense accounts (e.g., repairs and renewals) should be scrutinized to ascertain that new capital assets and improvements have not been included therein.

(g) Where fixed assets have been written-off or fully depreciated in the year of acquisition/ construction, the internal auditor should examine whether these were recorded in the fixed register before being written-off or depreciated.

(h) In respect of fixed assets retired i.e., destroyed, scrapped or sold, the internal auditor should examine whether:

(i) The retirements have been properly authorised and appropriate procedures for invitation of quotations have been followed, wherever applicable;

(ii) The asset and depreciation accounts have been properly adjusted;

(iii) The sale proceeds, if any, have been fully accounted for; and

(iv) The resulting gains or losses, if material, have been properly adjusted and disclosed in the profit and loss account.

4.73 It is possible that certain assets, which were destroyed, scrapped or sold during the year have not been recorded. The internal auditor may use the following procedures to ascertain such omissions:

(a) Review of work orders/physical verification reports to trace any retirements.

(b) Examination of major additions to ascertain whether they represent additional facilities or replacement of old assets, which may have been retired.

(c) Making enquiries of key management and supervisory personnel.

(d) Obtaining a certificate from a senior official and/or managers that all assets scrapped, destroyed or sold have been recorded in the books.

4.74 Ownership of assets such as, land and buildings should be verified by examining the original title deeds. The title deed should be in the name of the Society/Company, where they own the educational institutions. In case, other persons such as solicitors or bankers hold the original title deeds, confirmation should be obtained directly by the internal auditor through a request signed by the client. The internal auditor should also verify if the vehicles are registered in Road Transport Office (RTO) in the name of the institution.

4.75 It is the responsibility of the management to carry out physical verification of fixed assets at appropriate intervals in order to ensure that they are in existence. However, the internal auditor should satisfy himself that such verification was done. For this purpose, he should observe the verification being conducted by the management, wherever possible. He should also examine the written instructions issued to the staff by the management and the relevant working papers. The internal auditor should also satisfy himself that the persons conducting the verification, whether the employees of the organisation or outside experts (if employed), had the necessary competence.

4.76 The internal auditor should examine whether the method of verification was reasonable in the circumstances relating to each asset. Where the fixed assets can be moved and where verification of all assets cannot be conducted at the time, they should be marked with distinctive numbers.

4.77 The internal auditor should examine whether the frequency of verification was reasonable in the circumstances of each case. Where the assets are few and can be easily verified, an annual verification may be considered reasonable. However, where the assets are numerous and difficult to verify, verification, say, once every three years by rotation so that all assets are verified at least once in every three years, may be sufficient. The internal auditor should test-check the records of fixed assets with the physical reports. He should examine whether the discrepancies noticed on physical verification have been properly dealt with.

Valuation and Disclosure

4.78 The internal auditor should ensure that fixed assets have been valued and disclosed in the financial statements according to the generally accepted bases of accounting which are determined by law, professional pronouncements and prevailing practices governing educational institutions.

4.79 The internal auditor should test check the calculation of depreciation. The total depreciation arrived at should be compared with that of the preceding years to identify reasons for variations. The internal auditor should, particularly, examine whether the depreciation charge is adequate, keeping in view the generally accepted basis on accounting for depreciation.

4.80 Revaluation of fixed assets implies restatement of their book values on the basis of a systematic scientific appraisal, which would include ascertainment of working condition of each unit of fixed assets, technical estimate of future working life and the possibility of obsolescence. Independent and qualified persons such as engineers, architects, etc usually make such an appraisal. To the extent possible, the internal auditor should examine these appraisals. As long as the appraisals appear reasonable and based on adequate facts, he is entitled to accept the revaluation made by the experts.

4.81 Where several assets have been purchased for a consolidated price, the internal auditor should examine the method by which the consideration has been apportioned to the various assets. In case this has been done on the basis of an expert valuation, he should examine whether the same appears reasonable and is based on adequate facts. Where an organisation owns assets jointly with others (e.g., the office building being owned jointly by two companies), the internal auditor should examine the relevant organisation's share in such assets.

4.82 The internal auditor must review the fixed assets for impairment; wherever changes in circumstances indicate that the carrying amount may not be recoverable. Valuation of the impaired asset should be made as per Accounting Standard (AS) 28, "*Impairment of Assets*", where the assets whose carrying value exceeds the recoverable value are written down to the recoverable amount and the impairment loss is recognised.

Intangible Assets

4.83 An educational institution may develop or acquire an intangible asset like copyrights, patents, designs, trademarks, etc. during its course of activity or it may develop application software like an Accounting Software, Library Software, etc. The scope of work of an internal auditor may cover the development of an intangible asset starting from its inception stage to its implementation in the organisation covering monitoring of operations, racking progress, recommending improvements, etc. The *"Technical Guide on Internal Audit of Intangible Assets"* covers these aspects in details. Some important procedures to be carried out by an internal auditor are as follows:

(a) Review the policies and procedures relating to intangible assets for example authorisation policy, purchase policy/in-house development, deployment process, retirement and disposal policy, etc.

(b) Review the efficiency and effectiveness of use of intangible assets.

(c) Review the systems established to ensure compliance with laws, regulations, contracts, policies and procedures relating to intangible assets including copyrights, trademarks, patents and designs to determine whether the institution has complied with them or not. Monitor compliance with laws and regulations relating to intangible assets with particular reference to unauthorised use of intangible assets of others, e.g., patents, trademarks, computer software, etc. Review in-house procedures for protecting intangible assets e.g., implementation of code of conduct to be followed by employees, vendors, consultants etc.

(d) Review the means of safeguarding intangible assets.

(e) Review the recordkeeping and accounting of intangible assets.

4.84 The internal auditor should examine whether items included as intangible assets in the financial statements meet the definition of, and recognition criteria for, intangible assets as laid down in Accounting Standard (AS) 26, *'Intangible Assets'*. The internal auditor should also scrutinize whether any amount of intangible assets which was supposed to be capitalised, have not been charged off to revenue account.

Investments

4.85 Investments constitute a significant portion of the assets of an organisation. The investments are held under statutory requirement such as Section 11(5) of the *Income Tax Act, 1961* and may also be required to be maintained in case of restricted funds as per the directions of the donor. Sometimes the University requires a college to maintain investments for a particular course.

4.86 The investments could be short term or long term in nature. Short term investments are, normally, made to deploy temporary surplus funds in view of the peculiar fund flow position of an educational institution. The short term investments may be classified as current assets and normally valued at market value. The decline in the value of long term investments, other than permanent, is normally not adjusted from the book values. The following paragraphs cover internal audit procedures with respect to investments.

Verification of Transactions

4.87 The internal auditor must verify the transactions of investments with regards to the investment policy of the organisation. The internal auditor should examine whether the legal requirements relating to investments have been complied along with any other conditions relating to investments which restrict or qualify the right of ownership and/or disposal of investments. Where the organisation is claiming exemption from income tax, the internal auditor must examine whether the compliance with the provisions of the Income Tax Act, 1961, regarding the investment of the surplus funds is complied with or not. Where the amount of purchase/sales of investments are substantial, the internal auditor may check the prices paid/received with reference to the market rate.

Physical Inspection

4.88 The internal auditor should carry out a physical inspection of investments in the form of fixed deposits, shares, debentures or other securities. The physical inspection of scrips should normally be carried out at the close of business on the last day of the year. If this is not possible, of course, in such a case adjustments for transactions during the intervening period will be required. The internal auditor must check whether the investments held are in the name of the educational institution. The internal auditor should also consider the following important aspects:

(a) Where a substantial number of investments are held by the institution in its custody, the internal auditor should carry out a surprise inspection of investments in hand at least once during the year, in addition to the year-end verification.

(b) Where investments belonging to third parties are also held by the institution besides its own investments (e.g., banks may hold share scrips of customers as security against loans and advances), the internal auditor should ensure that such investments are properly identified and segregated at the time of physical inspection.

(c) Where the scrips relating to shares, debentures or other securities are with a custodial/depository organisation, the internal auditor should examine the certificate issued by it confirming the holdings of the institution. He should also examine the reconciliation of balances as per the records of the institution and those as per the certificate of the custodial or depository organisation.

(d) Where banks on behalf of the institution hold the investments, the internal auditor should examine the certificates/ confirmations received from the banks. Such certificates/ confirmations should preferably be received directly by the internal auditor.

(e) Where investments are held by a third party other than banks on behalf of the institution the internal auditor should examine whether there is a justification for such other party to hold the scrips. In such a case, physical inspection of the relevant documents may be made to the extent possible. In any case, evidence of securities held by third parties should be examined.

(f) If investments are held otherwise than in the name of the institution (e.g., in the name of nominees/ trustees), the internal auditor should ascertain the reasons therefor and examine the relevant documentary evidence supporting real/ beneficial interest of the institution in the investments e.g., written confirmations from the nominees/ trustees.

Valuation and Disclosure

4.89 The internal auditor should examine whether the investments have been valued according to the recognised accounting principles. Accounting Standard (AS) 13, *'Accounting for Investments'*, issued by the ICAI, deals with accounting for investments in the financial statements of enterprise and related disclosure requirements. The internal auditor should also examine whether the disclosure of investments in the financial statements is in accordance with the statutory requirements, if any. For example, Schedule VI to the Companies Act, 1956, contains detailed requirements relating to disclosure of investments.

4.90 To ascertain the fair value market value of investments (this may be required while determining the value of investments for balance sheet purposes), reference may be made to the official quotations of the stock exchange in the case of quoted securities. In the case of unquoted securities, the internal auditor should examine whether the method adopted is one of the recognised methods of valuation of securities, e.g., break-up value method, capitalisation-of-yield method, yield-to-maturity method, etc.

4.91 The internal auditor should examine whether any specific aspects relating to investments are required to be reported upon as per the provisions of the relevant statute governing the institution. For example, as per the provisions of section 227(1A) of the Companies Act, 1956, the internal auditor of a company (other than an investment company or a banking company) should enquire whether so much of the assets of the company as consist of shares, debentures and other securities have been sold at a price less than that at which they were purchased by the company.

Inventories

4.92 An illustrative list of inventory registers maintained in an educational institution is as under:

(a) Printing and Stationery

(b) Hardware

(c) Sanitary

(d) Electrical

(e) Fixtures and Furniture

(f) New Construction (for construction materials)

(g) Mess Equipments and Utensils

(h) General

(i) Lab Equipments

(j) Sports and Gym

(k) Physics Lab (for items issued to Lab)

(l) Chemistry Lab (for items issued to Lab)

(m) Daily maintenance receipt (for items issued for maintenance)

(n) Repairs (for items sent for repairing).

4.93 An internal auditor should:

(a) Examine the internal control over the receipt, issue, maintenance, leakage, etc. of the inventories.

(b) Verify the above mentioned inventory registers from the following documents:

  (i) Copy of Purchase Orders

  (ii) Challans/Duplicate Bills File

  (iii) Stores Issue Slips

  (iv) Material Inward Register

  (v) Bill Dispatch Register (for bill sent to accounts/purchase department)

  (vi) Issue and Received Register (for items issued but to be retuned back).

(c) Check the opening balances of the items.

(d) Verify the Gate Entry Register for items purchased or sent outside the premises for repairs, etc.

(e) Verify the list of defective/scrapped/destroyed items and the loss to be recognised in the income and expenditure account.

(f) Inspect reports of physical inspections carried out by the Inventory Management Department, Accounts Department, etc.

(g) Check that the inventory has been valued and disclosed in the financial statements according to the generally accepted bases of accounting which are determined by law, professional pronouncements and prevailing practices governing educational institutions. The internal auditor may refer to Accounting Standard (AS) 2, "*Valuation of Inventories*".

Cash and Bank Balances

4.94 The internal auditor should carry out the following procedures:

(a) The internal auditor should carry out physical verification of cash at the year-end. Where this is not feasible, verification may be carried out, on a surprise basis, at any time around the date of the balance sheet. In such a case, the internal auditor should examine whether the cash balance as shown in the balance sheet reconciles with the physically verified cash after making adjustments for cash receipts and payments during the interim period. Besides physical verification at or around the date of the balance sheet, the internal auditor should also carry out surprise verification of cash during the year. The following aspects of physical verification of cash may be noted:

(i) All cash balances in the same location (petty cash, cash of sister concerns/ staff societies, etc.) should be verified simultaneously.

(ii) If IOUs or other similar documents are found during physical verification, the internal auditor should seek explanations from the management regarding the reasons for such documents remaining pending. These should not be shown as cash in hand (but classified as short term advances).

(iii) The quantum of torn or mutilated currency notes should be examined to determine whether any provision for loss on this account is required.

(b) If the internal auditor finds that the organisation is consistently maintaining an unduly large balance of cash-in-hand, he should carry out surprise verification of cash more frequently. The internal auditor must be familiar with the written policies on the limits of holding cash. He should also examine the reasons for maintaining such large balances having regard to the normal working requirements of the organisation. Normally, the educational institution follow the policy of depositing the fees received in cash on the following day into the bank account maintained for the purpose. A large balance of cash in hand may point to possession of unrecorded funds by members.

(c) The internal auditor should vouch the cash payments made over the limits assigned requiring appropriate approvals.

(d) The internal auditor should advise the organisation to send a letter to all its bankers to confirm the balances directly to the internal auditor including those relating to dormant accounts as well as accounts closed during the year.

(e) The internal auditor should examine the bank reconciliation statements as at the year end. He may also examine the reconciliation statements as at other dates during the year. He should, particularly, examine whether the cheques issued but not presented and the cheques deposited but not cleared have been duly accounted for in the bank statements of the subsequent period. In case this is not so, he should examine whether the entries need to be reversed. The internal auditor should pay special attention to items, which are outstanding for unduly long periods and should consider whether such items require an adjustment/ write off.

(f) Where post dated cheques have been shown as collections, the internal auditor should ask for reversal of the entries. Similarly, post dated cheques issued by the organisation should not be accounted for as payments.

(g) The internal auditor should examine the bank statements relating to accounts which are apparently inoperative to ensure that no transactions have taken place in such accounts which have not been recorded in the books of account.

(h) In case of unduly large number of deposits or issue of cheques in the last few days of the year, the internal auditor may consider obtaining confirmations from the parties concerned. Similarly, where there are a large number of cheques on hand at the date of the balance sheet and a sizeable proportion has subsequently remained un-deposited/ un-cleared, the internal auditor may consider obtaining confirmations.

(i) The internal auditor should examine relevant receipts/ certificate /bank advices in respect of fixed deposits or other types of deposits.

(j) Remittances in transit should be examined with reference to their adjustments in the bank statements of the subsequent period.

Other Current Assets

Fees Receivable

4.95 An educational institution, if following an accrual based accounting shall charge the students for the fees due in the current financial year. Such fees if not received can either be represented in the name of Fees receivable or the balances of students in the Balance Sheet. Such amount should be evidenced with the list of student accounts from which the fees has not been received. The internal auditor may follow the following steps for audit of fees receivables:

(a) Check that the opening balances of fees receivable account have been transferred to the respective student accounts.

(b) Verify whether the fees receivable is recorded correctly during the current periods.

(c) Examine the next year's transactions and fees receipt books to ensure that the current year fees have been booked.

Security Deposits

4.96 As stated above, an educational institution may be required to deposit some security to other institution, government, local authority for conducting some course or exam. Further, an amount may be placed before any other department/agency for obtaining connection such as telephone connection, gas connection, etc. At the time of giving a security deposit, the receipt should be obtained and retained till such deposit gets refunded. A list should be prepared for the security deposits given and should be verified with the evidences.

Contingent Liabilities

4.97 Some of the contingent liabilities arising in case of an educational institution are:

(a) Amount indeterminable in respect of pending income tax assessments.

(b) Additional liability arising due to sales tax, service tax demand on completion of assessments or non-deduction of Provident Fund/ESI by the contractors.

(c) Amount indeterminable in respect of pending court cases by/against ex-employees or students.

(d) Claims against the institution in the courts/consumer courts not acknowledged as debts.

(e) Guarantees given.

(f) Guarantees issued by banks on behalf of the Institution.

(g) Non-deduction of TDS on provisions due to pending payments with the parties.

(h) Claim of refunds by the students.

(i) Claims of retirement benefit by employees.

(j) Cause of action arising out of breach of laws and regulations under which the institution operates or due to non-fulfillment of conditions for getting recognitions.

(k) Capital commitments.

4.98 The internal auditor should:

(a) Inquire the management about their knowledge of unrecorded commitments or contingent liabilities.

(b) Ascertain the amount of contingent liability as discussed with the management.

(c) Ensure that all contingent liabilities are raised or disclosed in the financial statements.

(d) Verify last year's contingent liabilities and ensure that these have been duly considered for the current year's account.

Chapter 5

Special Internal Audit Aspects in an Educational Institution

Internal Auditor's Role in Corporate Governance

5.1 Corporate Governance may be defined as a set of systems, processes and principles which ensure that an entity is governed in the best interest of all the stakeholders. It ensures commitment to values and ethical conduct of business; transparency in business transactions; statutory and legal compliance; adequate disclosures and effective decision making to achieve corporate objectives. Corporate Governance is about promoting corporate fairness, transparency and accountability.

5.2 Corporate Governance in an educational institution means emphasising on accountability, transparency, strict costing measures and quality education, student security, bringing in latest technology to benefit students and being self-sufficient. The internal auditors are required to evaluate and offer recommendations to improve governance processes by delivering:

(a) Assessment of governance policy of the management.

(b) Assessment of mission, objectives and goals of the institution.

(c) Evaluation of Risk and Internal control framework and suggesting best practices ideas.

(d) Detailed analysis of business processes and controls, policies and procedures and code of conduct.

(e) Sources of information for fraud and irregularities, and reporting their effectiveness to the audit committee.

(f) Review of compliance framework, their activities and issues.

Reporting of Frauds, Errors, Irregularities and Illegal Acts in an Educational Institution

5.3 The following types of frauds, errors, irregularities and illegal acts are commonly found in an educational institution:

(a) Charging capitation fees from students, where not allowed.

(b) Plagiarism - Availability of restricted data, violation of intellectual property rights or leakage of critical information on internet, for example, examination papers, course papers, essays or research notes.

(c) Sale of question papers and answers by employees, faculty, publisher, etc.

(d) Reproduction and distribution of unauthorised valuable documents, such as college diploma certificates or transcripts of student's records.

(e) Professional misconduct, educational malpractice including inappropriate changes in institution's curriculum, misuse of institution's resources and deliberate falsification of records.

(f) Teachers accepting cash payments for giving candidates extra time or other kind of assistance during examinations.

(g) Theft and tampering of records.

(h) Fabrication with falsification of data, records and credentials by a faculty member at the time of employment.

(i) Misappropriation of assets.

(j) Phantom Billing – Billing for work that was not performed or services that were never rendered.

(k) Double Billing – Error of charging a student twice for fees of a year.

(l) Phantom Employees – Charging for employees that were not on the job.

(m) Obtaining a contract through kickbacks, for example, accepting bribes from publishing houses for ordering text books.

(n) Improper use of grant money or misuse of government funding.

(o) Sanction of grant through improper means such as inflate the number of students or publish superior results of student performance.

Responsibilities of the Internal Auditor

5.4 Standard on Internal Audit (SIA) 11, "*Consideration of Fraud in an Internal Audit*", lays down that the primary responsibility for prevention and detection of frauds rests with management and those charged with governance. They achieve this by designing, establishing and ensuring continuous operation of an effective system of internal controls. An internal auditor should use his knowledge and skills to reasonably enable him to identify indicators of frauds. However, the internal auditor cannot be expected to possess the expertise of a person with specialised knowledge and skills in detecting and investigating frauds. It is essential for the internal auditor to gain an understanding of the components of the system of internal control which would keep him to assess the risk of frauds.

5.5 The internal auditor should help the management fulfill its responsibilities relating to fraud prevention and detection. The following paragraphs discuss the approach of the internal auditor regarding this:

(a) The internal auditor should obtain an understanding of the various aspects of the control environment and evaluate the same as to the operating effectiveness.

(b) The internal auditor should obtain an understanding of the policies and procedures adopted by the management to identify risks that can affect the achievement of the objectives of the entity and to distinguish risks from opportunities and evaluate the effectiveness of these policies and procedures. In the context of prevention of frauds, the internal auditor should, specifically evaluate the policies and procedures established by the management to identify and assess the risk of frauds, including the possibility of fraudulent financial reporting and misappropriation of assets.

(c) The internal auditor should assess the operating effectiveness of the policies and procedures established by the management to identify, capture and communicate relevant information to the concerned persons in the entity to enable them to make timely and effective decisions and discharge their responsibilities efficiently.

(d) The internal auditor should assess whether the controls implemented by the management to ensure that the risks identified are responded to as per the policy, or the specific decision of the management, as the case may be, are in fact working effectively and whether they are effective in prevention or timely detection and correction of the frauds or breach of internal controls.

(e) The internal auditor should evaluate the mechanism in place for supervision and assessment of the internal controls to identify instances of any actual or possible breaches therein and to take corrective action on a timely basis.

(f) The internal auditor should carefully review and assess the conclusions drawn from the audit evidence obtained, as the basis for his findings contained in his report and suggest remedial action. In case, the internal auditor comes across any actual or suspected fraud or any other misappropriation of assets, he should immediately bring the same to the attention of the management.

(g) The internal auditor should document fraud risk factors identified as being present during the internal auditor's assessment process and document the internal auditor's response. If during the performance of the internal audit fraud risk factors are identified that cause the internal auditor to believe that additional internal audit procedures are necessary, the internal auditor should document the same.

5.6 The internal auditor should carry out the following procedures which would help him to identify fraud risk factors:

(a) Review of personal accounts of employees and officers.

(b) Ensure that the management has taken the following steps:

(i) Incorporate a formal fraud control policy.

(ii) Ensure that there is proper system of prevention and detection of fraud, e.g., whistleblower policy should be made with the objective of providing employees, investors, suppliers, lenders, service providers, etc. an avenue to raise complaints.

(iii) Train employees, such as train tellers not to accept unusual transactions from insiders.

(iv) Encourage questioning and reporting of unusual transactions.

(v) Place a confidential hotline.

(vi) Sharing of information.

(vii) Exercise due care and reasonable safeguards to prevent fraud.

(viii) Direct supervision and control.

(ix) Communication of fraud to vendors and business partners.

Transactions with Related Parties

5.7 As per Accounting Standard (AS) 18, "*Related Party Disclosures"* issued by the Institute of Chartered Accountants of India, related parties are considered to be related if at any time during the reporting period one party has the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions. AS 18 deals only with related party relationships described in (a) to (e) below:

(a) Enterprises that directly, or indirectly through one or more intermediaries, control, or are controlled by, or are under common control with the reporting enterprise (this includes holding company, subsidiaries and fellow subsidiaries).

(b) Associates and joint ventures of the reporting enterprise and the investing party or venturer in respect of which the reporting enterprise is an associate or a joint venture.

(c) Individuals owing, directly or indirectly, an interest in the voting power of the reporting enterprise that gives them control or significant influence over the enterprise and relatives of any such individual. *'Relative'* in relation to an individual, means the spouse, son, daughter, brother, sister, father and mother who may be expected to influence, or be influenced by, that individual in his/her dealings with the reporting enterprise.

(d) Key management personnel and relatives of such personnel

(e) Enterprises over which any person described in (c) or (d) is able to exercise significant influence. This includes enterprises owned by directors or major shareholders of the reporting enterprise and enterprises that have a member of key management in common with the reporting enterprise.

5.8 *Section 6 of Companies Act, 1956*, lays down that a person shall be deemed to be a relative of another, if, and only if,

(a) They are members of a Hindu undivided family; or

(b) They are husband and wife; or

(c) The one is related to the other in the manner indicated in Schedule IA.

5.9 *Section 2(41) of Income Tax Act, 1961,* lays down that '*Relative'* in relation to an individual, means the husband, wife, brother or sister or any lineal descendant or descendant of that individual. Further, a person shall be deemed to have a substantial interest in a business or profession if:

(i) In case of company, the person, at any time during the year, carries not less than 20% of the voting power.

(ii) In any other case, the person, at any time during the year, is beneficially entitled to not less than 20% of the profits of such business or profession.

5.10 As already mentioned, the educational institutions, generally, exist solely on a not-for-profit basis. Such institutions generally exist either as a Society or as a Section 25 company. More so, because the affiliation conditions/regulations governing such institutions are very clear in this respect that the educational institution must run for charity and not for profiteering. However, it is quite common that the trustees or the promoters of such institutions who contribute substantial amount for setting up the institution are also the members of the governing body. These members are in privileged position to misuse the funds meant for the institution. In case of an educational institution, the following can be the related parties:

(a) Enterprises that directly or indirectly, control, or are controlled by, or are under common control with the educational institution, for example, sister educational or vocational institution, etc.

(b) Individuals owing, directly or indirectly, an interest in the voting power of the reporting enterprise that gives them control or significant influence over the enterprise and relatives of any such individual, for example, two societies having a same set of trustees.

(c) Key Management Personnel and relatives of such personnel for example directors, trustees, etc.

5.11 The responsibility for identification and disclosure of related parties and related party transactions is of the management.

However, the internal auditor must perform the following procedure for related party transactions:

(a) Obtain sufficient audit evidence regarding the identification and disclosure by management of related parties that are material.

(b) Review information provided by the management regarding the related parties.

(c) Review the institution's procedure for identification of related parties.

(d) Review with the management, of the financial statements before submission to the Board of Directors for approval, with reference to disclosure of any related party transactions.

(e) Review prior year working papers for names and transactions of related parties.

(f) Inquire affiliation of directors, key management personnel, officers with other entities.

(g) Review minutes of meetings and other statutory records, such as Director's Interest Register, etc.

(h) Review shareholders records to determine the names of principal shareholder or obtain a list of principal shareholders from the share register.

(i) Review the institution's Income tax returns.

(j) Review any other agreements entered into by the institution.

(k) Review the related party transactions and disclose material transactions with promoters or management or subsidiaries or relatives, etc. that may have possible conflict with the interests of the institution.

5.12 In case there are any unusual transactions with the related parties, the internal auditor must ensure that the same are reported and disclosed in the financial statements. The internal auditor must check transactions regarding related parties relating to abnormal terms of trade, such as excessive salary, unusual prices, interest rates, vehicle logs, use of property of the institution, guarantees and repayment terms or transactions that lack an apparent logical business reason for their occurrence or those that are of high-volume or significant amounts with certain customers or suppliers as compared with others, for example an internal auditor can compare the remuneration payable to a trustee with the remuneration payable to the unrelated personnel employed within the institution having similar background, qualifications, experience, etc. Similarly the internal auditor can verify the interest paid by the institution to the key management personnel with regards to the interest rate charged by the financial institutions or third party in the similar circumstances.

5.13 The following documents must be placed for the consideration of the Audit Committee:

(a) A statement of all related party transactions in the ordinary course of business.

(b) Details of material individual transactions with related party which are not in the normal course of business.

(c) Details of material individual transactions with related party which are not on an arm's length basis together with the management's justification for the same.

5.14 The reporting requirement of the entities may require disclosing the related party disclosures. The following instances in this context are relevant:

(i) Accounting Standard (AS) 18, "*Related Party Disclosures*" prescribes the following disclosures in respect of the transactions with related parties:

  (a) Name of the transacting related party;

  (b) A description of the relationship between the parties;

  (c) A description of the nature of transactions;

(d) Volume of the transactions either as an amount or as an appropriate proportion;

(e) Any other elements of the related party transactions necessary for an understanding of the financial statements;

(f) The amounts or appropriate proportions of outstanding items pertaining to related parties at the balance sheet date and provisions for doubtful debts due from such parties at that date; and

(g) Amounts written off or written back in the period in respect of debts due from or to related parties.

(ii) The *Companies Act, 1956* places significant emphasis on the concept of related parties and incorporates regulatory provisions for the same in various sections embodied in that Act. To illustrate:

(a) Section 297 provides for Board's sanction in cases of contracts in which directors are directly or indirectly interested.

(b) Section 299 requires such interested directors to disclose their interest at Board meetings.

(c) Section 300 debars interested directors from voting on such resolution pertaining to matters in which they are interested.

Internal Auditor's Role in Statutory and Legal Compliances of an Educational Institution

5.15 As per, Standard on Internal Audit (SIA) 17, *"Consideration of Laws and Regulations in an Internal Audit",* compliance with laws and regulations is an inherent part of the functioning of an entity. Since the role of an internal auditor is to carry out a continuous and critical appraisal of the functioning of an entity and suggest improvements thereto, the identification of non-compliance with laws and regulations is also an inherent part of his responsibilities. Thus, the scope of an internal audit is also affected by the statutory or regulatory framework in which the institution operates.

5.16 The internal auditor is required to consider at the time of planning and performing audit procedures as well as evaluating and reporting the results thereof, that any non-compliance by the institution with laws and regulations under which it operates may materially affect the financial statements and in some cases, may affect significantly the functioning of the institution. Yet, at the same time, that internal auditor cannot be expected to detect the non-compliance with all laws and regulations.

5.17 An example of serious non-compliance with laws, in the case of educational institution could be non-compliance with the terms and conditions under which affiliations, registration, etc., was granted to the entity to operate as an educational institution. Such non-compliance could be so significant as to effect going concern assumption. To illustrate, the regulatory environment in India is oriented towards allowing educational institutions to be run only by not-for-profit organisations. Any violation of this basic character by engagement in activities with the purpose of profiteering would automatically result in withdrawal of affiliations from the regulatory bodies. Further, this would also mean loss of benefits in the shape of exemption of taxes such as Income Tax, Wealth Tax, Municipal Taxes, etc. which are normally granted only to charitable entities. Other illustrations of breach of terms may be charging of higher fees than prescribed or payment of salaries to teachers at a rate lower than prescribed. All this could mean withdrawal of registrations/affiliations, which would effectively lead to ceasing of operations. There might be violation of laws which may not be as serious but may have limited financial impact, such as penalties for unauthorised constructions, non filing of tax returns, etc. Further, the internal auditor must check the statutory compliances under the *Service Tax, the Prevention of Food Adulteration Act & Rules, 1954, Shop & Establishment Acts, VAT Acts* in case of establishment of a canteen.

Internal Audit in an Information Technology Environment

5.18 According to Standard on Internal Audit (SIA) 14, "*Internal Audit in an Information Technology Environment"*, the overall objective and scope of an internal audit does not change in an information technology (IT) environment. However, the use of a computer changes the processing, storage, retrieval and communication of financial information and the interplay of processes, systems and control procedures which may affect the internal control systems employed by the entity. The internal auditor should consider the following aspects in an information technology environment:

(a) The extent to which the IT environment is used to record, compile, process and analyze information; and

(b) The system of internal control in existence in the entity with regard to:

- The flow of authorised, correct and complete data to the processing centre;

- The processing, analysis and reporting tasks undertaken in the installation; and

- The impact of computer based accounting system on the audit trail that could otherwise be expected to exist in an entirely manual system.

5.19 The internal auditor should obtain an understanding of the significance and complexity of the IT activities and the availability of the data for use in the internal audit. This understanding would include such matters as:

(a) The information technology infrastructure [hardware, operating systems and application software, etc.] used by the entity including changes, if any, therein since last audit.

(b) The significance and complexity of computerised processing in each significant application.

(c) Determination of the organisational structure of the client's IT activities and the extent of concentration or distribution of computer processing throughout the entity, particularly as they may affect segregation of duties.

(d) Determination of the availability of data, source documents, and computer files.

5.20 The internal auditor should obtain an understanding of the IT environment and whether it influences the assessment of inherent and control risks. The internal auditor should evaluate the reliability of the internal control systems. The internal auditor should review whether the information technology system in the institution considers the confidentiality, effectiveness, integrity, availability, compliance and validity of data and information processed. The internal auditor should also review the effectiveness and safeguarding of IT resources, including people, applications, facilities and data. The internal auditor should review the robustness of the IT environment and consider any weakness or deficiency in the design and operation of any IT control within the institution, by reviewing various reports generated, physical access records, logical access controls, application controls, IT Policy, etc. If the internal auditor is not able to rely on the effectiveness of the IT environment, he may perform such substantive testing or test of IT controls.

5.21 Information Technology systems may generate reports that might be useful in performing substantive tests (particularly, analytical procedures). The potential for use of computer assisted audit techniques may permit increased efficiency in the performance of internal audit procedures, or may enable the auditor to economically apply certain procedures to the entire population of transactions.

Internal Audit using Computer Assisted Audit Techniques (CAAT)

5.22 The major progress in the electronic data processing and a continuous development of range of internal auditing services have created a greater use of computers by the internal auditor to achieve his audit objectives more efficiently. Computers are useful where there is voluminous data and processing involved and statistical sampling is to be done. The tests which were previously performed manually by the internal auditor can now be done by the use of computer assisted audit techniques (CAAT). The computer assisted audit techniques help the internal auditor to improve the quality of audit as well as sharpen his capabilities to perform special reviews for management.

5.23 CAATs may be used in performing various auditing procedures, including the following:

(a) Tests of details of transactions and balances, for example, the use of audit for recalculating interest or the extraction of invoices over a certain value from computer records;

(b) Extract analytical reports and perform analytical procedures, for example, identifying inconsistencies or significant fluctuations;

(c) Tests of general controls, for example, testing the set up or configuration of the operating system or access procedures to the program libraries;

(d) Sampling programs to extract data for audit testing, data sorting and charting;

(e) Stratification of data - numeric, date, character;

(f) Tests of application controls, for example, testing the functioning of a programmed control;

(g) Re-performing calculations performed by the institution's accounting systems and confirmation of calculations;

(h) Use of macros;

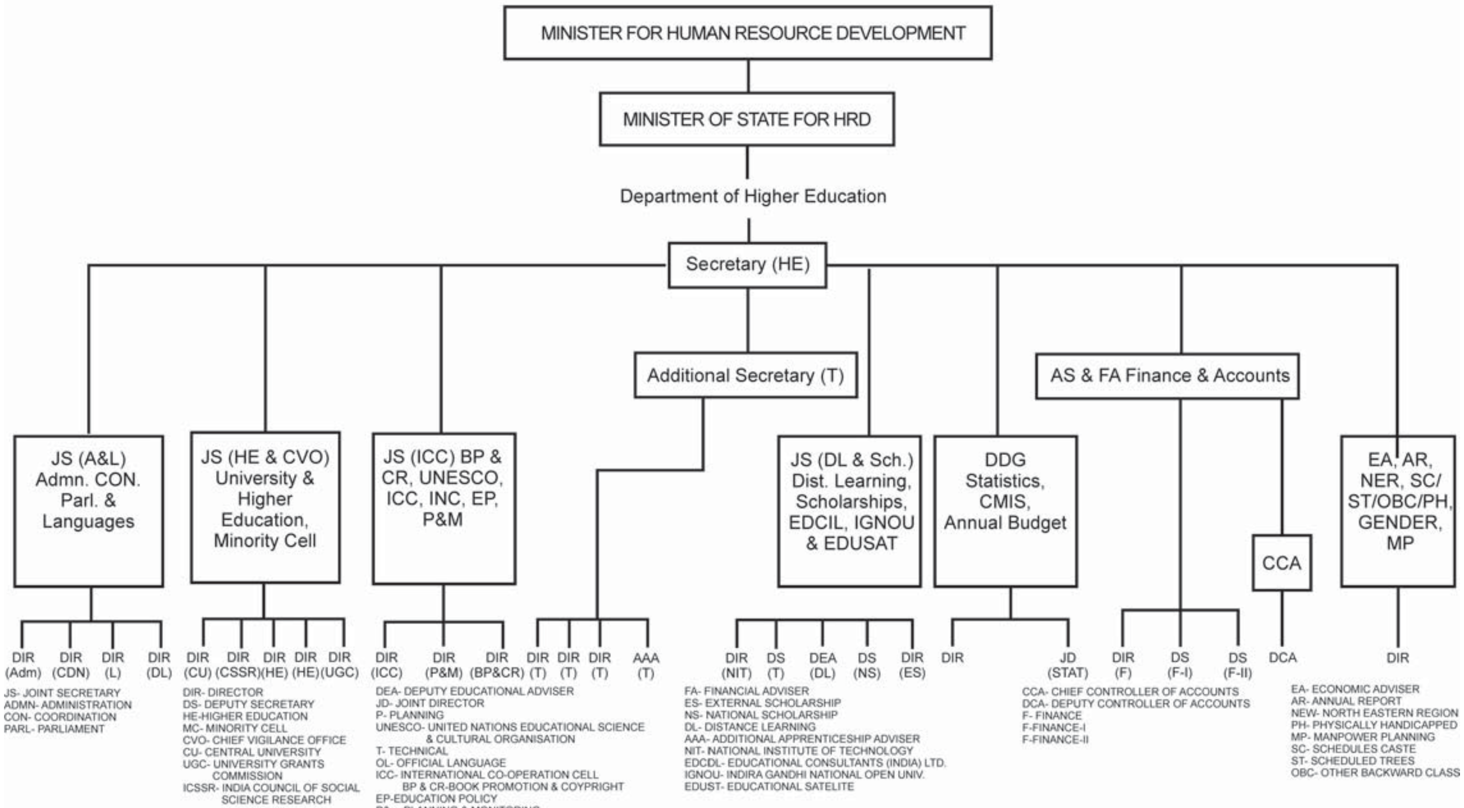
(i) Aging analysis;

(j) Detect duplicates and gaps;

(k) Compare files for variances; and

(l) Operate through a wide network of branches and departments, which are geographically dispersed.

Appendix 1
ORGANISATION CHART



Appendix 2

Application for Registration under the Foreign Contribution (Regulation) Act, 1976 for the Acceptance of Foreign Contribution

Form FC – 8
(see rule 3A)

Form of application for seeking registration with the Central Government under the Foreign Contribution (Regulation) Act, 1976 (hereinafter referred to as the Act) for the acceptance of foreign contribution by an Association having a definite cultural, economic, educational, religious or social programme

---

No : ______________________ Date :_________________

To

The Secretary to the Government of India,
Ministry of Home Affairs,
Jaisalmer House , 26 Man Singh Road
New Delhi – 110011.

Subject: Application for registration under the Foreign Contribution (Regulation) Act, 1976 for the acceptance of foreign contribution.

Sir,

I,____
on behalf on the Association named hereafter apply for registration of the Association under clause (a) of sub – section (1) of section 6 of the Act for the acceptance of foreign contribution.

1 (i) Name of the Association and its complete postal address :

Name

Address

Town / City

District

State

Pin code

(ii) If the Association is a registered trust or Society please indicate its :

(a) registration number

(b) place of registration

(c) date of registration *(certified copy of the registration certificate to be attached).*

(iii) Nature of Association :

(a) religious ;

(b) cultural ;

(c) economic ;

(d) educational ;

(e) social ;

Note : If a religious Association, state whether (a) Hindu; (b) Sikh; (c) Muslim; (d) Christian; (e) Buddhist; (f) Others.

(iv) Please indicate :

(a) The main aim(s) and object(s) of the Association (enclose a copy of the Memorandum of Association and/ or the Articles of Association, if applicable);

(b) the main object(s) and definite programme(s) for which the foreign contribution is to be accepted/ utilised;

(v) Please furnish the names and addresses of the members of the Executive Committee/ Governing Council etc. of the Association, including the Chief Functionary in the following manner

Sl. No	Name	Name of Husband	Nationality	Occupation	Office held in the Associ-ation, on if any	Relationship with office bearers, if any.	Address
1.	2.	3.	4.	5.	6.	7.	8.

2 Please indicate whether any member of the Executive Committee/ Governing Council etc. of the Association, including the Chief Functionary has in the discharge of his /her official function :

(a) been convicted by any court of law;

(b) a prosecution for any offence pending against him/ her;

(c) been found guilty of diversion or misutilisation of funds of the Association or any other association in the past.

3 Please indicate whether the applicant Association is a branch/ unit/ associate of foreign based organisation or another association already registered under the Act. If so, the name and address of the parent organisation.

4 Please indicate:

(i) whether the Association was:

(a) granted prior permission to receive foreign contribution under the Act in the past. If so, the number and date of the letter granting prior permission should be furnished;

(b) whether the account of the receipt and utilisation of the foreign contribution received above was sent to the Central Government in the prescribed form. If so, the date of submission of the accounts should be furnished;

(ii) whether the:

(a) Association has received foreign contribution without the prior permission under Act in the past. If so, full particulars of the foreign contribution received along with complete address of the bank branch and bank account number in which deposited should be furnished;

(b) Said violation has been condoned by the Central Government;

(c) Association has been prohibited from accepting foreign contribution under the Act.

5\. Please indicate whether the Association is functioning as editor, owner, printer or publisher of a publication required to be registered as "newspaper" under the Press and Registration of Books Act, 1867. If so, the details thereof.

6 Please indicate:

(i) whether the Association ever applied for registration under the Foreign Contribution (Regulation) Act, 1976, if so:

(a) the date of submission of application for registration;

(b) the number and date of the last communication, if any, received from the Ministry;

(c) whether registration was refused;

(d) whether application for registration is still pending.

(ii) whether the Association has close links with another association, or its unit or branch which has been:

(a) refused registration under the Act;

(b) prohibited from accepting foreign contribution.

7 Please furnish :

(i) details of the activities of the Association during the past three years;

(ii) Copies of the audited statement of accounts of the Association for the past three years;

(iii) Details of the area(s) of operation.

8 Please indicate whether the Association has been specified as an organisation of a political nature, not being a political party under section 5 of the Act. If so, the details of the notification should be furnished.

9 Please indicate :

(i) the name and address of the branch of the bank through which the foreign contribution shall be received;

(ii) Please specify the account number in the said branch of the bank.

9A Whether a recommendation certificate from the competent authority is attached (Yes / No).

10 Any other information which the Association may like to furnish.

Yours Faithfully

(Chief Functionary)
for and on behalf of the Association
(Name of the Association)

Declaration and Undertaking

The Association named here-in-above affirms that the information furnished above is correct and under-takes:

(i) to inform the Central Government (Ministry of Home Affairs) within thirty days, if any, change takes place in regard to the name of the Association, its address, its registration, its nature, its aims and objects with documentary evidence effecting the change;

(ii) to obtain prior permission for change of office bearer(s), if, at any point of time such change causes replacement of 50% or more of the office bearers as were mentioned in the application for registration under the Foreign Contribution (Regulation) Act, 1976 and undertakes further not to accept any foreign contribution except with prior permission till the permission to replace the office-bearer(s) has been granted;

(iii) not to change the bank or branch of the bank without prior permission of the Central Government. The reasons for change of bank or branch of the bank shall have to be relevant and justifiable; and

(iv) not to accept any foreign contribution unless it has obtained either the registration number, as applied for here in above, or prior permission of the Central Government under sub–section (1A) of section 6 of the Foreign Contribution (Regulation) Act, 1976.

(Chief Functionary)
for and on behalf of the Association
(Name of the Association)

Note:

(i) The receipt of application for registration is not a commitment for grant of registration by the Central Government;

(ii) An incomplete application i.e., without the required document/ details /explanations is likely to be rejected summarily;

(iii) In case of the space provided against any column is insufficient separate sheets should be attached; and

Please use **CAPITAL** letters.

CERTIFICATE

This is to certify that ________________________ (name of the association) having its registered office at ____________________ (address) has been engaged in economic, educational, cultural, religious and social activities in the _________________ (district) of ________________ (state) for last _________ years.

2. It has undertaken welfare activities in the area and has incurred expenditure (excluding administrative expenditure) amounting to ____________________ (Amount in Rupees) during the last three years on its chosen ______________ (Economic, Educational, Cultural, Religious and Social) field of activity.

3, The antecedents of the organisation have been verified and there is nothing adverse against them.

4. Grant of registration to aforesaid association to accept foreign contribution under the Foreign Contribution (Regulation) Act, 1976 is recommended.

(Recommending Authority)**
(With seal)

* strike out whichever is not applicable

** any concerned

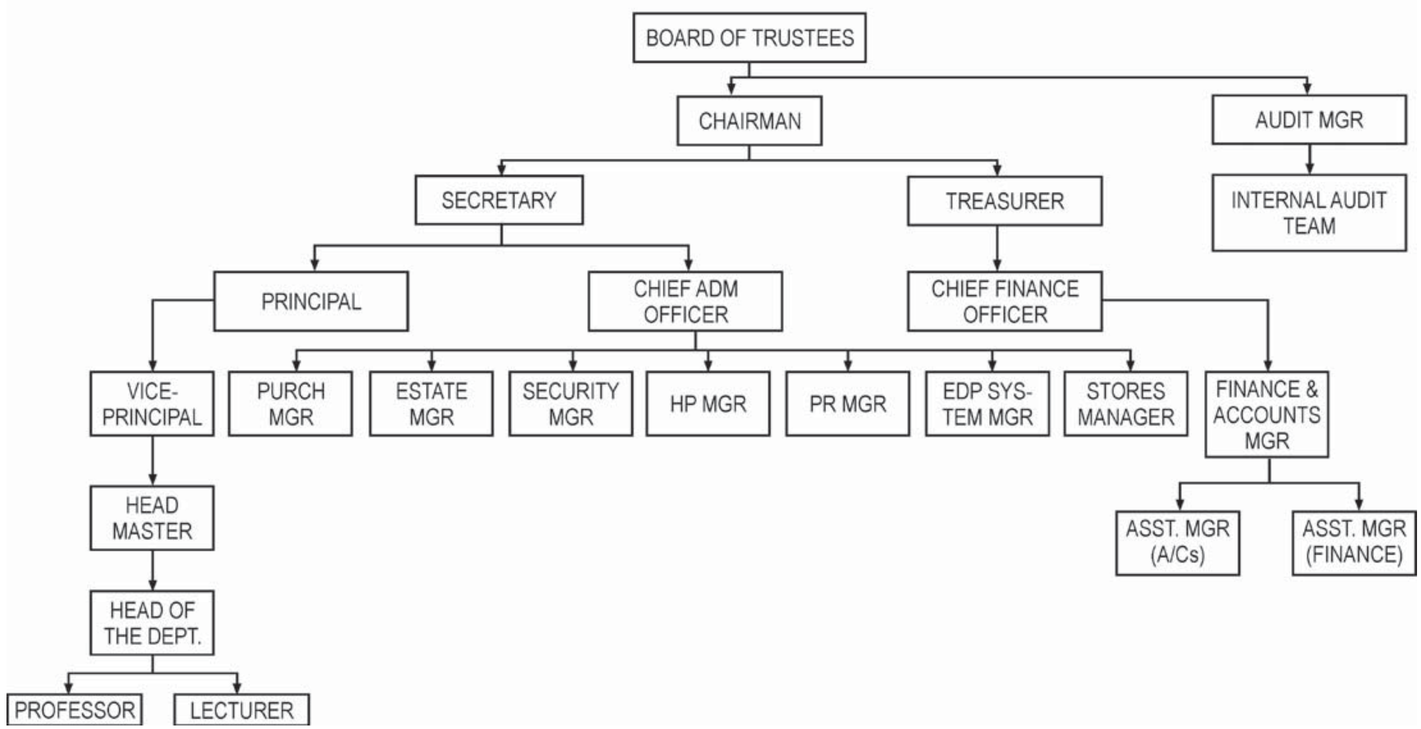
(1) Collector of District

(2) Department of State Concerned

(3) Ministry or Department of the Government of India*

Appendix 3

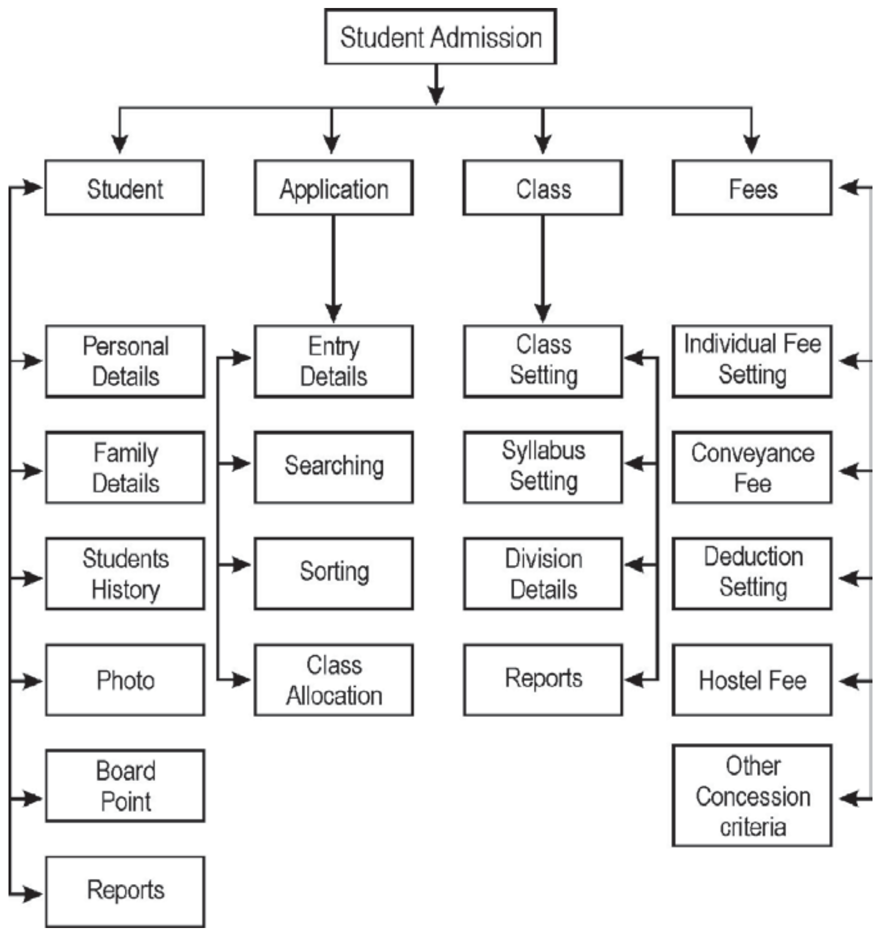
Organisation Structure of an Educational Institution



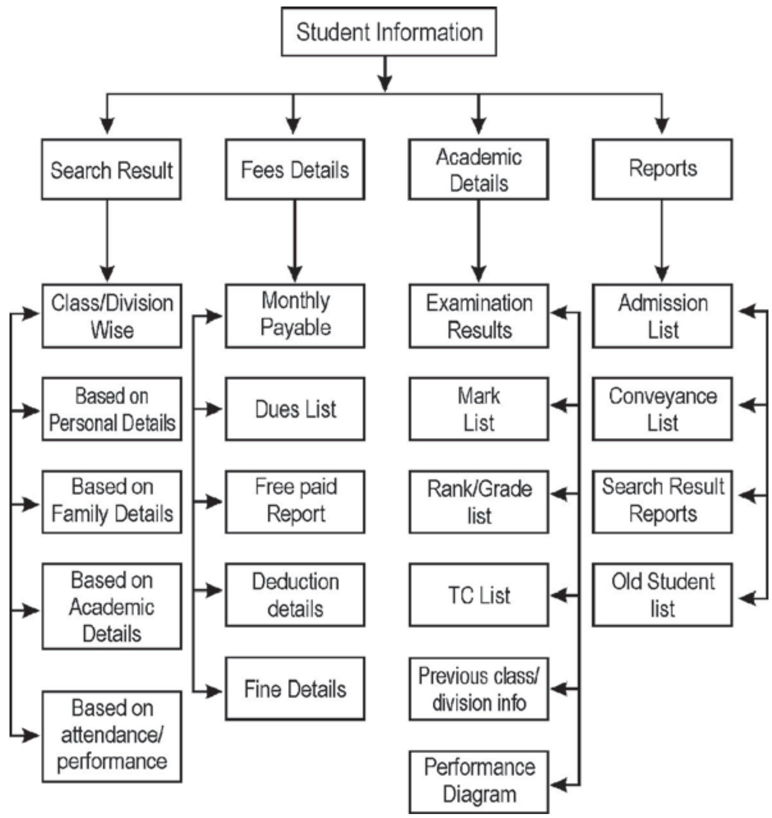
Appendix 4

Modules of Management Information System in an Educational Institution

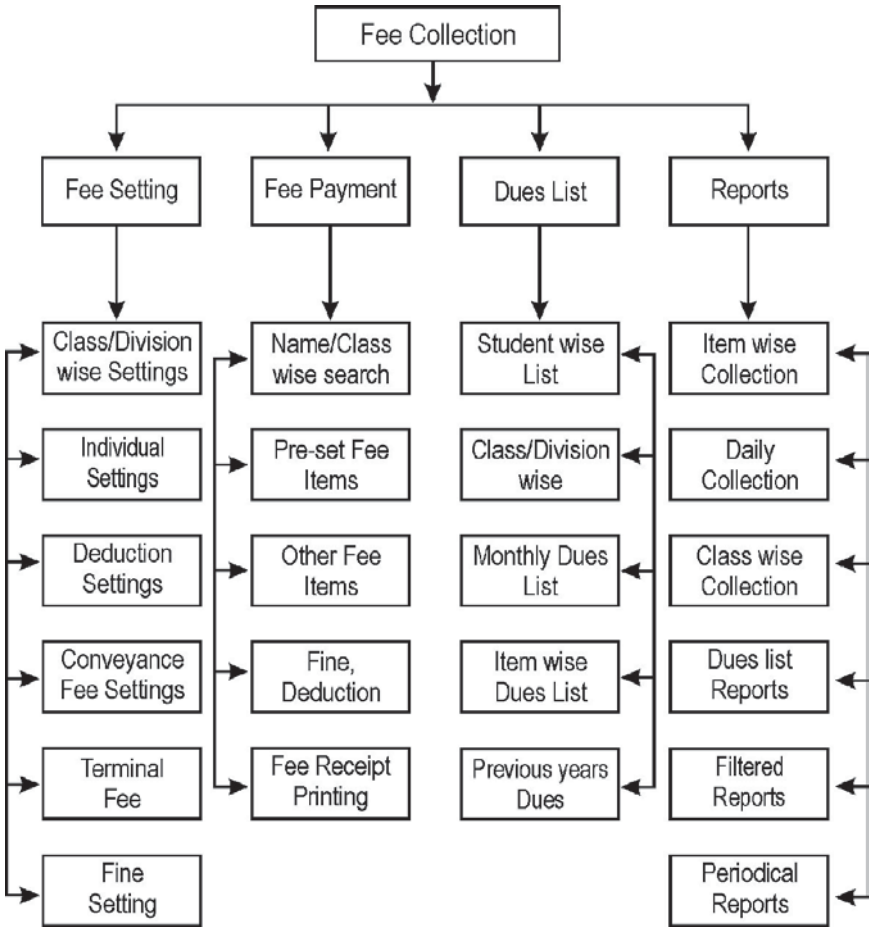
Student Admission System



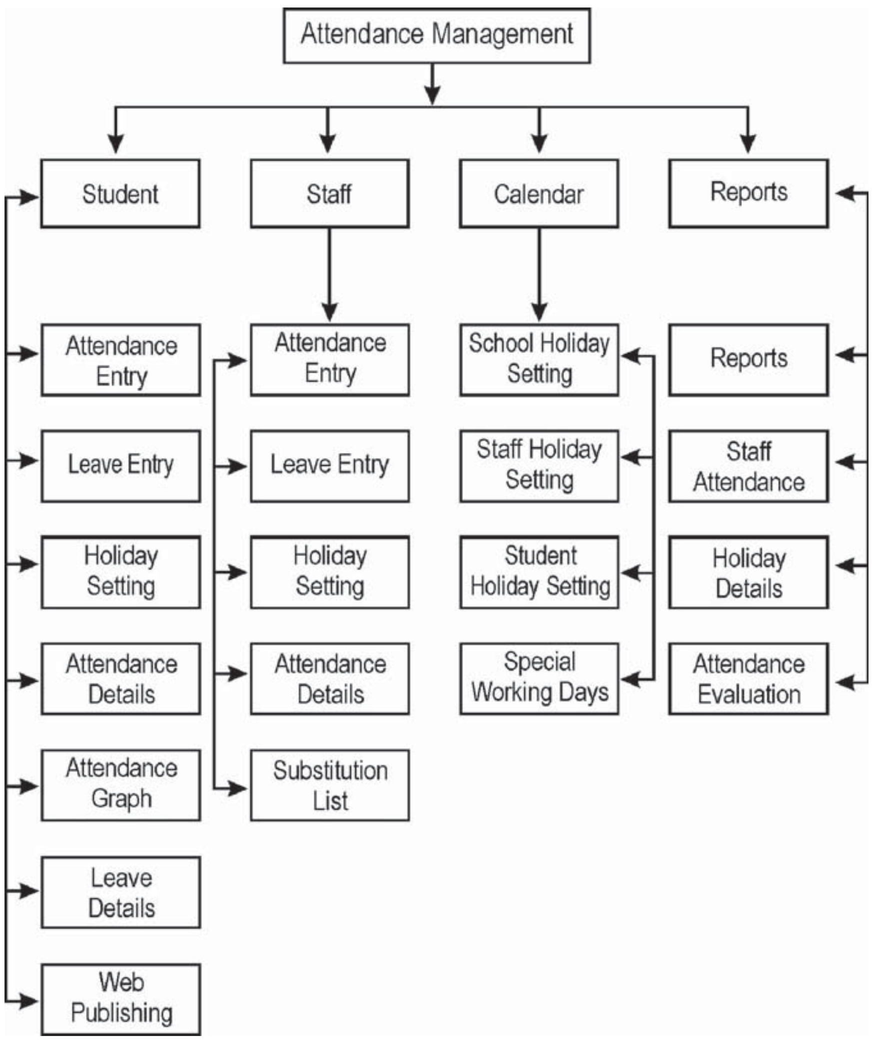
Student Information System



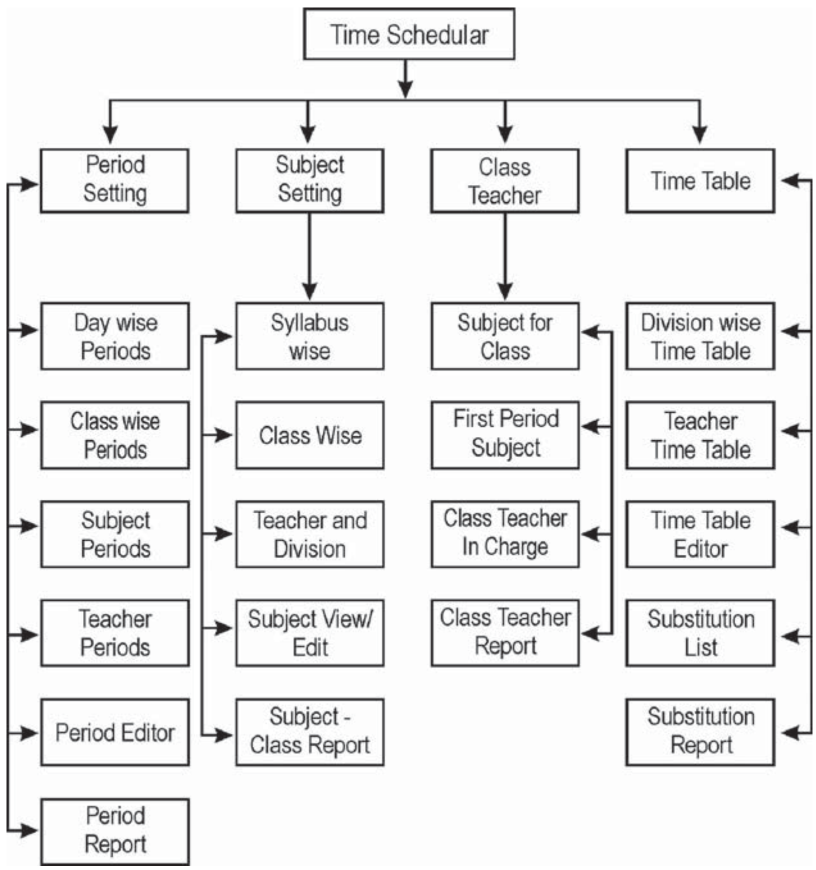
Student Fee Management System



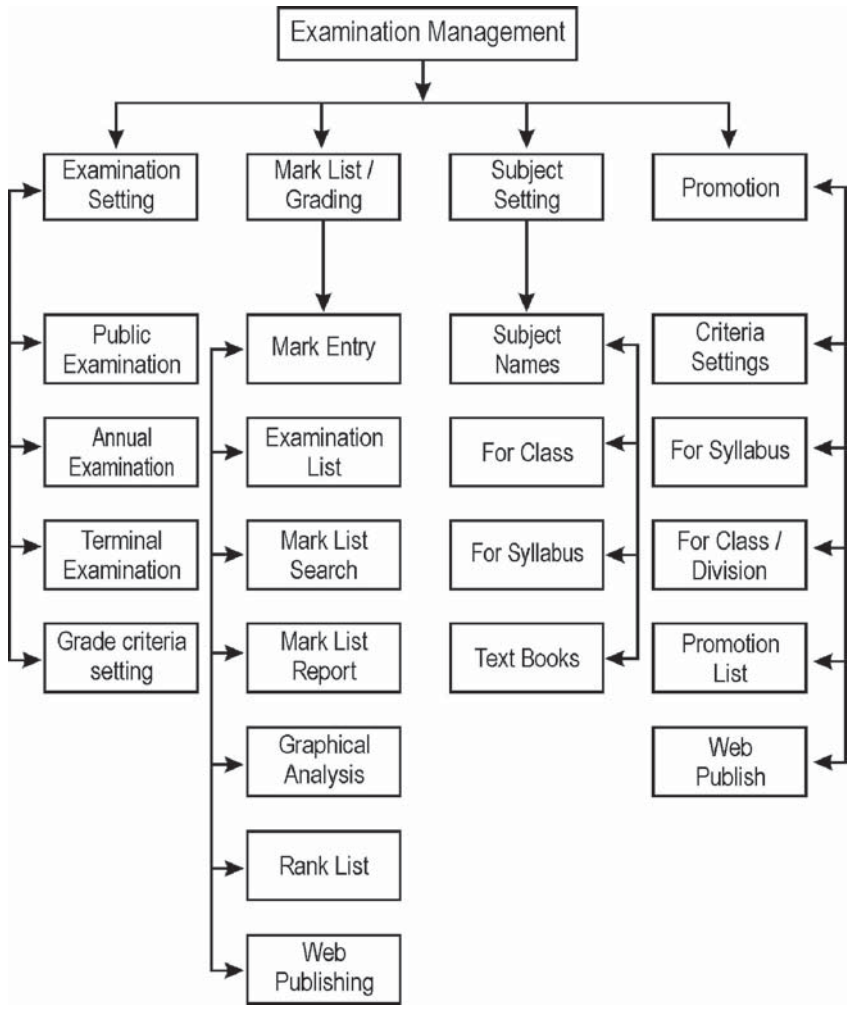
Attendance Management System



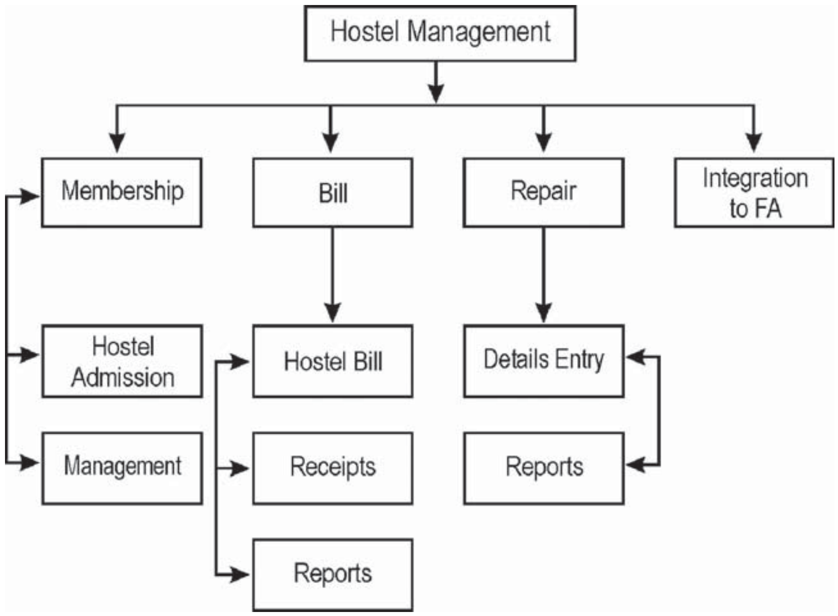
Time Table Generation System



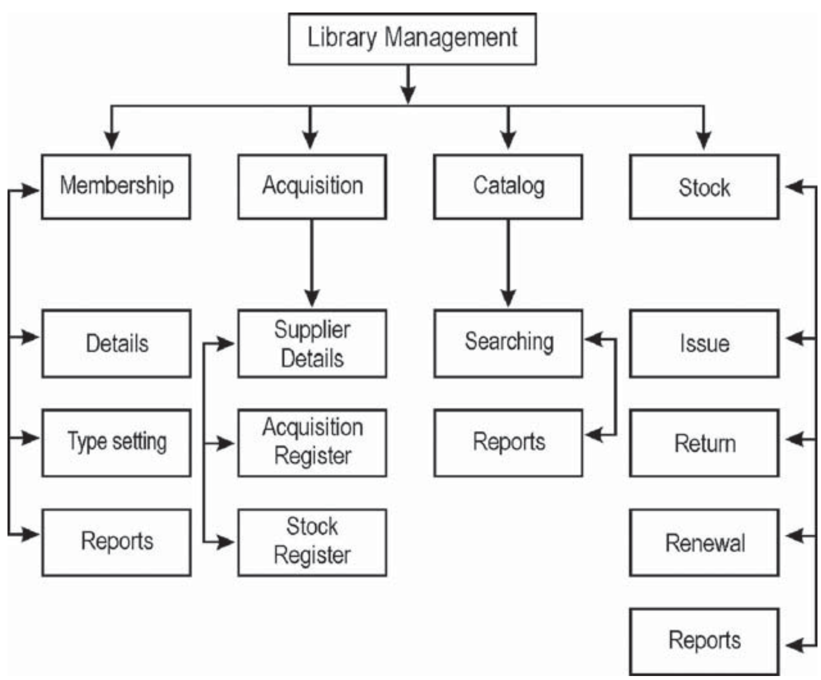
Examination Management & Result Analysis System



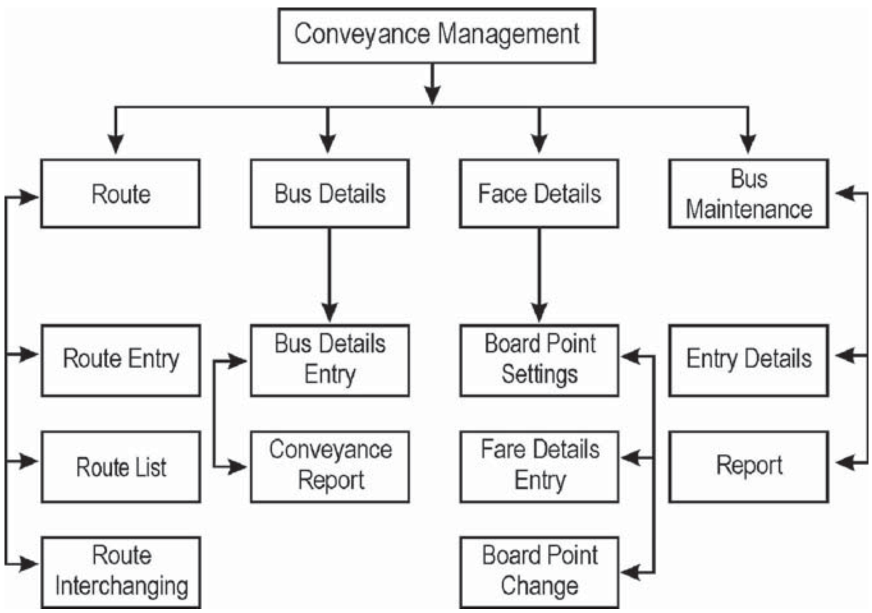
Hostel Management System



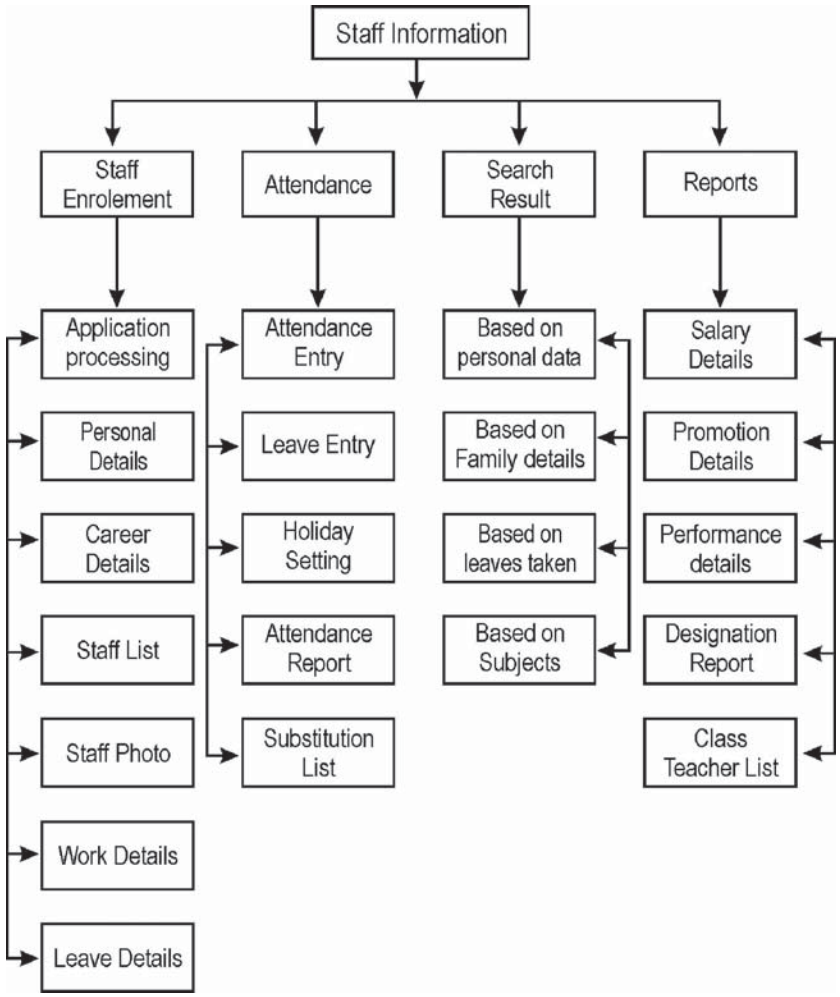
Library Management and Automation System



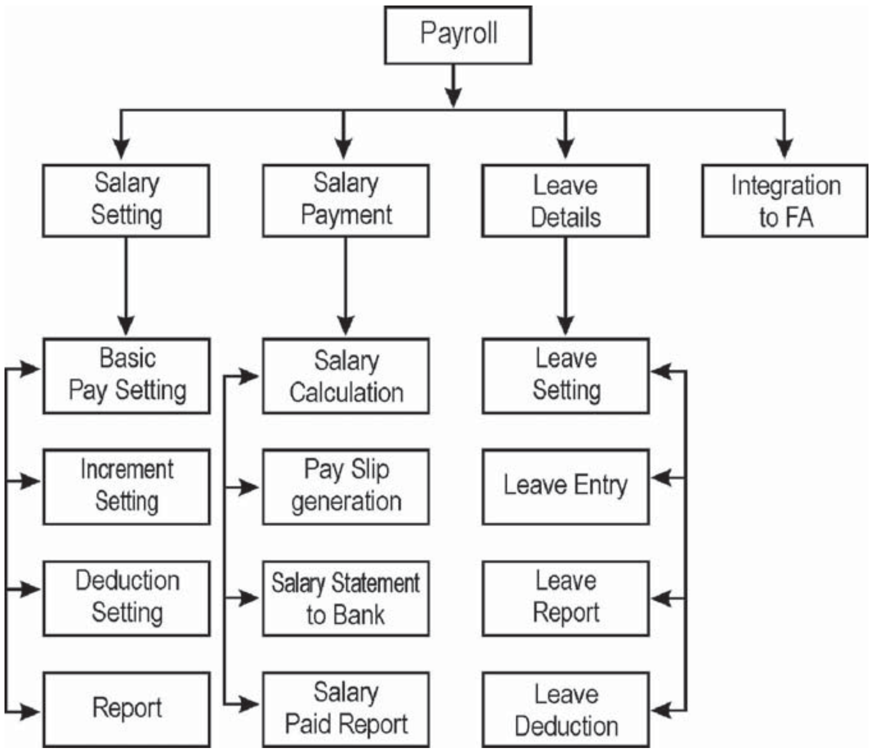
Conveyance Management System



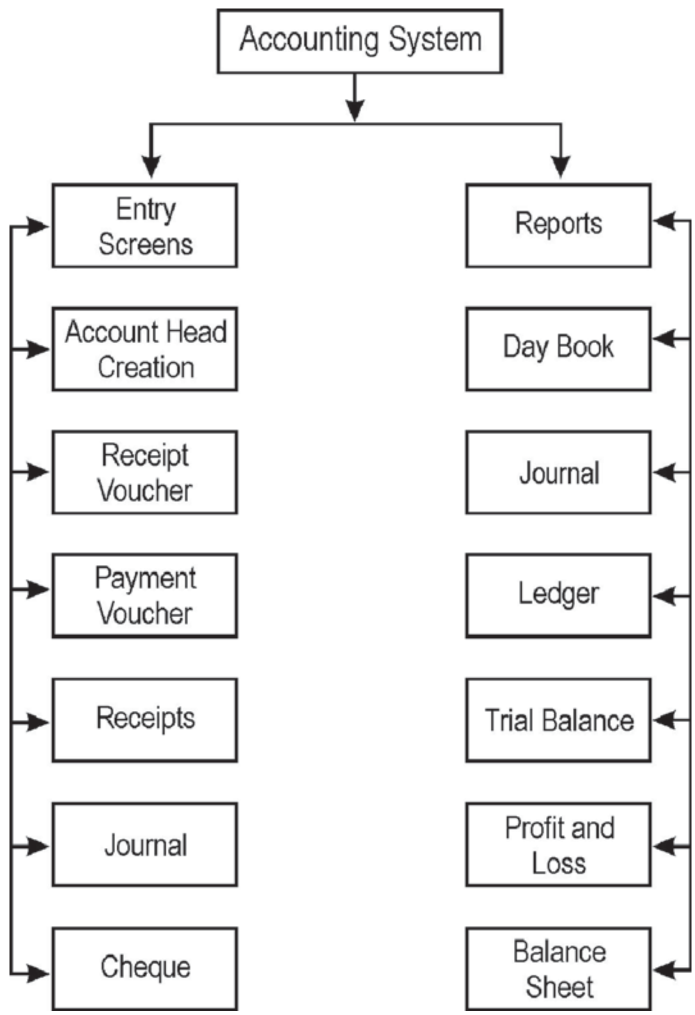
Staff Information System



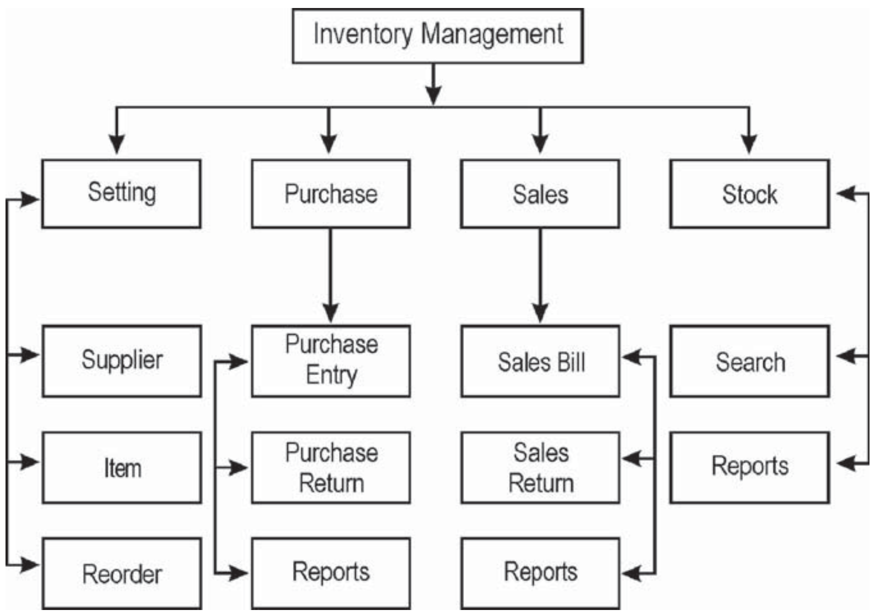
Payroll Management System



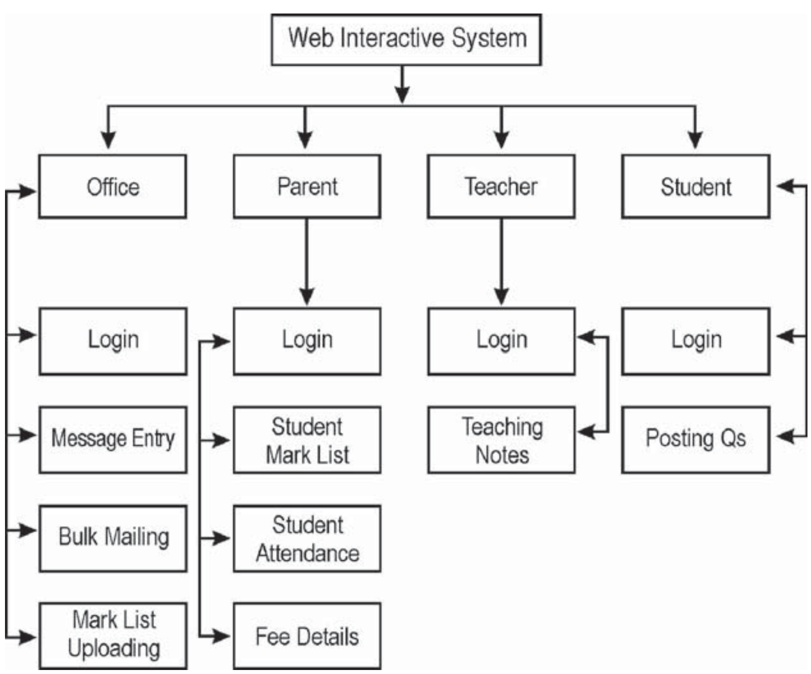
Financial Accounting System



Inventory Management System



Web Management System



Appendix 5

Reporting Format under Bombay Trust Rules, 1951

Report of an auditor relating to accounts audited under sub – section (2) of section 33 & 34 and rule 19 of the Bombay Public Trusts Act.

Registration No. ____________________

Name of the Public Trust ____________________________________

For the year ending____________________

(a) Whether accounts are maintained regularly and in accordance with the provisions of the Act and the rules;

(b) Whether the receipts and disbursements are properly and correctly shown in the accounts;

(c) Whether the cash balance and vouchers in the custody of the manager or the trustee on the date of audit were in agreement with the accounts;

(d) Whether all the books, deeds, accounts, vouchers or other documents or records required by the auditor were produced before him;

(e) Whether a register of movable and immovable properties is properly maintained, the changes therein are communicated from time to time to the regional office, and the defects and inaccuracies mentioned in the previous audit report have been duly complied with;

(f) Whether the manager or trustee or any other person required by the auditor to appear before him did so and furnished the necessary information required by him;

(g) Whether any property or funds of the trust were applied for any object or purpose other than the object or purpose of the trust;

(h) The amounts of outstandings for more than one year and the amounts written off, if any;

(i) Whether tenders were invited for repairs or construction involving expenditure exceeding Rs. 5,000/-;

(j) Whether any money of the public trust has been invested contrary to the provisions of section 35;

(k) Alienation, if any, of the immovable property contrary to the provisions of Section 36 which have come to the notice of the auditor;

(l) All cases of irregular, illegal or improper expenditure or failure or omission to recover monies or other property belonging to the public trust or of loss or waste of money or other property thereof, and whether such expenditure, failure, omission, loss or waste was caused in consequence of breach of trust or misapplication or any other misconduct on the part of the trustees or any other person while in the management of the trust;

(m) Whether the budget has been filed in the form provided by rule 16 A;

(n) Whether the maximum and minimum number of the trustees is maintained;

(o) Whether the meetings are held regularly as provided in such instrument;

(p) Whether the minute books of the proceedings of the meeting is maintained;

(q) Whether any of the trustees has any interest in the investment of the trust;

(r) Whether any of the trustees is a debtor or creditor of the trust;

(s) Whether the irregularities pointed out by the auditors in the accounts of the previous year have been duly complied with by the trustees during the period of audit;

(t) Any special matter which the auditor may think fit or necessary to bring to the notice of the Deputy or Assistant Charity Commissioner.

____

Chartered Accountants

Dated at: _______________ Auditors

The Bombay Public Trusts Act, 1950

SCHEDULE - IX C

(*Vide* Rule 32)

Statement of income liable to contribution for the year ending 31st March___________

Name of Public Trust: ___________________________________

Registered No. ______________________

			Amount Rs
I.	Income as shown in the Income and Expenditure Accounts (Schedule IX)		
II.	Items not chargeable to Contribution under Section 58 and Rules 32 :		
	(i)	Donations received from other Public Trusts and Dharmadas	
	(ii)	Grants received from Government and Local authorities	
	(iii)	Interest on Sinking or Depreciation Fund	
	(iv)	Amount spent for the purpose of secular education	
	(v)	Amount spent for the purpose of medical relief	
	(vi)	Amount spent for the purpose of veterinary treatment of animals	
	(vii)	Expenditure incurred from donations for relief of distress caused by scarcity, drought, flood, fire, or other natural calamity	
	(viii)	Deductions out of income from lands used for agricultural purposes: -	
		(a) Land Revenue and Local Fund Cess	

(b) Rent payable to superior landlord	
(c) Cost of production, if lands are cultivated by trust	
(ix) Deductions out of income from lands used for non- agricultural purposes:-	
(a) Assessment, cesses and other Government or Municipal Taxes	
(b) Ground rent payable to the superior landlord	
(c) Insurance premia	
(d) Repairs at 10 percent of gross rent of building	
(e) Cost of collection at 4 per cent of gross rent of buildings let out	
(x) Cost of collection of income or receipts from securities, stocks, etc. at 1 per cent of such income	
(xi) Deductions of accounts of repairs in respect of building not rented and yielding no income, at 10 per cent of the estimated gross annual rent	
Gross Annual Income chargeable to contribution Rs. Amount / Rs.	

Certified that while claiming deductions admissible under the above Schedule, the Trust has not claimed any amount twice, either wholly or partly, against any of the items mentioned in the Schedule, which have the effect of double-deduction.

____

Chartered Accountant

Dated: ________________ ____________________

Trustee

Trust Address:

Appendix 6

Form Yearly Account of Foreign Contribution Received and Utilised

Form FC-3

[See rule 4(a)]

To

The Secretary to the Government of India,
Ministry of Home Affairs, Jaisalmer House,
26, Mansingh Road, New Delhi – 110011

Account of Foreign Contribution for the year ending on 31st March_______

1. Associations details:

   (i) Name and address (in Capital Letters):

   (ii) Registration number and date [under the Foreign Contribution (Regulation) Act, 1976]:

   (iii) Prior permission number and date, if not registered:

   (iv) Nature of association: (1) Cultural (2) Economic (3) Educational (4) Religious (5) Social

   (v) Denomination in case of religious association: (a) Hindu (b) Sikh (c) Muslim (d) Christian (e)Buddhist (f) Others

1A (i) Total amount of foreign contribution received during the year:

   (ii) Interest earned on the foreign contribution during the year -

      (a) In the designated bank account:

      (b) On investments made (Fixed Deposit Receipt etc.) during the year or in the preceding years:

2. Purpose(s) for which foreign contribution has been received and utilised:

(in rupees)

S.No.	Purpose	Previous balance		Receipt during the year					Utilised		Balance	
				As 1st Recipient		As 2nd / Sub-sequent Recipient						
		In Cash	In Kind (Value)	In Cash	In Kind (Value)	In Cash	In Kind (Value)	Total	In Cash	In Kind (Value)	In Cash	In Kind (Value)
1.	2.	3.	4.	5.	6.	7.	8.	9.(5+6+7+8)	10.	11.	12.	13.

1. Celebration of national events (Independence/ Republic day)/ festivals etc.
2. Theatre/ Films.
3. Maintenance of places of historical and cultural importance.
4. Preservation of ancient/ tribal art forms.
5. Research.
6. Cultural shows.
7. Setting up and running handicraft centre/ cottage and Khadi industry/ social forestry projects.
8. Animal husbandry projects.
9. Income generation projects/ schemes.
10. Micro-finance projects, including setting up banking co-operatives and self-help groups.
11. Agricultural activity.
12. Rural Development.
13. Construction and maintenance of school/ college.

14. Construction and running of hostel for poor students.
15. Grant of stipend/ scholarship/ assistance in cash and kind to poor/ deserving children.
16. Purchase and supply of educational material – books, notebooks etc.
17. Conducting adult literacy programs.
18. Education/ Schools for the mentally challenged.
19. Non-formal education projects/ coaching classes.
20. Construction/ Repair/ Maintenance of places of worship.
21. Religious schools/ education of priests and preachers.
22. Publication and distribution of religious literature.
23. Religious functions.
24. Maintenance of priests/ preachers/ other religious functionaries.
25. Construction/ Running of hospital/ dispensary/ clinic.
26. Construction of community halls etc.
27. Construction and Management of old age home.
28. Welfare of the aged/ widows.
29. Construction and Management of Orphanage.
30. Welfare of the orphans.
31. Construction and Management of dharamshala/ shelter.
32. Holding of free medical/ health/ family welfare/ immunisation camps.

33. Supply of free medicine, and medical aid, including hearing aids, visual aids, family planning aids etc.
34. Provision of aids such as Tricycles, calipers etc. to the handicapped.
35. Treatment/ Rehabilitation of persons suffering from leprosy.
36. Treatment/ Rehabilitation of drug addicts.
37. Welfare/ Empowerment of women.
38. Welfare of children.
39. Provision of free clothing/ food to the poor, needy and destitute.
40. Relief/ Rehabilitation of victims of natural calamities.
41. Help to the victims of riots/ other disturbances.
42. Digging of bore wells.
43. Sanitation including community toilets etc.
44. Vocational training – tailoring, motor repairs, computers etc.
45. Awareness Camp/ Seminar/ Workshop/ Meeting/ Conference.
46. Providing free legal aid/ Running legal aid centre.
47. Holding sports meet.
48. Awareness about Acquired Immune Deficiency Syndrome (AIDS)/ Treatment and rehabilitation of persons affected by AIDS.
49. Welfare of the physically and mentally challenged.
50. Welfare of the Scheduled Castes.

51. Welfare of the Scheduled Tribes.
52. Welfare of the Other Backward Classes.
53. Environmental programs.
54. Survey for socio-economic and other welfare programs.
55. Establishment expenses -
    - (i) Asset building:
        - (a) Establishment of Corpus Fund, and
        - (b) Purchase of land
    - (ii) Construction/ Extension/ Maintenance of office, administrative and other buildings salaries/ honorarium
    - (iii) Publication of newsletter/ literature/ books etc
    - (iv) Other expenses
56. Activities other than those mentioned above (Furnish details).

Total

Caution: Submission of false information or concealment of material facts shall attract the relevant provisions of the Foreign Contribution (Regulation) Act, 1976, warranting appropriate action.

3. Name and address of the designated branch of the bank and account number (as specified in the application for registration/ prior permission or permitted by the Central Government).

A/c No:

Bank:

Branch:

Address:

4. Donor wise receipt of foreign contribution:

(in rupees)

Sl. No.	Institutional/individual/ other donors	Names(s) and address(es)	Purpose(s)	Date and month of receipt	Amount
1.	2.	3.	4.	5.	6.
(i)	Institutional donors				
(ii)	Individual donors above Rupees one lakh				
(iii)	Individual donors below Rupees one lakh (Only Column 4 and 6 need to be filled)				
	Total				

5. Country wise receipt of foreign contribution:

(in rupees)

Sl. No.	Name of the country	Amount
1.	2.	3.
Total		

Declaration

I hereby declare that the above particulars furnished by me are true and correct. I also affirm that the foreign contribution has been utilised for the purpose(s) for which the association has been registered / prior permission obtained, to the best of my knowledge. I have not concealed or suppressed any fact.

Signature of the Chief Functionary
(Name of the Chief Functionary
and Seal of the Association)

Place:

Date:

(Certificate to be given by Chartered Accountant)

I/We have audited the account of ________________________________

____

(name of association and its full address including State, District and Pin Code, if registered society, its registration number and State of registration) for the year ending 31st March____________ and examined all relevant books and vouchers and certify that according to the audited account:

(i) the brought forward foreign contribution at the beginning of the year was Rs _______;

(ii) foreign contribution of/worth Rs_________ was received by the Association during the year ________;

(iii) the balance of unutilised foreign contribution with the Association at the end of the year________ was Rs _________________;

(iv) Certified that the Association has maintained the accounts of foreign contribution and records relating thereto in the manner specified in Section 13 of the Foreign Contribution (Regulation) Act, 1976 read with sub-rule (1) of rule 8 of the Foreign Contribution (Regulation) Rules, 1976.

(v) The information is this certificate and in the enclosed Balance Sheet and Statement of Receipt and Payment is correct as checked by me/us.

Signature of Chartered Accountant
With Seal, Address and
Registration number.

Place:

Date:

(Notified in the Gazette of India Extraordinary vide GSR 557(E) dated 26th July 2001)

Appendix 7

Calculation of Application of Income for Charitable Purposes

For the Year ended March 31, 200X

		Amount (in Rs.)
<u>**Receipt of Income**</u>		
Gross Income as per Income and Expenditure Account	XXX	
Add: Income directly credited to Funds in Balance Sheet	XXX	
Add: Proceeds from Sale of Fixed Assets	XXX	
Less: Expenses incurred to earn income referred above	XXX	
Income for the year ended March 31, 200X	XXX	
Less: Amount set apart u/s 11(1)(a) i.e. 15%	XXX	
Amount required to be spent (A)		XXX
<u>**Application of Income**</u>		
Total expenses as per Income and Expenditure Account	XXX	
Add: Utilisation of amount lying in the Funds, which have not been routed through Income and Expenditure Account	XXX	
Add: Additions as per Fixed Assets Schedule	XXX	
Application of income for the year ended March 31, 200X (B)		XXX
Shortfall in Application (A-B)		XXX

Details of Surplus/(Deficit)

Assessment Year	Total Income	Less: 15% of Income	Net amount required to be spent	Application of Income		Surplus/ (Deficit) before depreciation		Depreciation	Surplus/(Deficit) after depreciation	
				For Revenue purposes	For Capital purposes	(in Rs.)	(as %)		(in Rs.)	(as %)
2008-2009										
2007-2008										
2006-2007										
2005-2006										
2004-2005										
2003-2004										

Appendix 8

Sample Analytical Ratios in an Education Institution

A. Financial Ratios

Per-Student related Ratios

(i)	Total Receipts per Student	$= \dfrac{\text{Total Receipt}}{\text{Average No. of Students}}$
(ii)	Tuttion fees per Student	$= \dfrac{\text{Tuition fees}}{\text{Average No. of Students}}$
(iii)	Education Expenses per Student	$= \dfrac{\text{Education Expenses}}{\text{Average No. of Students}}$
(iv)	Mess Expenses per Boarder	$= \dfrac{\text{Mess Expenses}}{\text{Average No. of Boarders}}$
(v)	Transportation fees per Student	$= \dfrac{\text{Transportation Fees}}{\text{Average No. of Students}}$
(vi)	Area of Hostel per Boarders	$= \dfrac{\text{Area of Hostel}}{\text{Average No. of Boarders}}$

B. Non-Financial Ratios

Staff Norms

(i)	Student Teacher Ratio (for Theory Lecture Class)	$= \dfrac{\text{No. of Students}}{\text{No. of Teachers}}$	
	As per AICTE Guidelines	=	60 times
(ii)	Student Teacher Ratio (for Tutorials)	$= \dfrac{\text{No. of Students}}{\text{No. of Teachers}}$	
	As per AICTE Guidelines	=	20 times

(iii) Student Teacher Ratio (for Lab. Practical/ Workshop/ Drawing) $= \frac{\text{No. of Students}}{\text{No. of Teachers}}$

As per AICTE Guidelines = 15 times

(iv) StudentTeacher Ratio (for Project Work) $= \frac{\text{No. of Students}}{\text{No. of Teachers}}$

As per AICTE Guidelines = 9 times

(v) Non-Teaching Staff/ Teaching Staff Ratio $= \frac{\text{No. of Non-teaching Staff}}{\text{No. of Teaching Staff}}$

As per AICTE Guidelines = 3 times

Infrastructure Norms

(i) Plinth to Carpet Area $= \frac{\text{Plinth Area}}{\text{Carpet Area}}$

As per AICTE Guidelines = 1.4 times

(ii) Classroom Carpet Area per student $= \frac{\text{Carpet Area of Classroom}}{\text{No. of Students}}$

As per AICTE Guidelines

Minimum = *1.30 sq. mts.*

Desirable = *1.50 sq. mts.*

(iii) Drawing/Examination Hall Carpet Area per student $= \dfrac{\text{Carpet Area of Drawing/ Examination Hall}}{\text{No. of Students}}$

As per AICTE Guidelines

Minimum = *2.50 sq. mts.*

Desirable = *2.50 sq. mts.*

(iv) Laboratories Carpet Area per student $= \dfrac{\text{Carpet Area of Laboratories}}{\text{No. of Students}}$

As per AICTE Guidelines

Minimum = *2.50 sq. mts.*

Desirable = *2.50 sq. mts.*

(v) Workshop Carpet Area per student $= \dfrac{\text{Carpet Area of Workshop}}{\text{No. of Students}}$

As per AICTE Guidelines = *2.50 sq. mts.*

(vi) Library Carpet Area per student $= \dfrac{\text{Carpet Area of Library}}{\text{No. of Students}}$

As per AICTE Guidelines = *1.67 sq. mts.*

Appendix 9

Sample Internal Control Checklist

An Illustrative Checklist Covering Aspects Important to Functioning of Educational Institutions

S.No.	Particulars	Remarks
1	***General***	
1.1	Obtain and document an understanding of the internal controls present in the organisation.	
1.2	Obtain and document an understanding of whether the internal controls present in the organisation have been effective throughout the year.	
1.3	Are there any significant changes to internal control?	
1.4	If yes, obtain the evidence about the nature and extent of any changes and consider the significance and impact of changes.	
1.5	Perform additional tests of controls and assess risk.	
1.6	Obtain and document an understanding of any department's separately maintained records if they are of a significant amount and outside the normal transaction cycle.	
2	***Control Environment***	
2.1	Review the following documents: ➢ Mission/vision statement of the organisation ➢ Strategic planning documents ➢ Manual for policies and procedures ➢ Organisational chart ➢ Current delegations of authority ➢ Recent job descriptions for key managerial personnel ➢ Training records for key employees and listing of training programs ➢ Performance targets	

S.No.	Particulars	Remarks
	➢ Chart of funds ➢ Management reports ➢ Business continuity plans ➢ List of key contacts for major activities	
2.2	Are there any significant changes in the operations of the organisation during the last year (for example, turnover in key managerial personnel, new developments in information systems, changes to policies and procedures, etc.)?	
2.3	Are all key managerial personnel, faculty and staff members familiar with the policies, finance and accounting guidelines and procedures, and other relevant operating and compliance requirements?	
2.4	Does the management express the importance of integrity and ethical values including the statement of core values to all the faculty and staff members and do they follow the code of ethics?	
2.5	Does the management express the importance of good communication, collaboration, and team effort?	
2.6	Has the management established a mission statement, set goals, and developed plans to meet its objectives?	
2.7	Are all goals and plans periodically assessed?	
2.8	Does the management prepare performance targets?	
2.9	Are the prepared performance targets realistic and attainable?	
2.10	Are the performance targets periodically assessed?	
2.11	Do all the faculty members understand the organisational structure and lines of authority?	
2.12	Is there proper segregation of duties in all departments of the Institution?	
2.13	Are all transactions approved by the appropriate level of management as per Institution's policy?	
3	***Governance/ Performance Review***	
3.1	Do the executive management in each department perform a regular review of academic and administrative	

S.No.	Particulars	Remarks
	resource inputs and outputs to ensure intended quality and value for money is obtained?	
4	***Conflict of Interest***	
4.1	Is there formal policy of not purchasing goods or services from vendors where there is a personal interest?	
4.2	Does the institution ensure that no staff member supervises or controls the work of a close relative in accordance with institution's policy regarding nepotism?	
4.3	Does the institution inform employees of the conflict of interest implications of receiving gifts personally from vendors?	
5	***Reconciliations***	
5.1	Are all financial reports prepared on a periodic basis and reviewed by management?	
5.2	Are all significant accounts (in quantum or sensitivity) reconciled to supporting documentation and from external confirmations on a periodic basis?	
6	***Budget Status/Detail Activity Reports***	
6.1	Does the Financial manager review monthly reconciliation in sufficient detail to assure himself of the reasonableness and appropriateness of the income and expenses reported?	
6.2	Is the budget status/detail activity reports reconciled at least monthly by an individual who is adequately knowledgeable of institution's policies and ideally who does not - ➢ Have access to cash or checks, ➢ Make purchases, or ➢ Authorise payments.	
6.3	Is comparison of source documents to detail activity reports, including personnel and operating expenses made?	
6.4	Identify transactions not yet recorded in the budget status/detail activity report to determine current funds available.	

S.No.	Particulars	Remarks
7	***Information Technology***	
7.1	Does the institution take back up of critical information on a regular, periodic basis and store the back up media off-site?	
7.2	Is computer virus protection software on every machine installed and updated on a regular, periodic basis?	
7.3	Are appropriate licenses for each installation of a software package obtained?	
7.4	Is system access necessary for employees to perform required job duties granted to them?	
7.5	Does the system access ensure separate incompatible functions of custody, recordkeeping, and authorisation?	
7.6	Are passwords used to protect access to systems and applications?	
7.7	Are passwords changed frequently, at minimum every 90 days or when password has been compromised?	
7.8	Is there a prohibition of sharing of passwords?	
7.9	Is there a policy of logging off the system prior to leaving your workstation or utilise password protected screen savers with workstations that are logged in and unattended?	
7.10	Is the system access for terminated employees removed promptly?	
8	***Record Retention***	
8.1	Are all departmental financial records, including all reports, reconciliations and supporting transaction documentation retained for the required number of years in accordance with institution's policy?	
8.2	Are institutions' policies and procedures for record retention followed?	
8.3	Are departmental records stored in a secured area?	
9	***Physical Access Controls***	
9.1	Are keys controlled to allow employees access to only the areas required to perform their job duties?	

S.No.	Particulars	Remarks
9.2	Are locks changed if terminating employees do not return keys?	
9.3	Are combinations and pass codes changed when employees with access terminate employment or when the combinations and pass codes have been compromised?	
10	***Signature Authority***	
10.1	Is signature authority delegated only to the supervisory level?	
10.2	Is every person prohibited from authorising his/her own payroll, procurement, travel reimbursement, or requisition documents?	
10.3	Are delegations of signature authority, including limitations of scope and duration documented?	
10.4	Determine which employees are authorised to sign- ➢ Payroll documents, ➢ Procurement documents, ➢ Travel reimbursements, and ➢ Material and supply requisitions.	
10.5	Is list of the department's authorised signers maintained and periodically updated?	
10.6	Do all employees with signature authority understand their responsibility?	
11	***Fixed Assets***	
11.1	Are all purchases of fixed assets made in accordance with institution's policy?	
11.2	Is there a proper utilisation of appropriate account codes for Fixed Assets purchases? ➢ Capital expense account codes for Fixed Assets with a useful life of more than one year. ➢ Operating expense account codes for non-capital Fixed Assets with a useful life of more than one year.	
11.3	Are all Fixed Assets tagged with a permanent and easily visible Institution's property tag?	

S.No.	Particulars	Remarks
11.4	Are all Non-capital Fixed Assets tagged at the department's request, particularly items that are vulnerable to theft or misappropriation, e.g., computer equipment, audio-visual equipment, cameras, etc.	
11.5	Are all moveable equipment secured to prevent theft or misappropriation?	
11.6	Is annual inventory of all fixed assets performed?	
11.7	Is document in writing equipment removed from campus by employees, maintained acknowledging receipt and responsibility for return of the equipment?	
11.8	Are all fixed assets lost or stolen notified to the Fixed Assets Manager?	
11.9	Are all obsolete fixed assets disposed of in accordance with institution policy?	
11.10	Document the transfer of custody of equipment when fixed assets are moved into or out of your unit.	
12	***Procurement***	
12.1	Are all purchases - ➢ Properly authorised, ➢ Sufficiently documented, and ➢ Appropriate for institution purposes.	
12.2	Are competitive prices for purchases obtained, where applicable?	
12.3	Follow Purchasing policies and procedures for procuring goods and services *via*- ➢ Obtain Purchase Order for goods and services ➢ Obtain Quotations for goods or services ➢ Direct Pay for small purchases ➢ Petty Cash Reimbursement for expenses incurred on behalf of the institution by an employee.	
13	***Safeguarding of Assets***	
13.1	Are all assets purchased by the department- ➢ Safeguarded ➢ Reviewed to ensure proper insurance cover is maintained.	

S.No.	Particulars	Remarks
14	***Independent Contractors***	
14.1	Is the Human Resources director contacted before hiring the services of any individual?	
14.2	Is Personal Services Contract purchase order made for independent contractors?	
14.3	Are Human Resources procedures followed to employ individuals who do not meet the criteria for an independent contractor?	
15	***Cash Handling (Including Cheques and Credit Card Payments)***	
15.1	Are there separate duties of preparing invoices from collecting cash?	
15.2	Do the supervisors monitor employees who handle cash?	
15.3	Is there a method to secure cash and checks received at all times?	
15.4	Does the institution provide pre-numbered receipts to all remitters of cash?	
15.5	Is there a prohibition of payments from funds collected?	
15.6	Does the person-in-charge deposit all cash daily at Billings & Collections?	
15.7	Is there a creation of following supporting documentation of cash collected- ➢ Copy checks. ➢ Maintain a cash receipt log with name of payer, amount, and purpose of payment.	
15.8	Is cash received reconciled daily (cashier closeout) by- ➢ Dual count cash in the presence of the individual who collected the cash and another independent individual. ➢ Ensure that the change fund is intact (if applicable). ➢ Account for all pre-numbered receipts. ➢ Prepare a reconciliation worksheet signed by both the counters that details the cash received, change fund, and pre-numbered receipts used.	

S.No.	Particulars	Remarks
15.9	Are deposits reconciled to the monthly budget status/ detail activity reports by - ➢ Compare source documents—check copies, cash receipt log, reconciliation worksheet, and billings & collections deposit receipt—to the deposits recorded in the detail activity report. ➢ Investigate immediately any differences noted during reconciliation. ➢ Monitor over/short trends.	
15.10	Is there rotation of duties among other staff?	
16	***Personnel/ Payroll***	
16.1	Does the Financial manager review labor distribution reports following each payroll to ensure that individuals and amounts listed are correct?	
16.2	Are all Human Resources procedures relating to employment followed before committing to hire an individual?	
16.3	Are references checked and education of candidates verified prior to offering employment?	
16.4	Are the duties of hiring, terminating, and approving promotions separate from preparing and submitting time records.	
16.5	Are confidential personnel and payroll records, especially those containing names, social security numbers, and dates of birth documented and secured?	
16.6	Is Pre-approval of overtime in writing in accordance with institution's policy obtained?	
16.7	Are actual hours worked and actual leave taken reported? ➢ Approval of hours worked for employees by having both the employee and the supervisor best able to verify the hours worked sign the time card. ➢ Approval of leave taken by employees by having both the employee and the supervisor sign the leave request.	

S.No.	Particulars	Remarks
16.8	Are time records to Payroll delivered in a sealed envelope?	
16.9	For terminating employees, does the institution - ➢ Notify Human Resources to remove the employee from payroll. ➢ Notify the appropriate person to remove computer system access. ➢ Collect keys and other access devices. ➢ Change combinations or pass codes used by the employee. ➢ Account for all institution's assets assigned to the employee.	
17	***Donations/Gifts***	
17.1	Is the appropriate authority notified when monetary and non-monetary gifts are received or anticipated?	
18	***Entertainment***	
18.1	Are only guests external to the institution entertained for business purposes, in accordance with institution's policy?	
18.2	Are the documentation of all entertainment expenses maintained in accordance with the - ➢ Name and title of person with authority to incur and assuming responsibility for the expense, ➢ Nature of the activity and business purpose, ➢ Names, official titles, and affiliations of all persons for whom the expenses are incurred, and Original itemised receipts.	
19	***Travel***	
19.1	Are all required travel authorisation obtained for out-of-state travel from the traveler's supervisory authority prior to committing any funds?	
19.2	Are all Travel Expense Vouchers submitted for all reimbursable expenses in accordance with institution policy?	
19.3	Are all traveling reimbursement authorised with signatures of the traveler, financial manager, and supervisory authority?	

I-7
TECHNICAL GUIDE ON INTERNAL AUDIT OF BPO INDUSTRY

Foreword

Outsourcing is a management process in the globalised business environment that has been tried and tested by many successful organisations across the world. The competitive pressures arising from the emergence of a 'boundaryless' economy, have spurred the faith in the process – as a means for providing significant cost savings, flexibility and improved operational performance. During the last decade, India has seen a steady growth of BPO sector, which is constantly witnessing changes driven by its key participants – service providers, clients, employees, external stakeholders and the Government.

This unique sector faces complexity of processes which give rise to a spectrum of strategic and operational risks. With sound domain knowledge, good analytical skills, and process understanding, chartered accountants would be able to plug into the position of the internal auditor of BPO industry. Apart from operational aspects, internal auditors can also play an important role in governance, risk and compliance aspects, which are essential to ensure that the BPO industry remains on the growth path.

I am happy to note that the Internal Audit Standards Board has brought this Technical Guide on Internal Audit of BPO Industry. This publication is aimed to equip the internal auditors with deeper understanding of this unique and complex industry. I congratulate CA. Rajkumar S. Adukia, Chairman, Internal Audit Standards Board and the members of the Board on the issuance of this Technical Guide.

It is my sincere hope that this publication would further strengthen the skills of our members as an internal auditor of BPO industry.

July 5, 2010 **CA. Amarjit Chopra**
New Delhi *President, ICAI*

Preface

Due to the open market and the demand for outsourcing, more and more BPO companies in India are setting up bases in various parts of the country. Most of these organisations cater to the global MNCs, banks and so on. The business process outsourcing sector is one of the booming industries in the country. The uniqueness of BPO sector gives rise to many critical parameters of operational excellence such as, shift utilisation, productivity, support costs, span of control, human resource management, etc.

Further, with the BPO industry of India entering into a phase of maturity, a significant change in the nature of opportunities and challenges is being witnessed. Concerns and solutions are no longer the same as they used to be. Internal audit is a service which can immensely help the industry to overcome the challenges and increase value. Keeping this in view, the Internal Audit Standards Board is issuing this "Technical Guide on Internal Audit of BPO Industry". This publication is an attempt to provide a consistent and comprehensive coverage of all the aspects of the BPO industry.

This publication has been divided into six chapters. Chapter 1 of the Guide deals with the objective and scope of the Guide. Chapter 2 of the Guide explains the evolution, history, special features and business processes of the industry. This chapter also provides guidance regarding the initiatives taken by the government, challenges faced by the entities and typical business process undertaken by the BPO industry. Chapter 3 explains the legal framework applicable to the industry. Chapter 4 provides guidance on the statutory laws applicable to the industry. Chapter 5 of the guide covers the methodology for the internal audit for the BPO industry as well as the internal audit in an information technology environment. This chapter also describes the procedures to overview the compliance of laws and regulations. Chapter 6 covers the detailed procedures to be undertaken by the internal auditor in respect of invoicing, payroll, operating costs, fixed assets, related party transactions, data security and risks faced by the industry. Appendix includes flow charts regarding various processes undertaken by industry. The Guide also contains glossary of the terms and abbreviations used in the BPO industry for providing valuable guidance to the readers.

At this juncture, I am grateful to CA. M. Guruprasad and his study group members, for sharing their experiences and knowledge with us and preparing the draft of the Guide.

I also wish to thank CA. Amarjit Chopra, President and CA. G. Ramaswamy, Vice President for their continuous support and encouragement to the initiatives of the Board. I must also thank my colleagues from the Council at the Internal Audit Standards Board, *viz.,* CA. Naveen N. D. Gupta, CA. Nilesh Vikamsey, CA. Atul C. Bheda, CA. K. Raghu, CA. J. Venkateswarlu, CA. Abhijit Bandyopadhyay, CA. Ravindra Holani, CA. Charanjot Singh Nanda, Shri K. P. Sasidharan, Shri Prithvi Haldea and Shri Sidharth Birla for their vision and support. I also wish to place on record my gratitude for the coopted members on the Board, *viz.,* CA. Sushil Gupta, CA. Smita Satish Gune, CA. Nagesh Dinkar Pinge, CA. Sumant Chadha and CA. Deepak Wadhawan as also special invitees on the Board for their devotion in terms of time as well as views and opinions to the cause of the professional development. I also appreciate efforts put in by CA. Jyoti Singh, Secretary, Internal Audit Standards Board and her team of officers, *viz.,* CA. Arti Aggarwal and CA. Gurpreet Singh, Senior Executive Officers, for their inputs in giving final shape to the publication.

I am confident that this publication would help the readers in understanding the emerging issues of the BPO sector.

July 5, 2010
Mumbai

CA. Rajkumar S. Adukia
Chairman
Internal Audit Standards Board

Abbreviations

ACD	Automatic Call Distributor
ACW	After Call Work
AHT	Average Handling Time
ASA	Average Speed of Answer
ASSOCHAM	Associated Chambers of Commerce and Industry of India
ATA	American Teleservices Association
BFSI	Banking, Financial Service and Insurance
BI	Business Intelligence
BOA	Board of Approval
BOSS	Burn Out Stress Syndrome
BPIAI	Business Process Industry Association of India
BPO	Business Process Outsourcing
BTP	Biotechnology Park
CBDT	Central Board of Direct Tax
CBPOP	Centre for BPO Professionals
CED	Countervailing Excise Duty
CLI	Calling Line Identification
CRM	Customer Relationship Management
CSR	Customer Service Representative

CTI	Computer Telephony Integration
DTA	Domestic Traffic Area
EHTP	Electronic Hardware Technology Park
EOU	Export Oriented Undertaking
EPZ	Export Processing Zone
FCR	First Call Resolution
FDCPA	Fair Debt Collection Practice Act
FDI	Foreign Direct Investment
FEMA	Foreign Exchange Management Act
FIRC	Foreign Inward Remittance Certificate
FTE	Full Time Equivalent
FTP	Foreign Trade Policy
GOI	Government of India
HBP V1	Handbook of Procedures (Vol 1)
HIPAA	Healthcare Insurance Portability and Accountability Act
HRO	Human Resource Outsourcing
IMTIA	Indian Medical Transcription Industry Association
ITES	Information Technology Enabled Services
ITSQC	IT Services Qualification Centre
IVR	Integrated/ Interactive Voice Response
KPI	Key Performance Indicators

KPO	Knowledge Process Outsourcing
LoI	Letter of Intent
LoP	Letter of Permit
LPO	Legal Process Outsourcing
MBPO	Medical Business Process Outsourcing
NASSCOM	National Association of Software and Service Companies
NTP	National Telecom Policy
OTTS	Outsourcing Through
PABX	Private Automatic Branch Exchange
PTP	Per Transaction Price
RPO	Recruitment Process Outsourcing
SEZ	Special Economic Zone
SIA	Standards on Internal Audit
SIGITES	Special Interest Group for IT Enabled Services
SLA	Services Level Agreement
STPI	Software Technology Park of India
TCV	Total Contract Value
TPSP	Third Party Service Providers
UPS	Uninterrupted Power Supply
VOIP	Voice Over Internet Protocol
WOS	Wholly Owned Subsidiaries

Glossary

I. Basic Definitions

Back-Office	Part of most organisations where tasks dedicated to running the operations of the entity take place.
Billing Matrix	Summary of billing terms of all clients for whom services are rendered by the entity.
BPO Industry	It includes entities operating in India as BPO, KPO, LPO, RPO, HRO, MBPO, ESO, SCO, Procurement BPO, and all other forms of back-office operations outsourced either in entirety or partially, irrespective of services being rendered in India or outside India.
Business Process Outsourcing (BPO)	Business Process Outsourcing (BPO) is the transference and delegation of back-office business functions to outside vendors.
Call Centre	A centralised office used for the purpose of receiving and transmitting a large volume of requests by telephone.
Contact Centre	In addition to a call centre, collective handling of letters, faxes, live chats, and e-mails are also done at one location.
Contract	Includes Master Service Agreement, Service Level Agreement, Statement of Work, Purchase Order or such other official formal agreement entered by the entity with the client related to provision of service.
Engineering Services Outsourcing (ESO)	Outsourcing of all or part of the engineering processes to an external service provider.

Entity	Includes companies, partnership firms, limited liability partnerships, hindu undivided families and any other legal form under which business operates.
External Service Provider	An entity having any legal form providing outsourced services to a client in India or abroad.
Human Resource Outsourcing (HRO)	Outsourcing or transferring all or part of human resource management function of an entity to an external service provider.
Knowledge Process Outsourcing (KPO)	Knowledge Process Outsourcing (KPO) is the outsourcing of high-end business functions in an organization. These functions may include both core and non-core activities.
Legal Process Outsourcing (LPO)	Outsourcing legal support services of an outside law firm or legal support services entity to an external service provider.
Master Service Agreement (MSA)	A contract that states the responsibilities, rights and obligations of one party with another.
Medical Business Process Outsourcing (MBPO)	Outsourcing all or part of medical record documentation, patient client history, case history, etc., to an external service provider.
Multisourcing	Framework in which different parts of the client business are to be sourced from different external service providers.
Off-shoring	Outsourced business functions done in another country.
Outsourcing	Outsourcing is the process of sourcing 'from outside the purview of the firm', where an organization transfers ownership of a process to an external service provider. It

	includes Business Processing Outsourcing (BPO) too.
Procurement BPO	Outsourcing of all or part of the procurement activities to an external service provider.
Purchase Orders	A commercial document issued by a buyer to a seller, indicating types, quantities, and agreed prices for products or services the seller will provide to the buyer.
Recruitment Process Outsourcing (RPO)	Outsourcing or transferring all or part of recruitment activities to an external service provider.
Related Party	As defined in Standard on Auditing (SA) 550, "*Related Parties*": "Parties are considered to be related if at any time during the reporting period one party has the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions."
Related Party Transaction (RPT)	Any transaction with a related party.
Research Process Outsourcing (RPO)	Outsourcing of all or part of the research work to external service providers.
Service Level Agreement (SLA)	Performance objectives reached by consensus between the user and the provider of a service, or between an outsourcer and an organization.
Statement of Work (SOW)	A formal document that captures and defines the work activities, deliverables and timeline a vendor will execute against performance of specified work for a customer.

Supply Chain Outsourcing (SCO)	Outsourcing of all or part of activities related to supply chain management to an external service provider.
Wholly Owned Subsidiaries (WOS)	An Indian company which is a 100% subsidiary of a foreign company providing services only to its holding company. It is also termed as in- house or captive service provider.

II. Technical Terminologies used in the BPO Industry[1]

A) General Terminologies applicable for any BPO Industry are as follows:

Agent	The person who handles the call.
Agent Group	A group of agents that share a common set of skills, such as, being able to handle customer complaints. Also called Split, Gate, Queue or Skills Group.
Agent Status	The mode an agent is in (talk time, after-call work, unavailable, etc).
Base Staff	The minimum number of agents required to achieve service level and response time objectives for a given period of time. Seated agent calculations assume that agents will be in their seats for the entire period of time. Therefore, schedules need to add in extra people to accommodate breaks, absenteeism and other factors that will keep agents from the phones. Also called Seated Agents.

1 Some of the terms introduced here might not be used in the Technical Guide; however, it would be useful to know the meanings and usage of each of them.

Customer Relationship Management (CRM)	A process that records customer contacts and information to allow for an enhanced relation with the customer.
Customer Service Representative (CSR)	An alternative name for an agent.
Computer Telephony Integration (CTI)	A function that provides for the telephony and customer information to be aligned. This allows for such functions as screen popping.
Data Processing	Any Process that converts data from one form to another.
Error Rate	It is either the number of defective transactions or the number of defective steps in a transaction.
Escalation Plan	A plan that specifies actions to be taken when the queue begins to build beyond acceptable levels.
Full Time Equivalent (FTE)	An expression of staff numbers calculated on the number of hours a full time staff member would work. or A term used in scheduling and budgeting, whereby the number of scheduled hours is divided by the hours in a full work week. The hours of several part time agents may add up to one FTE.
Private Automatic Branch Exchange (PABX)	The switch which manages calls with an organization.
Roster	A schedule of time to be worked.
Scheduling Exception	When an agent is involved in an activity outside of the normal or planned schedule.

Scorecard	A group of performance indicators that reflect the operations of the centre.
Screen Monitoring	A system capability that enables a supervisor or manager to remotely monitor the activity on agents' computer terminals.
Supervisor	The person who has front-line responsibility for a group of agents. Typical ratios are one supervisor to every 10-15 agents. However, help desks can have one supervisor for every 5 people, and some reservations centres have one supervisor for every 30 or 40 agents. Generally, supervisors are equipped with special telephones and computer terminals that enable them to monitor agent activities.
Threshold	The point at which an action, change or process takes place.
Transmission Control Protocol/ Internet Protocol (TCP/ IP)	The protocols that govern the exchange of sequential data. TCP/ IP was designed by the U.S. Department of Defence to link dissimilar computers across many kinds of networks. It has since become a common standard for commercial equipments and applications.
Voice Processing	A blanket term that refers to any combination of voice processing technologies, including Voice Mail, Automated Attendant, Audiotex, Voice Response Unit (VRU) and Faxback.
Voice Over Internet Protocol (VOIP)	System that enables voice calls to be carried over a data network.

(B) Apart from the general terminologies mentioned above, there are many specific terminologies applicable to each entity. A few important ones which might be of importance to an internal auditor are discussed below:

Call Centre Operations

Average Handle Time (AHT)	The sum of the Average Talk Time and Average After-Call Work for a specified time period.
Busy Hour	A telephone traffic engineering term, referring to the hour of time in which a trunk group carries the most traffic during the day. The average busy hour reflects the average over a period of days, such as two weeks. Busy Hour has little use for incoming call centres, which require more specific resource calculation methodologies.
Call Demand	Estimated number of calls that are expected to be received by the centre.
Cost per Call	A measurement of the financial cost of each call, usually calculated by the centre costs being divided by the number of calls received.
Delay	The time a caller spends in queue, waiting for an agent to become available. Average Delay is the same thing as Average Speed of Answer. Also called Queue Time.
Help Desk	A term that generally refers to a call centre set up to handle queries about product installation, usage or problems. The term is most often used in the context of computer software and hardware support centres.
Service Level	The percentage of incoming calls that are answered within a specified threshold: "X% of calls answered in Y seconds". Also called Telephone Service Factor, or TSF.
Speech Recognition	The capability of a voice processing system to decipher spoken words and phrases.

Talk Time	The time an agent spends with a caller during a transaction. Includes everything from “hello” to “goodbye”.

Data Entry Operations

Archive	It is the process of storing information for an extended period of time.
Back-up	It is the method of making multiple copies of data or programs for use when the original data or program gets lost or ruined.
Data Preparation	It is the method of putting big amount of data into any computer system for additional dealing. For example: scanning and typing.
Direct Data Entry	It is the method of directly putting some data into any computer system for immediate dealing. The data is presented to the users right away unlike data preparation where it is used for later processing.
Data Capture	It is the procedure of assembling and putting data for utilisation in a computer. eg., scanning of bar codes and reading gas meter.
Data Verification	It is the method of having a check on the data which is transferred by comparing copies of data before and after transfer.
File Filter	It is the software which is used to convert data and information from one format to another.

Contents

Chapter 1
Introduction

1.1 Outsourcing, in general, refers to the sub-contracting of a service or a manufacturing activity to an external service provider. It involves the transfer of the management and/or day-to-day execution of an entire business function/process to an external service provider. In this technical guide, we limit our scope in dealing about the internal audit procedures to be performed by an internal auditor relating to the Indian BPO Industry. In other words internal audit procedures for outsourcing of manufacturing processes are not dealt with in this technical guide.

1.2 The Indian BPO industry is a young and nascent sector in India and has been in existence for a little more than a decade. Despite its recent arrival on the Indian scene, the industry has grown phenomenally and has now become a very important part of the export-oriented IT software and services environment. Indian companies are offering a variety of outsourced services ranging from customer care, transcription, billing services and database marketing to web sales/marketing, accounting, tax processing, transaction document management, telesales/telemarketing, HR hiring and biotech research.

Looking at the success of India's IT and BPO industry, the Central Government identified BPO as a key contributor to economic growth, prioritized the attraction of FDI in this segment by establishing 'Software Technology Parks' and 'Export Enterprise Zones'.

Objective and Scope of the Technical Guide

1.3 This technical guide is intended to assist internal auditors in carrying out internal audit of entities operating in the BPO sector. The management in concurrence with the internal auditor, taking into consideration various pronouncements of ICAI and other regulatory requirements, assessments of control environment and business domain knowledge, primarily decides the scope of the internal audit. This technical guide deals with the operational areas of entities operating in this industry with emphasis on compliance of various regulations as applicable to such types of entities.

1.4 Outsourcing is a bucket term which includes all types of outsourcing from *manufacturing process* to *business processes*. In this technical guide, we deal with the industry which deals with the outsourcing of business processes, which includes outsourcing of business processes, legal processes, knowledge and research processes, human resource management, etc.

BPO undertakes the following processes:

(a) Data processing

(b) Basic data entry

(c) Department outsourcing

(d) Provides technical support

(e) Provides e-mail support to its customers.

The dividing line between Knowledge Process Outsourcing (KPO) and BPO is very faded; some experts say that KPO is not different from BPO. Broadly, KPO is a subset of BPO. It just occupies the higher end of the BPO spectrum.

KPO unlike BPO is not just restricted to information technology. It specializes in various other challenging sectors namely business research, clinical research, intellectual property research, etc.

1.5 This Technical Guide has been divided into 6 parts -

Part I - Glossary

Part II - Introduction

Part III - Elaborates the scenario in the Indian BPO Industry and challenges faced by an entity operating in the Indian BPO Industry

Part IV - Legal framework for entities operating in the Indian BPO Industry and a reference to the statutory laws applicable to the BPO Industry

Part V - A Discussion on Internal Audit and compliance

Part VI - Major areas of internal audit significance, risks faced by an entity operating in this industry, procedures that the internal auditor should perform and checklist of important audit procedures

Part VII - Appendices.

This technical guide does not covers the following aspects:

(i) Internal audit of routine operations in finance and other areas/ functions of business in a BPO organisation;

(ii) Internal audit performed by the holding company on its subsidiary in India;

(iii) Special audits; and

(iv) Investigations.

Chapter 2
About The Indian BPO Industry

2.1 It is important for an internal auditor to gain an understanding of the Indian BPO industry, its evolution, initiatives from the Government, special features of the BPO Industry and the challenges faced by entities operating in the BPO Industry in order to understand the critical areas, nuances and knowledge of the business thereby helping him frame internal audit procedures to perform an efficient and effective internal audit.

Evolution

2.2 The current stage of evolution of outsourcing revolves around the strategy that outsourcing is not only for work which is not important for the organisation but also for high end value jobs. Consequently, more and more organizations are selecting outsourcing based on effective delivery model and concentrating on their core function or core commodity.

The idea of outsourcing has its roots in competitive advantage theory propagated by Adam Smith in his book 'The Wealth of Nations' published as early as 1776. However, over the years and centuries there has been a sea change in outsourcing.

History of the BPO Industry in India

2.3 Outsourcing has existed across the globe from historic days, both in trade and commerce and domestic work. But, the BPO Industry is relatively new to India. Though the Information Technology Industry existed in the early 1980s, the BPO Industry emerged during the mid 1990s. Despite its recent arrival on the Indian scene, the industry has grown phenomenally, and has now become a very important part of the export–oriented IT Software and services environment. It initially began as an activity confined to multinational companies, but today it has developed into a broad based business platform backed by leading Indian IT software and services organisations and other third party service providers.

The spectrum of services offered by Indian companies has evolved substantially from its humble beginnings. Today, Indian companies are offering a variety of outsourced services including customer care, medical billing services, web sales/ marketing, accounting, tax processing, transaction document management, etc.

2.4 The emergence of rural BPO in India is in boom. BPO industry has thrived all these years because of its ability to deliver services at a low cost. Increasing infrastructure costs, real estate costs, and salaries have raised BPO costs significantly and as a result Indian BPOs in Tier-1 cities are looking at Tier-2 and Tier-3 cities for operation. Few entrepreneurs who had a vision of bringing rural India into the mainstream of knowledge economy have found an opportunity–by setting rural BPOs. The transformation of rural India started with the emergence of these Rural BPOs.

Reasons Supporting Outsourcing

2.5 There are several reasons for organisations to outsource their work. To summarise a few illustrative reasons are as under:

(i) To achieve cost of economies in operating cost to improve focus on core activities and core commodities.

(ii) To gain access to better class capabilities and use the existing resources for functions which would create a business advantage.

(iii) To bridge the gap where the internal resources are insufficient and also sharing of risks with an outsourcing company.

(iv) There are other common reasons to outsource like, head count, strategy drives, space constraints, etc.

(v) Access to operational based practice that would be difficult to develop in-house.

(vi) To achieve a change in the quality through adherence of service level agreements.

(vii) Access to talent and sustainable supply of skilled resource.

However, the other most important factor that has enabled outsourcing is the advent of internet and e-commerce.

2.6 The outsourcing industry has given a new dimension for globalization and created a level playing field for commerce where all the competitors have equal opportunity ('The World is Flat' by Thomas L. Friedman). The global outsourcing operating model has resulted in mere shoring, no shoring and right shoring that reflects the change of mix of location. This is evident from organisations becoming global and setting up offices other than their home country, which has become a common phenomenon.

Initiatives by the Government

2.7 The Central Government has introduced various stimuli to the BPO industry including the liberalisation of National Telecom Policy (NTP), introduced in the year 1999 and with the deregulation of the Telecom Industry, it opened up national, long distance, and international connectivity to competition. The Governments of various States also provided assistance to companies to overcome the recruitment, retention, and training challenges, in order to attract investments to their region.

2.8 The National Association of Software and Service Companies (NASSCOM), a non-profit global trade body with over 1200 member companies in the business of software development, software services, software products, BPO industry, was set up in 1988 to encourage members to provide world-class products, services and solutions and to create brand equity for the Indian IT and BPO sector. NASSCOM has created platforms for the dissemination of knowledge and research in the industry through its surveys and conferences. NASSCOM acts as an advisor, consultant and coordinating body for the BPO industry and liaisons between the Central and State Government committees and the industry.

The Indian Story

2.9 The Indian outsourcing industry can be broadly categorised into two segments, as per NASSCOM, as in-house or captive centres and third party providers.

In the case of in-house or captive centres, outsourcing is done by an arm of the parent organisation. Business processes are located at low-cost and high skill offshore locations. In this approach, the central unit itself will take care of and enforce all the regulatory issues that the offshore centre is subject to, as this is just an extension of the business that happens to be located outside the country.

However, in the case of third-party outsourcing centres, the scenario is different. These organisations have to keep themselves compliant with the latest quality and technological regulations in order to stay competitive in the global marketplace.

2.10 The IT and ITES Industry has been a great success since globalisation of Indian economy during 1991. There has been continuous and consistent growth for a couple of decades and considering the Compounded Annual Growth Rate over the last decade, it has been the fastest growing industry in India.

The unprecedented growth can be justified to following factors:

- Economies in operating cost;
- Organisations can focus on core activities;
- Skilled manpower at affordable prices;
- Access to operational based practice that would be difficult to develop in-house; and
- World class technology at lower rates.

Special Features of the Indian BPO Industry

2.11 The BPO Industry is unique in certain aspects with respect to other industries. These can be broadly be classified as follows:

(a) *Business Process Related*

The business of an entity operating in a BPO Industry has certain unique characteristics like risks, nuances, etc.

(b) *Client Contract and Billing*

Unlike many other industries, the contract and billing process are unique. This industry is relatively more organised.

(c) *Employee Related*

The employee related area in a BPO Industry is usually complex and poses major challenges. This is the one of the most important area to ensure control for long run growth to the industry considering that the industry is labour intensive in nature.

(d) *Economic Conditions*

The BPO Industry operates on a global basis. The impact of global economic changes has a significant impact on the industry.

(e) *Electronic Environment and Data Security*

Most BPO processes involve Information Technology and thereby resulting in significant data security and control issues.

2.12 It is, therefore, extremely important for the internal auditor to understand these special features for conducting the internal audit of the entity. These abovementioned special features have been discussed in detail below:

(a) Business Process Related

(i) The risks for a BPO industry are different from any other industry. The areas of risk can vary from business risk to business continuity risk.

(ii) The operations towards servicing the client may be similar to activities performed by the organisation for itself. For example, finance and accounting processes handled by a BPO for its clients may be similar in nature to the ones that are performed by its own finance and accounting team.

(iii) The process adapted for activities are client specific, and hence is subject to vary. Too many processes are linked to deliverables, and hence it makes it a specific matter to be dealt with in the BPO industry.

(iv) The industry is extremely labour intensive apart from being technical intensive. The industry requires labour at different levels and tiers to provide varied types of services. The specific issue becomes more complex with attrition, massive growth, retrenchment, employees on the bench related issues, etc.

(v) It requires complete integration of individual processes handled under different departments independently.

(vi) Timing of these entities is in accordance with the local time of the country for which the service is provided for contracts where near real time services are required to be provided.

(vii) Certain BPOs have to comply with foreign laws and regulations such as, Sarbanes-Oxley's Act, 2002 and alike, as elaborated in **Chapter 3**.

(b) Client Contract and Billing

(i) All services are rendered through proper contracts with clients, in general. The industry norms require strict adherence to the terms of the contract. Many activities and processes are dependent on the Service Level Agreement (SLA) as detailed out in the contracts. Adherence of the terms of the contract would be of vital importance to ensure the revenue would be billable.

(ii) Covenants of the agreement are, in general, stringent with strict exit clause. Violating the contract has severe costs.

(iii) Services are provided to some clients on a continuous basis, i.e., 24 hours a day and 365 days a year.

(iv) BPO entities also mandate near real time service delivery if demanded by the client, eg., updating records of banking and insurance clients.

(v) Billing in BPO is based on time. Most forms of billing involve the measure of time – directly or indirectly.

(c) Employees Related

(i) Strict adherence to employee time sheets, online attendance records to enable proper allocation of costs for the project, data security and process adherence measures.

(ii) In general, BPO Industry spends higher cost on recreation and entertainment to employees by arranging various parties, picnics, get-togethers, celebrations, gifts, team outings, etc.

(iii) Complex incentive schemes are framed for employees.

(iv) Employee retention schemes are also unique to this industry.

(v) The employee cost is directly linked to logistics costs, canteen costs, and infrastructure costs in many cases. The employee count can impact all the financial terms from fixed assets, to expenses, to revenue, etc.

(d) Economic Conditions

(i) The impact of global economic changes is extremely significant on a BPO Industry as compared to other industries. This is owing to the high reliance of foreign clients.

(ii) Since, significant revenue is in the form of foreign currency, fluctuations in foreign currency have a significant impact on the revenue of the organisation in BPO Industry.

(iii) Many companies in foreign countries would transfer their non-core activities to a BPO industry and, hence, a change in the economic condition would affect the outsourcing industry faster than the impact on the core factors.

(e) Electronic Environment and Data Security

(i) Generally, the operations are carried out in a completely electronic and computerised environment.

(ii) Entities invest heavily on high end technologies. Without such investment, it is difficult to monitor activity and provide reports on a continuous basis apart from ensuring better control, thereby preventing unethical activities by employees. The cost of investment would in most cases be directly proportionate to the number of employees.

(iii) BPO employees may be mandated to work on client's systems and services to ensure security of client's data.

Types of Services Provided by the BPO Industry

2.13 The various types of services provided by the BPO Industry include Customer Support Service; Marketing and Sales (inbound/ outbound); Technical support; Help desk; HR Administration services; Finance and Accounting services; Content development; Medical processes related services like, Analytics, support. transcription services; Knowledge Modelling, Forecasting and Legal support.

Customer Support Services

2.14 These are provided through multiple channels including voice, e-mail and chat on a continuous basis.

Example:

The client's customers contact the contact centre to enquire on their order status, to check for information on products and services, to verify their account status, to check their reservation status, etc.

Technical Support Services

2.15 It represents technical support and problem resolution services provided, especially, related to hardware, software, peripherals and for internet services, product support, upgrades, support before and after buying, troubleshooting and usage.

Example:

Resolution of issues on home computer, printer, scanner, etc. where customer calls the support centre. It could include employee IT help desk services also.

Insurance Processing

2.16 This type of outsourcing covers a wide array of services from sales to insurance policy maintenance and claims processing.

Example:

- Sales - Inbound/ Outbound sales, Underwriting, Policy issuance, etc.
- Policy Maintenance - Maintenance of policy and changes thereto; Collateral verification; Policy Surrender; Loans and Revival of lapsed policies.
- Claims processing - Verification and settlement of claims.

Telemarketing Services

2.17 Telemarketing and telesales services are provided by targeting potential customers and generating interest in the entity's products and services; or to up-sell/ promote and cross sell to existing customers.

Example:

Outbound calling to sell credit cards and other banking and insurance services are well known examples in India. Many other services are sold using this medium like, holidays, mobile services, broadband services, etc.

Data Entry/ Processing/ Conversion Services

2.18 It includes services provided in the nature of converting physical documents into electronic form.

Example:

- Data entry from paper/ books
- Data entry from Image file in any format
- Data entry of business transactions like, sales/ purchase/ payroll
- Conversion of data across various databases on different platforms
- Data conversion *via.,* Input/ Output for various media
- Data conversion for databases, word processors, spreadsheets, and many other standard and custom-made software packages as per requirement
- Conversion from one file format to another like, from MS word to MS power point or MS word to PDF, etc.

Document Management Services

2.19 This type of outsourcing includes converting large legal, scientific, governmental data into digitized method of verification. It also includes digitizing manuscripts, medical records and related data. With the advent of digital media, most hard copy documents including photographs, etc., get digitized under this form of outsourcing.

Form Processing Services

2.20 This type of services represents processing of various forms of the client.

Example:

Processing of Insurance Claim Form, Medical Form, Medical Billing Online Form Processing, Payroll Processing, etc.

Book Keeping and Accounting Services

2.21 This type of service includes providing Accounting and Book Keeping services in accordance with the requirements of the Local GAAP.

Example:

Maintain books of accounts in US GAAP for a client operating in the United States.

Financial Planning and Analysis

2.22 An advanced form of Book Keeping and Accounting Service which includes budgeting, preparation of MIS, variances, financial analytics, business analytics, etc.

Medical Transcription Services

2.23 It is digitization and indexation of medical records and includes on line activity such as, discharging summaries, prescriptions, insurance claims for medical insurance, collections, etc.

Example:

Digitizing prescriptions and/ or patient's case history.

Legal Support Services

2.24 This work includes drafting of legal documents, preparation of case papers, preparation of proposals, client time sheets, billing and collections also.

Business and Corporate Research

2.25 This type of service includes services provided in the nature of product and market research, market survey and analysis and alike. They represent high end service provided to the client.

Analytics, Modelling and Forecasting

2.26 Business analytics, valuation models, financial models, revenue forecasts, and all such other financial and operational analysis. Complex modelling and simulations are also part of this activity. This is a high-end support service.

Major Operational Challenges Faced by Entities in BPO Industry

2.27 The BPO industry is a services delivery based Industry. These service providers have unique type of billing and services are provided with varied features. Therefore, the sector has its own challenges.

This section is intended to highlight some of the significant challenges that the BPO industry faces so as to enable the internal auditor to plan and perform the internal audit accordingly. The internal auditor is required to perform such audit procedures specific to the entity as deemed necessary to ensure systematic evaluation of risk management, control and governance processes.

2.28 Attrition has been single largest challenge faced by the BPO industry. Though certain entities have been very effective in managing this problem, most entities face the problem of significant attrition rates. The rate of attrition faced by the industry is among the highest across all sectors. It has been observed that the major reasons for attritions are as follows:

(a) **Frustration of Doing only Repetitive Jobs** - BPOs do not present attractive career prospects. They are not challenging enough for the employees after a period. Most of them are stuck for good in their present placement once they start working in call centres.

(b) **Pace of Effort Required** – The expectations from outsourcing companies are, generally, high and tend to de-motivate the workers. In many cases, the outsourcers think only of only achieving their targets. Employees are unable to cope up with quality work, time frame and security processes after a point of time. The expectations should be realistic taking into account the work ethics of the region of the service provider, as well as, its culture.

(c) **Repetition** – Employees get bored and irritated on doing the same job again and again after a period of time. They are generally devoid of a sense of achievement. There are research findings on these statements.

(d) **Sense of Powerlessness or Lack of Control** – Employees feel powerless considering the routine nature of activity they are involved in.

(e) **Inefficient Operation** – The operations of the entity may not be completely organised and systematised resulting in unduly time delays and repetition of work.

(f) **Insufficient Pay/ Increment** – Remuneration paid to an employee might not be adequate in relation to other BPOs and increments might not be adequate to meet experience of the employee.

(g) **The Feeling of being Spied on** – Many BPOs have Closed Circuit Cameras which keep continuously monitoring employees. This creates a feeling of lack of being trusted and being spied on.

(h) **Odd Work Hours** – Some BPOs in order to provide call support or near real time delivery, work during the working hours of the client which might be different from the working hours of the entity operating in India. This creates a roadblock to the regular lifestyle of the employee.

The internal auditor on obtaining explanations for severe fluctuations and increase in attrition rate might get an insight of the management and processes.

2.29 Availability of manpower of required talent, qualification and experience at affordable cost is one of the major challenge. The internal auditor can assess risks of the business. There would be a need to assess the risk on business, contract SLA fulfilment with improper manpower selection process.

2.30 Legal compliance has been relatively high considering many other industries. The entity might be bound by stringent International laws. Apart from these, every contract entered by the entity has unique terms and conditions to be complied with, failing which may lead to high penalties and other consequences.

The internal auditor should assess risks of the business. Non-compliance of law both in India and as per adherence of terms of reference would mean, exposure to risks of penalty and in some cases governance.

2.31 Considering the nature of industry which provides services throughout the day (24 by 7, 365 days a year), there exists problem of cut-off for revenue booking. Moreover, the billing period might be different from the day on which books are closed for preparation of MIS/ accounts. Proper/ adequate procedures are required to ensure consistent and fair recognition of revenue by the entity in all cases.

The internal auditor should assess financial risk of recognition of revenue and incorrect billing apart from the effectiveness of the accounting process.

2.32 Internet Frauds have been noticed in many organizations. It has continued to exist in spite of the steps taken by the management towards prevention of the same. The internal auditor should assess business risk and data security risk.

2.33 Data privacy and integrity concerns act as one of the major concerns. Data privacy relates to the threat of loss/theft of data of the client which may be subject to Intellectual Property Rights. Data integrity refers to data that has a complete or whole structure. All characteristics of the data including, business rules, rules for how pieces of data relate dates, definitions and lineage must be correct for data to be complete. When many agents use the same data, in the absence of proper controls in the Information system, might lead to undesired modification/ creation of multiple versions of the same data.

2.34 Some projects require minimum criteria such as, Minimum Turnover requirement/ Minimum Net Worth requirement for bidding of clients. If the entity does not meet these criteria then it is not qualified to bid, thereby hindering its growth.

This should also be viewed as a risk, as the client BPO would have given representations and warranties, and violation of these terms, would be viewed as vital in the BPO industry.

2.35 Certain regulatory requirements mandate the submission of specific financial statements e.g., an entity might be operating in SEZ and non-SEZ unit. In such a case, it is required to maintain separate books of accounts in order to ensure proper determination of profit of these respective units from Income Tax and Service Tax point of view.

The internal auditor should assess sufficiency of legal compliance. The internal auditor has also to assess the cost allocations process, and the risks inherent in each of these activities.

2.36 Entities face challenges in adherence to the process of the client considering its unique nature and lack of expertise by employees. This results in delays and non-adherence to the client's requirements.

The internal auditor should assess brand/reputation risk apart from business risk.

2.37 Some BPOs are providing options of flexible timings and options to work from home. In such cases, challenges exist in the nature of loss of control on the employee, lack of data security apart from non-compliance with terms of contract or inability in meeting the service level requirements.

The internal auditor should assess sufficiency of controls with regard to these employees.

2.38 Certain BPOs continue to grow at a rapid pace and do not provide sufficient time for the management to adjust to the pace of growth in terms of implementing sufficient controls systems. Internal auditor can assess the sufficiency of compliance with regards to the expected growth of the entity.

The procedures that may be performed during an internal audit in this regard are discussed in detail in **Chapter 6**.

Typical Business Process in a BPO

2.39 The business for an entity operating in a typical BPO Industry originates from contracts with clients. Refer **Appendix 1** for the process of entering into a contract by a BPO. In general, once the contract is signed by both the parties, recruitment and training of agents required for the contract moves on simultaneously. Once, the agents required are trained by the entity, they are allocated to various processes in accordance with their profile, experience and capability which in turn converts into service provided to the client and billing thereof.

Certain BPOs have bench staff, i.e., staff recruited and already trained. Once the contract is signed, these employees are immediately deputed for the service to be provided.

Chapter 3
Legal Framework

3.1 Various regulations and acts are applicable to organisations operating in BPO Industry. This chapter details the various acts applicable and organisations that supervise and regulate the BPO Industry.

Gist of various statutory provisions applicable to the BPO industry are detailed under **Chapter 4** of this Technical Guide.

Ministry of Communication and Information Technology, GOI

3.2 Under this Ministry, the *Department of Information Technology* has been set up with a mission of e-Development of India through multi-pronged strategy of e-Infrastructure creation to facilitate and promote e-governance, promotion of Electronics & Information Technology- Information Technology Enabled Services (IT-ITeS) Industry, providing support for creation of Innovation/ Research & Development (R&D), building Knowledge Network and securing India's cyber space.

3.3 The objective of the Department of Information Technology is to move towards:

(a) *e-Government*: Providing e-infrastructure for delivery of e-services.

(b) *e-Industry*: Promotion of electronics hardware manufacturing and IT-ITeS industry.

(c) *e-Innovation/ R&D*: Providing support for creation of Innovation Infrastructure in emerging areas of technology.

(d) *e-Education*: Providing support for development of e-Skills and Knowledge network.

(e) *e-Security*: Securing India's cyber space.

The Software Technology Park of India has been set-up in India under this department.

3.4 Software Technology Park of India is an autonomous society under Department of Information Technology, Ministry of Communication & Information Technology, and Government of India (GOI) has been mandated to provide conducive environment for the software exporting companies. STPI operates through its centres located in various part of the country, which provide facilitation to Software Industry in that region.

Ministry of Commerce and Industry, GOI

3.5 The mandate of the Department of Commerce is regulation, development and promotion of India's international trade and commerce through formulation of appropriate international trade and commercial policy and implementation of various provisions thereof. This Ministry formulates the regulatory provisions pertaining to the Special Economic Zones and EXIM Policy in India.

The Department of Industrial Policy and Promotion, set-up under the Ministry of Commerce & Industry is responsible for Intellectual Property Rights relating to patents, designs, trade marks and geographical indication of goods and oversees initiative relating to their promotion and protection. This Department also formulates, promotes, approves and facilitates the Foreign Direct Investment (FDI) Policy.

Director General of Foreign Trade (DGFT) is a government organization in India responsible for the formulation of Export–Import guidelines and principles for Indian importers and Indian exporters of the country. The basic role of the Department is to facilitate the creation of an enabling environment and infrastructure for accelerated growth of international trade.

Ministry of Finance, GOI

3.6 The Ministry of Finance, Government of India looks after various financial affairs of the state of India. The Ministry of Finance is responsible for monitoring various aspects of the Indian economy. The Ministry of Finance operates through various departments.

- Department of Economic Affairs
- Department of Disinvestment
- Department of Expenditure
- Department of Financial Services
- Department of Revenue

Various statutes such as, Customs Act, 1962, Foreign Exchange Management Act, 1999, Income Tax, 1961 to name a significant, as applicable to the BPO Industry are formulated and governed by this Ministry.

A Gist of Important Regulations Applicable to an Entity in BPO Industry

Foreign Exchange Management Act, 1999

3.7 Most of the organisations operating in the BPO Industry provide services to clients outside India. In this regard, the entity is required to comply with FEMA, 1999, as regards receipt of foreign currency on invoicing, returns and documentation.

Software Technology Park of India

3.8 It is an export oriented scheme for the development and export of computer software, including export of professional services. It provides for physical infrastructure, including dedicated high speed connectivity to technology parks, freedom for 100% foreign equity investment and tax incentives.

Special Economic Zone Act, 2006

3.9 An SEZ is a trade capacity development tool, with the goal to promote rapid economic growth by using tax and business incentives to attract foreign investment and technology. The Central Government has framed the policy framework for SEZs through the SEZ Act. The State Governments play a significant lead role in the development of SEZs in their respective States by stipulating the conditions to be adhered to by an SEZ and granting the necessary approvals. These supporting procedures are laid down in SEZ Rules as framed by the State Government.

Foreign Trade Policy (FTP)

3.10 The Foreign Trade Policy prescribes the benefits for an entity operating in SEZ/ EOU/ EHTP/ BTP. The main objectives of the Foreign Trade Policy is to increase exports, earn foreign exchange to the country, transfer of latest technologies, stimulate direct foreign investment and to generate additional employment.

A number of entities operating in the BPO industry provide services for clients operating outside India. In this context, the Foreign Trade Policy provides for benefits to these units. Units undertaking to export their entire production of goods and services (except permissible sales in DTA), may be set up under the Export Oriented Unit (EOU) Scheme, Electronics Hardware Technology Park (EHTP) Scheme, Software Technology Park (STP) Scheme or Bio-Technology Park (BTP) Scheme for manufacture of goods, including repair, re-making, reconditioning, re-engineering and rendering of services. Trading units are not covered under these schemes.

3.11 A few significant clauses of Foreign Trade Policy (FTP) are given below. The internal auditor is advised to be aware of the provisions of FTP so as to enable him to perform procedures to test compliance of FTP, as required.

(i) *Code (IEC) Number*

No export or import shall be made by any person without an IEC number unless specifically exempted. An IEC number shall be granted on application by competent authority in accordance with procedure specified in HBP version 1.

(ii) *Private/ Public Bonded Warehouses for Imports*

Private/Public Bonded Warehouse may be set up in a DTA as per the terms and conditions of notification issued by the Department of Revenue. Any person may import goods except prohibited items, arms and ammunition, hazardous waste and chemicals and warehouse them in such bonded warehouses.

Such goods may be cleared for home consumption in accordance with provisions of FTP and against authorisation, wherever required. Customs duty as applicable shall be paid at the time of clearance of such goods.

If such goods are not cleared for home consumption within a period of one year or such extended period as the custom authorities may permit, importer of such goods shall re-export the goods.

(iii) *Denomination of Export Contracts*

All export contracts and invoices shall be denominated either in freely convertible currency or Indian rupees but export proceeds shall be realised in freely convertible currency. However, export proceeds against specific exports may also be realized in rupees, provided it is through a freely convertible Vostro account of a non resident bank situated in any country other than a member country of ACU or Nepal or Bhutan. Additionally, rupee payment through Vostro account must be against payment in free foreign currency by buyer in his non- resident bank account. Free foreign exchange remitted by buyer to his non- resident bank (after deducting the bank service charges) on account of this transaction would be taken as export realization under export promotion schemes of FTP.

(iv) *Net Foreign Exchange (NFE) Earnings*

EOU/ EHTP/ STP/ BTP unit shall be a positive net foreign exchange earner except for sector specific provision of Appendix 14 -I-C of HBP v1, where a higher value addition shall be required. Net Foreign Exchange Earning (NFE) shall be calculated cumulatively for a period of five years from the commencement of production according to the following formula :

$$\textit{Positive NFE} = A - B > 0$$

Where :

A : is the FOB Value of exports by the SEZ units; and

B : is the sum total of the CIF value of all imported inputs and the CIF value of all imported capital goods, and the value of all payments made in foreign exchange by way of commission, royalty, fees, dividends, interest on external borrowings during the first five year period or any other charges. "Input" means raw materials, intermediates, components, consumables, parts and packaging materials.

Whenever a unit is unable to export due to prohibition/restriction imposed on export of any product mentioned in Letter of Permit (LoP), the five year block period for calculation of NFE earnings may be suitably extended by BoA.

3.12 Some other entitlements of EOU/ EHTP/ STP/ BTP unit are as under:

(a) Exemption from Income Tax as per Section 10A and 10B of Income Tax Act.

(b) Exemption from industrial licensing for manufacture of items reserved for SSI sector.

(c) Export proceeds will be realised within 12 months.

(d) Units will be allowed to retain 100% of its export earnings in the EEFC account.

(e) Unit will not be required to furnish bank guarantee at the time of import or going for job work in DTA, where unit has :

- A turnover of Rs. 5 crores or above;
- Unit is in existence for at least 3 Years; and
- The unit:
  - ❖ has achieved positive NFE/export obligation, wherever applicable;
  - ❖ has not been issued a show cause notice or a confirmed demand, during the preceding 3 years,

on grounds other than procedural violations, under the penal provisions of the Customs Act, the Central Excise Act, the Foreign Trade (Development & Regulation) Act, the Foreign Exchange Management Act, the Finance Act, 1994 covering Service Tax or any allied Acts or the rules made thereunder, on account of fraud/ collusion/wilful misstatement/suppression of facts or contravention of any of the provisions thereof;

(f) 100% FDI investment permitted through automatic route similar to SEZ units.

(g) Units shall pay duty on the goods produced or manufactured and cleared into DTA on monthly basis in the manner prescribed in the Central Excise Rules.

Information Technology Act, 2000

3.13 The main objective is "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". This Act is of significance in the current context since the operations of BPO Industry are significantly carried out through the electronic media.

Other Applicable Indian Acts to the Industry

3.14 Standard on Internal Audit (SIA) 17, "*Consideration of Laws and Regulations in an Internal Audit"* issued by the ICAI, requires that when planning and performing audit procedures and in evaluating and reporting the results thereof, the internal auditor should recognize that non-compliance by the entity with relation to laws and regulations may materially affect the financial statements. However, the internal auditor is not responsible for preventing non-compliance and cannot be expected to detect non-compliance with all laws and regulations.

3.15 Thus, in addition to the various Acts, Rules, Bye Laws, Regulations, Circulars, etc., the internal auditor is required to verify some other applicable regulations which includes the following:

(a) Governance Laws

- The Companies Act, 1956
- Partnership Act, 1932
- Limited Liability Partnership Act, 2008
- The Hindu Successions Act, 1956
- The Indian Penal Code.
- The Negotiable Instruments Act, 1888

(b) Economic Laws

- The Income tax Act, 1961
- Central Excise Act, 1944
- The Customs Act, 1965
- Chapter V of the Finance Act, 1994 relating to Service Tax
- Value Added Tax and Sales Tax Act

(c) Contract Laws

- The Indian Contract Act, 1872
- Securities Contracts Regulation Act, 1956

(d) Labour Laws

- Employees Provident Fund Scheme, 1952
- Employee State Insurance Act, 1948

- Payment of Gratuity Act, 1972
- Payment of Bonus Act, 1965
- Professional Tax enacted by the respective states
- Shops and Establishment Act enacted by the respective states

(e) Intellectual Property Rights

- Product Patent Act, 2005
- Indian Copyright Act, 2000
- Geographical Indications Act, 1999

(f) Other Laws as applicable to the Industry

- Specific Relief Act, 1963
- Securities Exchange Board of India Act, 1992
- Foreign Contribution Regulation Act, 1976
- Consumer Protection Act, 1986

3.16 Apart from the abovementioned laws, the internal auditor is required to be aware of the local legislations under which the entity/undertaking operates e.g., under Karnataka Shops and Commercial Establishments Act, 1961, the daily and weekly hours, extra wages for overtime work, holidays for all entities established in Karnataka has been prescribed.

The internal auditor is required to ensure the compliance of respective state legislations too as part of his internal audit procedures. The internal auditor is also expected to be aware of various circulars issued by the RBI towards foreign currency transactions.

Other Applicable Acts to the BPO Industry

3.17 Apart from the above Indian regulations that the BPO Industry is surrounded with, there are other regulations pertaining to the country of the client for whom the services are provided or due to listing status. The principal regulations that affect Indian BPOs are as follows:

(i) The Sarbanes-Oxley Act, 2002

(ii) HIPAA (Healthcare Insurance Portability and Accountability Act)

(iii) UK Data Protection Act

(iv) Fair Debt Collection Practices Act, 1972

Chapter 4
Statutory Laws Applicable to Indian BPO Industry

4.1 This chapter is intended to provide broad overview of various laws, compliances required for entities opting for special status such as STPI, SEZ or EOU Status. The internal auditor may refer to bare act of these laws and regulations and study the different cases judgements by competent authorities.

Considering that these regulations undergo frequent amendments/ changes, a detailed checklist has not been prepared. The internal auditor must update himself with the amendments, pronouncements, new regulations from time to time to ensure effective performance of internal audit.

STPI Scheme

4.2 Approved units under STPI scheme may import all types of goods including capital goods required by it for carrying on its approved software export activities (as per Foreign Trade Policy). Such goods may be imported either on outright purchase basis or free of cost or on loan basis from the client without payment of custom duty.

Capital goods are defined as any plant, machinery, equipment or accessories required for manufacture or production, either directly or indirectly, of goods or for rendering services.

Procedure

4.3 Units intending to import equipment goods duty free under the scheme need to comply with the following requirements:

(i) A list of equipments/ goods proposed to be imported should be attested by STPI and submitted to Customs and Central Excise Department (if not already done at the time of obtaining custom bonding license).

(ii) Copy of custom bonding license valid as on date.

(iii) Application in the prescribed form along with the supporting documents to be submitted to STPI and an import clearance certificate obtained from STPI for the import of each individual consignment.

4.4 The following are the documents that are required to be submitted at the time of import of Capital Goods :

(i) A request letter from the STPI unit.

(ii) Shipping invoice/ commercial invoice/ proforma invoice in duplicate.

(iii) High seas sales agreement in case purchase is on high seas purchase basis.

(iv) Chartered Engineer's certificate or self declaration in case of import of second hand capital goods.

(v) Leased agreement in case purchase is on lease basis.

Issue of Imports Certificate

4.5 The procedure to apply for Import Certificate is as follows:

(a) Application as per the standard application format.

(b) Original Shipping Invoice/ Commercial Invoice (In duplicate).

If the equipment is imported on Loan or Free of cost, the invoice should clearly state: "Material is sent on Loan or Free of Cost basis and the value is for custom purpose only".

(c) Other conditions:

- If the importation is on Loan basis, the maximum period of loan is 24 months only.

- Import of second-hand Capital Goods is permitted by STPI.

- The capital goods to be imported are less than seven years old; a Self Declaration Form has to be attached with the import request letter.

- The Capital Goods to be imported are more than seven years old; a Chartered Engineer's Certificate has to be accompanied with the request letter.

Procedure for Certification of Software Export

4.6 The procedure for certification of software export is as follows:

(a) Offshore Services

Export of computer software in non-physical, i.e., Export through Data communication/ Satellite links should be declared through ***SOFTEX*** form. Each set of SOFTEX forms comprises three copies marked Original, Duplicate and Triplicate. All the three forms in each set should be completed and entire set should be submitted for the purpose of certification together with relevant documents. Each exporter will have to designate a single branch of an Authorized Dealer to whom export documents, in respect of all software exports made via dedicated earth stations/ satellite links will be submitted by him together with the relative SOFTEX forms for negotiation orcollection.

(b) Disposal of Softex Form

After certifying all the three copies of SOFTEX forms, the designated official will forward the original directly to the nearest office of the Exchange Control Department of the RBI. The duplicate will be returned to the exporter and the triplicate will be retained by the STPI office for record purpose. Within 21 days from the date of certification of SOFTEX Form by the STPI the exporter should submit the duplicate copy together with a copy of the supporting documents to the authorized dealer. The duplicate copy of the form together with documents will be retained by the authorized dealer till full export proceeds have been realized and repatriated and thereafter will be submitted to the RBI, duly certified under cover of an appropriate return along with the copy of invoice/ statement of invoices.

(c) Export Declaration

STPI units are required to file a copy of Purchase Order/ Agreement/ Contract with STPI as soon as the STPI unit enters into purchase agreement with their client. This can be done one time before raising the first invoice.

The following documents are to be submitted to the STPI:

(a)	Softex Form	3 Copies
(b)	Contract Copy	
(c)	Statement of Invoice	3 Copies
(d)	Copy of Invoice	1 Copy
(e)	Proof of Valid Data Communication	
(f)	Valid Customs Bonding License	If not submitted earlier

Refer **Appendix 3** for format of SOFTEX Form to be filed with the STPI Authorities.

Procedure for Issuing Approval for Sub-Contracting

4.7 The STPI/ EHTP units are also permitted to sub-contract part of their production process through job work by units in the DTA or other 100 % EOU/ EPZ/ SEZ/ STPI units. Requests in this regard is permitted by STPI as per the Foreign Trade policy on the basis of such factors as the fixation of Input and Output norms and the permission is processed by Customs authority. If the job is sub-contracted to another 100% EOU/ SEZ/ EPZ/ EHTP then only one of them is eligible to claim export benefit.

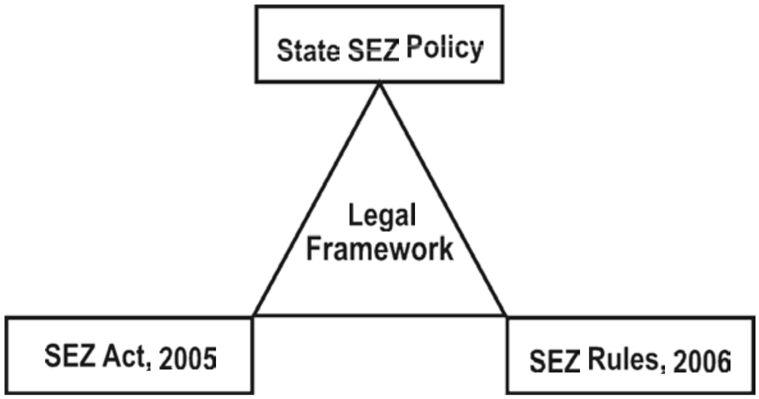
4.8 In case of sub-contracting of production process abroad, the goods may be exported from the sub-contractor premises subject to the conditions that job work charges shall be declared in the export declaration forms, invoices, etc., and full repatriation of foreign exchange.

4.9 The STPI Scheme also provides guidelines and procedures for following:

- Change of name
- Change of location
- Expansion of STP unit
- Domestic Tariff Area (DTA) Entitlement permission
- De-bonding of equipment
- Re-bonding of equipment
- De-bonding of obsolete equipment
- Re-export of capital goods
- Shifting/ transfer of imported capital goods
- Enhancement of Capital Goods limit
- Donations.
- Excise exemption
- Procedures for CST reimbursement
- Cancellation of STP registration.

Special Economic Zone

4.10 Legal Framework for setting up Special Economic Zone (SEZ) is defined under SEZ Act, 2005, supported by SEZ Rules, 2006, and State SEZ Policy.



Legal Framework for setting up Special Economic Zone (SEZ)

The Special Economic Zones Act, 2005

4.11 The main objectives of the SEZ Act are generation of additional economic activity and promotion of exports. The SEZ Act, 2005, envisages key role for the State Governments in Export Promotion and creation of related infrastructure. The SEZ Act deals primarily with the following matters:

- Establishment of the SEZ and the various authorities constituted in this connection.
- Appointment of the Developer, Co-developers and approval for units to be located in the notified area.
- Exemptions, drawbacks and concessions including exemptions from customs duty (on goods brought into or exported from the SEZ), excise, service tax, securities transaction tax, sales tax and income tax.
- Setting up of off-shore banking units and International Financial Services Centre in SEZs.
- A single enforcement agency/officer for certain notified offences as well as the designation of courts by the state governments for such offences committed and for civil suits arising in SEZs.

SEZ Rules, 2006

4.12 The main provisions of the SEZ Rules, 2006 can be summarized as promotion of industrialization and economic growth through sustainable development of Indian industries. The main essence of the Indian SEZ Rules 2006, states that these Special Economic Zones of India shall be offered tax rebates, fiscal incentives and lands at subsidized rates. The SEZ Rules provide for simplified procedures for development, operation and maintenance of the Special Economic Zone and for setting up units and conducting business in SEZ.

4.13 Some of the key provisions of the SEZ Rules, 2006 are mentioned as below:

- SEZ should be exempted from duties on all imports for project development.
- SEZ should be exempted from excise/ VAT on domestic sourcing of capital goods for project development.
- SEZ should be offered 10-year tax holiday in a block of the first 20 years.
- No foreign ownership restrictions in developing zone infrastructure and no restrictions on repatriation.
- Freedom to develop township in the SEZ with residential areas, markets, play grounds, clubs and recreation centers without any restrictions on foreign ownership.
- SEZ Should be exempted from taxation on business income.
- SEZ Should be exempted from import duty, VAT and other taxes.
- SEZ should be allowed 10% FDI through the automatic route for all manufacturing activities.
- Procedural ease and efficiency for speedy approvals, clearances and customs procedures and dispute resolution.

- Simplification of procedures and self-certification in the labor acts.
- Artificial harbor and handling bulk containers made operational throughout the year.
- To be equipped with airports for easy transit of men and goods.
- To be equipped with host of public and private bank chains to offer financial assistance for business houses.
- SEZ should be a vibrant industrial city with abundant supply of skilled manpower, covering the entire spectrum of industrial and business expertise.
- SEZ should be well connected with network of public transport, local railways and cabs.
- To encourage pollution free environment with proper drainage and sewage system.
- To house in-house customs clearance facilities.
- SEZ should have easy access to airport and local railway station.
- Full authority to provide services such as, water, electricity, security, restaurants and recreational facilities within the zone on purely commercial basis.
- SEZ should have abundant supply of technically skilled manpower.
- SEZ should have abundant supply of semi-skilled labor across all industry sectors.

Income Tax

4.14 Most BPO units are eligible for deduction either under Section 10A or Section 10AA of the Income Tax Act, 1961. These provisions offer tax sops to STPs (Software Technology Parks), SEZs (Special Economic Zones) and EOUs (Export Oriented units). As such, most units registered as STP or SEZ need not pay any corporate tax except MAT (minimum alternative tax). However, it is important that the business profits are determined using arm's length pricing. This aspect is, generally, in the purview of the statutory auditor but it is advisable that the internal auditor understands the various requirements and compliances under these statutes/ regulations and conducts audit of the same.

4.15 The internal auditor must examine the taxability of foreign enterprise engaged the Indian unit for outsourcing activities. These can be classified as under :

- The non-resident entity has no permanent establishment in India.
- The non-resident entity has a permanent establishment in India.

If there is no business connection between the two, the resident entity may not be a permanent establishment of the non-resident entity, and the resident entity would have to be assessed to income-tax as a separate entity. In such a case, the non-resident entity will not be liable under the Income-tax Act, 1961. If the non-resident entity is having a business connection with the resident Indian entity, it should be treated as the permanent establishment of the non-resident entity.

4.16 The CBDT has issued a circular regarding the tax treatment of the permanent establishment. The summary of the circular is:

- The non-resident entity will be liable to tax in India only if the IT-enabled BPO unit in India constitutes its permanent establishment (PE).
- The non-resident entity will be taxable only if it has a permanent establishment in India.
- If there is no PE then the resident entity would have to be assessed to income tax as a separate entity.

- PE has the same meaning as defined in Article 5 of the Double Taxation Avoidance Agreements (DTAA) entered into India with different countries.
- If the non-resident entity is having PE in India, then the profits attributable to such PE is taxable.
- In determining the profits of the PE, there shall be allowed as deductions expenses which are incurred for the purposes of the PE including executive and general administrative expenses so incurred, whether in the State in which the Permanent Establishment is situated or elsewhere.
- The profits to be attributed to a PE are those which that PE would have made if, instead of dealing with its Head Office, it had been dealing with an entirely separate enterprise under conditions and at prices prevailing in the ordinary market. This corresponds to the arm's length principle.
- The circular has made it clear that the profits attributable to an Indian entity constituting the permanent establishment (PE) of the non-resident or foreign entity would be determined on the basis of "arm's length principle". The stance taken in the circular is in consonance with the OECD guidelines on attribution of income to a permanent establishment.
- It is clearly specified that the profits attributable to a PE would have to be determined on an arm's length basis by adopting the existing transfer pricing provisions in the Income Tax Act, 1961. The arm's length price would have to be computed on the basis of Indian transfer pricing provisions.
- The circular has also held that business connection between two entities need not necessarily result in a PE. This is also a welcome step. Thus, PE would be decided on the basis of the actual tests for constitution of PE. This is much better than assuming that every business connection would necessarily result in a PE.

Service Tax

4.17 At present, service tax is levied at 10.30 % on specified services. BPO service would get categorized, generally, under the category of business auxiliary services or management consultancy services depending upon the exact nature of the service. Services exported outside India are, normally, exempt. Services are considered exported if the recipient of such services is located outside India.

A new category, business and support services, was also specified leading to BPO services being considered as taxable services. Letter No. 334/4/2006-TRU, dated 28/2/2006 clarifies that outsourcing services and business service centres are covered. However, such services would be eligible for refund of the service tax on input services.

4.18 The following services are exempt under the service tax:

- Call centres and Medical transcription centres are exempted from payment of service tax (Notfn.8/2003 S.T. dated 20.06.2003). However, call centre services being the service provided by a person on behalf of a client, falls under business auxiliary services and would, accordingly, be liable for service tax.
- Telecommunication services.
- Deduction with respect to the value of materials on which VAT can be claimed from the gross amount of value.

4.19 The following is an illustrative list of major capital goods, inputs and input services on which CENVAT can be availed:

- CED/ Additional Duty of Customs (CVD) on machinery or equipments.
- CED on office equipment and computers.
- CED on consumable tools and packing materials.
- CED on chemicals used or consumed.

- Construction of office or factory.
- Transportation of goods by road service.
- Internet charges.
- Market research and market survey.
- Recruitment and supply of manpower service.
- Rental and insurance for premises and goods.
- Telecommunications.
- Consulting engineering.
- Designing.
- Other services used for providing business auxiliary service.
- Other services used in business.

The input credit can be availed only on payment made. The input credit cannot be availed on accrual basis. However, in case, there is excess credit during the month, the same can be carried forward to the following month and can be set-off whenever service tax liability arises.

Valuation of Taxable Service

4.20 The value of services includes the following:

- Gross amount charged for such services;
- Any cost or expenditure incurred in connection with providing of the services will also form part of the taxable value;
- If any cost or expenditure incurred as pure agent is allowed as deduction subject to conditions set out in Service Tax (Determination of Value) Rules, 2006;and
- The reimbursable expenditure would also form part of the taxable value.

Exporter of Services without Payment of Service Tax

4.21 By virtue of Rule 4 of Export of Services Rules, 2005, the exporter of services need not suffer any service tax though the same is taxable service. For the purpose of CENVAT credit rules, export of services is not generally considered as exemption under CENVAT Credit Rules, instead it is considered as a separate category in itself. This is for the reason that though the services are exported without payment of service tax, the corresponding duty paid on inputs and service tax paid on input services can be availed and enjoyed in terms of Rule 5 of CENVAT Credit Rules. Therefore the provisions of Rule 6 of the CENVAT Credit Rules, 2004 will not be applicable.

Export of Services

4.22 The following are the conditions to be fulfilled for the services to be regarded as export of services:

- Service recipient is situated outside India
- Services are provided from India and used outside India
- Payments against services are received in convertible foreign exchange.

The exporter of service has three options to pay service tax. Normally, the exporter can export services without payment of service tax. The following are the options available for exporter of service:

(i) Rebate of Service Tax on Taxable Services Exported to Any Country other than Nepal and Bhutan

4.23 In addition to the above, section 93A of the Finance Act is enabling the Central Government to grant rebate of service tax paid on taxable services which are used as input services for the goods exported or services exported. The provisions of rebate comes with a rider that where rebate is granted under this section and the sale proceeds/ consideration is not received by the exporter in India within the time allowed by the RBI under section 8 of FEMA 1999, the rebate shall be deemed never to have been allowed. The same shall be recovered by the Government.

4.24 The following are the conditions involved for claiming rebate of service tax and education cess paid on taxable services exported:

- Taxable service is exported.
- Payment should be received in India in convertible foreign exchange.
- Service tax claimed as rebate should have been paid.
- The amount of rebate shall be Rs. 500 or more.

(ii) Rebate of Central Excise Paid on Inputs and Service Tax and Education Cess Paid on Input Services used in Providing the Taxable Services Exported to Any Country other than Nepal and Bhutan

4.25 Subject to the following conditions and limitations, the central excise and service tax paid on inputs and input services are allowed as rebate:

- Taxable services are exported.
- Payment should be received in India in convertible foreign exchange.
- Payment of duty on the inputs and service tax on input services for which the rebate claim is made should be paid.
- The amount of rebate shall be Rs. 500 or more.
- The said duty or tax should not be claimed as CENVAT Credit.

Import of Services

4.26 Section 66A envisages taxation of the services which are received in India from a foreign national or foreign entity. The situation envisaged is that any taxable service:

- Provided or to be provided by a person who has :
  - Established a business in a country other than India; or
  - A fixed establishment from which the service is provided or to be provided in a country other than India; or
  - His permanent address or usual place of residence is in a country other than India.

  (And)

- Received by a person (recipient) who has his :
  - Place of business in India;
  - Fixed establishment in India;
  - Permanent address in India;
  - Usual place of residence in India.

4.27 Import of service is not to be treated as output services. The taxable services for which the liability is created in terms of Section 66A cannot be treated as output services for the purpose of availing CENVAT credit of duty/ tax paid on inputs or input services. Credit of inputs and input services used in the said services received cannot be considered as inputs by the service receiver.

Further, the credit available cannot be used for payment of service or tax liability on import of services. However, the service tax paid on import of services can be availed as input credit against the output liability or rebate of the same can be claimed.

Value Added Tax

Output VAT

4.28 All the BPOs and KPOs in India are providing domestic and international services which are subject to service tax. Since, both the Service tax and VAT are mutually exclusive and there is no movement of goods/ products, there is no need to pay VAT.

Input Credit Set-off Scheme

4.29 "Input" means any goods including capital goods purchased by a dealer in the course of his business for re-sale or for use in the manufacture or processing or packing or storing of other goods or any other use in business.

As there is no need to pay VAT on the services provided by the BPOs and KPOs, they are not eligible to take input credit on purchases made by them.

Registration

4.30 As there is no liability to pay VAT on output services of BPOs and KPOs, it is advisable to take voluntary registration under their respective VAT Act to obtain or bring goods from outside the state whether as a result of purchase or otherwise at lower tax rate. Voluntary registration will enable the dealer to buy goods at a concessional rate. The benefit of registration is that when the purchaser of goods is a registered dealer, he can buy the goods against C Form. In that case, the vendor will be entitled to charge only 2% CST on the value of goods sold and not 10% which is the minimum rate of tax if ordinary goods are sold without obtaining the C Form. Here, the goods that are bought should be those goods which are eligible for concessional tax rate as per Sec. 8(3) and such goods should be included in the buyer's registration certificate.

Chapter 5
Internal Audit

Need for Internal Audit

5.1 Considering the nature of the BPO Industry and the pace at which the Industry has grown over the past decade, need for ensuring proper controls need not be over emphasized. With the increasing number of frauds in the software field, and considering the vulnerability of the sector to modification of data, internal audit becomes significant. Internal audit also helps in verifying the controls in place within the entity with regard to sufficiency and effectiveness in the light of overall business. Internal audit also helps in assessing the risks faced by the entity and provide a method for management of the same. Internal controls and risk management are extremely important activities in a entity operating in the BPO Industry.

Moreover, with various stimuli provided by the Government to this sector over a period, the BPO industry has undergone tremendous evolution. With newer business models and innovative types of outsourcing growing every day, the risks of business have undergone a complete change.

5.2 Effective Internal Audit provides a tool to ease out all complexities, ensures that systems and processes are adequate to support the growth and are adapted to the changes in various regulations, thereby ensuring sustained growth and development.

"*Preface to the Standards on Internal Audit*", issued by the Institute of Chartered Accountants of India defines the term Internal Audit as:

"Internal Audit is an independent management function, which involves a continuous and critical appraisal of the functioning of an entity with a view to suggest improvements thereto and add value to and strengthen the overall governance mechanism of the entity, including the entity's strategic risk management and internal control system."

The definition highlights the following facets of internal audit:

- Internal auditor should be independent of the activities they audit. The internal audit function is, in general, considered independent when it can carry out its work freely and objectively. Independence permits internal auditors to render impartial and unbiased judgment essential to the proper conduct of audits.

- Internal audit is a management function, thus, it has the high-level objective of serving management's needs through constructive recommendations in areas such as, internal control, risk, utilisation of resources, compliance with laws, management information system, etc.

- Internal audit's role should be a dynamic one, continually changing to meet the needs of the organisation. There is often a need to change audit plans as circumstances warrant. These changes may include coverage of new areas, assistance to management in solving problems, and the development of new internal audit techniques.

- An effective internal audit function plays a key role in assisting the board to discharge its governance responsibilities. Thus, it contributes in accomplishment of objectives and goals of the organisation through ethical and effective governance.

- Risk management enables management to effectively deal with risk, associated uncertainty and enhancing the capacity to build value to the entity or enterprise and its stakeholders. Internal auditor plays an important role in providing assurance to management on the effectiveness of risk management.

- Internal audit function constitutes a separate component of internal control with the objective of determining whether other internal controls are well designed and properly operated. Thus, the examination and appraisal of controls are normally components, either directly or indirectly, of every type of internal auditing assignment.

Factors Contributing to the Evolution of Internal Audit

5.3 "*General Guidelines on Internal Audit*" issued by the Institute of Chartered Accountants of India describes the factors contributing to the evolution of internal audit in India. A few such factors are as follows:

(i) Increased Size and Complexity of Businesses

Increased size and business spread dilutes direct management oversight on various functions, necessitating the need for a full time, independent and dedicated team to review and appraise operations.

(ii) Enhanced Compliance Requirements

Increase in the geographical spread of the businesses has also led to crossing of political frontiers by businesses in a bid to tap global capital. This has thrown up compliance with the laws of the home country as well as the laws of that land as a critical factor for existence of businesses abroad.

(iii) Focus on Risk Management and Internal Controls to Manage Them

Internal auditors can carry out their job in a more focused manner by directing their efforts in the areas where there is a greater risk, thereby enhancing the overall efficiency of the process and adding greater value with the same set of resources.

(iv) Stringent Norms Mandated by Regulators to Protect Investors

The regulators are coming up in a big way to protect the interests of the investors. The focus of the latest regulations being ethical conduct of business, and enhanced corporate governance and financial reporting requirements, etc.

(v) Unconventional Business Models

Businesses today use unconventional models and practices, for example, outsourcing of non-core areas, such as accounting.

(vi) Intensive Use of Information Technology

Information technology (IT) is invariably embedded in all spheres of activities of a modern business enterprise today, from data processing to resource planning to online sales and e-commerce. Use of IT has, however, increased the threat of data thefts or losses on account of systems failure or hacking/ espionage, as well as the need to comply with the cyber laws, etc.

(vii) An Increasingly Competitive Environment

Whereas deregulation and globalisation have melted the political as well as other barriers to entry in the markets for goods and services, free flow of capital, technology and know-how among the countries as well as strong infrastructure has helped in bringing down the costs of production and better access to the existing and potential consumers. This in turn, has lured more and more players in the existing markets, thereby, stiffening the competition.

Standards on Internal Audit

5.4 The Institute of Chartered Accountants of India (ICAI) has, till date, issued seventeen Standards on Internal Audit (SIAs) and the same are as follows:

SIA 1 Planning an Internal Audit

SIA 2 Basic Principles Governing Internal Audit

SIA 3 Documentation

SIA 4 Reporting

SIA 5 Sampling

SIA 6 Analytical Procedures

SIA 7 Quality Assurance in Internal Audit

SIA 8 Terms of Internal Audit Engagement

SIA 9 Communication with Management

SIA 10 Internal Audit Evidence

SIA 11 Consideration of Fraud in an Internal Audit

SIA 12 Internal Control Evaluation

SIA 13 Enterprise Risk Management

SIA 14 Internal Audit in an Information Technology Environment

SIA 15 Knowledge of the Entity and its Environment

SIA 16 Using the Work of an Expert

SIA 17 Consideration of Laws and Regulations in an Internal Audit

5.5 These Standards are recommendatory in nature and codify the best practices in the field of internal audit. "*Framework for Standards on Internal Audit*" promotes professionalism in the internal audit activity and comprises of four components, *viz.*, the Code of Conduct, the Competence Framework, the Body of Standards and the Technical Guide.

Standards on Internal Audit (SIAs) are important for carrying out internal audit of BPO Industry. The internal auditor and the audit team are expected to be updated on the latest pronouncements issued by the Institute in order to conduct an effective internal audit.

Terms of Internal Audit Engagement

5.6 The auditee is expected to formally communicate the appointment to the internal auditor. Upon receiving the communication, the internal auditor should send an engagement letter, preferable before the commencement of engagement so as to avoid any misunderstanding. The internal auditor and the auditee should agree on the terms of engagement before commencement. Standard on Internal Audit (SIA) 8, "*Terms of Internal Audit Engagement*" establishes standards and provides guidance in respect of terms of engagement of the internal audit activity whether carried out in house or by an external agency.

5.7 The engagement letter should generally include reference to the following:

(i) Objective of internal audit;

(ii) Management's responsibilities;

(iii) Scope of internal audit (including reference to the applicable legislation, regulation and various pronouncement of ICAI);

(iv) Access to records, documents and information required in connection with the internal audit;

(v) Expectation to receive management's written confirmation in respect to representation made in connection with the audit;

(vi) Basis on which fees shall be computed and the billing arrangements thereof;

(vii) Industry specific area;

(viii) References received from the parent company, if any; and

(ix) Undertakings and locations to be covered.

The scope of the terms of the engagement, after delineating the broad areas of function of internal audit, should clarify that any additional services that are not encompassed by the engagement letter shall be performed only on mutual agreement and with separate engagement letter.

5.8 The terms of the engagement should clearly lay down the requirements as to manner and frequency of reporting and the list of intended recipients of the internal audit report. The engagement letter should contain a condition that the report of the internal auditor should not be distributed or circulated by the auditee or the internal auditor to any party other than that mutually agreed between the internal auditor and the auditee unless there is a statutory or a regulatory requirement to do so.

Knowledge of the Business

5.9 Before the commencement of audit assignment the internal auditor should have or obtain the knowledge of the business and its environment. The internal auditor should acquire sufficient knowledge to enable him to identify and understand the events, transactions and practices that can have significant effect on the internal audit process. Such knowledge shall be helpful to the internal auditor in assessing the inherent risk and control risk and in determining the nature, timing and extent of the internal audit procedures. Knowledge of the business assists the internal auditor in:

- Assessing the risk and identifying the problems;
- Planning and performing the internal audit effectively and efficiently;
- Evaluating audit evidence; and
- Providing better service to the client.

5.10 Standard on Internal Audit (SIA) 15, *"Knowledge of the Entity and Its Environment*" establishes standards and provides guidance on what constitutes knowledge of an entity's business, its importance to the various phases of an internal audit engagement and the techniques to be adopted by the internal auditor in acquiring such knowledge about the client entity and it's environment, prior to commencing an internal audit engagement and subsequently thereafter, at all stages of the internal audit process.

5.11 The internal auditor should prepare the flow of events, transactions, processes and practices within the organisation. This will help in gaining better understanding of the processes and the existence of the internal controls. Illustrative flowchart of "A Typical Process in a BPO Industry" is given as **Appendix 1**.

Audit Planning, Materiality and Sampling

5.12 After acquiring the knowledge of business and various laws and regulation applicable to the BPO industry, the internal auditor should plan out the internal activity. Planning helps in achieving the objectives of internal audit function. Adequate planning ensures that:

- Appropriate attention is devoted to significant areas of audit.
- Potential problems are identified.
- Skill and time of the staff are appropriately utilised.
- Work is carried out in accordance with the applicable pronouncements of ICAI.
- Work is carried out in conformity with the applicable laws and regulation.

5.13 Standard on Internal Audit (SIA) 1, "*Planning an Internal Audit*" provides guidance in respect of planning an internal audit plan. An internal audit plan is a document defining the scope, coverage and resources, including time, required for an internal audit over a defined period. In preparing an internal audit plan, internal auditor should obtain an understanding of the accounting and internal control system prevalent within the entity and exercise preliminary judgement regarding the critical areas to be considered during the internal audit. It also helps the auditor in determining the audit materiality, nature and extent of audit procedures to be adopted.

5.14 While designing an audit sample, the internal auditor should consider the specific audit objectives, materiality, population from which the internal auditor wishes to select the sample, areas of audit significance and the sample size. Standard on Internal Audit (SIA) 5, "*Sampling*" provides that ***when using either statistical or non-statistical sampling methods, the internal auditor should design and select an audit sample, perform audit procedures thereon, and evaluate sample results so as to provide sufficient appropriate audit evidence to meet the objectives of the internal audit engagement unless otherwise specified by the client.***

Internal Control

5.15 Standard on Internal Audit (SIA) 12, "*Internal Control Evaluation*" states that "*Internal controls are a system consisting of specific policies and procedures designed to provide management with reasonable assurance that the goals and objectives it believes important to the entity will be met*".

5.16 "*Internal Control System*" means all the policies and procedures (internal controls) adopted by the management of an entity to assist in achieving management's objective of ensuring, as far as practicable, the orderly and efficient conduct of its business, including adherence to management policies, the safeguarding of assets, the prevention and detection of fraud and error, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information. The internal audit function constitutes a separate component of internal control with the objective of determining whether other internal controls are well designed and properly operated.

5.17 SIA 12 lays down that internal control system consists of interrelated components as follows:

- Control (Or Operating) Environment
- Risk Assessment
- Control Objectivity Setting
- Event Identification
- Control Activities
- Information and Communication
- Monitoring
- Risk Response.

5.18 The system of internal control must be under continuous supervision by management to determine that it is functioning as prescribed and is modified, as appropriate, for changes in environment. The internal control system extends beyond those matters which relate directly to the functions of the accounting system.

5.19 ***The internal auditor should obtain an understanding of the significant processes and internal control systems sufficient to plan the internal audit engagement and develop an effective audit approach. The internal auditor should use professional judgment to assess and evaluate the maturity of the entity's internal control. The auditor should obtain an understanding of the control environment sufficient to assess management's attitudes, awareness and actions regarding internal controls and their importance in the entity.***

5.20 ***The internal auditor should examine the continued effectiveness of the internal control system through evaluation and make recommendations, if any, for improving that effectiveness.***

The importance of internal controls in a BPO entity need not be over-emphasized. Internal audit plays a major role in determining the effectiveness of internal controls and highlights areas for improvement.

Internal Audit in an Information Technology Environment

5.21 Computer Information System (CIS) environment exist when one or more computer(s) of any type or size is (are) involved in the processing of financial information, including quantitative data and the significance in relation to the audit, whether those computers are operated by the entity or third party.

5.22 The overall objective and scope of internal audit does not change in a CIS environment. However, the use of computer changes the processing, storage, retrieval and communication of financial information and may affect the accounting and internal control systems employed by the entity. Moreover, the risks involved in an audit may too undergo a change. The internal auditor should have sufficient knowledge of the CIS environment to plan, direct, supervise, control and review the work performed.

5.23 The data in a BPO entity operating in a CIS environment is, generally, voluminous. The CIS automatically generates material transaction or entries and exchanges transaction automatically with other organisation as in Electronic Data Interface (EDI) systems. Source documents, computer files and other evidential matter exist only for short period and in machine readable form. The use of the Computer Assisted Audit Technique (CAAT) shall increase the efficiency in the performance and enable the internal auditor to economically apply certain procedures to the entire population or accounts transaction.

5.24 The internal auditor should consider the CIS environment in designing audit procedures to reduce the audit risk to an acceptable low level. The internal auditor should also document the audit plan, the nature, the timing and the extent of audit procedures performed and the conclusions drawn from the evidence obtained which may be in the electronic form. The internal auditor should ensure that such electronic evidence is adequately and safely stored and is retrievable in its entirety as and when required.

5.25 Standard on Internal Audit (SIA) 14, "*Internal Audit in an Information Technology Environment*" establishes standards on procedures to be followed when an internal audit is conducted in an information technology environment. The internal auditor should also review the effectiveness and safeguarding of IT resources, including - people, applications, facilities and data.

5.26 ***The internal auditor should review the robustness of the IT environment and consider any weakness or deficiency in the design and operation of any IT control within the entity, by reviewing:***

a) System Audit reports of the entity, conducted by independent Information System auditors;

b) Reports of system breaches, unsuccessful login attempts, passwords compromised and other exception reports;

c) Reports of network failures, virus attacks and threats to perimeter security, if any;

d) ***General controls like segregation of duties, physical access records, logical access controls;***

e) ***Application controls like input, output, processing and run-to-run controls; and***

f) ***Excerpts from the IT policy of the entity relating to business continuity planning, crisis management and disaster recovery procedures.***

Overview of Compliance

5.27 Compliance means ensuring conformity and adherence to Acts, Rules, Laws, Regulation, Directives and Circulars.

Standard on Internal Audit (SIA) 17 "*Consideration of Laws and Regulations in an Internal Audit*" issued by the Institute of Chartered Accountants of India requires that ***when planning and performing audit procedures and in evaluating and reporting the results thereof, the internal auditor should recognize that non compliance by the entity with laws and regulation may materially affect the financial statements***. The requirements in this SIA are designed to assist the internal auditor in identifying the significant impact of non- compliance with laws and regulations on the functioning of the entity. However, in view of the inherent limitations on the role of the internal auditor, he is not responsible for preventing non-compliance and cannot be expected to detect non-compliance with all laws and regulations.

5.28 The term "*Non compliance*" refers to acts of omission or commission by the entity either intentional or unintentional, which are contrary to the prevailing laws or regulations. Such acts include transactions entered into by, or in the name of the entity or on its behalf, by those charged with governance, management or employees. Non-compliance does not include personal misconduct (unrelated to the business activity of the entity) by those charged with governance, management or employees of the entity.

5.29 Laws and regulations vary considerably in their relation to the financial statements. Some laws or regulations determine the form or content of an entity's financial statement or the amounts to be recorded or disclosures to be made in financial statements. Other laws or regulation are to be complied with by management or prescribe the provisions under which the entity is allowed to conduct its business. Non-compliance with laws and regulation could result in financial consequences for the entity such as, fines, litigation, etc. It may also, in extreme cases, have a potential effect on going concern as an entity.

5.30 The internal auditor should plan and perform the internal audit recognizing that the audit may reveal conditions or events that would lead to questioning whether an entity is complying with laws and regulations. In order to plan the internal audit, the internal auditor should obtain an understanding of the legal and regulatory framework applicable to the entity and how the entity is complying with that framework.

To obtain the understanding of laws and regulations, the internal auditor would ordinarily:

- Use the internal auditor's existing knowledge of the entity's industry and business.
- Inquire of management as to the laws or regulations that may be expected to have a fundamental effect on the operations of the entity.
- Inquire of management concerning the entity's policies and procedures regarding compliance with laws and regulations as well as ethical issues within the entity.
- Discuss with management the policies or procedures adopted for identifying, evaluating and accounting for litigation claims and assessments.

5.31 After obtaining the understanding, the internal auditor should perform procedures to identify instances of non-compliance with those laws and regulations where non-compliance should be considered while preparing financial statements, specifically:

- Inquiring with management as to whether the entity is in compliance with such laws and regulations.

- Inspecting correspondence with the relevant licensing or regulatory authorities.
- The internal auditor should also perform substantive tests of details of classes of transactions, account, balances or disclosures.

5.32 The significance of compliance are as follows:

(i) The benefits to the Industry are:

- Helps in compliance with legal terms and covenants and thereby reduces penalties and charges.
- Increased internal control.
- Reduction of internal frauds and losses.
- More time available for other core activities.
- Increases efficiency in operations.
- Customer satisfaction.

(ii) Benefits to the stakeholder:

- Ensures risk containment and safer market place
- Better investor confidence
- Uniform practices
- Better image, hence, better value for the investor.

Chapter 6

Major Areas of Internal Audit Significance

6.1 Internal audit procedures that apply to any industry also apply to an entity operating in the BPO Industry. In this technical guide, internal audit procedures pertaining to BPO Industry have been specified. These audit procedures are an illustrative list which can be performed in addition to the regular internal audit procedures performed by an internal auditor.

Invoicing

6.2 BPOs, generally, follow the below mentioned billing methods and the method is built into the contract with the client. It is, therefore, important that the internal auditor studies client contract carefully. In, general, most BPOs bill the client for the services rendered at the end of the month. As part of the internal audit process, the internal auditor should understand the billing cycle for each of the client and the process followed by the entity to ensure cut-off on a periodic basis. This section is only intended to provide an idea of the various billing methods and is not intended to be exhaustive. A BPO may use complex billing methods or combination of methods.

6.3 A few common types of billing include:

(i) **Per Call** – Generally, voice based support service providers bill on this basis. The billing can be done on the basis of no. of calls attended or on the basis of time per call on an average.

(ii) **Per Transaction** – This type of billing is done in the case of data entry, insurance, medical processing, etc., where the base is the no. of transactions handled. There may be requirements as to the minimum no. of transactions that need to be handled, the quality of work performed and nature of work handled. The cost per transaction varies due to these factors.

(iii) **Per Time** – The billing is done for the no. of minutes/ hours/ days the entity has provided service to the client. In general, the client places a no. of ceiling caps to ensure good performance and to prevent intentional excessive billing. Moreover, there are a no. Of service criteria as stipulated in the Service Level Agreement (SLA) that needs to be met. If these service criteria are not completely met, penalties are charged on to the entity.

(iv) **Full Time Equivalent** – Where services in the nature of research are provided by the entity, the billing is done on the basis of Full Time Equivalent (FTE). The entity bills the client for every person employed along with the costs incurred by the person on a flat charge as mutually agreed between the parties on a periodic basis. Some entities also provide onsite services to its clients. In general, for such services rendered too, the billing is based on this model.

(v) **Cost plus Basis** – In cases of Captive Service Provider or Wholly Owned Subsidiary, a mark up is agreed between the holding company and its subsidiary. The billing is done on the cost plus mark-up. Clients usually reimburse additional costs incurred by the BPO in the nature of recreation/ gifts to employees working on their project or bonus incentives additionally paid to these employees for motivating them to perform better or even leased line charge. These are either specifically communicated or mutually accepted at the time of entering into the contract.

Certain contracts may act as an embedded derivative, wherein the client may agree to bear the loss on account of wide appreciation in the value of foreign currency, provided the foreign exchange rate moves below a particular base rate.

6.4 The internal auditor needs to verify all these clauses as a part of performance of internal audit procedures. The internal auditor may also perform certain analytical procedures such as computation of following:

(a) Operational Margins Period-Wise

The internal auditor may compute the operational margins such as, gross profit margin, period to period and ascertain the variance between the different periods compared with. For eg., the internal auditor compares the gross margin for the month of February with that of January or February of the preceding year, he might observe huge variances in the margins. The internal auditor is required to seek explanations from the management for such significant fluctuations and understand the reason for such fluctuations. This might provide an insight on the effectiveness of the management in operations apart from ensuring that there has not been any fraud during the period.

(b) Significant fluctuations in Revenue from a Contract

Most contracts in a BPO industry are for a long tenure, say 2 to 3 years. In such a scenario, if there are significant fluctuations from a contract between periods, the internal auditor needs to understand the reason for such fluctuations.This will provide a deeper insight of the risks faced by the internal auditor and also a deeper understanding of the client's business apart from identifying irregularities.

(c) Revenue per Employee Project-wise

The internal auditor can compute the revenue generated by a contract during a period per employee and compare the same with a different period. This would help the internal auditor to assess the change in revenue per employee and the effectiveness of an employee on a project over a period of time.

(d) Operating Costs to Revenue Ratio

The internal auditor can assess the ratio between operating costs and revenue per project and through comparison between different periods and different projects, understand the project's performance in relation to other projects.

(e) Revenue Earned per Hour (Project-wise)

The internal auditor can compute the revenue per project per person per hour, especially, in the case of time based billing and map it with the total billed amount. This would help the internal auditor analyse the effectiveness of controls related to the billing cycle.

(f) Total Calls Handled to Total Calls Received, Calls Resolved to Calls Handled

Ratios such as, total calls handled to total calls received are particularly applicable to a call centre. The management, generally, have data pertaining to the total calls received and total calls handled. In such cases, the internal auditor is required to ensure that the calls handled is not significantly low as compared to the calls received.

Another ratio which the internal auditor can verify is the total calls resolved to total calls handled. This would establish the effectiveness of the operating team in dealing with the calls. The internal auditor is also required to verify the SLA compliances in such cases.

(g) Project-wise Profitability and Budgeted Profit Margins Comparison

Project-wise profitability ratio helps the internal auditor to verify as to whether there is a significant fluctuation in profitability between projects. In cases of significant fluctuations, the internal auditor needs to verify whether profitability ratio is in accordance with the budgeted profitability ratio. Deviations should be noted and proper explanations for deviations need to be obtained.

(h) Delays in Raising Invoices to Total Invoices

The frequency of raising invoices on a delayed basis might help the internal auditor to verify the internal controls related to raising the invoice. Reasons for such delays could throw light to inherent weaknesses in control.

(i) Percentage of Errors and Rejections

The internal auditor can verify the quality of work performed through measurement of ratios of total errors and rejections as against the total volume of work handled. This would help the internal auditor to assess legal and compliance risk, entity's effectiveness in handling projects apart from obtaining a deeper understanding about the management's initiative.

6.5 These ratios should be prepared and compared over a period of time. If these ratios are inconsistent over that period, proper explanations need to be obtained, thereby helping the internal auditor in assessing effectiveness, sufficiency, appropriateness of controls and also to highlight the risk environment the business is under. It should also be verified whether the entity monitors such ratios on a regular basis.

6.6 The following is a model Checklist related to client service agreements and billing process:

S.No.	PARTICULARS	Yes	No	N/A
1	**Client Service Agreements**			
1.1	Does the entity enters into agreements with all clients – existing and proposed?			
1.2	Is the agreement entered into with the clients signed by both the parties before commencement of work?			
1.3	Is there a proper level of authority designated by the management for signing of the contract on behalf of the entity?			
1.4	Does the entity ensure that the agreement has been signed by proper authority on behalf of the client?			
1.5	Does the entity provides services to related parties?			

S.No.	PARTICULARS	Yes	No	N/A
1.6	Are there proper systems in place to ensure that there is unbiased pricing in the case of related parties so as to ensure that the pricing is done at arm's length price?			
1.7	Verify the agreements entered by the entity during the prior years and ensure that the agreement has not expired.			
1.8	Verify the controls in place to ensure renewal of agreement at the appropriate time.			
1.9	Does the entity also enter into Statement of Work with the client for service provided for a short term, usually not more than a year?			
1.10	Is the Statement of Work signed by people of the same designation?			
1.11	Have changes in the terms of Master Service Agreement during the current period under review been verified and have appropriate changes in the controls/ systems been timely implemented to suit these changes, if required?			
2	**Verification of Billing Mechanism**			
2.1	Does the client maintain a billing matrix for all its clients?			
2.2	Is the billing matrix prepared and maintained by authorised person?			
2.3	Is the billing matrix updated every month to ensure proper billing?			

S.No.	PARTICULARS	Yes	No	N/A
2.4	Is the billing matrix approved by appropriate level of authority?			
2.5	Is the billing matrix complete in all aspects?			
2.6	Does the billing matrix also include notes of regular reimbursements that the client has agreed to make?			
2.7	Are there any mismatches between the billing matrix and contracts with clients tested on a sample basis?			
2.8	Does the client maintain a process flow which acts as a control mechanism for the monthly billing cycle?			
2.9	Has proper level of authority approved the data billed to the client?			
2.10	Are there mismatches between the billing matrix and the invoicing made to the client?			
2.11	Have there been wide fluctuations over a period of time in meeting the service requirements of the client?			
2.12	Is the invoice prepared in accordance to the format, contents, delivery, frequency to the Master Service Agreement?			
2.13	Are penalties/ charges for not meeting service requirements received on a frequent/ repetitive basis?			
2.14	Have there been significant fluctuations in billing during every invoicing period?			

S.No.	PARTICULARS	Yes	No	N/A
2.15	Have all charges that are reimbursable to the client captured on an efficient basis and approved by the appropriate level of authority before being billed to the client?			
2.16	Are reimbursements that are billed to the client raised separately as a debit note and not as a part of invoicing?			
2.17	Have there been any delays in completion of the invoice process?			
2.18	Does the client obtain a confirmation mail of the amount and workings that are to be billed for the billing period before final invoicing?			
2.19	Have discounts, if any provided to the client, approved by the appropriate level of authority?			
2.20	In circumstances where billing cycle does not end during the last day of the month, are the procedures and processes for accounting for unbilled revenue for the month commensurate?			
2.21	Does the entity have proper procedures for dealing with scenarios like work invoiced but not/partially accepted by the client? Is it in accordance with Accounting Standards and pronouncements of the ICAI?			
2.22	Are there controls wherein there is regular monitoring of unmatched customer orders?			
2.23	Does the entity monitors client-wise			

S.No.	PARTICULARS	Yes	No	N/A
	services rendered with their contract so as to ensure compliance of minimum service criteria?			
2.24	Does the entity monitors the payment received against invoices raised?			
2.25	Does the entity has a process of cross checking the outstanding balance due on a period to period basis?			
2.26	Has the entity obtained Foreign Inward Remittance Certificate (FIRC) for all foreign remittances?			
2.27	Does the entity maintains control of the list of invoices for which remittances are yet to be received?			
2.28	Has the foreign remittance been received within 6 months as stipulated in FEMA, 1999 or 1 year as per FTP, if applicable?			
2.29	Is there a proper follow up mechanism in place for cases where remittances have not been received even after the due date?			
2.30	Have the invoices been accounted for during the period for which they have been raised(on accrual basis)?			
2.31	Does the entity use foreign exchange rates from authorised sources in accordance with the accepted practice and in compliance with Accounting Standards?			
2.32	Has the entity filed Softex Form in accordance with the STPI Scheme?			

S.No.	PARTICULARS	Yes	No	N/A
2.33	Does the Master Service Agreement acts as an embedded derivative as regards Foreign Exchange? Are there proper controls in place to ensure proper accounting and billing in such cases?			

SLA Adherence

6.7 The entity needs to ensure compliance with Service Level Agreement/ SOW/ PO as the case may be for the Service Level specified in the agreement. The Service Level may be in relation to the minimum level of service, maximum billable time per transaction, maximum permissible errors, percentage of unsolved/ unanswered queries, etc.

6.8 Compliance with Service Level Agreement is extremely important for the entity with regards to ensuring that the quality of work performed is in accordance with that required by the agreement. In case the entity is unable to meet its SLA, then it is important for the entity to ensure compliance with SLA through providing of incentives for employees, training and other methods. The compliance with SLA requirements gains importance considering that it helps in brand building and client satisfaction.

For example, if the Service Level Agreement requires an agent to resolve 40 queries in a week, the internal auditor can verify if the agent is efficient in providing service as per the Service Level Agreement.

6.9 The internal auditor can also verify the procedures of the management towards quality checks and controls. The procedures can be through external consultants or through the internal quality assurance team. An effectively defined quality assurance framework can be termed as a prerequisite, but it should not be confused with a fail safe and comprehensive solution. There is still the implementation part and if that is not carried out properly, delivering quality assurance would always pose a big challenge for outsourcing service providers.

6.10 A step-by-step procedure that outsourcing service providers can use for ensuring the quality of service deliverables is given below:

(i) Test viability of service deliverables

(ii) Tweaking the processes, if required

(iii) Deploying quality management systems

(iv) Tracking project progress and providing feedback

The internal auditor can verify the compliance of SLA on a month to month basis; verify whether the Service Level is sufficiently higher than that prescribed by the client to ensure compliance with the terms of the agreement and also continuity of service.

Payroll

6.11 The highest cost for any entity operating in the BPO Industry would be the payroll cost, therefore, importance of proper controls for processing payroll need not be over-emphasised. The entity needs to maintain adequate records, documents, policies, processes for all aspects of payroll.

Most BPO companies process payroll for the month, based on the records of a different period. For example, when payroll for the month of December is processed, then the leave records, performance record for the period 21st November to 20th December would be considered. The main reason for such processing is to ensure disbursement of payroll by the specified day of the month.

6.12 The internal auditor needs to ensure that proper, adequate and appropriate cut-off procedures are in place to ensure proper computation and disbursement of salary to the employees. The procedures for computation of amount to be deducted on various heads also need to be verified in accordance with organisational policies and procedures. The internal auditor needs to verify the policies and procedures and compliance of the same on a sample basis.

Computation of incentives is a complex area in any entity operating in a BPO Industry. The reason for such complexity owes to the variety of schemes offered to the employees by the entity. The entity, generally, provides incentives in accordance with the nature of job, level of employee in the entity, client for whom the employee provides service and the offer letter given to the employee. Compliance with various regulations too is a tedious job considering the volume of work to be performed. The entity, generally, has protocols for ensuring compliance with regulations.

6.13 Certain entities operating in the BPO Industry provide an opportunity for employees to take ownership in the company through issue of stocks. It could be in the nature of any one of the following:

- Stock Awards;
- Employee Stock Option Plan;
- Employee Stock Purchase Plan.

The entity prescribes minimum level of the management for whom these plans would be applicable. In the case of captive service provider, the holding company's shares may also be issued to the employee subject to compliance of legal requirements.

6.14 The internal auditor through his internal audit procedures is required to find out whether any fictitious employees are employed in the organisation. The procedures performed could be in the form of inquiries and discussions with the management, verification of employee records, verification of bank records for testing disbursement, etc.

There could be cases where employees are allowed to come on a flexible timing basis and work from home. In such cases, the internal auditor should ascertain sufficient controls over the employee.

6.15 A *time sheet* is a method for recording the amount of a worker's time spent on each job. Time sheet places a very important role in estimation of the cost incurred for every project by the entity and also in some cases billing is based on the number of hours an employee works on the project. Therefore, the internal auditor should verify the entity's effectiveness in recording and maintenance of the time sheet.

In some situations, the recording of time sheet is done through an electronic/automatic process and is driven by software. In such cases, the internal auditor is required to understand the process in detail and verify the process on a sample basis. Exceptions if any noted on the project should be taken seriously by the internal auditor and adequate explanations should be obtained.

6.16 The internal auditor may also perform additional analytical procedures over a period of time and compare them for ascertaining any inconsistency such as following:

(i) Productive Hours Ratio

Productive hour's estimation is a measure of the efficiency of the work force during a particular period. In other words, it is the ratio between hours an employee works effectively to the total hours he works. By analysing this ratio, the internal auditor can understand the motivation level of employees, steps taken by the management towards maintaining efficiency and to some extent the trend of attrition.

(ii) Manpower on Client Project to Total Manpower

Manpower per project to total manpower ratio can be helpful to estimate the importance of a project in terms of manpower requirement. If there is a decline in the manpower and if there is no consequent decline in revenue, the internal auditor needs to verify this anomaly.

(iii) Average Employee Cost per Head per Project

Average cost incurred for an employee (cost includes incentives, gifts, entertainment costs incurred for the project) can be computed by dividing the total cost incurred for a period on a project to average number of employees during the period. The internal auditor may compare this information between different periods, or with other projects, where the services rendered are of a similar nature.

(iv) Employee Turnover Ratio

Employee turnover ratio helps the internal auditor to verify the attrition rate and assess the entity's effectiveness and steps taken towards prevention of attrition and retention of key employees. In case of employee turnover ratio being higher than the industry, the internal auditor must obtain explanations for the reason for such high turnover ratio.

(v) Revenue Generated by an Employee against Incentive Paid

Generally, incentives are paid to an employee based on his performance. By comparing the revenue earned through an employee and the incentive paid to him, the internal auditor can ensure compliance of the incentive schemes in place within the organisation.

(vi) Reconciliation with Respect to Changes in the Number of Employees

The internal auditor can assess the movement in employees for a month in comparison with another by tracing the additions and deletions due to additions, terminations, retirements, etc in a month based on each grade and obtain an insight on the plans of the management.

6.17 The following is a model checklist related to payroll process:

S.No.	PARTICULARS	Yes	No	N/A
1	**Specific Areas of Payroll Processing**			
1.1	Does the entity have a payroll process as approved by the appropriate level of authority?			
1.2	Is the payroll process complete in all aspects, as applicable to the entity?			
1.3	Does the entity maintains a checklist of statutory remittances to be made on account of PF, ESI, Labour Welfare Fund, etc			

S.No.	PARTICULARS	Yes	No	N/A
1.4	Are cheques prepared and signed by two different employees?			
1.5	If the entity opts for bank transfer then is there sufficient level of authority to issue bank transfer instruction to the bank?			
1.6	Is the payroll processing cross checked before payment is made?			
1.7	Are there sufficient manual records maintained by the entity with regard to their recruitment, offer letter, appraisals and increments and all other correspondences with the employee?			
1.8	Have the incentive schemes been verified by the internal auditor on a test basis?			
1.9	Are controls in place to ensure that incentives are computed in accordance with the schemes?			
1.10	Have these controls been tested for effectiveness?			
1.11	Have we performed sample testing of incentive workings made and paid to the employee to ensure adherence to the incentive system?			
1.12	Is the attrition rate exceedingly high? Have justifications for such a high rate, if any obtained?			
1.13	Does the entity maintains separately all complaints and redressals received from the employees?			
1.14	Have the reasons and explanations been obtained for any failures and			

S.No.	PARTICULARS	Yes	No	N/A
	control weaknesses observed on review of these complaints?			
1.15	Does the entity comply with the accounting requirements for ESOP, ESPP schemes and has maintained proper records of the shares opted by the employees?			
1.16	Does the entity has sufficient time records for its employees and leave records as approved by the appropriate level of authority and does this form the basis for the computation of salary?			
1.17	Does the entity has sufficient controls and records for cases where disbursements are made to employees working from home?			
1.18	In cases of flexible timings and work from home option provided to an employee, has appropriate approval been obtained in such cases?			

Operating Costs

6.18 The significant operating costs in any BPO include the following:

(i) Lease Expenses

Lease expenses could be of the nature of leasing of office building for work space, or leasing of assets for official purpose or accommodation provided to the employees.

(ii) Communication Expenses

It represents expenses in the nature of leased line charges and is considered significant in comparison to other costs.

Moreover, BPOs, generally, have a contingency plan in case of any failure.

(iii) Recruitment and Training Expenses

These expenses are also considered to be high considering the high attrition and turnover ratio of the industry and its growth over the past few years. Most entities have contracts with HR Consultants and reputed trainers to ensure that the costs are controlled.

(iv) Sub-contracting Expenses

Some BPOs sub-contract a part of their operations to an external party. This can be done so only if agreed to by the parties.

(v) Logistics

Considering the labour Intensive nature of the BPO Industry apart from odd working hours, logistics plays an extremely important role in the entity. Most employees use the logistics provided by the entity to commute to work place. Considering the significance of this department, usually, entities enter into contracts with logistic providers in order to limit their liability and manage them professionally. The entity must maintain sufficient controls for proper usage of vehicles.

6.19 The internal auditor should verify the systems, processes, controls and procedures built within the system so as enable smooth and proper movement of the employees to and fro from the work place. There should also be proper controls for usage of logistics for purpose of business only. The internal auditor can perform various procedures such as, cross checking logistics records with attendance registers, verification of in time and out time records with logistic records, cost per employee travelled, etc.

6.20 In case the entity has undertakings in SEZ, STPI, EOU and/ or undertaking without any such exemptions, then it is required under certain regulations such as, Income Tax Act, 1961, to ascertain profit separately for each of these undertakings. In such a scenario, the entity is required to apportion certain common costs between these undertakings.

In case the entity provides services in India and outside India, the services provided in India would be considered as a Domestic Tariff Area (DTA) clearance. Thereby, these services would not be considered as export of service. The internal auditor needs to ensure proper allocation procedure of costs for services rendered in India and outside India.

6.21 The internal auditor is required to verify the procedures and controls for capturing of specific expenses with regards to its sufficiency, appropriateness and efficiency. Moreover, the internal auditor needs to ensure that common expenses are allocated across these undertakings in a justifiable basis. The internal auditor may also perform additional analytical procedures over a period of time and compare them for ascertaining any inconsistency such as following:

(i) Total Fixed Cost

Significant increases in the total fixed cost signals expansion activity. In such cases, the internal auditor needs to verify the sufficiency of controls with respect to the growing entity.

(ii) Operating Cost to Revenue (Undertaking-wise)

An entity operates in varied legal environment and different challenges are faced by the entity operating in each such environment. The internal auditor can estimate the operating cost (i.e., cost including labour, communication, lease and all other variable expense to the particular undertaking) to the revenue generated by it. This would provide a basis for evaluating the cost effectiveness of operating in each of the undertakings.

(iii) Variable Cost per Man Hour per Undertaking

Variable cost per man hour can be computed by dividing the total cost incurred in an undertaking divided by man hours for the same period. This can be compared with different periods to verify whether there has been a significant increase/ decrease in the expense and identify reasons for the same.

(iv) Penalty Costs to Total Cost

The internal auditor can estimate the significance of penalty cost in relation to total cost through this method. Any penalty/ non–compliance must be viewed seriously by the internal auditor.

(v) Interest Cost to Loans

Interest cost to loans provides a basis for the estimation of the average cost of borrowed funds in the entity. The internal auditor can estimate the average cost of borrowing and compare them with the existing rate to verify whether the interest paid is significantly high.

6.22 The following is a model checklist related to expenses:

S.No.	PARTICULARS	Yes	No	N/A
1	Internal Audit of Communication andLogistics related Expenses			
1.1	Have the terms of the contract with the various service providers been verified on a sample basis to ensure compliance of the same?			
1.2	Does the entity has a contingency plan in case of any failure of the main telecommunication line?			
1.3	Does the entity avail services from various providers to ensure reduced risk of reliance of one service provider?			
1.4	Does the entity maintains a sufficient list of all vehicles that enter and exit from the workplace and also the employees travelling in these vehicles?			

S.No.	PARTICULARS	Yes	No	N/A
2	**Internal Audit of Sub-contracting of Work**			
2.1	Has the entity sub-contracted any work?			
2.2	Does the Master Service Agreement provides an option of sub-contracting the work to the entity?			
2.3	Are the clauses pertaining to sub-contracting satisfied?			
2.4	Has the entity considered the risks of sub- contracting like, service delivery?			
2.5	Has the sub-contract been mutually signed by the appropriate levels of authority?			
2.6	Does the entity supervise the work post sub- contract to ensure proper, timely and quality deliverable to the client?			
2.7	Has the agreement/contract with the sub-contractor been verified?			

Fixed Assets

6.23 For the BPO Industry, in general, the fixed assets such as, servers, computers, laptops, EPABX and alike may be that of the entity's or provided by the client. This is so, to prevent theft of confidential information of the client which may be subject to Intellectual Property Rights. It might also include software provided by the client on which the entity might be working or owned by the entity itself.

6.24 The internal auditor may also perform additional analytical procedures over a period of time and compare them for ascertaining any inconsistency such as following:

(i) Total laptops and desktops to on-field employees

For employees providing on-site services, the internal auditor can verify the employees on-site and the laptops provided to them (grade-wise). This would help the internal auditor to verify the controls in laptops given to the employees.

(ii) Total EPABX to number of on-field employees

Total EPABX to on-field employees provides a ratio between the employees and the EPABX installed. This would help the internal auditor to verify the control in laptops given to the employees.

(iii) Asset utilisation ratio

Asset utilisation ratio is the ratio of total revenue to the total assets. It helps the internal auditor to assess the effectiveness of assets with respect to the revenue generated by the entity. The greater the asset utilisation ratio, the higher the efficiency of operations of the entity.

If the internal auditor is required to perform fixed asset verification procedures too as part of the scope of his work, the auditor can refer to ***Guidance Note on Audit of Fixed Assets***. Audit techniques which the internal auditor can perform for verification of assets include procedures such as, verification of laptops at the time of logging on to the server/network monitored through a special software, verification of software licences and validity, number of licences against number of computer systems used for specific purpose and so on.

6.25 The following is a model checklist related to fixed assets:

S.No.	PARTICULARS	Yes	No	N/A
1	**Internal Audit of Fixed Assets**			
1.1	Has the entity separately identified assets owned by it and assets received from the client?			
1.2	Does the entity complies with all the requirements for utilisation of the client's assets?			

S.No.	PARTICULARS	Yes	No	N/A
1.3	If there are laptops issued to employees, does the information system division has sufficient control over the laptops? Are these laptops verified on a frequent basis?			
1.4	Does the entity has sufficient protection for its servers from both internal and external damage?			
1.5	Are there sufficient controls and processes to ensure capitalisation of assets on the appropriate date?			

Related Party Transactions

6.26 Many BPOs have significant related party transactions. Certain BPOs are captive service providers which are incorporated to provide services to its holding company. Hence, sufficient controls should exist within the organisation to

ensure that all transactions with related parties are identifiable and monitored. These transactions could be in the nature of the service provided by the entity to

its holding company or in the nature of other transactions, not related to operations that are transacted on a routine basis like, deputation of manpower, payment of dividends, reimbursing costs incurred on behalf of the holding company, etc. The internal auditor is also required to verify the transfer pricing implications faced by the entity with regards to controls and processes in the entity to ensure proper estimation of arm's length price.

Arm's length price means a price which is applied or proposed to be applied in a transaction between persons other than associated enterprises, in uncontrolled conditions

6.27 The following is a model checklist related to related party transactions:

S.No.	PARTICULARS	Yes	No	N/A
1	**Internal Audit of Related Party Transactions**			
1.1	Has the entity identified related parties in accordance with the regulations?			
1.2	Are there controls in place to identify all transactions with related parties?			
1.3	Has the entity raised debit notes or invoices appropriately and consistently?			
1.4	Does the entity have proper methods of identifying related parties and associated enterprise with relation to provisions of the Income tax Act?			
1.5	Does the management frequently verifies whether international transactions come under the ambit of transfer pricing?			
1.6	With regard to allocation of costs between transactions with associated enterprise and non-associated enterprise, are there sufficient			
1.7	Does the entity maintains sufficient documentation as required under the provisions of transfer pricing for all transactions with related parties?			
1.8	Does the entity have proper control of identifying all transactions made with related parties?			
1.9	Does the entity have a proper pricing policy with regards to associated enterprises and others? Is the pricing			

S.No.	PARTICULARS	Yes	No	N/A
	policy fair in the overall light of business and in accordance with the provisions of transfer pricing regulations?			
1.10	In case of international transactions, does the entity have sufficient control of imports and exports received/ provided at free of cost? Does the entity value these in accordance with the transfer pricing regulations?			

Data Security

6.28 Data security is a major problem in a BPO industry. The various sources of danger to data can be in the form of following:

(a) Natural Calamity

Fire, flood, earthquake, falling elephants can cause damage to hardware including server, computers and other physical storage devices.

(b) Theft of Data

Data theft is a growing problem primarily perpetrated by office workers with access to technology such as, desktop computers and hand-held devices capable of storing digital information such as, flash drives, iPods and even digital cameras. Since employees often spend a considerable amount of time developing contacts and confidential and copyrighted information for the company they work for, they often feel they have some right to the information and are inclined to copy and/or delete part of it when they leave the company, or misuse it while they are still in employment.

While most organizations have implemented firewalls and intrusion- detection systems very few take into account the threat from the average employee that copies proprietary data for personal gain or use by another company. A common scenario is where a sales person makes a copy of the contact database for use in their next job. Typically, this is a clear violation of their terms of employment.

(c) System Crash

A system crash is a condition where a program (either an application or part of the operating system) stops performing its expected function and also stops responding to other parts of the system. Often the offending program may simply appear to freeze. If this program is a critical part of the operating system kernel the entire computer may crash.

(d) Computer Fraud

Computer fraud covers a variety of activity that is harmful to people. Computer fraud is using the computer in some way to commit dishonesty by obtaining an advantage or causing loss of something of value. This could take form in a number of ways, including program fraud, hacking, e-mail hoaxes, auction and retail sales schemes, investment schemes and people claiming to be experts on subject areas.

(e) System Bugs

A bug is the common term used to describe an error, flaw, mistake, failure, or fault in a computer program or system that produces an incorrect or unexpected result, or causes it to behave in unintended ways. Most bugs arise from mistakes and errors made by people in either a program's source code or its design, and a few are caused by compilers producing incorrect code.

(f) Power Failure, Accidental Deletion/ Modification

Power failure and accidental deletion/ modification of files is a common type of problem faced by many small entities due to lack of sufficient infrastructure and also training to the employees.

(g) Hacking

Hacking could be in the form of:

- Passwords required to enter or change the PC's BIOS;
- Passwords required to enter a network;
- Passwords required to start the operating system;
- Passwords required to enter major software packages (e.g., payroll); or
- Encrypted (encoded) data files.

(h) Telecommunication Failure

Sometimes, the telecommunication network might fail which might result in freezing of flow of data from and to the computing system. During such time, the entity might not be able to perform its operations.

(i) Virus Problem

A computer virus is a computer program that can copy itself and infect a computer. A computer virus has two major classifications. They have the ability to replicate itself, and the ability to attach itself to another computer file. Every file or program that becomes infected can also act as a virus itself, allowing it to spread to other files and computers.

(j) Unknown Risks

There might be threat to data due to other reasons not included above. The internal auditor must keep an eye on these too to ensure complete data security.

6.29 The data of both the client and the entity needs protection. There might be severe penalties imposed by the client on account of fraudulent activities by the entity. The work area would not be reasonably accessible by an outsider without proper security check and prior authorisation to ensure safety of data and to prevent theft thereto. Conditions such as, inhibition of use of mobile phones, personal laptops, cameras, and pen–drives are enforced.

The internal auditor needs to verify the sufficiency of control of data. He should also obtain explanations for any loss/ damage of data, if any during the reporting period apart from steps taken to prevent them in the future. He should also verify whether the policies and procedures are put in place. The internal auditor may refer to SIA 14*, "Internal Audit in an Information Technology Environment"* and SIA 16*, "Using the Work of an Expert".*

6.30 The following is a model checklist related to internal audit under computer environment:

S.No.	PARTICULARS	Yes	No	N/A
1	**Internal Audit of Computer Environment**			
1.1	Is there a sound computer/ laptop usage policy formed by the entity?			
1.2	Does the usage policy covers all possible areas?			
1.3	Is it frequently updated and circulated to all users?			
1.4	Are there sufficient firewalls installed in the server to ensure proper security and is it frequently updated?			
1.5	Is there a proper internet usage policy and does it bind all the employees?			
1.6	Is there a frequent systems audit done to ensure in time detection of all irregularities?			
1.7	Does the entity take all possible steps to prevent, detect and punish fraud?			

Risks faced by a BPO Industry

6.31 The internal auditor should make a risk assessment of the entity under audit. This is extremely important on account of prevention of any non-compliance or undesirable event. Given below is a brief of the different risks faced by the entity operating in the BPO Industry. The internal auditor needs to verify whether sufficient controls are available in the entity to detect such risks and prevent them from happening in the light of overall business environment.

6.32 The risks faced by a BPO Industry is broadly classified as follows:

(i) Business risk

(ii) Price risk

(iii) Political risk

(iv) Process risk

(v) Human capital risk

(vi) Brand/ Reputation risk

(vii) Systemic risk

(viii) Accessibility risk, Business continuity, Security risks

(ix) Technology risk

Business Risk

6.33 Business Risk comprises of following:

(i) A change in scope of services at the customer's request.

(ii) A change in the legal environment that imposes new conditions, costs or restrictions upon the manner of providing the services, the means by which the services are delivered to the enterprise customer or the right of the enterprise customer to purchase such services in its home country.

(iii) A change in the volume of the services being consumed, either to :

- Increase (requiring additional hiring and perhaps a change in business process) or

- Decrease (resulting in sub-optimization of dedicated resources or re-allocation of resources across multiple enterprise customers without any decrease in SLA commitments).

(iv) An early termination that occurs before the service provider has earned out the sunken costs of pursuing and capturing the contract opportunity and paid the unpaid start-up and transition costs.

(v) There is mergers and acquisition risk that an enterprise or a service provider might change owners. Enterprise managers need to adapt the sizing and pricing of their outsourcing transactions to include possible mergers, acquisitions, divestitures and restructuring activity within the term of the outsourcing agreement. Service providers need to provide assurances that a change of control, such as in a merger or restructuring, will not impair the competitive position of the enterprise customers. Accordingly, "M & A risk" should be identified by both parties in order to evaluate and negotiate appropriate contract provisions to manage and mitigate the impact of major changes in ownership or capital structure.

Price Risk

6.34 Pricing risks arise as soon as the parties agree upon the service terms, conditions and pricing. For the service provider, the "pricing risk" is that the benchmarking process or other price adjustment will result in a loss or significant reduction in profitability and an inability to recapture the investment made in capturing and transitioning an enterprise customer to the outsourced business process platform. The service provider can never stand still, though, since if it fails to make ongoing investments in process improvement and cost containment, upon the expiration of the contract, it will cease to be competitive for new customers.

The art of outsourcing includes identifying and providing commercially reasonable solutions for both parties. Commercial and financial transactions contain pricing risks at many levels. The design of contracts to manage and mitigate pricing risks is an art form. Multiple techniques are available, each with its own limitations and additional risks.

Political Risk

6.35 Political risk represents the degree to which social and governmental environments may change in the future. This risk may manifest itself in events over which a government has no control – such as, riots or new elections. Other events may be caused by a government, such as, an embargo on imports or exports, increases in tariffs, new prohibitions on transactions with specific countries.

Political risk may arise from actions of the home government of the enterprise. In international outsourcing transactions, political risks need special attention due to the long-term nature of the relationship. There are a number of techniques that can mitigate, but not eliminate, such risks. Moreover, the entity is affected by outsourcing policies of the country for which the entity provides services. For example, if outsourcing is not encouraged by a country by imposing additional tax or cut of tax sops, then, the Indian entities providing services for clients in that country, may face a bottleneck for expansion of operations.

Process Risk

6.36 "Process risk" refers to the possibility that the processes used to deliver a service might need to change dramatically during the term of a sourcing arrangement. This can be favorable or unfavorable. Since processes will likely change, the parties need to identify the significant processes that form the basis of the bargain and that, if impacted by a change, could justify a renegotiation, termination, repricing or expansion or contraction of the scope of service.

Process risk denotes the risk that the processes adopted by the service provider will not fit the needs of the enterprise customer. This risk is somewhat complex.

(a) There may be process risks during the transition period where the service provider was not aware of important existing processes that were underlying the general services in the outsourcing agreement.

(b) Process risk may also arise due to changes, over time, of the enterprise customer's needs and the "best practices" in the relevant business process.

(c) Some processes may become illegal or subject to regulation, while other processes may become technologically outdated.

(d) The duration of the contract might be so long that the parties do not clearly understand the open nature of the commitments, promises and emerging needs of each other.

Process risk can be managed by appropriate due diligence, contract planning, negotiation, transitioning, integration management and relationship governance. Legal planning techniques can also be used, particularly those relating to termination for convenience and termination for failure to manage the processes in an agreed fashion.

Human Capital Risk

6.37 Human capital risk arises from the risk that an enterprise's investment in human resources might lose value due to the departure of individuals or groups necessary to the future success of the enterprise. Human capital has its greatest value at the level of senior management, but as executives they can only achieve the enterprise's mission through others.

6.38 When choosing business models and solutions to the sourcing dilemma, executives and managers need to evaluate the human capital risk and develop plans for contingencies. Contingency planning should include the possibility of morphing the current or future sourcing solutions into new models that involve human capital. Thus, planning and implementing outsourcing requires careful attention on human capital management during and after the term of any outsourcing agreement.

Brand/ Reputation Risk

6.39 Enterprise viability depends on maintaining the goodwill of the enterprise brand. Damage to reputation might never be recovered, or might only be recovered at great expense and distraction. Most outsourced business processes are essential to the enterprise's operations. Particularly in customer relationship management and help desk support services, outsourcers may directly "touch" the enterprise's customer without disclosing the existence of the outsourcing relationship. Reputational risk is especially significant in such customer-facing "front office" services. However, even non-voice interactions with customers can have the same impact on an enterprise's goodwill.

6.40 Brand risk management techniques include the use of scripts, supervision, random audits, ongoing training and customer feedback. Legal issues in reputational risk can arise where the customer wishes to terminate a service provider, redirect its efforts or adjust the pricing to reflect a loss of goodwill.

Systemic Risk

6.41 Regulators and governments focus on the risks to the systems that support local and global economies. A systemic risk affects all participants in an economic sector or industry.

To some degree, outsourcing both increases and reduces systemic risk. Outsourcing permits individual enterprises to share systemic risks by hiring service providers who understand and invest in risk-controlling technologies, human capital and other resources. At the same time, in concentrated industries with a small number of service providers, such a concentration of process management in the hands of a small number of service providers could pose systemic risks in the form of anti-trust or anti-competitive conduct, the risk of massive losses due to a single loss incident affecting multiple enterprise customers and the dependency of the service provider upon a favourable regulatory climate.

When planning any solution to the sourcing dilemma, executives and managers need to understand the nature of systemic risk and adopt appropriate risk planning strategies.

Accessibility Risk, Business Continuity, Security Risk

6.42 Supply chain management requires careful attention to the risks of loss of accessibility to the service provider, loss of the service provider's services and impairments to the security of confidential, proprietary, trade secret, private and protected information. Any one of these risks could prove fatal or severely damage to the customer.

During the planning and implementation phases of outsourcing and business process management, these risks need to be identified, allocated, monitored and managed.

Technology Risk

6.43 Technology risk refers to the risk that an entity faces due to change in technology or obsolescence of existing technology. An entity operating in the BPO Industry, in general, invests huge sums of money on purchase of technology. In the event of change in technology, the investment made by the entity becomes futile. Technology could be in the form of purchase/ creation of software or hardware.

Maintenance of Books of Accounts and Documents

6.44 The internal auditor is required to verify the sufficiency of controls related to maintenance of books of accounts by the entity. The internal auditor is also required to verify the controls for allocation of costs between different project, different undertakings and for DTA and non-DTA are adequate and reliable in the light of the business operations.

Moreover, if the entity provides export services, the entity is required to file Softex Form to the STPI Department of the respective state. The internal auditor is required to verify the following:

(i) The amount as documented in the books of accounts with the invoice.

(ii) The invoice with the Softex form filed.

(iii) The Softex form filed with the Softex form approved.

(iv) The Softex form approved with the limit granted.

6.45 The model checklist related to maintenance of accounts and documents is as follows:

S.No.	PARTICULARS	Yes	No	N/A
1	**Books of Accounts and Documents**			
1.1	Does the entity have proper accounting system commensurate with the regulatory requirements?			
1.2	Does the Entity have specific books of accounts for each branch located in a STPI or SEZ?			
1.3	Are the Control Systems in place in estimating the revenue generated location- wise sufficient to ensure that proper books are maintained for the location?			
1.4	In cases where there is a central EPABX and all calls are diverted from the central EPABX, are there sufficient controls to estimate the calls that are diverted to the respective locations and thereby estimating the revenue earned?			
1.5	Does the organisation have proper and reasonable system to allocate various costs incurred to the respective STPI or SEZ as applicable?			
1.6	Does the entity have location wise employee details to ensure proper allocation of payroll cost to the location?			
1.7	Are the books of accounts closed every			

S.No.	PARTICULARS	Yes	No	N/A
	month?			
1.8	Whether the time period for the closure of the books of accounts on a monthly basis is reasonable with regards to the operations of the entity?			
1.9	Are the controls for re-opening of books proper to ensure that prevention of manipulation?			
1.10	Does the entity maintain separately the statutory returns submitted along with acknowledgement to the various authorities– for every STPI, SEZ.			
1.11	If the entity has Domestic Tariff Area Clearances, does it maintain separate books of accounts for such clearances? Are there sufficient controls in place so as to ensure that the books are properly maintained?			

Compliance with Regulations

6.46 As discussed in detail under Clauses 5 and 6 regarding the various statutory requirements the BPO Industry has to comply with, the internal auditor is required to verify the compliance of these statutes and report thereon as part of his internal audit. The internal auditor also needs to verify registration with various statutory authorities and renewal of the same as part of his internal audit procedures.

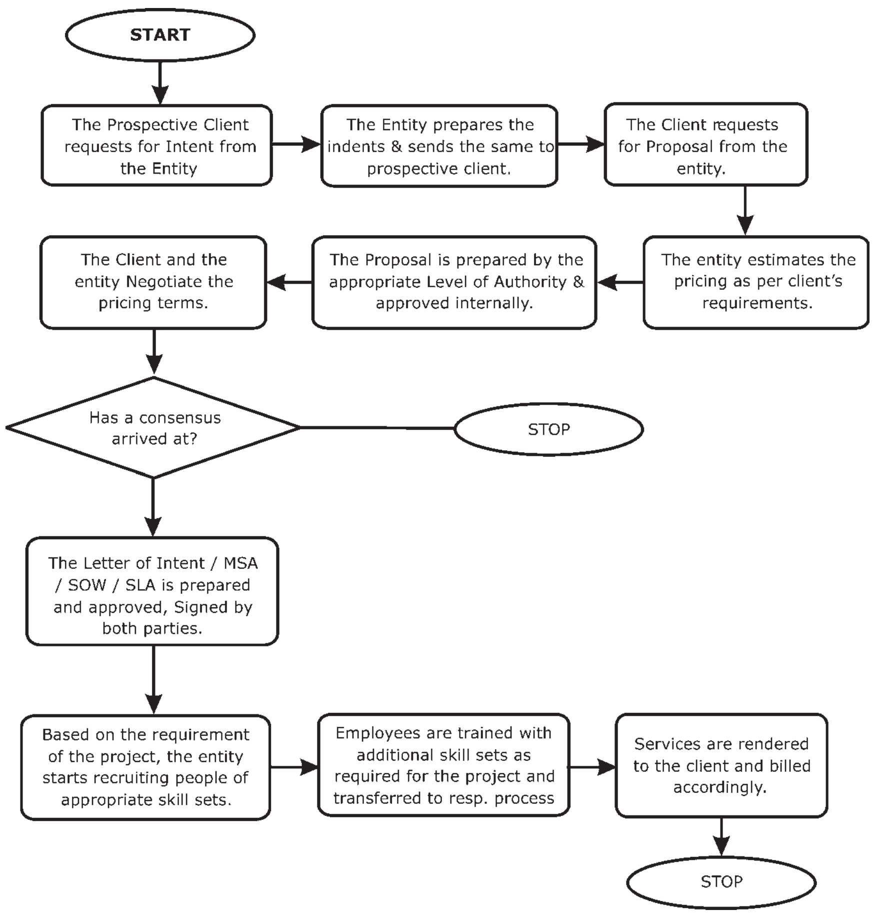
6.47 The following is a model checklist related to compliance with regulations :

S.No.	PARTICULARS	Yes	No	N/A
1.	**Compliance with Various Statutes**			
1.1	Has the client obtained registration from various statutory authorities: - Software Technology Park of India - Customs Authorities - Special Economic Zone - Service Tax - VAT - Central Excise Authorities - Reserve Bank Of India.			
1.2	Has the client renewed its registration with the statutory authorities as regards to : - Software Technology Park of India - Customs Authorities - Special Economic Zone - Service Tax Authorities - VAT - Central Excise Authorities - Reserve Bank Of India.			
2.	**Internal Audit of Statutory Provisions**			
2.1	Has the internal auditor verified the different provisions as applicable to the entity?			
2.2 2.3	Has the entity been able to maintain a positive net foreign exchange earnings? Has the entity ensured renewal of			

S.No.	PARTICULARS	Yes	No	N/A
	green card with the customs for ensuring private bonding, if applicable?			
2.4	Has the entity obtained STPI approval for domestic tariff area clearances?			
2.5	Has the entity written-off uncollected amounts in accordance with provisions stipulated by the RBI?			
2.6	Has the entity ensured compliance with provisions of the National Telecom Policy(NTP)?			

Appendix 1

A Typical Process in a BPO Industry



Appendix 2

Indicative Compliance Due Dates

(The compliance due dates given below are only an indicative list and is subject to change in the provisions of the respective regulations. Further, the applicability of these due dates is subject to the status of the entity. A list of forms frequently used by the entity is also included along with its uses.)

S. No.	Applicability	Name of the Form	Due Date	Remarks
1.	SEZ, STPI, EOU	Form AB (Software Export Declaration Form)	230 days from the date of invoice	Only for Services to Foreign Clients
2.	EOU	Quarterly Return	#	
3.	EOU	Annual Return	#	
4.	STPI Scheme	Monthly Progress Report	Within 10th of the next month*.	
5.	STPI Scheme	Quarterly Progress Report	l10th of the month from the end of the quarter*.	
6.	STPI Scheme	Tentative Annual Performance Report	Last Week of March	
7.	STPI Scheme	Annual Performance Report	30th April every year	
8.	STPI Scheme	Audited Annual Performance Report	30th June every year	

* Varies from state to state. Some states have 7th and some states have 5th as due date.

\# Varies from state to state.

Appendix 3

Software Export Declaration (Softex) Form

Slip 2
[AD/MA 1/1999]

EXCHANGE CONTROL
SOFTWARE EXPORT DECLARATION (SOFTEX) FORM
(For declaration of Software Exports through data-communication links and receipt of Royalty on the Software Packages/Products exported)

FORM NO: AB

---

1. Name and address of the exporter

2. STPI Centre within whose jurisdiction the unit is situated

3. Import-Export Code Number

4. Category of exporter : STP/EHTP/EPZ/100% EOU/DTA unit

5. Buyer's name and address including country and their relationship with exporting unit (if any)

6. Date and Number of Invoice

7. a) Whether export contract/ purchase order already registered with STPI. (If 'No', please attach copy of the contract/ purchase order) ☐ Yes ☐ No

   b) Does contract stipulate payment of royalty ☐ Yes ☐ No

SECTION - A
(For exports through data communication link)

8. Name of authorised datacom serviceprovider — **STP/VSNL/DOT/Internet/Others** (Please specify)

9. Type of software exported (Please mark '√' on the appropriate box on the left side)

(a) Computer Software — RBI Code

		RBI Code
☐	Data Entry jobs and Conversion Software Data Processing	9 0 6
☐	Software Development	9 0 7
☐	Software Product, Packages	9 0 8
☐	Others (Please specify)	9 0 9

(b) Other Software

☐	Video/TV Software	9 1 0
☐	Others (Please specify)	9 1 1

10. Analysis of Export Value — Currency — Amount

(a) Full export value
Of which :

i) Net value of exports without transmission charges

ii) Transmission charges Included in invoice

(b) Transmission charges (if payable Separately by the overseas client)

(c) Deduct: Agency commission, At the rate of …….%

(d) Any other deduction as Permitted by RBI (please specify)

(e) Amount to be realised [(a+b) - (c+d)]

11. How export value will be realised (mode of realisation) (Please mark ' ' on the appropriate box)

☐ (a) Under L/C	(a) Name and address of Authorised Dealer____________
	(b) Authorised Dealer Code No.___________________
☐ (b) Bank Guarantee	(a) Name and address of Authorised Dealer____________
	(b) Authorised Dealer Code No.___________________
☐ (c) Any other arrangement e.g. advance payment, etc. including transfer/ remittance to bank account maintained overseas (Please specify)	(a) Name and address of Authorised Dealer____________ (b) Authorised Dealer Code No.___________________

SECTION - B

(For receipt of Royalty on Software Packages/Products exported)

12. Details of Software Package(s)/ Product(s) exported ____________________

(a) Date of export ____________________

(b) GR/SDF/PP/SOFTEX Form No. on Which exports were declared ____________________

(c) Royalty agreement details

☐ %age and amount of royalty ____________________

☐ Period of royalty agreement (Enclose copy of Royalty agreement, if not already registered) ____________________

13. How royalty value will be realised (as defined in Royalty agreement) ____________________

14. Calulation of royalty amount (Enclose copy of communication from the foreign customer) ____________________

15. Name and address of designated Authorised Dealer in India through whom payment has been received/ to be received. A.D.Code No. ____________________

SECTION - C

16. Declaration by exporter

I/We hereby declare that I/we am/are the seller of the software in respect of which this declaration is made and that the particulars given above are true and that the value to be received from the buyer represents the export value contracted and declared above. I/we also declare that the software has been developed and exported by using authorised and legitimate datacom links.

I/We undertake that I/we will deliver to the bank named above the foreign exchange representing the full value of the software exported as above on or before ………….. (i.e. within six months from the date of invoice / date of last invoice raised during a month), in the manner specified in the Regulations made under the Foreign Exchange Management Act,1999.

____
Signature of the Exporter

Place:

Stamp

Name:____________________

Date:

Designation:_______________

Enclosure:

(1) Copy of Export Contract [17(a)]
(2) Copy of Royalty Agreement [12(c)]
(3) Copy of communication from foreign customer [14]

Space for use of the competent authority (i.e. STPI) on behalf of Department of Electronics

Certified that the software described above was actually transmitted and the export/royalty value declared by the exporter has been found to be in order and accepted by us.

Place:

Date:

(Signature of the Designated Official of STPI/EPZ/SEZ on behalf of Ministry of Communications & Information Technology)

Name:______________________

Stamp

Designation:_________________

Reference:

1	NASSCOM	www.nasscom.in
2	BPO India	www.bpoindia.org
3	BPO Watch	www.bpowatchindia.com
4	Software Technology Parks of India	www.stpi.in
5	An ASSOCHAM Initiative on the Indian Outsourcing Industry	http://www.assocham.org/bpo/index.ht ml
6	Department of Information Technology, Ministry of Communication and Information Technology, GOI	http://www.mit.gov.in
7	Department of Telecommunications, Ministry of Communication and Information Technology, GOI	http://www.dot.gov.in
8	National Informatics Centre	http://www.nic.in/
9	Directorate General of Foreign Trade, Ministry of Commerce and Industry, GOI	http://dgft.delhi.nic.in/
10	Telecom Regulatory Authority of India	http://www.trai.gov.in
11	Working group on Information Technology for Masses	http://itformasses.nic.in

I-8
TECHNICAL GUIDE ON INTERNAL AUDIT OF RETAIL INDUSTRY

Foreword

Retail industry is one of the fastest growing industries in India, especially over the last few years. A large number of players are operating in this sector. The growth of this industry is boosted by various factors such as, availability of professional practices, media proliferation, various brands which are gaining value thereby enhancing industry growth, availability of various funding options, sea change in demographics of country and international exposure.

In view of the significant developments in the industry, it has become imperative to introduce robust system/ processes that would not only address to the problems relating to internal controls but would also bring effective governance so as to serve the interests of management, consumers, government and the society in general. An effective internal audit function is a fundamental component of good governance. In addition to it, the internal auditors play a key role with respect to multi-dimensional challenges faced by this industry.

Considering the growth of this sector, a need was being felt to bringing out a Technical Guide on Internal Audit to address this industry-specific issue. I congratulate the Internal Audit Standards Board of the Institute for bringing this Technical Guide on Internal Audit of Retail Industry. I also wish to place my deep appreciation for CA. Rajkumar S. Adukia, Chairman, Internal Audit Standards Board for steering this Technical Guide in short span of time. I am happy to note that this Technical Guide is also quite comprehensive in its coverage dealing with various aspects of internal audit of retail industry.

I am sure that the issuance of this Technical Guide would also prove to be immense use of internal auditors in discharging their professional duties.

February 10, 2011 **CA. Amarjit Chopra**
New Delhi *President, ICAI*

Preface

The Indian retail market is one of the India's fastest growing industries. In today's dynamic and shaky business world, the issues faced by a successful retailer are unnerving. With an endless array of customer choices, fierce competitors, pervasive use of the internet, and a complex global economy, retailers need to focus on finding ways to sustain and grow their businesses.

Internal audit is a service which can immensely help the industry overcome the challenges and increase value. Internal auditors who understand the basic structure and processes of the retail industry can play a meaningful role by assisting the retail industry in facing the challenges and pressures in today's tough retail environment. Keeping this in view, the Internal Audit Standards Board is issuing this "Technical Guide on Internal Audit of Retail Industry". This publication is an attempt to provide a consistent and comprehensive coverage of all the aspects of the retail industry.

This publication has been divided into six chapters. Chapter 1 of the Guide deals with the objective and scope of the Guide. Chapter 2 of the Guide explains the evolution, history and special features of the industry. This chapter also provides guidance regarding the initiatives taken by the government, challenges faced by the entities. Chapter 3 explains legal framework applicable to the industry. Chapter 4 provides guidance on the statutory laws applicable to the industry. Chapter 5 of the guides covers the methodology for the internal audit for the retail industry as well as internal audit in an information technology environment. This chapter also describes the procedures to overview the compliance of laws and regulations. Chapter 6 covers the detailed procedures to be undertaken by the internal auditor in respect of invoicing, payroll, procurement of material and consumption, operating costs, fixed assets, data security and risks faced by the industry, Appendix includes flow charts regarding various process undertaken by the industry. The Guide also contains glossary of terms used in the retail industry for providing valuable guidance to the readers.

At this juncture, I am grateful to CA. M. Guruprasad and his study group members for sharing their experiences and knowledge with us and preparing the draft of the Guide.

I also wish to thank CA. Amarjit Chopra, President and CA. G. Ramaswamy, Vice President for their continuous support and encouragement to the initiatives of the Board. I must also thank my colleagues from the Council at the Internal Audit Standards Board, *viz*., CA. Naveen N. D. Gupta, CA. Nilesh S. Vikamsey, CA. Atul C. Bheda, CA. K. Raghu, CA. J. Venkateswarlu, CA. Abhijit Bandyopadhyay, CA. Ravindra Holani, CA. Charanjot Singh Nanda, Ms Usha Sankar, Shri Prithvi Haldea and Shri Sidharth Birla for their vision and support. I also wish to place on record my gratitude for the co-opted members on the Board, *viz*., CA. Sushil Gupta, CA. Smita Satish Gune, CA. Nagesh Dinkar Pinge, CA. Sumant Chadha and CA. Deepak Wadhawan as also special invitees on the Board for their invaluable guidance as also their dedication and support to the various initiatives of the Board.

I am confident that this publication would help the readers in understanding the emerging issues of the Retail industry.

February 8, 2011
Mumbai

CA. Rajkumar S. Adukia
Chairman,
Internal Audit Standards Board

Glossary

Anchor Store	A major retail store used to drive business to smaller retailers. These larger department stores or grocery stores are generally part of a retail chain and are the prominent business in a shopping mall.
Aspirational Products	Good quality and high priced lifestyle products.
Bar Code	A series of vertical or horizontal parallel lines forming a code that is optically read and interpreted by a bar code scanner. Used on envelopes and forms for rapid entry of data and for sorting. Bar coding may be an indication that the inventory is computerised.
Brick and Mortar	Brick and mortar store refers to retail shops that are located in a building as opposed to an online shopping destination, door-to-door sales, kiosk or other similar site not housed within a structure.
Broad Banding	In a broadband pay structure, the numbers of salary grades are consolidated into fewer, but broader, pay ranges. Broadband pay structures encourage the development of broad employee skills, because non-managerial jobs are appropriately valued and skill development is rewarded.
Bundled Pricing	Involves a retailer providing a number of services for one basic price, most often seen in mobility service packages.

Cannibalism	The impact that a new location will have on an existing store's sales in a chain corporation.
Chain Store	One of a number of retail stores under the same ownership and dealing in the same merchandise.
Chargebacks	The retailer's invoice for claims against a vendor resulting from items such as damaged merchandise, cooperative advertising costs, adjustments, and the recovery of transportation charges for improperly routed merchandise. Chargebacks are usually shown on the vendor's invoices.
Cooperative Advertising	Advertising paid for jointly by the advertiser and its wholesalers or retailers. For example, the landlord of a strip mall may collect a percentage of advertising from each tenant. This is used for advertising that will benefit all of the tenants.
Customer Loyalty Program	A customer loyalty program is a structured and long-term marketing effort which provides incentives to repeat customers who demonstrate loyal buying behavior.
DIY (Do It Yourself) Stores	Modern, usually large-format stores specialising in the sale of construction materials, finishing, decoration and garden products.
Drug Store and Cosmetics Shops	Outlets whose key offering is made up of cosmetics, toiletries, hygiene products, accessories, and possibly also household chemicals.
Electronic Article Surveillance	Involves attaching specially designed tags or labels to products to curb shoplifting.

E-retailing	It is usually referred to an Internet retailing, covers retailing using a variety of different technologies or media, mostly the internet. Products are chosen *via.* a published catalog and payments made through credit cards and secure payment gateways.
Fast Moving Consumer Goods (FMCG)	A group of products sold quickly at a relatively low cost, usually referring to food (excluding fresh food) and cosmetics/ toiletry items.
Flag Ship Store	The Flag Ship Store refers to a store located at retailer's primary location – A store in a prominent location, a chain's largest store, the store that holds or sells the highest volume of merchandise, a retailer's most well-known location, a chain's first retail outlet, or the store location in a chain which carries the most high-priced merchandise catering to the most upscale customers.
Footfall	The number of shoppers entering a store or shopping mall.
High Street	A place or locality in a major city or principal street of a small town, which would be the main point of purchase from well known shops stocking high quality, apparels and non-apparels.
Horizontal Price Fixing	An agreement between two or more parties, generally considered to be competitors, to set, maintain, and charge a specified price for a particular product. This is considered to be a collusion to artificially set prices at a certain level, rather than allowing the free market to organically drive price levels.

Internet Auction, Internet Auction Platform	An internet service through which products can be sold and auctioned *via* internet.
Keystone Pricing	A pricing method of marking merchandise for resell to an amount that is double the wholesale price.
Kiosk	A small stand-alone structure used as a point of purchase. This can be either a computer or display screen used to disseminate information to customers or may be a free-standing, full-service retail location. Kiosks are often found in malls and other high-traffic locations.
Layaway	The act of taking a deposit to store merchandise for a customer to purchase at a later date.
M-Commerce (Mobile Commerce)	M-Commerce is the buying and selling of goods and services through wireless handheld devices such as cellular telephone and personal digital assistants (PDAs), known as next-generation e-commerce. M-Commerce enables users to access the Internet without needing to find a place to Plug-in.
Mazur Plan	Retail store management technique under which all retail activities are divided into four functional areas: merchandising, publicity, store management, and accounting and control.
Merchandising	In the broadest sense, merchandising is any practice which contributes to the sale of products to a retail consumer. At a retail in-store level, merchandising refers to the variety of products available for sale and the display of those products in such a way that it stimulates interest and entices customers to make a purchase.

Mystery Shopping	A quality checks system employed by companies. Dummy customers are sent into stores to check upon quality of service, behaviour and knowledge of store employees, etc.
Never-out List	Never-out List used when a retailer plans stock levels for best-sellers. Items accounting for high sales volume are stocked in a manner that ensures they are always available.
Niche Retailing	Niche Retailing enables retailers to identify customer segments and deploy unique strategies to address the desires of those segments.
Open-to-Buy	The difference between planned purchases and the purchase commitments already made by a buyer for a given time period, often a month. It represents the amount the buyer has left to spend for that month and is reduced each time a purchase is made.
Order Lead Time	The period from the date an order is placed by a retailer to the date merchandise is ready for sale (received, price-marked, and put on the selling floor).
Parasite Store	An outlet that does not create its own traffic and that has no real trading area of its own.
Percentage Variation Method	An inventory-level planning method where beginning-of-month planned inventory level during any month differs from planned average monthly stock by only one-half of that month's variation from estimated average monthly sales. Beginning-of-month planned inventory level (at retail) = Planned average monthly stock at retail x ½ [1 + (Estimated monthly sales/ Estimated average monthly sales)]

Perpetual-Inventory Unit-Control System	Keeps a running total of the number of units handled by a retailer by ongoing record-keeping entries that adjust for sales, returns, transfers to other departments or stores, receipt of shipments, and other transactions. It can be done manually, use tags processed by computers, or rely on point-of-sale devices.
Planogram	Visual description, diagram or drawing of a stores layout to include placement of particular products and product categories.
Point of Sale (POS)	Point of Sale (POS) refers to the area of a store where customers can pay for their purchases. The term is normally used to describe systems that record financial transactions. This could be an electric cash register or an integrated computer system which records the data that comprises a business transaction for the sale of goods or services.
Point-of-Purchase (POP) Display	Point-of-purchase displays, or POP displays, are marketing materials or advertising placed next to the merchandise it is promoting. These items are generally located at the checkout area or other location where the purchase decision is made.
Power Centre	A shopping site with (a) up to a half-dozen or so category killer stores and a mix of smaller stores or (b) several complementary stores specialising in a product category.
Power Retailer	The status reached by a company that is dominant in some aspect of its strategy. Consumers view the company as distinctive enough to become loyal to it and go out of their way to shop there.

Precision Retailing	Using data in information systems to make refined merchandising decisions store by store.
Predatory Pricing	Involves large retailers that seek to destroy competition by selling goods and services at very low prices, thus causing small retailers to go out of business. The practice is restricted by federal and state laws.
Premarking	A system in which the manufacturer, rather than the retailer, marks merchandise with the retail price.
Prestige Pricing	Assumes consumers will not buy goods and services at prices deemed too low. It is based on the price-quality association.
Price comparison website	A specialised website comparing the prices of products across various internet stores.
Price Guarantees	Protect retailers against possible price declines. If a retailer cannot sell an item at a given price, the manufacturer pays it the difference between planned retail and actual retail selling prices.
Price Lining	A practice whereby retailers sell merchandise at a limited range of price points, with each price point representing a distinct level of quality.
Primary Trading Area	Encompasses 50 percent to 80 percent of a store's customers. It is the geographic area closest to the store and possesses the highest density of customers to population and the highest per-capita sales.
Product/ Service Mix	The number and kind of products and services a general merchandise retailer will offer.
Product Breadth	The product breadth is the variety of product lines offered by a retailer. Product breadth is

	also known as product assortment or merchandise breadth.
Product Depth	Product depth is the number of each item or particular style of a product on the shelves. Product depth is also known as product assortment or merchandise depth.
Pull Policy	A promotional policy aimed at building strong consumer demand for a product.
Push Policy	A promotional policy aimed at markets with the intention of getting retailers to stock a product in order to build supply in the marketplace.
Regression Model	A computer site-selection model that develops a series of mathematical equations showing the association between potential store sales and various independent variables at each location under consideration.
Retail Information System	Anticipates the information needs of retail managers; collects, organizes, and stores relevant data on a continuous basis; and directs the flow of information to the proper retail decision makers.
Sales Floor	The sales floor is the location of a retail store where goods are displayed and sales transactions take place.
Same-Store Sales	A statistic used in retail industry analysis. It compares sales of stores that have been open for a year or more. This statistic allows investors to determine what portion of new sales has come from sales growth and what portion from the opening of new stores. Same store sales are usually released by retail companies on a monthly basis. This is also known as "comps".

Stock Keeping Unit (SKU)	The Stock Keeping Unit (SKU) is a unique number assigned to a product by a retail store to identify the price, product options and manufacturer of the merchandise.
Sliding	A loss prevention term referring to the act of a cashier passing merchandise around the cash register barcode scanner without actually scanning the item.
Specialist Food Stores	Outlets selling a selected category of groceries. These include butchers' shops, bakeries, cake shops, off-licences and greengrocers'.
Standardisation	A strategy of directly applying a tried and tested retail strategy to newer markets to ensure customers get the same experience across all stores of a chain.
Storefront	The total physical exterior of a store. It includes the marquee, entrances, windows, lighting, and construction materials.
Target Market	A segment of consumers that is most likely to purchase the products and services offered by a particular retailer.
Universal Product Code (UPC)	UPC is a categorisation where each item is given a ten-digit number, pre-marked on the package by the producer in the form of a bar code over ten corresponding numbers.
Vertical Retailers	Retailers that sell only their own branded merchandise. These goods are not found anywhere except in their own stores or catelogues (also called lifestyle retailer).

Contents

Chapter 1

Introduction

1.1 Retail refers to the sale of goods to end users, not for resale, but for use and consumption by the purchaser. The retail transaction is at the end of the supply chain. In India the retail sector is the second largest employer after agriculture, although it is highly fragmented and predominantly consists of small independent, owner – managed shops. The Indian retail industry is the fifth largest industry in the world.

1.2 Retail industry is one of the fastest growing industries in India. The retail industry comprises of organised and unorganised sectors.

Organised retailing refers to trading activities undertaken by licensed retailers, i.e., those who are registered for sales tax, income tax, etc. These include the corporate-backed hypermarkets and retail chains, and also the privately owned large retail businesses.

Unorganised retailing refers to the traditional formats of low-cost retailing, For example, the local kirana shops, owner manned general stores, hand cart and pavement vendors, etc.

The organised sector represents only 5% share of the retail industry.

1.3 Post liberalisation the retail sector in India is heralded as one of the sunrise industries. Today within the booming service sector, retailing is the single biggest contributor in terms of GDP to the national income. Retail has played a major role world over in increasing productivity across a wide range of consumer goods and services.

1.4 The term retailing is a very broad term which can be used to denote a large range of products including durables and consumables. This sector can be categorised into:

(i) Food products

(ii) Soft goods – clothing, apparel, and other fabrics.

(iii) Hard goods ("hardline retailers") – appliances, electronics, furniture, sporting goods, etc.

Further, the retail industry includes the sale/ distribution of the following products:

- Clothing, textiles and fashion accessories
- Jewellery
- Watches, Footwear
- Health and Beauty Care Services
- Pharmaceuticals
- Consumer Durables, Home Appliances/ Equipments
- Mobile handsets, Accessories and Services
- Furnishings, Utensils, Furniture for Home and Office
- Food and Grocery
- Books, Music and Gifts
- Other personal products

Objective and Scope of Technical Guide

1.5 This technical guide is intended to assist internal auditors in carrying out internal audit of entities operating in the Retail Industry. The management in concurrence with the internal auditor, taking into consideration, various pronouncements of ICAI and other regulatory requirements, assessments of control environment and business domain knowledge, primarily decides the scope of the internal audit. This technical guide deals with the operational areas of entities operating in this industry with emphasis on compliance of various regulations as applicable to such types of entities.

1.6 This Technical Guide covers the following aspects:

Part I	Glossary of terms peculiar to retail industry
Part II	Introduction
Part III	Scenario in the Indian retail industry and challenges faced by an entity operating in this sector.
Part IV	Legal framework and the entities for operating.
Part V	Discussion on internal audit and compliance related issues.
Part VI	Major areas of Internal audit significance, risks faced by an operating in this sector, procedures that the internal auditor entity should perform, and checklist of important audit procedures.
Part VII	Appendix

This technical guide does not cover the following aspects:

(a) Internal audit of routine operations in finance and other areas/ functions of business;

(b) Internal audit performed by the associated enterprises;

(c) Special audits;

(d) Investigations; and

(e) Retailing through E-commerce.

Chapter 2

About the Indian Retail Industry

2.1 Indian retail industry is one of the fastest growing industries in India, especially over the last few years. Though initially, the retail industry in India was mostly unorganised, and especially with the change of tastes and preferences of the consumers, the industry is getting more significant and organised as well. It is important for an internal auditor to have relevant business knowledge in this light, he needs to gain an understanding of the Indian retail industry, its evolution, initiatives from the Government special features of the retail Industry and the challenges faced by entities operating in this sector in order to understand the critical areas, nuances and knowledge of the business thereby helping him frame internal audit procedures to perform an efficient and effective internal audit.

Evolution of Retail Industry

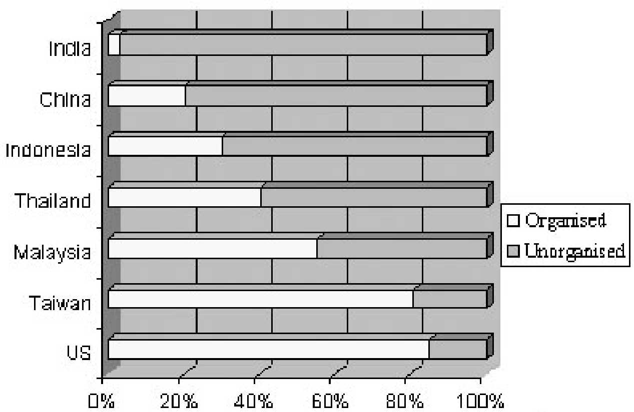
2.2 The origin of retail industry in India can be traced back to prior to the emergence of kirana stores and mom-and-pop stores, wherein weekly markets, village and rural melas were a source of commercial exchange and has been in existence for ages. Subsequently developed these stores used to cater to the local people providing convenience to neighbourhood, a pervasive reach, facilities of credit and a personal touch. Eventually, the government supported the rural retail. Many indigenous franchise stores came up with the help of Khadi and Village Industries Commission. Public distribution system and co-operatives emerged as a low cost method of distribution as supported by various Government schemes. The economy began to open up in the 1980s resulting in the change of retailing. The first few companies to come up with retail chains were in textile sector. With the passage of time, new entrants moved on from manufacturing to pure retailing.

2.3 Shopping malls emerged in the urban areas giving a world-class experience to the customers from the mid 1990's. Eventually, hypermarkets and supermarkets have emerged. The evolution of the sector includes the continuous improvement in the supply chain management, distribution channels, technology, back-end operations, etc. This would finally lead to consolidation, mergers and acquisitions and huge investments, resulted in development of the organised sector in Indian Retail Industry.

2.4 One of the major factors leading to the growth of the large retail industry was the introduction of an efficient banking system, especially, with the introduction of credit cards into the mainstream buying habits. This has led to the growth of the organised sector in the retail industry in small businesses couldn't afford the cost of purchases with credit cards because the turnover and profit margins didn't allow it.

2.5 The next revolution staring down the industry is the e-retailing. E-retailing was once considered a competitor of little threat because of the initial miscalculation of business focus compounded with outlandish outlays and unrealistic business models. But, e-retailing has refused to die and has taken the time to learn from their mistakes. The result is a mounting adversary to the giant chain stores in the shopping malls today. Their tool for success is, ironically, the same tool that help the larger chain stores push the smaller establishment into extinction, i.e., the banking revolution and the advent of credit cards and debit cards.

In spite of the recent sprout in large format stores, the ratio of organised retail to un-organised retail in India is significantly less in comparison globally.



	US	Taiwan	Malaysia	Thailand	Indonesia	China	India
Unorganised	15%	19%	45%	60%	70%	80%	97%
Organised	85%	81%	55%	40%	30%	20%	3%

Role of the Indian Government

2.6 The Government has been protecting the Indian retail sector from global players ever since liberalisation of the business in India. The government has been supporting the local grocery shops which might be wiped out in the event of complete opening of the retail market for Foreign Direct Investment (FDI) by global players, typically, to support the millions of small kirana shops and it forms the basis of livelihood for millions of people.

2.7 The government has taken steps to provide growth of e-commerce which eventually acts as the back-bone for growth of e-retailing. Besides developing the e-infrastructure in the country through effective telecom policy measures, the Indian government has created the necessary legal and administrative framework through the enactment of the Information Technology (IT) Act which combines e-commerce transactions and computer misuse and frauds rolled into an Omnibus Act. The Controller of Certifying Authorities (CCA) has been put in place for effective implementation of the IT Act. The Act also enables e-governance applications for electronic delivery of services to citizens.

Distribution System in Retail Industry

2.8 The industry has a three-tier system for the distribution of its products. The first tier is the manufacturer, the second tier is the intermediary, basically, the distributor or wholesaler, and the third tier is the retailer. The manufacturer sells or grants licenses based on different criteria. Each state government controls what products are brought inside its border.

2.9 The distributor or wholesaler sells and distributes the products to the retailers. An intermediary dealing with one type of product, is called as a distributor, dealer or a franchisee. In such a scenario, the goods/ products would be branded and the retailer intends to make substantial profits by buying directly from supplier/ wholesale agent and selling it to the customers.

Another option available for the intermediary would be dealing with multiple brands of a similar product from various manufacturers to prevent customers moving away to competitors due to lack of availability of desired brand.

2.10 Retailers purchase a product, mark up its cost, and advertise it for sale. The mark-up process is the key to the retailer's business because if the product is marked up too high, consumers will not buy it; and if it is marked up too low, there will be no profit and the supply may be quickly exhausted. In any case, the product value cannot exceed the Maximum Retail Price fixed by the manufacturer.

2.11 India is witnessing change in life styles of large section of the population. The need to understand the emerging markets and consumers has become a big challenge for the corporate world, especially, in creating and managing a powerful brand. By developing a powerful brand, entities can establish 'brand equity' and the equity assists firms to manage competition and to maintain market share. Branding is one of the most effective competitive tools and it is a challenging task for the marketer to nurture a brand into a strong profitable brand.

Today's brands are more visible than those in the past. They are everywhere-on the TV, hoardings, posters and print media. Brands while proclaiming their positive qualities pull down those of their rivals. Intangible assets such as brands, patents and know-now have become increasingly dominant elements of entity's value.

Today's brands are more visible than those in the past. Brands while proclaiming their positive qualities pull down of their rivals. Therefore, intangible assets such as brands, patents and know-how have become increasingly dominant elements of entity's value.

E-Retailing in India

2.12 E-retailing, also known as e-tailing, is shopping through the internet and other media forms. There are many things that are common between direct retail stores and online retail stores. Both have the process of billing of the customers and have to maintain a relationship with the suppliers.

Bottlenecks Faced By E-Retailing in India

2.13 The bottlenecks faced by e-retailing in India are as follows:

(i) ***Problems with the Payment System***

People in India are not used to the online shopping system and moreover the online payment system through the credit card is also totally alien to them. Most of them do not avail of the transaction facilities offered by the credit cards/ debit cards. They are also dubious regarding the online payment system through the credit cards. Hence different payment options should be made available to them like the credit card/ debit cards, cash on delivery and net banking to give them further assurance.

(ii) ***Problems with Shipping***

The customers using the online shopping channel should be assured that the products that they have ordered would reach them in due time. For this, the retail companies have resorted to private guaranteed courier services as compared to postal services.

(iii) ***Offline Presence***

The customers should be assured that the online retailers are not only available online but offline as well. This gives them the psychological comfort that these companies can be relied upon.

(iv) ***Products Offered at Discounted Rates***

The online retailers save on the cost of building and employee salaries. Some part of this benefit should be moulded to the online customers by a reduction in the price of the product. The customers should be conveyed this message that they are getting the products at a discounted price.

(v) ***Linguistic Mismatches***

Most internet retail shops use English as their mode of communication. English may not be comprehensible to the majority of the Indian population. To increase the customer base, content in the online retail shops should be provided in local language.

(vi) ***Psychological Factors***

In general, Indians prefer to touch the products physically before buying them. This facility is provided through the multi-brand outlets, not available online. Further, the preferences of the customers are towards the traditional shopping methods.

Fraud Management System

2.14 The fraud management system must have the following important features:

(i) Business rules engine to allow the setup and maintenance of custom business rules.

(ii) Transaction processing APIs (Application Programming Interface) which allow multiple parameters as input, the ability to evaluate these parameters against the defined business rules and as a result provide as output the decision to accept, review or reject the order transaction.

(iii) The ability to setup and maintain fraud negative lists.

(iv) A risk prediction model or algorithm to provide a risk score based on historical data. It is possible that single software may not be able to provide these capabilities. In such scenarios, real time interfaces to an online risk prediction service (third party ASP model) may be required to determine the risk score which could then be used as an input to the business rules engine.

(v) A workflow engine to model the fraud business process. Another alternative is to build the workflow within the order management system (OMS). The details are as below.

- Fraud review screens for the order information and the rules tripped. As explained above, the alternative approach could be to build these on the OMS.

- The ability to record and store authorisation and settlement data for credit cards. This ability can be used to reconcile chargebacks from the payment providers against the original order transaction.

Order Management System (OMS)

2.15 The important activities performed by the Order Management System (OMS) to facilitate the fraud management process are:

(i) As in the case of the online store front, the Order Management System (OMS) must provide the ability to interface with the payment gateway for real time authorisations, AVS checks, card verification codes and payment programs, etc. This is based on the assumption that order and tender modifications are managed in the Order Management System (OMS).

(ii) The order related information required as input by the fraud rules engine is supplied by the Order Management System (OMS). This implies that the Order Management System (OMS) must have services to invoke the appropriate fraud APIs and act on the decisions provided by the rules engine.

(iii) Based on the directive provided by the rules engine, the Order Management System (OMS) must have the ability to put the order on hold and transition to the fraud business process. It should also have the ability to restart the order fulfillment process based on an accept decision from the rules engine or the fraud analyst.

(iv) The Order Management System (OMS) ideally should provide workflow capabilities to model the fraud business process flow. This could also include fraud review screens, ability to generate alerts and manage fraud related queues.

(v) The fraud review process can result in changes to the order including cancellations (for fraudulent orders), changes in payment types (new credit cards/ debit cards provided by customer) etc. If these modifications are managed within the Order Management System (OMS), then it should provided the user interface to make these changes as well as manage the backend processes of deallocating inventory, refunding the customers money etc.

(vi) In case the Order Management System (OMS) manages the customer related communications (sms, emails etc.,), hence it should also be able to manage the communication associated with payment and fraud related problems.

Date Warehousing Systems (EDW)/ Analytics

2.16 It is very important to have a data warehousing strategy associated with a fraud management implementation. The important functions to be performed by such a system are described below:

(i) The EDW needs to pull data from the fraud management system and the Order Management System (OMS).

(ii) The extent of the fraud problem faced by an online retailer can only be determined through analysis of order history data. This helps determine the direct and indirect fraud rates.

(iii) The validity of the business rules can be verified by using the EDW. They can also be prioritised based on analysis done on the EDW data.

(iv) The risk prediction models are only as good as the history data provided. These models must be continuously validated and updated based on data pulled by the EDW system.

(v) The thresholds for the rules engine can be validated using the EDW.

Fraud Prevention Techniques

2.17 The different types of fraud prevention tools and techniques used by online retailers are as follows:

(i) ***Online Payment Authorisation of Credit Cards/ Debit Cards***

The process ensures that the credit card/ debit card being used is not lost or stolen. It also makes sure that the card has enough credit balance to pay for the purchase. It cannot however make out that the person using the card is actually authorised to do so.

(ii) ***Address Verification Services (AVS)***

An AVS check matches the billing address provided by the customer with the billing address on file for that credit card/ debit card. The customer's address data is submitted together with each payment authorisation request. The system responds with a "score" signifying how well the address data matched. This tool is not very effective as it may not lead to a match in as many as 40% of the transactions and fraudster will have to file address of his credit card, hence nullifying the advantage of such a check.

(iii) *Use of Card Verification Codes (CVV)*

These codes consist of 3 or 4 digit numbers printed on the front or back of credit cards. These codes are required along with the credit card/ debit card details for authorisations to occur. These codes are not printed on receipts or stored in retailer databases to prevent easy access of the same by fraudster. This process requires that the card be physically present at the time of the transaction thus reducing card not present fraud scenarios.

(iv) *Negative Files*

These files, typically, define the set of minimum criteria an order transaction must satisfy before proceeding for fulfilment. These consists of lists of known fraudulent data such as email ids, stolen credit card/ debit card numbers and bad shipping addresses, etc. These files are based on past experiences, data mining of fraudulent orders and periodic updates by credit card/ debit card companies.

(v) *Risk Prediction Techniques/ Models*

Risk prediction model software analyzes data from million of online sales to extract the profile of fraudulent transactions. Based on these large and historical order samples, the software develops an algorithm to identify fraudulent orders. Every order transaction is evaluated by passing its attributes through this algorithm and a risk score is arrived at. Thresholds of this score can be used to identify orders to reject, review or accept.

(vi) *Rules Based Detection Techniques*

With rule – based detection software, online merchants define a set of criteria that each order transaction must meet. These criteria are a combination of risk scores, order information, tender information, customer demographics, geo locations and order history, etc. The software will automatically screen incoming order by these specific criteria and automate the decision to reject, review, or accept the order.

(vii) ***Manual Reviews***

This involves the manual review of potentially fraudulent orders by fraud analyst. These analysts review orders and get in touch with customers and payment providers to verify that orders are not fraudulent. This technique should be used in conjunction with risk prediction models and rules based detection. This ensures that the fraud analysts only look at a focused subset of orders having a high likelihood of being fraudulent. While manual review may be viable for smaller merchants with low order volumes, it is not normally a cost – effective or scalable solution for larger merchants with high order volumes or seasonal order peaks.

(viii) ***Verified by Visa/ MasterCard Secure Code***

These programs enable 2 parties (card holder and card issuer) to authenticate each other by exchanging electronic passwords before proceeding with an online transaction. When a previous register password is entered by a card holder and authenticated by the Visa/ Master Card System, the order cannot be charged back due to fraudulent reasons and the merchant is assured of zero liability by the payment providers. Implementation of payer authentication systems can protect merchants from certain charge backs due to fraud, but this protection may only apply if a merchant can maintain low chargeback levels.

All of the tools mentioned above are complementary to one another, as they each inspect different components of a transaction. The best way to combat fraud is to use layers of fraud protection. These layers of fraud protection can be introduced at different stages within the order lifecycle. These stages can be classified into the order capture business process within the online store front and order fulfilment business process within the order execution system.

Factors Leading to the Growth of Retailing in India

2.18 As purchasing power of Indian urban consumer is growing and branded merchandise in categories like apparels, cosmetics, shoes, watches, beverages, food and even jewellery, are slowly becoming lifestyle products. Indian retailers are taking advantage of this growth and aiming to grow, diversify and introduce new formats and are forced to pay more attention to the brand building process.

2.19 The contemporary retail sector in India is reflected in sprawling shopping centres and multiplex malls that offer shopping, entertainment and food under one roof. The concept of shopping has altered in terms of format and consumer buying behaviour, ushering in a revolution in shopping in India.

2.20 The trends that are driving the growing of the retail sector in India are as follows:

(i) Increase in disposable income and customer aspiration;

(ii) Low share of organised retail;

(iii) Abundance of requisite manpower;

(iv) Increase in expenditure for luxury items;

(v) Overall growth of economy at a rapid pace;

(vi) Increase in pay-scales of young workers in India; and

(vii) Increase in standard of living of the urban population.

Classification of Entities in the Retail Industry

2.21 The Entities in retail industry may be classified on the following basis:

Based on Business Structure

There are different businesses in which an entity operating in the retail industry can be set up. The major ones are elaborated hereunder:

(i) ***Agency/ Partnership System***

It refers to the methods of practicing and using another person's business model. The network partner manages the outlet but does not usually own the goods he is selling. The goods belong to the licensor. The agent signs buy-sell contracts on behalf of the licensor. In return for the sales of goods or services, the agent receives a commission specified in the licensing contract.

(ii) ***Dealership***

Retailers may find the business model of a licensed dealership as a mix of franchise and independent retailer. The licensee has the right (sometimes this is exclusive) to sell a brand of products. Unlike a franchise, the dealer can sell a variety of brands and there generally no fees is paid to the licensor. Dealerships may or may not be identified as an authorised seller or by the company's trademark.

(iii) ***Direct Distribution***

Offering goods and services directly to consumers, through face-to-face contact, usually at the client's home workplace or elsewhere outside of retail sales points a form of retail distribution outside of a chain of shops.

(iv) ***E-store, Internet Store, On-line Store***

A sales point involved in e-trading over the internet under a unique world wide web (www) address, with an interactive form that allows the consumer to place an order for a product or service using the information provided (including price and method of payment).

(v) ***Franchising System***

It refers to the methods of practicing and using another person's business model. The parties signing a franchising agreement remain totally independent of each other. Both the outlet and the goods (which are frequently supplied by the franchisor) belong to the franchisee. The franchisee purchases goods and services on its own behalf and account; the complete sales revenue belongs to the franchisee, who pays periodic franchise fees to the franchisor.

(vi) ***Integrator***

It is a firm running a franchise or partnership-based retail chain. It may operate on a commission basis or act as supplier if the integrator is a wholesaler.

(vii) ***Independent Retailer***

An independent retailer is one who builds his/ her business from the ground up *i.e.*, from the business planning stage to opening day of the retail store. He/ she may hire consultants, staff and others to assist in the business endeavor.

(viii) ***Network Marketing***

Multi-level marketing (MLM) or network marketing is a business model where the selling of products depends on the people in the network. Not only a product is being sold, but other sales people are being recruited to sell that same product or product line.

Based on Size Operations

In India, there are different types of retail entities which can be classified in accordance with the size of operations as follows:

(i) ***Grocery Shop/ Store***

A retail outlet offering typical foodstuffs, non-food merchandise (mixed grocery and non-food stores), or groceries only. These refer to the kirana stores.

(ii) ***Small-format Shops***

There are grocery or mixed grocery and non-food shops under 400 sq. mtr in size. They are commonly referred to as mom and pop stores.

(iii) ***Convenience Stores***

Small-format chain stores open at least 11 hours a day, with a basic range of groceries, alcohol, cigarettes and newspapers/ magazines.

(iv) ***Exclusive Stores***

These stores are ranging from a size of 500 sq. ft. to 5,000 sq. ft. and above. This are owned/ managed by the company or through its franchise. These can offer single brand as well as multiple brands.

(v) Speciality Stores

These stores focus on a specific product category. These are medium sized layout in strategic location. Specialty stores provide a large variety base for the consumers to choose from the specific category.

(vi) Large-format Stores

These are grocery and mixed grocery and non-food stores typically above 400 sq. mtr in size (retail space). This covers hypermarkets, supermarkets and discount stores.

(vii) ***Discount Stores, Discounters***

These are grocery or mixed grocery and non-food stores around 1,000 sq. mt. in size, offering on average around 800 - 1,200 products, chiefly foodstuffs, often under the retailer's own private label or produced exclusively for the retailer. Prices are on average 15-30% lower than the market averages. These are of following two types:

Hard discounters - A type of discounter characterised by a limited product range and a predominance of low price private labels.

Soft discounters - A type of discounter characterised by a broader product range, including fresh food and mostly manufacturers' brands.

(viii) ***E-shopping Mall***

A website which presents the offers of a number of internet stores.

(ix) ***Hypermarkets***

These are mixed grocery and non-food stores over 2,500 sq. mt. in size, offering on average 40,000 items, around 50% of which are foodstuffs.

(x) ***Supermarkets***

These are mixed grocery and non-food or grocery stores over 300 - 2,500 sq. mt. in size, offering on average 5,000 -10,000 products, at least 70% of which are foodstuffs.

(xi) ***Delicatessen Supermarkets***

These are supermarkets with an extended premium range, targeting medium and high income customers.

Special Features of the Retail Industry

2.22 The retail industry is unique in certain aspects with respect to other industries. These can be broadly be classified as follows:

(a) Business Process Related

The business of an entity operating in a retail industry has certain unique characteristics, risks, nuances. Some of them are as follows:

(i) Most of big sized retailers have multiple stores across various locations and management of all department stores involves a sophisticated and comprehensive management information system (MIS). This would require periodic analysis of data on a store wise and department level wise basis.

(ii) The industry is labour intensive and requires trusted, young, attractive salesmen to enable sufficient pushing of products to the customers and stores. In the case of small grocery store, the owner directly supervises the entire activity. In large stores, there are sophisticated surveillance systems to supervise the activity to enable prevention and detection of thefts and shop-lifting by customers.

(iii) The success of a store is determined based on the correctness of the demand forecasting in a location as against the actual number. Hence, right information is required by the decision makers as regards the demand for a location.

(iv) The business processes and control systems are unique and needs to be commensurate to the size of retail store.

(v) The work timings of these stores would vary taking into consideration the size, location, customers they cater, products and employee availability.

(vi) Branding plays an important role in the Indian retail industry. Branded products as well as branded retails are chosen by informed customers and unbranded products still occupies a significant part of the retail market, especially in the rural areas.

(vii) Corporate strategy might be required to be periodically challenged in the light of changing business scenario and trends across markets. Further, there is need of standardisation of practices across locations and stores. This would require quick adaptability by the entire organisation to the dynamic changing environment.

(viii) Competition among products is extremely high with various promotional offers and schemes. Bigger retailers virtually kill the business of many small retailers in the vicinity through their intense marketing and offer to attract customers.

(ix) The demand factors for consumables and durables are significantly different and business intelligence plays an extremely important role for the success of the entity.

(x) The risks for a retail industry are different from any other industry. The areas of risk can vary from business risk to business continuity risk.

(b) Supply Chain Management and Billing

Unlike many other industries, the contract and billing process are unique. There is wide range of practices taking into consideration the depth of penetration of this industry. Some important aspects are as follows:

(i) The dynamics of the Supply Chain Management (SCM) plays the most critical part of the retail industry and involves the efficient management of the distribution processes and delivery processes to enable success in its operations. This is taking into consideration the complexity of the procurement process from suppliers across geographical locations at varied terms and conditions.

Big entities have warehouses which act as incubators for their stores and replenish them on a periodic basis. Further, such replenishments might be from local purchases or from a centralised location.

(ii) Significant economies of scale exist in related to format of the store.

(iii) Payment might be made in the form of cash, cheque or debit/ credit card, discount coupons/ vouchers, etc. Considering the volume of transactions, the entities might face challenges ensuring an error free billing of its products.

(iv) Billing process is typically related to format of the store. It is system driven in the case of large form stores and fairly simple and unorganised in the case of small format stores. Billing needs to be done on a real time basis and there cannot be any delays on this front.

(c) Material Storage and Handling

The success of the store depends on efficiency of management of products and materials, considering the perishable nature of products. Some special features are as follows:

(i) Considering the size and volume of materials, entities find it relatively challenging to maintain sufficient control on the inventory and to perform routine inventory verification. Further, there must be a unique comprehensive inventory management system to provide for the precise tracking of inventory across locations and distributors to enable the retailers to appropriately deal with them.

(ii) Proper accounting and control is required to be performed for stock returns, freebies and offers apart from gift vouchers.

(iii) Certain products are perishable and in certain products, pilferage too would be a major concern. Proper handling of these materials is an integral part of proper inventory management.

(iv) Inventory requirement at each location would be unique in accordance with the cultural preferences, demography of people and lifestyle of the vicinity. The availability of inventory should be in accordance with.

(v) In the case of transfer between stores or locations of the same management, there needs to be sufficient tracking of transferred stock and periodic reconciliation to enable proper tracking of inventory.

(vi) Visual Merchandising is an integral part of promotional activities and plays a major role in strategy making in the retail industry.

(d) Economic Conditions

Uncertainty/ instability of economic conditions – both globally and in India has an impact on the industry. Some important aspects are as follows:

(i) Consumer Confidence Index (CCI) is widely considered an economic indicator of household consumption expenditure. Consumers tend to increase consumption when they feel confident about the current and future economic situation of the country and their own financial situation. Business is directly based on the Consumer Confidence Index of the consumers.

(ii) The impact of global economic changes is extremely significant with a retail Industry. This is owing to the high reliance of foreign suppliers for sourcing of certain key products and materials.

(iii) In general, the retail industry involves a significant amount of expenditure in foreign currency for the sourcing of various products.

(e) Other Unique Features

There are certain unique features apart from those mentioned above which an internal auditor might be required to be aware of:

(i) Information technology plays a very significant role in providing the right picture to the managers and decision makers. In the event of a failure in business systems, it would lead to a complete paranoiac situation across business units and standstill of operations.

(ii) Retail Industry faces a lot of *"Window Shoppers"* where shoppers engage in the activity of browsing shops with no intent to purchase, possibly just to pass the time between other activities, or to plan a later purchase.

(iii) Considering that in certain cases, when the demand is seasonal, there might be requirement for extra work force which could be in the form of an additional temporary employee or extra shift of an existing employee. Proper employee management plays a key role in the overall success of the entity.

It is therefore, extremely important for an internal auditor to understand these special features for conducting the internal audit of the entity.

Stock Keeping Unit

2.23 It is a unique identifier for each distinct product and service that can be purchased. The usage of Stock Keeping Unit (SKU) is rooted in data management, enabling the company to systematically track its inventory or product availability, such as in warehouses and retail outlets. They are often assigned and serialised at the merchant level. Each Stock Keeping Unit (SKU) is attached to an item, variant, product line, bundle, service, fee, or attachment. SKUs are often used to refer to different versions of the same product.

Challenges Faced by an Entity Operating in the Retail Industry

2.24 This section is intended to highlight some of the significant challenges faced by an entity operating in the retail industry so as to enable the internal auditor to plan and perform the internal audit accordingly. The internal auditor is required to perform such audit procedures specific to the entity as deemed necessary to ensure systematic evaluation of risk management, control and governance processes. Some of these challenges are given below:

(i) Control over Loss of Inventory due to factors such as Spoilage, Damages, Wastages, Theft and Shop Lifting, etc.

A perennial problem faced by an entity operating in this industry is dealing with inventory and its loss. Success of any entity operating in this space is based on the efficacy of inventory management. Further, loss of control over inventory might be due to other factors such as frequent shifting of inventory in accordance with specific product promotional schemes or consumer needs and fashion, change in visual merchandising strategy, stock levels. It might also be difficult to perform physical verification of stock in the event of continuous operations.

The internal auditor needs to ensure that there is an adequate system to ensure proper inventory management and to ensure that there is no unnecessary loss has been inflicted due to lack of an appropriate inventory management system.

(ii) Lack of Trained Work Force and Required Skill for Retail Management

Lack of trained and reliable work force acts as a major barrier towards expansion for an entity operating in this sphere and finding capable managers has become a perennial challenge predominantly on account of limited preference given to retail sector by highly educated labour class. This might lead to following unidentified business potentials, risks and problems:

(a) Declined stock and cash control;

(b) Delay in billing of products leading to poor consumer satisfaction;

(c) Impacts on the overall brand of the entity;

(d) Control over contract workers for menial jobs;

(e) Odd working hours;

(f) Female workers and their timings;

(g) Dynamic incentive system; and

(h) Employee turnover.

The internal auditor can assess management of employment recruitment policy.

(iii) Overall Management of Various Stores/ Establishments by an Entity

This is one of the most critical challenges that the entity might face. The management information system of the entity should be comprehensive enough to deal with all complexities that might arise in the process. This is more significant considering the changing customer preferences. Reasons for the same are as follows:

(a) Local consumption habits.

(b) Need for variety.

(c) Cultural issues – In and around the store.

Management becomes challenging on account of following intrinsic factors:

(a) Dynamic corporate environment and changing corporate strategy.

(b) High competition in the field and the stress to deliver something new and to attract customers.

(c) Decision on sufficiency of safety measures such as insurance coverage.

(d) Shop in Shop accounting.

(e) Payment controls.

(f) Daily collection controls.

(g) Employee turnover, etc.

The internal auditor has to assess the overall management of stores across locations and verify in the light of his observations, the efficiency of the overall management information system.

(iv) Absence of Developed Supply Chain and Integrated IT Management

As an entity grows, a proper supply chain management system needs to be in place to enable sustained growth of the entity. This can be further achieved through implementation of the appropriate system. The system might be in-house or through an external service provider and the decision is required to be taken after making a comprehensive cost-benefit analysis. Supply chain bottlenecks may be due to following factors:

(a) Several products are reserved for SSIs;

(b) Distribution, logistics constraints, restrictions of purchase and movement of food grains, absence of cold chain infrastructure; and

(c) Long intermediation chain.

This would result in:

(a) Limited product range;

(b) Makes scaling up difficult;

(c) High cost and complexity of sourcing and planning; and

(d) Lack of value addition and increase in costs by almost 15%.

Further, supply chain management needs to be managed through an appropriate Enterprise Resource Planning (ERP) system and might require periodic review as to ensure sufficiency of controls of the system in the current scenario.

The internal auditor can assess management of supply chair. The internal auditor may, accordingly, assess the risk of business with regards to alignment of the existing business practices/ procedures to the required.

(v) Intrinsic Complexity of Retailing

The intrinsic complexities in the industry are due to following factors:

(a) Rapid price changes;

(b) Constant threat of product obsolescence;

(c) Inability to move to an efficient inventory management system;

(d) Low margins;

(e) Strict competition leading to price wars;

(f) Multiple licences/ clearances required for starting up;

(g) Consignment sales;

(h) Sales returns;

(i) Speed of expansion to new locations; and

(j) Security systems required and unique technology identified.

The internal auditor has to assess such types of risks and precautions taken by management to avoid them.

(vi) High Cost of Real Estate and Lack of Sufficient Infrastructure for Scaling-up

Another major factor would be the cost incurred for initial set up and establishment cost which is directly related to the real estate cost, i.e., cost of construction/ rental of the location for retailing and thereby might push up the cost of operation significantly. Lack of clear ownership of titles and high stamp duty costs, result in increase of start up cost for retailer. Hence acts as a restricting barrier for the organised sector in retail industry.

The internal should assess the process of evaluating the suitability of location for retail business and forecasting the profitability for the location.

Structural impediments could be in the nature as follows:

(a) Lack of urbanization

(b) Poor transportation infrastructure

(c) Consumers habit of buying fresh foods and

(d) Administered pricing.

(vii) Timings of operations

Entities operating in this sector would open quite early in the morning and closes late at night. There would be a lot of operational challenges, such as, rotation of employees, daily closure of books and completion of regular processes, etc.

The internal auditor should assess sufficiency of controls for routine/ daily closure.

Forces that Affect the Retail Industry

An analysis of the forces that affect the entity operating in the retail industry is summarised below:

(i) *Threat of New Entrants*

Over the last decade, there has been a decrease in the number of independent retailers predominantly because of the entry of huge corporates into this sector. Their vertical structure and centralised buying gives chain stores a competitive advantage over independent retailers.

(ii) *Power of Suppliers*

Historically, retailers have tried to exploit relationships with suppliers. Big retailers have extraordinary influence on the suppliers and they have the ability to make or break a small supplier. In the retail industry, suppliers tend to have very little bargaining power.

(iii) *Power of Buyers*

Individually, customers have very little bargaining power with retail stores. If customers demand high-quality products at bargain prices, it keeps retailers within limits and are conscious of the customers.

(iv) *Availability of Substitutes*

The tendency in retail is not to specialize in one good or service, but to deal in a wide range of products and services. This means that what one store offers you will likely find at another store. Retailers offering products that are unique have a distinct or absolute advantage over their competitors.

(v) *Competitive Rivalry*

Retailers always face stiff competition. The slow market growth for the retail market means that firms must fight each other for market share. More recently, they have tried to reduce the cut-throat pricing competition by offering frequent flier points, memberships and other special services to gain the customer's loyalty.

Technological Updates

Many softwares are available based upon the unique need of the retailer.

The internal auditor should have an indepth understanding of Standard on Internal Audit (SIA) 14, *Internal Audit in an Information Technology Environment,* to perform required internal audit procedures around the system.

The predominant softwares are listed below:

(i) *Point of Sales and Inventory Management Software*

A wide range of Point of Sale (POS) applications have been developed on platforms such as Windows and UNIX. The availability of local processing power, local data storage, networking, and graphical user interface made it possible to develop flexible and highly functional POS systems. The most common software are as follows:

(a) ACCESS

(b) Active Retail – Retail Management Software

(c) GAAP Software

(d) InFlow Inventory Management System

(e) WinTill

(ii) *Retail Management Systems Software*

Retail Management Systems Software, manages financial reporting, accounting and operations of retail stores by integrating core business processes such as Point of Sale (POS), Customer Relationship Management (CRM), inventory management, accounting, human resources, marketing and e-commerce. By implementing a retail management system, organizations can increase sales, decrease costs and maximise competitive advantage. These applications facilitate the distribution of key data throughout an enterprise and provide the infrastructure for accurate sales reporting and revenue forecasting. The most common retail management software include the following:

(a) Chain Drive

(b) Epicor Retail

(c) Retail Pro

Apart from the above, there are many Retail Accounting Softwares which include SAP, Tally ERP 9, Microsoft Dynamics RMS and the internal audit needs to have appropriate knowledge of these softwares to ensure selection of appropriate audit procedures to perform an effective internal audit.

(iii) *The Major Innovations*

Over the past few years, there have been many major innovations which include the following:

(a) *Radio-frequency Identification (RFID):* This involves identifying customers by issuing them smart cards embedded with smart chips. These cards would be Radio-frequency Identification (RFID) enabled and would give information regarding the customer like his preferences, shopping behaviour, etc.

(b) *E-Catalogue based Selling:* Limited range of merchandise is available in-store, while the range of a hyper format is made available through self browse kiosks.

(c) *Mobile Point of Sale (POS):* This would enable the purchase of goods while putting them in a shopping cart. The customer would be spared from the hassle of standing in long queues.

(d) *Digital Signage:* Static signboards have not proved beneficial in terms of helping a customer to track a product. Digital signboards integrated with an automated tracking system can make this easier.

(e) *Intelligent Database:* A detailed database of the customer is made available online and helps the retailer to understand a particular customer's buying characteristics.

Chapter 3

Legal Framework

3.1 This Chapter details the various acts applicable and organisations that supervise and regulate the Retail Industry. Gist of various statutory provisions applicable to the Retail Industry is detailed under ***Chapter 4*** of this Technical Guide.

Ministry of Commerce and Industry, GOI

3.2 The mandate of the Department of Commerce is regulation, development and promotion of India's international trade and commerce through formulation of appropriate international trade and commercial policy and implementation of various provisions thereof. This Ministry formulates the regulatory provisions pertaining to the Industrial Policy and Promotion and EXIM Policy in India.

The Department of Industrial Policy and Promotion (DIPP), set up under the Ministry of Commerce and Industry is responsible for Intellectual Property Rights relating to patents, designs, trade marks and geographical indication of goods and oversees initiative relating to their promotion and protection. This Department also formulates, promotes, approves and facilitates the Foreign Direct Investment (FDI) Policy.

Director General of Foreign Trade (DGFT) is a government organisation in India responsible for the formulation of export-import guidelines and principles for Indian importers and Indian exporters of the country. The basic role of the Department is to facilitate the creation of an enabling environment and infrastructure for accelerated growth of international trade.

Ministry of Finance, GOI

3.3 The Ministry of Finance, Government of India looks after various financial affairs of the state of India. The Ministry of Finance is responsible for monitoring various aspects of the Indian economy. The Ministry of Finance operates through various departments.

- Department of Economic Affairs
- Department of Disinvestment
- Department of Expenditure
- Department of Financial Services
- Department of Revenue

Various statutes,

- Customs Act, 1962,
- Central Excise Act 1944,
- Value Added Tax Act,
- Central Sales Tax, 1956,
- Income Tax Act, 1961
- Service Tax Act

to name a significant as applicable to the retail industry are formulated and governed by this ministry.

Ministry of Consumer Affairs, Food and Public Distribution, GOI

3.4 This Ministry operates through two significant departments:

(i) ***Department of Consumer Affairs***

The Department of Consumer Affairs under Ministry of Food and Consumer Affairs is responsible for the formulation of policies for consumer co-operatives, monitoring prices, availability of essential commodities, consumer movement in the country and controlling of statutory bodies like Bureau of Indian Standards (BIS) and Weights and Measures.

(ii) ***Department of Food and Public Distribution***

The Department of Food and Public Distribution is charged with the prime responsibility of the management of the food economy of the country. The twin objectives of the department are to ensure the following:

- Remunerative rates for our farmers.
- The supply of food grains at reasonable prices to the consumers through the public distribution system.

Ministry of Food Processing Industries

3.5 The Ministry of Food Processing Industries is the nodal agency of the Government of India for processed foods and is responsible for developing a strong and vibrant food processing sector with emphasis on the following:

- Stimulating demand for appropriate processed foods.
- Achieving maximum value addition and by-product utilisation.
- Creating increased job opportunities particularly in rural areas.
- Enabling farmers to reap the benefits of modern technology.
- Creating surpluses for exports.

In the era of economic liberalisation where the private, public and co-operative sectors are to play their rightful role in development of food processing sector, the Ministry acts as a catalyst for bringing in greater investment into this sector, guiding and helping the industry in a proper direction, encouraging exports and creating a conducive environment for the healthy growth of the food processing industry.

A Gist of Important Regulations Applicable to an Entity in Retail Industry

Foreign Direct Investment Policy

3.6 The Foreign Direct Investment (FDI) Policy is formulated by the Department of Industrial Policy and Promotion under the Ministry of Commerce and Industry. The FDI Policy governs the foreign investments in equity of entities established in India. There are different limits allowed for FDI in India for investment in retail sector. The Government has taken steps to protect the smaller retailers and prevented the entry of large global retailers into the Indian markets.

Information Technology Act, 2000

3.7 The main objective is "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 (E-commerce)", which involves the use of alternatives to paper-based methods of communication and storage of information, to facilitate electronic filing of documents with the government agencies". This Act is of significance in the current context since the operations of Retail Industry are significantly carried out through the electronic media.

Other Applicable Indian Acts to the Industry

3.8 Standard on Internal Audit (SIA) 17, "*Consideration of Laws and Regulations in an Internal Audit*" issued by the ICAI requires that when planning and performing audit procedures and in evaluating and reporting the results thereof, the internal auditor should recognize that non-compliance by the entity with relation to laws and regulations may materially affect the financial statements. However, the internal auditor is not responsible for preventing non-compliance and cannot be expected to detect non-compliance with all laws and regulations.

3.9 Thus, in addition to the various Acts, Rules, Bye Laws, Regulations, Circulars, etc., the internal auditor is required to verify some other applicable regulations which include the following:

(a) *Governance Laws*

- The Companies Act, 1956
- Partnership Act, 1932/ Limited Liability Partnership Act, 2008
- Shops and Establishments Act of respective states
- The Sale of Goods Act, 1930
- The Negotiable Instruments Act, 1881

(b) *Economic Laws*

- The Income tax Act, 1961
- Central Excise Act, 1944
- The Customs Act, 1962
- Value Added Tax and Sales Tax Act
- Central Sales Tax Act, 1956
- Service Tax under the Finance Act, 1994
- The Agricultural Produce Cess Act, 1940

(c) *Labour Laws*

- Employees Provident Fund Scheme, 1952
- Employee State Insurance Act, 1948
- Payment of Gratuity Act, 1972

- Payment of Bonus Act, 1965
- Professional Tax enacted by the respective states
- The Child Labour (Prohibition and Regulation) Act, 1986
- The Minimum Wages Act, 1948
- The Weekly Holidays Act, 1942

(d) *Consumer Protection*

- Consumer Protection Act, 1986
- The Essential Commodities Act, 1955
- Prevention of Black Marketing and Maintenance of Supply of Essential Commodities Act, 1980
- Emblems and Names (Prevention of Improper Use) Act, 1950
- The Standards of Weights and Measures Act, 1976.

(e) *Intellectual Property Rights*

- Trademark Act, 1999
- The Patents Act, 1970
- Indian Copyright Act, 1957

(f) *Other Laws as applicable to the Industry*

- The Indian Contract Act, 1872
- Foreign Contribution Regulation Act, 1976
- Securities Exchange Board of India Act, 1992
- Securities Contracts Regulation Act, 1956

- The Land Acquisition Act, 1894
- The Specific Relief Act, 1963

3.10 Apart from the abovementioned laws, the internal auditor is required to be aware of the local legislations under which the entity/ undertaking operates e.g., Karnataka Shops and Commercial Establishments Act, 1961, prescribes the daily and weekly hours, extra wages for overtime work, holidays for all entities established in Karnataka.

The internal auditor is required to ensure the compliance of respective state legislations too as part of his internal audit procedures. The internal auditor is also expected to be aware of various circulars issued by the RBI towards foreign currency transactions.

Other Applicable Acts to the Retail Industry

3.11 Apart from the above Indian regulations that the Retail Industry is surrounded with, there are other regulations pertaining to the country of the client for whom the services are provided or due to listing status. The principal regulations that affect Indian Retail Industry are as follows:

The Sherman Antitrust Act, 1890

The Sherman Antitrust Act, 1890, has been passed in the United States to enable a free market economy and the best consumer protection. The Sherman Act outlaws all contracts, combinations and conspiracies that unreasonably restrain interstate and foreign trade. The Sherman Act also makes it a crime to monopolize any part of interstate commerce. An unlawful monopoly exists when only one firm controls the market for a product or service, and it has obtained that market power, not because its product or service is superior to others, but by suppressing competition with anti-competitive conduct. The Act is not violated simply when one firm's vigorous competition and lower prices take sales from its less efficient competitors i.e., competition is working properly.

There have been many other regulations subsequently legislated to further the objective of the Sherman's Antitrust Act, 1890 such as the Claytons Act, 1914 and the Robinson-Patman's Act, 1936.

Chapter 4

Statutory Laws Applicable to Retail Industry

4.1 This chapter is intended to provide broad overview of various laws, compliances normally required for entities operating in this sector. The internal auditor may refer to bare act of these laws and regulations and study the different cases judgements by competent authorities.

Considering that these regulations undergo frequent amendments/ changes, a detailed checklist has not been prepared. The internal auditor must update himself with the amendments, pronouncements, new regulations from time to time to ensure effective performance of internal audit.

Value Added Tax Act and Central Sales Tax Act, 1956

Value Added Tax

4.2 Considering that retail industries are involved in the distribution and sale of products in different states, Value Added Tax Act of the respective state would be applicable for all such sales made by the entity.

Input Credit set off Scheme

4.3 "Input" means any goods including capital goods purchased by a dealer in the course of his business for re-sale or for use in the manufacture or processing or packing or storing of other goods or any other use in business.

The entity can claim input credit on all sales made in the state of procurement itself.

In the event the goods are transferred and sold in another state, then VAT paid on procurement of such goods would not be eligible for input credit.

Registration

4.4 Registration under Value Added Tax Act would be applicable to all retailers wherein the total turnover exceeds a basic limit as prescribed in the respective Value Added Tax Act.

Central Sales Tax Act, 1956

4.5 The objects of the Act, as stated in preamble of the CST Act are as follows: –

- To formulate principles for determining (a) when a sale or purchase takes place in the course of inter-state trade or commerce, (b) When a sale or purchase takes place outside a State, and (c) When a sale or purchase takes place in the course of imports into or export from India.
- To provide for levy, collection and distribution of taxes on sales of goods in the course of inter-state trade or commerce.
- To declare certain goods to be of special importance in inter-State trade or commerce and specify the restrictions and conditions to which State laws imposing taxes on sale or purchase of such goods of special importance (called as declared goods) shall be subject.

Central Sales Tax Act, 1956 deals with sale between different states and provisions for claiming credit on payment of Central Sales Tax.

Service Tax

4.6 Retail Industry is a product based industry. But, the industry would be utilising the services of many other service providers. Service Tax paid by the entity can be availed credit/ set-off under Central Excise Act, 1994.

4.7 The following is an illustrative list of major capital goods, inputs and input services on which CENVAT can be availed:

- Central Excise Duty (CED)/ Additional Duty of Customs (CVD) on machinery or equipments.
- Central Excise Duty (CED) on office equipment and computers.
- Central Excise Duty (CED) on consumable tools and packing materials.
- Central Excise Duty (CED) on chemicals used or consumed.
- Advertisement Agency.
- Courier Services.
- Clearing and Forwarding Agent.
- Goods Transport Agency.
- Manpower Recruitment and Supply Agent.
- Real Estate Agent.
- Storage and Warehousing Services.
- Intellectual Property.
- Franchise.
- Professionals and Consultants.
- Business Auxiliary Services.
- Construction of Office or Factory.
- Transportation of Goods by Road Service.
- Market Research and Market Survey.

- Recruitment and Supply of Manpower Service.

The input credit can be availed only on payment made. The input credit cannot be availed on accrual basis. However, in case there is excess credit during the month, the same can be carried forward to the following month and can be set-off whenever service tax liability arises.

Import of Services

4.8 Section 66A envisages taxation of the services which are received in India from a foreign national or foreign entity. The situation envisaged is that any taxable service:

- Provided or to be provided by a person who has:
  - Established a business in a country other than India; or
  - A fixed establishment from which the service is provided or to be provided in a country other than India; or
  - His permanent address or usual place of residence is in a country other than India.

(And)

- Received by a person (recipient) who has his:
  - Place of business in India;
  - Fixed establishment in India;
  - Permanent address in India;
  - Usual place of residence in India.

4.9 Import of service is not to be treated as output services. The taxable services for which the liability is created in terms of section 66A cannot be treated as output services for the purpose of availing CENVAT credit of duty/ tax paid on inputs or input services. Credit of inputs and input services used in the said services received cannot be considered as inputs by the service receiver.

Further, the credit available cannot be used for payment of service tax liability on import of services. However, the service tax paid on import of services can be availed as input credit against the output liability or rebate of the same can be claimed.

Trademark Act, 1999

4.10 A Trade Mark is a visual symbol in the form of a word, a device, or a label applied to articles of commerce with a view to indicate to the purchasing public that is a good manufactured or otherwise dealt in by a particular person as distinguished from similar goods dealt or manufactured by other persons, i.e.,

- It identifies the product of its origin;
- It guaranties its unchanged quality;
- It advertises the products; and
- It creates an image for products.

4.11 The objective of the Trademarks Act, 1999 is to register trademarks applied for in the country and to provide for better protection of trade mark for goods and services and also to prevent fraudulent use of the mark. The Trademarks Act, 1999 has been implemented for the following purposes:

- Registration of Service Marks allowed in addition to Trademarks for goods.
- No separate application necessary for each category/ class of goods or services i.e., a single application would be required. However, filing fee will be charged separately for each class of goods/ services.
- The term of registration of trademark is ten years, subject to renewal thereafter.

- The system of maintaining registration of trademark in Part A and Part B with different legal rights, dispensed away.
- Registration of trademarks which are imitations of well known trademarks not permitted.
- Registration of Collective Marks owned by associations allowed.
- Offences relating to trademark made cognizable.
- Filing fees enhanced by more than 8 times.
- Extension of application of convention countries.

Central Excise Act, 1944

4.12 The Central Excise Act, 1944, has been enacted for enduring the following objectives:

- Realising the revenues in a fair, equitable and efficient manner;
- Administering the Government's economic, tariff and trade policies with a practical and pragmatic approach;
- Creating a climate for voluntary compliance by providing guidance and building mutual trust;
- Combating revenue evasion, commercial frauds and social menace in an effective manner.

4.13 The main statutes which are related to the levy and collection of Central Excise duty are as follows:

- The Central Excise Act, 1944
- The Central Excise Tariff Act, 1985
- The Central Excise Rules, 2002

- CENVAT Credit Rules, 2004
- Central Excise Valuation (Determination of Price of Excisable goods) Rules, 2000

4.14 Valuation can be made through different methods and the most common method for pricing of products is through the ***Retail Sale Price Method***.

(i) The Central Government may, by notification in the Official Gazette, specify any goods, in relation to which it is required, under the provisions of the Standards of Weights and Measures Act, 1976 (60 of 1976) or the rules made there under or under any other law for the time being in force, to declare on the package thereof the retail sale price of such goods, to which the provisions of sub-section (2) shall apply.

(ii) Where the goods specified under sub-section (1) are excisable goods and are chargeable to duty of excise with reference to value, then, notwithstanding anything contained in section 4, such value shall be deemed to be the retail sale price declared on such goods less such amount of abatement, if any, from such retail sale price as the Central Government may allow by notification in the Official Gazette.

(iii) The Central Government may, for the purpose of allowing any abatement, take into account the amount of duty of excise, sales tax and other taxes, if any, payable on such goods.

Shops and Establishment Act

4.15 The purpose of this Act is to regulate conditions of work and employment in shops, commercial establishments, residential hotels, restaurants, eating houses, theatres, other places of public entertainment and other establishments. This act provides for regulation of establishments, employment of children, young persons and women, leave and payment of wages, health and safety, etc.

The applicability of the act extends to following:

(a) It applies to all local areas specified in the Act.

(b) Establishment means any establishment to which the Act applies and any other such establishment to which the State Government may extend the provisions of the Act by notification.

(c) Employee means a person wholly or principally employed whether directly or through any agency, whether for wages or other considerations in connection with any establishment.

Considering this act is governed by the State Government, the returns, rules, forms, regulations and procedures vary in accordance with the state enactments.

The Standards of Weights and Measures Act, 1976

4.16 This Act has been enacted to establish standards of weights and measures, to regulate trade or commerce in weights, measures and other goods which are sold or distributed by weight, measure or number, to provide for matters connected therewith or incidental thereto.

This act applies to whole of India and, basically, provides different guidelines regarding the following:

- Establishment of Standards as related to Weights and Measures.
- Physical representation of standard units.
- Standards of weights and measures.
- Custody and verification of standard equipments.
- Inter-state trade or commerce in weight, measure or other goods.
- Import and export of weights and measures.

- Regulation of the Act.
- Penal Provisions.

Competition Act, 2002

4.17 The Monopolies and Restrictive Trade Practices Act, 1969 has metamorphosed into the new law, Competition Act, 2002. The new law is designed to repeal the extant MRTP Act. The basis of the Competition Act, 2002, is to promote the welfare of the people by securing and protecting as effectively, as it may, a social order in which justice social, economic and political shall inform all the institutions of the national life, and the State shall, in particular, direct its policy towards securing:

(a) That the ownership and control of material resources of the community are so distributed as best to subserve the common good; and

(b) That the operation of the economic system does not result in the concentration of wealth and means of production to the common detriment.

Components of Competition Act

4.18 The rubric of the new law, Competition Act, 2002 has essentially four compartments:

(a) Anti Competition Agreements.

(b) Abuse of Dominance.

(c) Combinations Regulation.

(d) Competition Advocacy.

(a) Anti Competition Agreements

Entities enter into agreements, which may have the potential of restricting competition. Horizontal agreements are among competitors and the vertical agreements are relating to an actual or potential relationship of purchasing or selling to each other. A pernicious type of horizontal agreements is the cartel. Vertical agreements are pernicious, if they are between firms in a position of dominance.

Most competition laws view vertical agreements, generally, more leniently than horizontal agreements, as prima facie, horizontal agreements are more likely to reduce competition than vertical agreements.

Horizontal agreements, which include members of cartels, are presumed to lead to unreasonable restrictions on competition and are, therefore, presumed to have an appreciable adverse effect on competition. In other words, they are per se illegal. The underlying principle in such presumption of illegality is that the agreements in question have an appreciable anti-competitive effect.

(b) Abuse of Dominance

Dominant Position has been appropriately defined in the Act in terms of the position of strength, enjoyed by an enterprise, in the relevant market, in India, which enables it to (i) operate independently of competitive forces prevailing in the relevant market; or (ii) affect its competitors or consumers or the relevant market, in its favour.

The Act prevents enterprise from abusing its dominant position. Dominant position is the position of strength enjoyed by an enterprise in the relevant market which enables it to operate independently of competitive forces prevailing in the market or caffects its competitors or consumers or the relevant market in its favour.

Dominant position is abused when an enterprise imposes unfair or discriminatory conditions in purchase or sale of goods or services or in the price of purchase or sale of goods or services. Again, the philosophy of the Competition Act is reflected in the provision, where it is clarified that a situation of monopoly per se is not against public policy but rather the use of the monopoly status such that it operates to the detriment of potential and actual competitors.

(c) Combinations Regulation

The Competition Act is also designed to regulate the operations and activities of combinations, i.e., a term, which contemplates acquisitions, mergers or amalgamations. Thus, the operation of the Competition Act is not confined to transactions strictly within the boundaries of India but also such transactions involving entities existing and/ or established overseas.

(d) Competition Advocacy

Competition advocacy creates a culture of competition. There are many possible valuable roles for competition advocacy, depending on a country's legal and economic circumstances. The Regulatory Authority under the Act, namely, Competition Commission of India (CCI), in terms of the advocacy provisions in the Act, is enabled to participate in the formulation of the country's economic policies and to participate in the reviewing of laws related to competition at the instance of the Central Government.

4.19 The internal auditor should understand these regulations in depth before charting down his audit procedures and areas of verification.

Chapter 5

Internal Audit

Need for Internal Audit

5.1 Considering the nature of the Retail Industry and the pace at which the Industry has grown over the past decade, need for ensuring proper controls need not be over emphasized. With the increasing number of frauds in the software field, and considering the vulnerability of the sector to modification of data, internal audit becomes significant. Internal audit also helps in verifying the controls in place within the entity with regard to sufficiency and effectiveness in the light of overall business. Internal audit also helps in assessing the risks faced by the entity and provide a method for management of the same. Internal controls and risk management are extremely important activities in a entity operating in the Retail Industry.

5.2 Effective internal audit provides a tool to ease out all complexities, ensures that systems and processes are adequate to support the growth and are adapted to the changes in various regulations, thereby ensuring sustained growth and development.

"Preface to the Standards on Internal Audit", issued by the Institute of Chartered Accountants of India defines the term *"Internal Audit"* as follows:

"Internal Audit is an independent management function, which involves a continuous and critical appraisal of the functioning of an entity with a view to suggest improvements thereto and add value to and strengthen the overall governance mechanism of the entity, including the entity's strategic risk management and internal control system."

The definition highlights the following facets of internal audit.

- Internal auditor should be independent of the activities they audit. The internal audit function is in general considered independent when it can carry out its work freely and objectively. Independence permits internal auditors to render impartial and unbiased judgment essential to the proper conduct of audits.

- Internal audit is a management function, thus, it has the high-level objective of serving management's needs through constructive recommendations in areas such as, internal control, risk, utilisation of resources, compliance with laws, management information system etc.

- Internal audit's role should be a dynamic one, continually changing to meet the needs of the organisation. There is often a need to change audit plans as circumstances warrant. These changes may include coverage of new areas, assistance to management in solving problems, and the development of new internal audit techniques.

- An effective internal audit function plays a key role in assisting the board to discharge its governance responsibilities. Thus, it contributes in accomplishment of objectives and goals of the organisation through ethical and effective governance.

- Risk management enables management to effectively deal with risk, associated uncertainty and enhancing the capacity to build value to the entity or enterprise and its stakeholders. Internal auditor plays an important role in providing assurance to management on the effectiveness of risk management.

- Internal audit function constitutes a separate component of internal control with the objective of determining whether other internal controls are well designed and properly operated. Thus, the examination and appraisal of controls are normally components, either directly or indirectly, of every type of internal auditing assignment.

Factors Contributing to the Evolution of Internal Audit

5.3 "*General Guidelines on Internal Audit*" issued by the Institute of Chartered Accountants of India describes the factors contributing to the evolution of internal audit in India. A few such factors are as follows:

(i) Increased Size and Complexity of Businesses

Increased size and business spread dilutes direct management oversight on various functions, necessitating the need for a full time, independent and dedicated team to review and appraise operations.

(ii) Enhanced Compliance Requirements

Increase in the geographical spread of the businesses has also led to crossing of political frontiers by businesses in a bid to tap global capital. This has thrown up compliance with the laws of the home country as well as the laws of that land as a critical factor for existence of businesses abroad.

(iii) Focus on Risk Management and Internal Controls

Internal auditors can carry out their job in a more focused manner by directing their efforts in the areas where there is a greater risk, thereby enhancing the overall efficiency of the process and adding greater value with the same set of resources.

(iv) Stringent Norms Mandated by Regulators to Protect Investors

The regulators are coming up in a big way to protect the interests of the investors. The focus of the latest regulations being ethical conduct of business, enhanced corporate governance and financial reporting requirements, etc.

(v) Unconventional Business Models

Businesses today use unconventional models and practices, for example, outsourcing of non-core areas, such as accounting.

(vi) Intensive use of Information Technology

Information technology (IT) is invariably embedded in all spheres of activities of a modern business enterprise today, from data processing to resource planning to online sales and e-commerce. Use of IT has, however, increased the threat of data thefts or losses on account of systems failure or hacking/ espionage, as well as the need to comply with the cyber laws, etc.

(vii) An Increasingly Competitive Environment

Whereas deregulation and globalisation have melted the political as well as other barriers to entry in the markets for goods and services, free flow of capital, technology and know-how among the countries as well as strong infrastructure has helped in bringing down the costs of production and better access to the existing and potential consumers. This in turn, has lured more and more players in the existing markets, thereby, stiffening the competition.

Standards on Internal Audit

5.4 Internal Audit Standards Board of the Institute of Chartered Accountants of India (ICAI) has, till date, issued seventeen Standards on Internal Audit (SIAs) and the same are as follows:

SIA 1 Planning an Internal Audit

SIA 2 Basic Principles Governing Internal Audit

SIA 3 Documentation

SIA 4 Reporting

SIA 5 Sampling

SIA 6 Analytical Procedures

SIA 7 Quality Assurance in Internal Audit

SIA 8 Terms of Internal Audit Engagement

SIA 9 Communication with Management

SIA 10 Internal Audit Evidence

SIA 11 Consideration of Fraud in an Internal Audit

SIA 12 Internal Control Evaluation

SIA 13 Enterprise Risk Management

SIA 14 Internal Audit in an Information Technology Environment

SIA 15 Knowledge of the Entity and its Environment

SIA 16 Using the Work of an Expert

SIA 17 Consideration of Laws and regulations in an Internal Audit

5.5 These Standards are recommendatory in nature and codify the best practices in the field of internal audit. "*Framework for Standards on Internal Audit*" promotes professionalism in the internal audit activity and comprises of four components, *viz.*, the Code of Conduct, the Compliance Framework, the Body of Standards and the Technical Guide.

Standards on Internal Audit (SIAs) are important for carrying out an internal audit of Retail Industry. The internal auditor and the audit team are expected to be updated on the latest pronouncements issued by the Institute in order to conduct an effective internal audit.

Terms of Internal Audit Engagement

5.6 The auditee is expected to formally communicate the appointment to the internal auditor. Upon receiving the communication, the internal auditor should send an engagement letter, preferable before the commencement of engagement so as to avoid any misunderstanding. The internal auditor and the auditee should agree on the terms of engagement before commencement. Standard on Internal Audit (SIA) 8, "*Terms of Internal Audit Engagement*" establishes standards and provides guidance in respect of terms of engagement of internal audit activity whether carried out in house or by external agency.

5.7 The engagement letter should generally include reference to the following:

(i) Objective of the Internal Audit;

(ii) Management's responsibilities;

(iii) Scope of internal audit (including reference to the applicable legislation, regulation and various pronouncement of ICAI);

(iv) Access to records, documents and information required in connection with the internal audit;

(v) Expectation to receive management's written confirmation in respect to representation made in connection with the audit;

(vi) Basis on which fees shall be computed and the billing arrangements thereof;

(vii) Industry specific area;

(viii) References received from the parent company, if any; and

(ix) Undertakings and locations to be covered.

The scope of the terms of engagement, after decineating the broad areas of function of internal audit, should clarify that any additional services that are not emcompassed by the engagement letter shall be performed only on mutual agreement and with separate engagement letter.

5.8 The terms of the engagement should clearly lay down the requirements as to manner and frequency of reporting and the list of intended recipients of the internal audit report. The engagement letter should contain a condition that the report of the internal auditor should not be distributed or circulated by the auditee or the internal auditor to any party other than that mutually agreed between the internal auditor and the auditee unless there is a statutory or a regulatory requirement to do so.

Knowledge of the Business

5.9 Before the commencement of audit assignment the internal auditor should have or obtain the knowledge of the business and its environment. The internal auditor should acquire sufficient knowledge to enable him to identify and understand the events, transactions and practices that can have significant effect on the internal audit process. Such knowledge shall be helpful to the internal auditor in assessing the inherent risk and control risk and in determining the nature, timing and extent of the internal audit procedures. Knowledge of the business assists the internal auditor in:

- Assessing the risk and identifying the problems;
- Planning and performing the internal audit effectively and efficiently;
- Evaluating audit evidence; and
- Providing better service to the client.

5.10 Standard on Internal Audit (SIA) 15, "*Knowledge of the entity and its Environment*" establishes Standards and provides guidance on what constitutes knowledge of an entity's business, its importance to the various phases of an internal audit engagement and the techniques to be adopted by the internal auditor in acquiring such knowledge about the client entity and its environment, prior to commencing an internal audit engagement and subsequently thereafter, at all stages of the internal audit process.

5.11 The internal auditor should prepare the flow of events, transactions, processes and practices within the organisation. This will help in gaining better understanding of the processes and the existence of the internal controls. Illustrative flowchart of "A Typical Process in Retail Industry" is given as **Appendix 1.**

Audit Planning, Materiality and Sampling

5.12 After acquiring the knowledge of business and various laws and regulation applicable to the Retail industry, the internal auditor should plan out the internal activity. Planning helps in achieving the objectives of internal audit function. Adequate planning ensures that:

- Appropriate attention is devoted to significant areas of audit.
- Potential problem are identified.
- Skills and time of the staff are appropriately utilised.
- Work is carried out in accordance with the applicable to pronouncement of ICAI.
- Work is carried out in conformity with the applicable laws and regulation.

5.13 Standard on Internal Audit (SIA) 1, "*Planning an Internal Audit*" provides guidance in respect of planning an internal audit plan. An internal audit plan is a document defining the scope, coverage and resources including time, required for an internal audit over a defined period. In preparing an internal audit plan, internal auditor should obtain an understanding of the accounting and internal control system prevalent within the entity and exercise preliminary judgement regarding the critical areas to be considered during the internal audit. It also helps the auditor in determining the audit materiality, nature and extent of audit procedures to be adopted.

5.14 While designing an audit sample, the internal auditor should consider the specific audit objectives, materiality, population from which the internal auditor wishes to select the sample, area of audit significance and the sample size. Standard on Internal Audit (SIA) 5, "*Sampling*" provides that ***when using either statistical or non-statistical sampling methods, the internal auditor should design and select an audit sample, perform audit procedures thereon, and evaluate sample results so as to provide sufficient and appropriate audit evidence to meet the objective of internal audit engagement unless otherwise specified by the client.***

Internal Control

5.15 Standard on Internal Audit (SIA) 12, *"Internal Control Evaluation"* states that *"Internal controls are a system consisting of specific policies and procedures designed to provide management with reasonable assurance that the goals and objectives it believes important to the entity will be met".*

5.16 *"Internal Control System"* means all the policies and procedures (internal controls) adopted by the management of an entity to assist in achieving management's objective of ensuring, as far as practicable, the orderly and efficient conduct of its business, including adherence to management policies, the safeguarding of assets, the prevention and detection of fraud and error, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information. The internal audit function constitutes a separate component of internal control with the objective of determining whether other internal controls are well designed and properly operated.

5.17 SIA 12, "Internal Control Evaluation" lays down that Internal control system consists of interrelated components as follows:

- Control (or Operating) Environment
- Risk Assessment
- Control Objectivity Setting
- Event Identification

- Control Activities
- Information and Communication
- Monitoring
- Risk Response.

5.18 The system of internal control must be under continuous supervision by management to determine that it is functioning as prescribed and is modified, as appropriate, for changes in environment. The internal control system extends beyond those matters which relate directly to the functions of the accounting system.

5.19 ***The internal auditor should obtain an understanding of the significant processes and internal control systems sufficient to plan the internal audit engagement and develop an effective audit approach. The internal auditor should use professional judgment to assess and evaluate the maturity of the entity's internal control. The auditor should obtain an understanding of the control environment sufficient to assess management's attitudes, awareness and actions regarding internal controls and their importance in the entity.***

5.20 ***The internal auditor should examine the continued effectiveness of the internal control system through evaluation and make recommendations, if any, for improving that effectiveness.***

The importance of internal controls in a Retail entity need not be over-emphasised. Internal audit plays a major role in determining the effectiveness of internal controls and highlights areas for improvement.

Internal Audit in an Information Technology Environment

5.21 Computer Information system (CIS) environment exist when one or more computer(s) of any type or size is (are) involved in the processing of financial information, including quantitative data and the significance in relation to the audit, whether those computers are operated by the entity or third party.

5.22 The overall objective and scope of internal audit does not change in a Computer Information System (CIS) environment. However, the use of computer changes the processing, storage, retrieval and communication of financial information and may affect the accounting and internal control systems employed by the entity. Moreover, the risks involved in an audit may too undergo a change. The internal auditor should have sufficient knowledge of the CIS environment to plan, direct, supervise, control and review the work performed.

5.23 The data in a retail entity operating in a CIS environment is, generally, voluminous. The CIS automatically generates material transaction or entries and exchanges transaction automatically with other organisation as in Electronic Data Interface (EDI) systems. Source documents, computer files and other evidential matter exist only for short period and in machine readable form. The use of the Computer Assisted Audit Technique (CAAT) shall increase the efficiency in the performance and enable the internal auditor to economically apply certain procedures to the entire population or accounts transaction.

5.24 The internal auditor should consider the CIS environment in designing audit procedures to reduce the audit risk to an acceptable low level. The internal auditor should also document the audit plan, the nature, the timing and the extent of audit procedures performed and the conclusions drawn from the evidence obtained which may be in the electronic form. The internal auditor should ensure that such electronic evidence is adequately and safely stored and is retrievable in its entirety as and when required.

5.25 Standard on Internal Audit (*SIA)* 14 *"Internal Audit in an Information Technology Environment"* establishes standards on procedures to be followed when an internal audit is conducted in an information technology environment. The internal auditor should also review the effectiveness and safeguarding of IT resources, including- people, applications, facilities and data.

5.26 ***The internal auditor should review the robustness of the IT environment and consider any weakness or deficiency in the design and operation of any IT control within the entity, by reviewing:***

(a) ***System Audit reports of the entity, conducted by independent Information System auditors;***

(b) ***Reports of system breaches, unsuccessful login attempts, passwords compromised and other exception reports;***

(c) ***Reports of network failures, virus attacks and threats to perimeter security, if any;***

(d) ***General controls like segregation of duties, physical access records, logical access controls;***

(e) ***Application controls like input, output, processing and run-to-run controls; and***

(f) ***Excerpts from the IT policy of the entity relating to business continuity planning, crisis management and disaster recovery procedures.***

Overview of Compliance

5.27 Compliance means ensuring conformity and adherence to Acts, Rules, Regulation, Directives and Circulars.

Standard on Internal Audit (*SIA) 17 "Consideration of Laws and regulations in an Internal Audit"* issued by the Institute of Chartered Accountants of India requires that ***when planning and performing audit procedures and in evaluating and reporting the results thereof, the internal auditor should recognize that non compliance by the entity with laws and regulation may materially affect the financial statements.*** The requirements in this SIA are designed to assist the internal auditor in identifying the significant impact of non-compliance with law and regulation on the functioning of the entity. However, in view of inherent limitations on the role of the internal auditor, he is not responsible for preventing non-compliance and cannot be expected to delete non-compliance with all law and regulations.

5.28 The term "*Non compliance*" refers to acts of omission or commission by the entity, either intentional or unintentional, which are contrary to the prevailing laws or regulations. Such acts include transactions entered into by, or in the name of the entity or on its behalf, by those charged with governance, management or employees. Non-compliance does not include personal misconduct (unrelated to the business activity of the entity) by those charged with governance, management or employees of the entity.

5.29 Laws and regulations vary considerably in their relation to the financial statements. Some laws or regulations determine the form or content of an entity's financial statement or the amounts to be recorded or disclosures to be made in financial statements. Other laws or regulation are to be complied with by management or prescribe the provisions under which the entity is allowed to conduct its business. Non-compliance with laws and regulation could result in financial consequences for the entity such as, fines, litigation, etc. It may also, in extreme cases, have a potential effect on going concern as an entity.

5.30 The internal auditor should plan and perform the internal audit recognising that the audit may reveal conditions or events that would lead to questioning whether an entity is complying with laws and regulations. In order to plan the internal audit, the internal auditor should obtain an understanding of the legal and regulatory framework applicable to the entity and how the entity is complying with that framework.

To obtain the understanding of laws and regulations, the internal auditor would ordinarily:

- Use the internal auditor's existing knowledge of the entity's industry and business.

- Inquire with management as to the laws or regulations that may be expected to have a fundamental effect on the operations of the entity.
- Inquire with management concerning the entity's policies and procedures regarding compliance with laws and regulations as well as ethical issues within the entity.
- Discuss with management the policies or procedures adopted for identifying, evaluating and accounting for litigation claims and assessments.

5.31 After obtaining the understanding, the internal auditor should perform procedures to identify instances of non-compliance with those laws and regulations where non-compliance should be considered while preparing financial statements, specifically:

- Inquiring with management as to whether the entity is in compliance with such laws and regulations.
- Inspecting correspondence with the relevant licensing or regulatory authorities.
- The internal auditor should also perform substantive tests of details of classes of transactions, account balances or disclosures.

5.32 The significance of compliance are as follows:

(i) The benefits to the Industry are:

- Helps in compliance with legal terms and covenants and thereby reduces penalties and charges.
- Increased internal control.
- Reduction of internal frauds and losses.
- More time available for other core activities.
- Increases efficiency in operations.

- Customer satisfaction.

(ii) Benefits to the Customers:

- Ensures safer market place.
- Safeguards the customer interests.
- Quality assurance.
- Enhanced consumer protection.

(iii) Benefits to the stakeholder:

- Ensures risk containment and safer market place.
- Better investor confidence.
- Uniform practices.
- Better image, hence, better value for the investor.

Chapter 6

Major Areas of Internal Audit Significance

6.1 Internal audit procedures that apply to any industry also apply to an entity operating in the retail industry. In this technical guide, internal auditing procedures pertaining to Retail Industry have been specified. These audit procedures are an illustrative in nature which can be performed in addition to the regular internal audit procedures performed by an internal auditor.

Invoicing

6.2 The invoicing process varies significantly and is directly based on the size of the retail store. To elaborate, it varies from a systematic billing process and checking process in the case of large stores to non-systematic cash-based billing in the smaller stores. The billing and invoicing process in the retail industry needs to be simple, systematic, fast, secure and error-free to ensure avoiding unnecessary waiting time for billing and plays a major role in the success of the organisation.

It might be pertinent to note that potential for omitted/ manipulating income is greater in e-retailing, due to the borderless and paperless feature of the organisation. With online retail, the reconciliation of shipment costs with both cost of goods sold and income is another quality audit technique.

In general, cheques are received from customers whom the management is familiar with or from customers who procure large quantities of products. The management might also offer "*on account*" payment from such customers.

6.3 A few common types of billing include:

(i) *Cash Pay Outs*

As discussed above, the accounting for cash is a primary focus for the internal auditor. Considering that cash is paid for a significant part of the billing by the entity, maintenance of proper records is a critical part of the overall organisation management. It is equally important to ensure that there is sufficient and appropriate fixing of responsibility in the case of management of cash.

(ii) *Z Tapes*

Most simple cash registers contain a "Z" key which can only be operated by the manager, owner or a key employee. The Z key totals the entire history of activity on the cash register for a period of time, providing a summary total for (sales) taxable sales, non (sales) taxable sales, credit card sales, credit card tips, cash sales, lottery sales, coupons and discounts, etc. Each day's Z tape is used to record the daily sales in the sale journal. These tapes must be retained by the owner and made available for the examination.

(iii) *Point of Sale (POS)*

This is a computerised accounting system that records sales along with related items, such as employee's time and tips received, or reductions to inventory and calculations of profit on each sale. These machines can produce financial statements, periodic statements of profit and loss, profits per item, payroll checks, etc.

6.4 Transfer of property of products can through the following methods:

(i) ***Counter service***—Where goods are out of reach of buyers and must be obtained from the seller. This type of retail is common for small expensive items (like jewellry) and controlled items like medicine and liquor. It was common before the 1900s in the United States and is more common in certain countries.

(ii) ***Delivery (Commerce)***—Where goods are shipped directly to consumer's homes or workplaces. Ordering on telephone is now common, either from a catalog, newspaper, television advertisement or a local restaurant menu, providing for immediate service.

(iii) ***Door-to-Door Sales***—Where the salesperson sometimes travels with the goods for sale.

(iv) ***Self-service***—Where goods may be handled and examined prior to purchase. It has become more common since the 1920s.

6.5 Retailers use different methods to collect and account for cash. In some stores, only the owner collects cash from customers. In larger stores, key employees collect and account for cash. In more sophisticated systems, a Point of Sale (POS) cash register may record sales and decrease inventory at the same time.

Considering the nature of the sector, frequent job rotation would enable the entity to prevent errors and de-motivate the employee to do any fraudulent activity.

6.6 The accounting policy for recognition of revenue too would be an integral part of the internal audit procedures to be performed by the internal auditor. He should understand the process in depth to ensure its appropriateness.

If the internal auditor suspects the billing system/ process followed by the management, he can take the help of a systems expert to ensure that there are no manipulations in the system.

6.7 The internal auditor needs to verify all these clauses as a part of performance of internal audit procedures. The internal auditor may also perform following analytical procedures:

(a) *Same-store Sales*

Same-store sales is a business term which refers to the differential in revenue generated by a retail chain's existing outlets over a certain period of time (often a fiscal quarter or a particular shopping season), compared to an identical period in the past, usually in the previous year

(b) ***Initial Mark up Percentage***

The initial markup is the average markup required on all products to cover the cost of all items, incidental expenses, and to obtain a reasonable profit. The initial markup is expressed as a percentage and this helps the entity to estimate the cost of the product for determination of the sale price.

(c) ***Sales Mix Ratio***

The term *"Sales Mix Ratio"* refers to the relative proportion in which an entity's products are sold. The concept is to achieve the combination that will yield the greatest amount of profits. Most companies have many products, and often these products are not equally profitable. Hence, profits will depend to some extent on the company's sales mix. Profits will be greater if high margin rather than low margin items make up a relatively large proportion of total sales. Hence, the entity must ensure that it pushes the right products through visual merchandising. The internal auditor might comment on the efficiency of the entity in maximising profits through an effective sales mix.

(d) ***Operational Margins Period Wise***

The internal auditor may compute the operational margins such as gross profit margin, periodically and ascertain the variance between the different periods compared with. For e.g., the internal auditor compares the gross margin for the month of February with that of January or February of the preceding year, he might observe huge variances in the margins. The internal auditor is required to seek explanations from the management for such significant fluctuations and understand the reason for such fluctuation. This might provide an insight on the effectiveness of the management in operations apart from ensuring that there has not been any fraud during the period.

(e) ***Significant Fluctuations in Revenue***

Significant fluctuations in gross revenue over a period time needs to be explained in the overall light of the business scenario, taking into consideration seasonal changes and promotional offers. This will provide a deeper insight into the risks faced by the internal auditor and also an insight to the client's business apart from identifying irregularities. The internal auditor might also compare the revenue over a period of time to verify the change in turnover and seek explanations as appropriate.

(f) ***Revenue per Square Foot***

One of the methods to evaluate and compare the department wise performance would be to compare the revenue per square foot/ square metre, whereby a common metric is formulated to compare the performance of the department and justify the cost incurred towards the store. Efficiency of usage of space can be understood by the internal auditor by this estimate.

The internal auditor might make a suitable analysis by estimating the revenue per square foot pertaining to that particular department and justify the space provided to the same. This enables proper allocation of office space to enable profit maximisation and enhance customer satisfaction.

(g) ***Actual Profitability vs Budgeted Profit Comparison***

In general, every store is given a daily, weekly and monthly turnover targets. These budgets/ targets are determined based on following factors:

(i) Turnover achieved on the same day during the previous period.

(ii) Location of the store.

(ii) Size, availability of products.

(iv) Promotional offers and discount sales.

The effectiveness of the budgets can be estimated based on its comparison with the actual sales. The internal auditor can assess the efficiency of budget making and verify whether the entity's procedures with regards to target setting are realistic. The internal auditor might suggest any changes required to be made to ensure proper function of the existing system.

(h) ***Ratio on the Modes of Revenue***

The internal auditor might analyse and compare the ratio of revenue received through following:

(i) Credit Card Payments:

(ii) Cash Billing:

(iii) Credit Billing:

(iv) Passes/ Coupons: and

(v) Discount Vouchers.

This would provide an insight on the collection system. It also enables the auditor to understand the cash flow mechanism and strengthen controls suitably.

(i) ***Average Revenue per Bill***

This ratio can be ascertained by estimating the total revenue and total bills raised in a particular period. This ratio is the total amount billed divided by the number of bills raised and analysed store-wise over a period of time. This would provide an insight whether the customer's confidence, requirement of number of billing counters and proper queuing system.

(i) ***Percentage of Errors and Rejections***

The internal auditor can verify the quality of billing through measurement of total errors and rejections as against the total volume of billing made. This would help the internal auditor to assess risk of loss of revenue due to incorrect billing, entity's training in billing and efficiency of the billing staff.

(k) ***Revenue from Categories of Goods***

The internal auditor may estimate the total revenue received from products sold at discounts and products sold at MRP. It might provide an insight of effectiveness of discount given to a particular product *vis-a-vis* in increasing the customers flocking to the store and incidentally, the turnover.

6.8 These ratios should be prepared and compared over a period of time. If these ratios are inconsistent over that period, proper explanations needs to be obtained, thereby helping the internal auditor in assessing effectiveness, sufficiency, appropriateness of controls and also to highlight the risk environment the business is under. It should also be verified whether the entity monitors such ratios on a regular basis.

6.9 The following is model checklist related to the billing process:

S.No.	PARTICULARS	Yes	No	N/A
1	***Verification of Billing Mechanism***			
1.1	Is there a proper billing system commensurate with the size of business?			
1.2	Have the controls been verified to ensure fixing of appropriate responsibility to the person? Are there sufficient systems to ensure periodic			

S.No.	PARTICULARS	Yes	No	N/A
	job rotation preventing mis-appropriation of funds?			
1.3	Are the systems inbuilt to detect any billing mistakes and errors?			
1.4	Is there any log maintained by the entity as regarding errors and mistakes in billing?			
1.5	Does the entity take sufficient measures in ensuring prevention of such instances?			
1.6	Does the entity have a proper system of collection of the amount billed?			
1.7	Is the collection made in a manner enabling quick movement of customers apart from ensuring that there are sufficient control processes?			
1.8	Is there a routine checking of collections (cash, coupons, vouchers, credit card receivables, etc.) made at the time of change in billing personnel?			
1.9	Is the checking performed by an authorised person?			
1.10	Is the collection verified and reconciled on a daily basis and approved?			
1.11	Are the processes sufficient to ensure appropriate banking of cash and sending of coupons to the head office?			
1.12	Is there sufficient monitoring by the entity to ensure prevention and			

S.No.	PARTICULARS	Yes	No	N/A
	detection of losses on account of shop-lifting and theft?			
1.13	Has there been a sufficient system for audit/ verification to ensure that the billing system is without any mistakes?			
1.14	Has any statistical function been performed for estimating the queuing system and area allocation system of the store?			

Cash Management Policies

6.10 Efficient cash management processes are pre-requisites to execute payments, collect receivables and manage liquidity. Managing the channels of collections, payments and accounting information efficiently becomes imperative with growth in business transaction volumes. This includes enabling greater connectivity to internal corporate systems, expanding the scope of cash management services to include "full-*cycle*" processes (i.e., from purchase order to reconciliation) *via,* e-commerce, or cash management services targeted at the needs of specific customer segments. Cost optimisation and value-add services are customer demands that necessitate the creation of a mechanism to serve the various customer groups.

6.11 Some of the cash management techniques followed by companies are as follows:

(i) Account Reconciliation Services

Balancing a cheque book for a very large business can be quite a difficult process. Banks have developed a system to overcome this issue. They allow companies to upload a list of all the cheques whereby at the end of the month, the bank statement will show not only the cleared cheques but also uncleared ones.

(ii) Positive Pay

It is an effective anti-fraud measure for cheque disbursements. Using the cheque issuance data, updated regularly with cheque issuance and payment, the bank balances all cheques offered for payment in bank. In the case of any discrepancies, the cheque is reported as an exception and is returned.

(iii) Balance Reporting Services

Balance reporting services help in procuring a company's current banking information from its accounts. With this service, the banks can offer almost all types of transaction-specific details.

(iv) Lockbox

It facilitates the cash improvement where, instead of being delivered to business address, customer payments are delivered to a special post office (PO) box. It is only the customers' payments that are delivered in the PO box and the company's own bank collects the amount and delivers them to the banks of the customers. The bank of the customer processes the payments for direct deposit to the entity's bank account. Lockbox contents are regularly removed and processed.

(v) Cheque Writing

In order to execute the payments faster, banks are providing cheque writing facility to the corporate customers wherein customer can print the cheques locally at their own office with the facility of digital signatures and company logos.

(vi) Bin Management of Post-dated cheque(PDC)

Corporates are outsourcing the activity of Post Dated Cheque (PDC) management to the banks for further reducing the cost of operations, administration, and data maintenance.

(vii) Liquidity Management

In order to have efficient utilisation of excess funds, corporate avail the facility of liquidity management. Liquidity management system prudently manages various assets and liabilities (on- and off-balance sheet) and ensures that cash inflows have an appropriate relationship to the approaching size of cash outflows. The system ensures that necessary funds are available to entertain all cash outflows as they fall due.

Adequate cash management mechanisms ensure efficient collection, systematic disbursements, and ideal deployment of idle funds, tiding over immediate cash needs, and compensating the banks that support these activities of the company. An advanced cash management system enhances the possibilities of earning high net interest income, creates efficient balance sheets, minimises expenses on resources, and reduces the company's exposures to potential risks related to seasonality of business and debt repayments.

Cash continues to play a dominating role in the retail industry. Even the ascent of the cashless payments, more than 50 percent are cash transactions with variations depending on region, industry and sales format. Small shopping baskets, in particular, are usually paid for in cash. Cash handling is a cost intensive process for retail companies, and offers major potential for improving productivity.

6.12 The internal auditor's analytical procedures is divided into the following four steps:

(i) *Analysis of Structures and Processes*

Analyse the factors such as, customers' payment habits at the point of sale. This gives an exact picture of the status-quo in a company store.

(ii) Development of Solution Proposals

Parallel to this, the retailer's intentions and objectives with regard to cash automation are discussed and specified.

Together with the hard facts from the status quo analysis, these aspects form the basis for working on concrete solution scenarios.

(iii) ***Piloting in the Store***

Recommendations involve not only the Point of Sale (POS) hardware but also include re-design and optimisation of the entire cash process in a store. These include return on investment calculations, which, due to the current situation analysis, already contain very detailed and realistic pay-back forecasts.

(iv) ***Decision on the Project***

With the experiences gained during piloting, possibly enhanced with a customer survey, the retailer has sufficient data and facts on which to take his investment decision. This is then specified, the project is planned in detail, and the rollout scope and schedule defined.

Retailing is very heterogeneous, various segments, national regulations, different processes and corporate cultures necessitate a tailored solution that fits exactly.

Advantages

(i) Potential for savings through automated end-to-end handling of the cash flow from the point of sale to the cash office and on to the cash-in-transit operator for posting at the bank.

(ii) Considerable reduction in discrepancies (at the point of sale and between the cash center and store) due to efficient controlling and better monitoring facilities.

(iii) Fewer interfaces thanks to a closed cash cycle.

(iv) Cash flow transparency with end-to-end controlling and reporting to reduce operational risk.

Objective

The objective of cash management systems is to eliminate potential security loopholes by implementing a closed cash cycle.

Procurement of Materials and Consumption

6.13 Procurement is the most important activity in the retail industry. It refers to the products procured by the concern for sales. The procurement involves sourcing of products from different vendors across various geographical locations. Management of procurement of products plays an important role in the success of the entity.

6.14 Sourcing can be done directly from the following sources:

- Manufacturers,
- Intermediaries - wholesalers, distributors and dealers,
- Internet and web-based softwares

6.15 Considering that the total cost of goods consumed accounts for around 75% of the expenditure incurred by the entity and the entity generally operates in a very small net margin, the importance of procurement of products at the right time and the right sources plays a significant role in ensuring the profitability of business and sustainability of business.

6.16 Evaluation of a vendor is a very complex process due to of the following factors:

- No. of suppliers.
- No. of products.
- Varied geographical location of suppliers.
- Different terms with each supplier with regards to credit period, delivery time, time lag, etc.

- Cost of products.
- Perishable nature of certain key products
- Different handling requirements for different products.
- Size and volume of the products.

Supplier evaluation needs to be performed by every retailer to ensure that there are no constraints in supply on timely basis, quality of the products are ensured, reliability and terms of arrangement. Further, the screening process should ensure that the vendor has ethics and has no track record of any fraud in the past. The internal auditor needs to verify whether the entity has evaluated each vendor. The internal auditor also verify the basis and process of evaluation.

Some common types of system driven vendor frauds include the following:

- An employee's home address matches a vendor's address.
- An employee's initials match a vendor's name.
- Checks are written to "*cash*".
- A vendor's address contains a P.O. box.
- Vendor data are missing or found to be illogical.

6.17 The following procedures might be performed by the internal auditor.

(i) Sell-through Rate

The sell-through rate is a calculation, commonly represented as a percentage, comparing the amount of inventory a retailer receives from a manufacturer or supplier against what is actually sold to the consumer. This enables the internal auditor to understand the movement of goods.

(ii) Open to Buy

The goal of good inventory management is to maintain an appropriate level of inventory for the amount of sales. This enables the internal auditor to evaluate the utilisation of working capital in the entity.

(ii) Fill Rate

The ratio refers to the percentage of consumer orders satisfied from stock at hand. It is a measure of inventory's ability to meet demand. This enables the internal auditor to estimate whether the entity has been placing order sufficient enough to meet the demand of products from customers and to ensure that there is no loss of sales and customer loyalty.

(iii) Suppliers for a Key Product

It might be better for the entity to have multiple suppliers for a critical product to ensure the availability of products on a timely basis, risk reduction, avoiding over reliance on a particular supplier and ensuring better bargaining power. The internal auditor might provide the management an analysis for such products.

(iv) Percentage of Delayed Delivery by Supplier

The internal auditor may estimate the percentage of deliveries received on a delayed basis to total deliveries from a particular supplier. This enables the internal auditor to obtain an insight on the efficiency of the supplier.

(v) Total Consumption to Total Revenue Product Wise

The internal auditor shall assess whether the entity has a proper control on the consumption to sales ratio (product wise) to verify whether there have been significant fluctuations over a period and have explanations obtained from client for such deviations. The internal auditor can evaluate whether there have been any losses in any of the products and whether the entity is taking steps to ensure that visual merchandising is performed for the right product. In the event of the consumption being excess of revenue, the entity might obtain an understanding that the particular product that gets easily damaged/ perished or stolen and accordingly, would deal with them.

(vi) Inventory Turnover

This Ratio measures the number of times, on average, the inventory is sold during the period. Its purpose is to measure the liquidity of the inventory. This enables the internal auditor to estimate the efficiency of movement of goods and management of inventory by the entity.

S.No.	PARTICULARS	Yes	No	N/A
1	**Procurement of Materials and Consumption**			
1.1	Does the entity have a written policy for the procurement process?			
1.2	Is the written policy sufficient and complete in all aspects?			
1.3	Is the policy updated on a frequent basis?			
1.4	Is there a proper requisition note with approval from the appropriate level of authority sent from the concerned department?			
1.5	Does the entity raise an approved Request for Quotation (RFQ) within reasonable time across various suppliers?			
1.6	On receipt of various quotations, are there sufficient processes to ensure that the right quotation is approved			

S.No.	PARTICULARS	Yes	No	N/A
	as regards quality, reliability, price amongst other factors?			
1.7	On selection of the supplier, has an approved purchase order been placed with the supplier within reasonable time?			
1.8	Are there sufficient controls to trace the purchase order and its status within the entity to ensure receipt of materials without delay?			
1.9	Are there any contracts entered by the entity with suppliers for critical materials to ensure adequate supply at a reasonable price?			
1.10	Are there sufficient procedures to inspect materials as regards to specification and quantity, received by the entity at the site before unloading and signing of the delivery note?			
1.11	Are there sufficient documentary controls such as Gate Pass for entry of goods?			
1.12	Has a sample check for compliance of procedures performed?			
1.13	Is the process of receipt of material properly co-ordinated to the finance department to ensure proper accounting?			
1.14	Does the material receiving department maintain sufficient records of receipt and inspection of material?			

S.No.	PARTICULARS	Yes	No	N/A
1.15	Has the delivery note been approved by the appropriate level of authority before making the entry?			
1.16	In cases where materials are supplied by client, has the internal auditor ensured that there has been appropriate accounting of such material?			
1.17	Does the entity have proper control for materials received from the client? Are they separately identified and demarcated?			
1.18	In case of critical materials or slow moving material does the entity transfer the materials from one site to another rather than from purchasing them from external sources?			
1.19	Does the entity have a process of evaluation of all the vendors?			
1.20	Has the level of approval been specified for each vendor?			
1.21	In the event the entity is sourcing from foreign suppliers, has the entity entered into a contract / legal agreement for such supplies?			
1.22	Has the contract between suppliers made complete with all terms and conditions and have the risks appropriately specified?			
1.23	Has the entity made an analysis of the suppliers that may cause critical			

S.No.	PARTICULARS	Yes	No	N/A
	operational problems if there was any default?			
1.24	What would be the likely financial impact of a critical operational issue/ disruption to the operations?			
1.25	Does the entity have a system of consumption booking commensurate to the size of business?			
1.26	In the case of credit sales, does the entity have sufficient measures to book sales at the appropriate time in accordance with the terms of sale?			
1.27	In case of any sales returns, does the entity have a uniform policy across all stores?			
1.28	Does the entity have a proper control on such returns to ensure appropriate accounting of them?			

Supply Chain Management

6.18 Supply Chain Management (SCM) is the management of a network of interconnected businesses involved in the ultimate provision of product and service packages required by end customers. Supply Chain Management spans all movement and storage of raw materials, work-in-progress and finished goods from point of origin to point of consumption.

6.19 Supply Chain Management ensure that the availability of products is at the right time and at affordable cost. The Supply Chain function involves vendor management, quality assurance and transportation. Vendor management assumes critical importance in retail business where one has to deal with multiple products. Supply Chain Management is viewed in fully vertically integrated firms, where the entire material flow is owned by a single firm and those where each channel member operates independently

6.20 Six Sigma, in Supply Chain Management (SCM), helps in achieving substantial benefits in terms of costs and quality. For effective implementation of Six Sigma in Supply Chain Management, it require collection of data from multiple organisations spread across multiple geographical locations.

6.21 Supply Chain Management involves two broad categories i.e., *strategic and operational.* As the term implies, strategic decisions are made typically over a longer time horizon. These are closely linked to the entity's strategy and guide supply chain policies from a design perspective. On the other hand, operational decisions are short term, and focus on activities over a day-to-day basis. The effort in these type of decisions is to effectively and efficiently manage the product flow in the "*strategically*" planned supply chain.

6.22 The strategic decision in Supply Chain Management needs to include four major decision areas:

- Location,
- Production,
- Inventory, and
- Transportation (distribution),

6.23 Typically, a Supply Chain Management would include the following components

(i) ***Distribution Network Configuration***: Number, location and network missions of suppliers, production facilities, distribution centers, warehouses, cross-docks and customers.

(ii) ***Distribution Strategy:*** Operating control (*e.g., centralized, decentralized or shared*); Delivery scheme, (*e.g., direct shipment, pool point shipping, cross docking, Direct Store Delivery (DSD), closed loop shipping*); Mode of transportation, (*e.g., motor carrier, including truckload, parcel, railroad;*

intermodal transport, including trailer on flatcar (TOFC) and container on flatcar (COFC); Ocean freight, air freight); Replenishment strategy *(e.g., pull, push or hybrid)*; and Transportation control *(e.g., owner-operated, private carrier, common carrier, contract carrier, or Third Party Logistics (3PL))*.

(iii) ***Trade-Offs in Logistical Activities***: The above activities must be well co-ordinated in order to achieve the lowest total logistics cost. Trade-offs may increase the total cost if one of the activities is optimised. For example, full truckload (FTL) rates are more economical on a cost per pallet basis than less than truckload (LTL) shipments. If, however, a full truckload of a product is ordered to reduce transportation costs, there will be an increase in inventory holding costs which may increase total logistics costs. It is therefore imperative to take a systems approach when planning logistical activities. These trade-offs are key to developing the most efficient and effective Logistics and SCM strategy.

(iv) ***Information***: Integration of processes through the supply chain to share valuable information, including demand signals, forecasts, inventory, transportation, potential collaboration, etc.

(v) ***Inventory Management***: Considering the volume of inventory, and that certain products are perishable in nature. The entity needs to ensure that the materials are stored to facilitate retrieval based on the expiry date of the particular product. To enable this, the system should be comprehensive enough to track details of all products procured from different suppliers.

(vi) ***Cash-Flow***: Arranging the payment terms and methodologies for exchanging funds across entities within the supply chain.

6.24 Operations Research (OR) is a critical tool that enables the entity in framing the ideal supply chain management system.

6.25 Internal audit is an important functions activity as entities work to manage its increasingly complex and pervasive supply chain risk. Supplier disruption can immediately and significantly affect profitability, impair growth opportunities, shatter shareholder value, and compromise reputation through a decreased level of public confidence.

Six Sigma

6.26 Six Sigma is a business management strategy. It is widely used in many sectors of industry. Six Sigma seeks to improve the quality of process outputs by identifying and removing the causes of defects (errors) and minimising variability in manufacturing and business. It uses a set of quality management methods, including statistically methods and creates a special infrastructure of people within the organisation ("Black Belts", "Green Belts", etc.) who are experts in these methods.

6.27 Each Six Sigma project carried out within an organisation follows a defined sequence of steps and has quantified financial targets (cost reduction or profit increase). A six sigma process is one in which 99.99966% of the products manufactured are statistically expected to be free of defects (3.4 defects per million).

6.28 Six Sigma enables:

- Improvement in delivery time.
- Reduction of logistics cost.
- Lesser inventory cost.
- Improvement in the final finished product/ service.

6.29 To achieve this, Six Sigma uses a methodology known as DMAIC. DMAIC is an acronym for the following five-step improvement process, i.e., Define, Measure, Analyze, Improve, Control:

(i) ***Define Opportunities:*** Define design goals that are consistent with customer demands and the enterprise strategy.

(ii) ***Measure Performance:*** Measure and identify CTQs (characteristics that are Critical To Quality), product capabilities, production process capability, and risks.

(iii) ***Analyze Opportunity:*** Analyze to develop and design alternatives, create a high-level design and evaluate design capability to select the best design.

(iv) ***Improve Performance:*** Improve or optimise the current process based upon data analysis using techniques, such as, design of experiments or mistake proofing, and standard work to create a new, future state process. Set up pilot runs to establish process capability.

(v) ***Control Performance:*** Control the future state process to ensure that any deviations from target are corrected before they result in defects. Implement control systems such as, statistical process control, production boards, and visual workplaces, and continuously monitor them.

Implementation of Six Sigma

6.30 One key innovation of Six Sigma involves the "*professionalising*" quality management functions. Prior to Six Sigma, quality management in practice was largely related to the production floor and to statisticians in a separate quality department. Formal Six Sigma programs borrow martial arts ranking terminology to define a hierarchy (and career path) that cuts across all business functions.

Analysis of a failed project helps the team to know about the lack of commitment as well as attention by senior management, towards the business and cultural investment that were required for accomplishing and sustaining the new levels of performance.

Assessing the Various Deployment Stages of Six Sigma

6.31 Six Sigma Assessment Procedures cannot be the same. The assessment procedure developed by an organisation cannot be applied to any other organisation, or for even any other process. Companies that are successful in their own right have always developed. In fact, some of them have even used their internal audit system along with their own criteria in assessment.

One of the most important things to remember in the implementation process is assessing the status quo at various intervals. Assessing a process reveals any deviations, if done from the intended line of progress. Process optimisation and control are needed to render progressively higher quality in the deployment process. Performance efficiency and timeliness are also important, to put into place as an appropriate set of balances and checks to control all these factors.

6.32 The internal auditor is required to have good understanding of the entity and the possible challenges the entity might face in the process of implementing Six Sigma. Each entity have different challenges in the process of implementation of Six Sigma.

Six Sigma Assessment Procedures

6.33 The basic function of an assessment procedure is to understand the gap between "*as is*" and "*what it should be*" state of the process stage. The "*should be*" list indicates at the points decided in the very starting. Six Sigma assessment procedures include the following:

- Leadership.
- Communication and implementation in day-to-day activities.
- Project performance competency and effectiveness.
- Organisational transformation.
- The impact of the customer on processes.

The assessment method used in this category includes written tests and interviews of top level managers all the way down to line employees, along with other meetings and seminars.

The overall results are applicable only to core business areas. In addition, result of the leadership assessment also show possible areas of weakness and improvement. In fact, these results help in drawing up a course correction plan.

6.34 The internal auditor required to frame his own procedures for testing the effectiveness of implementation of Six Sigma taking into consideration the uniqueness of each implementation in light of its overall business situation.

6.35 The following analytical procedures might be performed by the internal auditor regarding supply chain management system:

S.No	PARTICULARS	Yes	No	N/A
1	**Analysing the Supply Chain Management System**			
1.1	Has the entity made a comprehensive study on the supply chain?			
1.2	Is the supply chain management system commensurate with the size of business?			
1.3	Has the entity taken steps to evaluate the cost-benefit of having an in-house system to an external service provider?			
1.4	Are the terms of contract with the external service provider appropriate in the overall business scenario?			
1.5	Are there sufficient indemnification clauses available in the agreement to enable management of risk to an appropriate level?			
1.6	Are there established risk tolerances by type of risk, supplier, commodity, etc?			

S.No	PARTICULARS	Yes	No	N/A
1.7	Is there a clear understanding of the true cost (direct plus indirect) of supply chain risk events?			
1.8	Is the estimate of the cost made and reviewed at frequent intervals?			
1.9	Are there any pre-defined management responses corresponding to increased levels of supplier risk?			
1.10	Is there a system of Risk-based pricing and performance analysis to support improved risk response development?			
1.11	Has the entity focussed on early intervention and identification of any default than a crisis management?			
1.12	Is there a contingency plan for recovery in the event the distributor/ distribution system fails for any reason?			
2	**Distribution Network Configuration**			
2.1	Has the entity analysed the benefit of an external distributor as against an internal system?			
2.2	Considering the importance of the distribution network, does the entity have a prescribed network and organised system of movement of products?			

S.No	PARTICULARS	Yes	No	N/A
2.3	Does the entity have a written policy for its distribution network and mobilisation of goods?			
2.4	Does the entity have all its major suppliers at strategic locations?			
2.5	Are there sufficient controls within the entity for procuring same or similar products from various suppliers/ distributors?			
2.6	Are the distribution centres located at strategic locations to enable quick movement and timely availability of products?			
2.7	Are there sufficient controls in the entity to ensure that the decisions are made by the appropriate personal and every movement is authorised by the appropriate level of authority?			
2.8	Does the entity have a process of identifying frequent delays/ errors/ losses and rectifying the same?			
2.9	Does the entity have a control matrix for sourcing of good and products from various production locations, warehouses and distribution centres?			
2.10	Are the controls sufficient to ensure that sourcing is made from the right suppliers/ distributors and available on a timely basis?			
3	**Distribution Strategy**			
3.1	Does the entity have a strategy for efficient handling and managing inventory movement?			

S.No	PARTICULARS	Yes	No	N/A
3.2	Does the strategy clearly cover all areas of decision making?			
3.3	Is the strategy renewed at a frequent basis?			
3.4	Are there instances wherein the entity has procured goods/ transported goods at a price which is more than its alternative?			
3.5	In such cases, are there sufficient approvals obtained to incur higher costs for the procurement of goods?			
3.6	Are there sufficient control systems installed to enable capture of exceptions and appropriately highlight such variances?			
3.7	Has the entity estimated the cost of various strategies and its benefits accepting the final strategy?			
4	**Trade-offs in Logistical Activities**			
4.1	Has the entity made an evaluation of the cost of alternatives possible?			
4.2	Does the entity have a scientific basis of evaluation the overall cost of transportation?			
4.3	Has the method of evaluation of cost of transport between options made in a comprehensive manner?			
4.4	Do the Logistics Company cause any critical operational problems? Are they reliable?			

S.No	PARTICULARS	Yes	No	N/A
4.5	Has a comprehensive agreement made between them to ensure that the Logistics Company would bear the risks related to transportation of goods?			
4.6	If the entity has an in-house logistics division, are there sufficient controls within the entity to ensure that there is no excess cost involved in transportation?			
4.7	Are there written policies for logistics cost to be incurred?			
5	**Information**			
5.1	Does the entity have a comprehensive system to track all the cost incurred for logistics operations and distribution system management?			
5.2	Does the entity make a risk analysis based on such information?			
5.3	Has the entity have a comprehensive system to study the transportation time, transportation cost per product, lead time, and inventory level of all products?			
5.4	Does the entity make forecasts of demand of individual products to procure them on a timely basis?			
6	**Inventory Management**			
6.1	Does the entity have sufficient control on the individual product stock available at different locations?			

S.No	PARTICULARS	Yes	No	N/A
6.2	Is there an automated/ semi-automated system of routing of inventory from different locations to enable the availability of products?			
6.3	Taking into consideration the volume of products and the types of products, does the entity have a periodic reconciliation system?			
6.4	Is frequent physical verification performed at all locations at a simultaneous basis and reconciled with the books on a periodic basis?			
6.5	Are the procedures to conduct physical verification of inventory sufficient taking into consideration the volume of transactions and the no. of stores involved?			

Payroll

6.36 In a retail industry, the cost of payroll in relation to the turnover of the entity might not be very significant. But, the success of the retailer depends on the management of personnel and the availability of right persons. Thought the entity individually might hire huge number of employees, but, the collective employment given due to the retail industry is quite significant in terms of number of people employed in this sector across the nation.

Most entities process payroll for the month, based on the records of a different period. For example, when payroll for the month of December is processed, then the leave records, performance record for the period 25th November to 24th December would be considered. The main reason for such processing is to ensure disbursement of payroll by the specified day of the month.

6.37 The internal auditor needs to ensure that proper, adequate and appropriate cut-off procedures are in place to ensure proper computation and disbursement of salary to the employees. The procedures for computations of amount to be deducted on various heads also need to be verified in accordance with organisational policies and procedures. The internal auditor needs to verify the policies and procedures and compliance of the same on a sample basis.

Computation of incentives is a complex area in any entity operating in a retail industry. The entity, generally, provide incentive based on location, store's turnover, growth in business, innovative approach applied by the Stores Manager, etc. The process becomes complex, especially, when the entity needs to estimate the said information for every store across all geographical locations. For smaller entities, the process is much simple as there is no need for such detailed evaluation.

Compliance with various regulations too is a tedious job, especially, when the entity has presence across different states. In such a scenario, the entity might have to obtain separate registration certifications for different statutes, such as, VAT, Shops and Establishments Act, Professional Tax, Tax Deduction Account Number (TAN), etc. The entity generally has protocols for ensuring compliance with regulations.

6.38 Certain entities operating in the retail industry provide an opportunity for employees to take ownership in the company through issues of stocks. The schemes may be in the follwing form:

- Stock Awards
- Employee Stock Option Plan
- Employee Stock Purchase Plan.

These schemes also enable creation of a long term relationship and trust between the entity and the employee and helps in employee retention.

6.39 The internal auditor needs to verify the following policies of the entity:

(i) ***Job Rotation***

Job rotation is an approach to management development where an individual is moved through a schedule of assignments designed to give the employee exposure to the entire operation. It is also practiced to allow qualified employees to gain more insights into the processes of a company, and to reduce boredom and increase job satisfaction through job variation. Job rotation might be between posting of an employee to different departments within the store to different operations such as maintenance, supervision, billing, reporting, etc.

(ii) ***Different Shifts***

In general, big entities and retail stores build customer loyalty by providing them the convenience of time of shopping through working for more hours. Thereby, most stores established work more than 12 hours a day. Considering the duration of operation, the entity might have to hire employees on a shift basis. The internal auditor may verify the processes in the entity to support such a shift system and enable proper handing over of responsibilities.

6.40 A *time sheet* is a method for recording the amount of a worker's time spent at work to enable tracking of details related to leave and absence to enable the determination of employee's compensation. In some situations, the recording of time sheet is done through an electronic/ automatic process and is driven by software. In such cases, the internal auditor is required to understand the process in detail and verify the process on a sample basis, exceptions, if any, noted on the project should be taken seriously by the internal auditor and adequate explanations should be obtained.

6.41 The internal auditor may also perform additional analytical procedures over a period of time and compared them for ascertaining following inconsistencies:

(i) ***No. of Bills Raised/ No. of Hours***

This ratio is determined by the number of bills an employee processes to the total time taken by him over a period of time. By analysing this ratio, the internal auditor can understand the skill level of employees, steps taken by the management towards maintaining efficiency, importance of training and ability of the management in identifying the right person for the job. This ratio gains significance, especially, because by processing of bills quickly, customer's, satisfaction can be maintained and thereby enables development of brand and loyalty.

(ii) ***Average Employee Cost per Store***

Average cost incurred for an employee (cost includes incentives, gifts, entertainment costs incurred for a store) can be computed by dividing the total cost on employees in a store incurred for a period to average number of employees during the period. The internal auditor may compare this information between different periods or with different stores and ensure that there is no significant unexplainable difference in the average employee cost per store.

(iii) ***Total Revenue per Store to Number of Employees/ Employee Cost***

This ratio can be computed based on the total revenue of the store in a particular period to the number of employees/ employee cost in the same month. This would enable the internal auditor to understand the importance of a firm in terms of its significance.

(iv) ***Employee Turnover Ratio***

Employee turnover ratio helps the internal auditor to verify the attrition rate and assess the entity's effectiveness and steps taken towards prevention of attrition and retention of key employees. In case of employee turnover ratio being higher than the industry, the internal auditor must obtain explanations for the reason for such high turnover ratio.

(v) ***Reconciliation with Respect to Changes in the Number of Employees***

The internal auditor can assess the movement in employees for a month in comparison with another by tracing the additions and deletions due to additions, terminations, retirements, etc., in a month based on each grade and obtain an insight on the plans of the management.

6.42 The following is a model checklist related to payroll process:

S.No.	PARTICULARS	Yes	No	N/A
1	**Specific areas of payroll processing**			
1.1	Does the entity have a payroll process as approved by the appropriate level of authority?			
1.2	Is the payroll process complete in all aspects, as applicable to the entity?			
1.3	Does the entity maintain a check-list of statutory remittances to be made on account of PF, ESI, Labour Welfare Fund etc.?			
1.4	Are cheques prepared and signed by 2 different employees?			
1.5	If the entity opts for bank transfer, is there sufficient level of authority to issue to a bank transfer instruction to the bank?			
1.6	Is the payroll processing cross checked before payment is made?			
1.7	Are there sufficient manual records maintained by the entity with regards to their recruitment, offer letter,			

S.No.	PARTICULARS	Yes	No	N/A
	appraisals and increments and all other correspondences with the employee?			
1.8	Have the incentive schemes been verified by the internal auditor on a test basis?			
1.9	Are controls in place to ensure that incentives are computed in accordance with the schemes?			
1.10	Have these controls been tested for effectiveness?			
1.11	Have we performed sample testing of incentive workings made and paid to the employee to ensure adherence to the Incentive system?			
1.12	Is the attrition rate exceedingly high? Have justifications for such a high rate, if any obtained?			
1.13	Does the entity maintain separately all complaints, and redressals received from the employees?			
1.14	Have the reasons and explanations for any failures and control weakness observed on review of these complaints?			
1.15	Does the entity comply with the accounting requirements for ESOP, ESPP schemes and have a proper record of the shares opted by the employees?			
1.16	Does the entity have sufficient controls and records for cases where disbursements are made to employees working from home?			

Fixed Assets

6.43 In general, an entity operating in the retail industry would have the following types of fixed assets:

- Freehold land and leasehold land
- Buildings, warehouses and leasehold improvements
- Plant and Machinery
- Office equipment
- Computer and software
- Furniture and Fixtures
- Electrical Installations
- Vehicles

6.44 In case, the event of a comprehensive distribution system is being operated by the entity, the entity have a large number of warehouses and storage locations apart from transportation vehicles. The entity is required to have sufficient control in such cases to ensure that the assets are being used properly and periodic physical verification might be of paramount importance.

6.45 The entity might lease certain assets for installation at the stores. The internal auditor might be required to verify whether there is proper control over such leased assets.

Further, the internal auditor might be required to ensure that there are sufficient controls within the entity to differentiate between own assets and those assets provided by the vendors/ manufacturers to promote their product. The internal auditor may also perform additional analytical procedures over a period of time and compared them for ascertaining any inconsistency such as following:

(i) ***Ratio of Assets Installed to Area***

The internal auditor might verify the ratio of the total value/ no. of assets put to use per square foot across different stores and in case of any significant difference arising in such a ratio, the internal auditor needs to seek explanation thereon.

(ii) ***Asset Utilisation Ratio***

Asset utilisation ratio is the ratio of total revenue to the total assets. It helps the internal auditor to assess the effectiveness of assets with respect to the revenue made by the entity. The greater the asset utilisation ratio, the higher is the operating efficiency of the entity.

(iii) ***Asset Coverage Ratio***

Asset coverage ratio is a measure of company's ability to cover the amount of its existing debts. Essentially, an asset coverage ratio measures the tangible, physical and monetary assets of a company against its outstanding debts and overall liability to derive an understanding of the company's current financial situation. This ratio is a part of a larger liquidity analysis, which takes into consideration factors like, cash on hand, long-term financial obligations, and current liquidity assessments.

If the internal auditor is required to perform fixed asset verification procedures too as a part of the scope of his work, the auditor can refer to ***Guidance Note on Audit of Fixed Assets***. Audit techniques which the internal auditor can perform for verification of assets include procedures such as, verification of laptops at the time of logging on to the server/ network monitored through a special software, verification of software licences and validity, number of licences against number of computer systems used for specific purpose and so on.

6.46 The following is a model checklist related to fixed assets:

S.No.	PARTICULARS	Yes	No	N/A
1	**Internal Audit of Fixed Assets**			
1.1	If there are laptops issued to employees, does the information system division have sufficient control over the laptops? Are these laptops verified on a frequent basis?			
1.2	Does the entity have sufficient protection for its Servers from both internal and external damage?			
1.3	Are there sufficient control and processes to ensure capitalisation of assets on the appropriate date?			
1.4	Has the entity taken assets on lease and is there sufficient control on such assets?			
1.5	In case, assets are held at mobile/ temporary stores, does the entity have sufficient control over them and does it make a periodic physical verification?			
1.6	How are assets received from manufacturers identified and ensured that they are not disposed off?			
1.7	In the event, the entity is dealing with distribution/ sale of products which are of the nature of fixed assets, are there sufficient controls and procedures to ensure appropriate classification?			

Data Security

6.47 Data security is a major problem in the retail industry. Security in a retail industry can be bifurcated into two significant components:

(i) Information Technology Security

The various sources of danger to data can be in the form of following:

(a) Natural Calamity

Fire, flood, earthquake, falling elephants can cause damage to hardware including server, computers and other physical storage devices.

(b) Theft of Data

Data theft is a growing problem primarily perpetrated by office workers with access to technology such as, desktop computers and hand-held devices capable of storing digital information such as, flash drives, iPods and even digital cameras. Since employees often spend a considerable amount of time developing contacts and confidential and copyrighted information for the company they work for, they often feel they have some right to the information and are inclined to copy and/or delete part of it when they leave the company, or misuse it while they are still in employment.

While most organizations have implemented firewalls and intrusion-detection systems very few take into account the threat from the average employee that copies proprietary data for personal gain or use by another company. A common scenario is where a sales person makes a copy of the contact database for use in their next job. Typically, this is a clear violation of their terms of employment.

(c) System Crash

A system crash is a condition where a program (either an application or part of the operating system) stops performing its expected function and also stops responding to other parts of the system. Often the offending program may simply appear to freeze. If this program is a critical part of the operating system kernel the entire computer may crash.

(d) Computer Fraud

Computer fraud covers a variety of activity that is harmful to people. Computer fraud is using the computer in some way to commit dishonesty by obtaining an advantage or causing loss of something of value. This could take form in a number of ways, including program fraud, hacking, e-mail hoaxes, auction and retail sales schemes, investment schemes and people claiming to be experts on subject areas.

(e) System Bugs

A bug is the common term used to describe an error, flaw, mistake, failure, or fault in a computer program or system that produces an incorrect or unexpected result, or causes it to behave in unintended ways. Most bugs arise from mistakes and errors made by people in either a program's source code or its design, and a few are caused by compilers producing incorrect code.

(f) Power Failure, Accidental Deletion/ Modification

Power failure and accidental deletion/ modification of files is a common type of problem faced by many small entities due lack of sufficient infrastructure and also training to the employees.

(g) Hacking

Hacking could be in the form of:

- Passwords required to enter or change the PC's BIOS;
- Passwords required to enter a network;
- Passwords required to start the operating system;

- Passwords required to enter major software packages (e.g. payroll); or
- Encrypted (encoded) data files

(h) Telecommunication Failure

Sometimes, the telecommunication network might fail, which might result in freezing of flow of data from and to the computing system. During such time, the entity might not be able to perform its operations.

(i) Virus Problem

A computer virus is a computer program that can copy itself and infect a computer. A computer virus has two major classifications. They have the ability to replicate itself, and the ability to attach itself to another computer file. Every file or program that becomes infected can also act as a virus itself, allowing it to spread to other files and computers.

(j) Unknown Risks

There might be threat to data due to other reasons not included above. The internal auditor must keep an eye on these too to ensure complete data security.

6.48 The data of both the client and the entity needs protection. There might be severe penalties imposed by the client on account of fraudulent activities by the entity. The work area would not be reasonably accessible by an outsider without proper security check and prior authorisation to ensure safety of data and to prevent theft thereto. Conditions such as inhibition of use of mobile phones, personal laptops, cameras, and pen drives are enforced.

The internal auditor needs to verify the sufficiency of control of data. He should also obtain explanations for any loss/ damage of data, if any during the reporting period apart from steps taken to prevent them in the future. He should also verify whether the policies and procedures are put in place. The internal auditor may refer to SIA 14, "Internal Audit in an Information Technology Environment" and SIA 16, "Using the work of an Expert".

6.49 The following is a model checklist related to internal audit under computer environment

S.No.	PARTICULARS	Yes	No	N/A
1	**Internal Audit of Computer Environment**			
1.1	Is there a sound computer/ laptop usage policy formed by the entity?			
1.2	Does the usage policy cover all possible areas?			
1.3	Is it frequently updated and circulated to all users?			
1.4	Are there sufficient firewalls installed in the server to ensure proper security and is it frequently updated?			
1.5	Is there a proper internet usage policy and does it bind all the employees?			
1.6	Is there a frequent systems audit done to ensure in time detection of all irregularities?			
1.7	Does the entity take all possible steps to prevent, detect and punish fraud?			

(ii) Physical Security

The entity should safeguard their property, staff and customers. Entity also uses physical security as a deterrent to prevent shoplifting and crime. Further, to ensure enhanced security, entities are looking towards technology and automated systems to prevent shoplifting and crime. The tools include video surveillance and integrated systems.

Ensuring the security of retail organization would mean protecting customers, staff and assets, while benefitting from complete visibility of sales floor, point-of-sale (POS), receiving doors, distribution centres and parking facilities. It would involve security of the following areas/ activities:

(a) ***In-Store***

- Ensure integrated surveillance of POS and cash-handling areas.
- Manage access to restricted areas and locked displays.
- Protect customers and employees.
- Verify fire, intrusion and electronic article surveillance (EAS) event alarms using video.

(b) ***Back Office and Warehouse***

- Protect employees and prevent theft.
- Safeguard assets and equipment.
- Monitor productivity and safety.
- Track time and attendance through access control.

(c) ***Parking and Outdoor Premises***

- Identify suspicious vehicles.
- Ensure entry and exit point security.
- Protect assets and buildings.
- Monitor merchandise delivery.

Further, International organisations have also established standards and guidelines for physical security as part of an overall security management program that also includes information security and meets governmental requirements and consumer expectations.

Certain examples of internationally recognised standards and guidelines that are used to implement security management systems to effectively manage physical security pertaining to the retail industry would include following:

- BS 25999-1:2006: Business Continuity Management Code of Practice (management system for disaster recovery and business continuity)
- BS 7799-3:2006: Guidelines for Information Security Risk Management (management system approach for the assessment and treatment of risk)
- ISO/PAS 28000:2005: Specification for Security Management Systems for the Supply Chain (management system specification for physical security)
- ISO 22000:2005: Food Safety Management Systems - Requirements for Any Organization in the Food Chain (management system for preventing the introduction of food safety hazards)
- OHSAS 18001: Occupational Health and Safety Management (specification for health and safety management systems)

The internal auditor might extend his scope of internal audit to verify the importance given by management to physical security system. Further, he might be able to understand and correlate the relationship between reduction of costs related to theft/ shrinkage and incurred for enhanced physical security.

6.50 An illustrative list of procedures that an internal auditor might perform would include:

S.No.	PARTICULARS	Yes	No	N/A
2	**Physical Security**			
2.1	Does the entity provide sufficient importance to physical security and security measures?			

S.No.	PARTICULARS	Yes	No	N/A
2.2	Are the security arrangements made reviewed by the management on a periodic basis to ensure that there is sufficiency of security measures at each store/ location?			
2.3	Does the management ensure a continuous shifting of security personnel from each department/ location?			
2.4	How does the management treat theft and shoplifting cases in the event the fraudster has been traced?			
2.5	Does the management believe in periodic modification of security procedures and systems to ensure that there is limited possibility for external people and employees in ascertaining failures in internal security?			
2.6	Does the management make an estimate to verify as to what would be the maximum possible loss in the event of failure of security measures and systems?			
2.7	Are there sufficient Disaster recovery systems within the organisation to act in the event of any mishap/ failing of security measures? Are the employees sufficiently trained in that aspect?			

Operating Costs

6.51 The significant operating costs for any entity operating in a retail industry include the following:

(i) Lease Expenses

Lease expenses could be of the nature of leasing of office building for work space, or leasing of assets for official purpose or accommodation provided to the employees. This would be a significant part of the expenses considering that the entity needs to own the location or lease the location for its display. The success of the entity is based on location of store and, incidentally, to have a store at the right location would mean incurring higher cost.

(ii) Advertisement and Marketing Expenses

Advertisement expenses are incurred predominantly for the purpose of creation and development of a strong brand name. Branding is one of the most important aspects of any business, large or small, retail or Business to Business (B2B). An effective brand strategy gives major edge in increasingly competitive markets. A brand is something that tells the customers (existing and prospective) what they can expect from the entity's products, and also differentiates offering from competitors.

The various strategies that the entity might use for marketing are as follows:

(a) ***Loyalty Program***

A retail establishment or a retail group may issue a loyalty card to a consumer who can use it as a form of identification when dealing with that retailer. By presenting the card, the purchaser is typically entitled to either a discount on the current purchase, or an allotment of points that can be used for future purchases.

The loyalty program might be monitored by program managers who are typically agencies with specialist skills in loyalty consulting, creative and communication, data analytics, loyalty software, and back end operations.

(b) ***Multi-channel Marketing***

Multichannel marketing is using many different marketing channels to reach a customer. A channel might be a retail store, a web site, a mail order catalogue, or direct personal communications by letter, e-mail or text message. The objective of the company doing the marketing is to make it easy for a consumer to buy from them in most appropriate manner.

To be effective, multi-channel marketing needs to be supported by good supply chain management (SCM) systems, so that the details and prices of goods on offer are consistent across the different channels. It might also be supported by detailed analysis of the return on investment from channel, measured in terms of customer response and conversion of sales. Multi-channel marketing allows the retail merchant to reach its prospective or current customer in a channel of his/ her liking.

(c) ***Penetration Analysis***

Penetration analysis deals with the analysis of the extent of reach of a particular commodity. The analysis helps the management in identifying the requirement of stock at a particular location and methods to promote the same.

(iii) **Store Maintenance Expenses**

Maintenance of a store is inevitable to provide customer satisfaction and to ensure that goods are not perished earlier than they are supposed to. Hence, the entity has to incur significant maintenance expenses. In general, the entity might enter into an Annual Maintenance Contract (AMC) with agencies to enable such maintenance on a regular and professional basis.

(iv) **Finance Charges**

Finance charges are incurred for the purpose of working capital and capital expenditure of a retail industry. The entity needs to ensure cost efficiency in borrowing of funds. The entity might also opt for an external commercial borrowing for the purpose of incurring expenditure in foreign currency.

Measuring Operational Efficiency

6.52 The internal auditor can measure the operational efficiency by following methods:

- Operations research - based method.
- Data Envelopment Analysis (DEA).

A retail store is deemed efficient (efficiency = 1), if its output is optimal (maximum possible) for given inputs in comparison with the outputs and inputs of all comparable stores. The efficient frontier is a series of points or a line connecting the most efficient stores which are determined after comparing outputs and inputs of all retail stores. Therefore, Data Envelopment Analysis (DEA) produces relative efficiency boundaries of the retail stores under study, which are called envelopes.

In this study, efficiency is the ratio of the weighted sum of outputs to the weighted sum of inputs. The weights are estimated separately for each retail store such that its efficiency is the maximum possible or is equal to 1. Weights are automatically calculated for all the stores while calculating their relative efficiencies. Therefore, weights change each time a store's efficiency is calculated using this model and are measured relative to the remaining stores.

6.53 The internal auditor is required to verify the procedures and controls for capturing of specific expenses with regards to its sufficiency, appropriateness and efficiency. Moreover, the internal auditor needs to ensure that common expenses are allocated across these undertakings in a justifiable basis. The internal auditor may also perform additional analytical procedures over a period of time and compare them for ascertaining any inconsistency such as following:

(i) *Total Fixed Cost*

Significant increases in the total fixed cost signals expansion activity. In such cases, the internal auditor needs to verify the sufficiency of controls with respect to the growing entity.

(ii) *Operating Cost to Revenue (Undertaking-wise)*

An entity operates in varied legal environment and different challenges are faced by the entity operating in each such environment. The internal auditor can estimate the operating cost (i.e., cost including labour, communication, lease and all other variable expense to the particular undertaking) to the revenue generated by it. This would provide a basis for evaluating the cost effectiveness of operating in each of the undertakings.

(iii) *Variable Cost per Man Hour per Undertaking*

Variable cost per man hour can be computed by dividing the total cost incurred in an undertaking divided by man hours for the same period. This can be compared with different periods to verify whether there has been a significant increase/ decrease in the expense and identify reasons for the same.

(iv) *Interest Cost to Loans*

Interest cost to loans provides a basis for the estimation of the average cost of borrowed funds in the entity. The internal auditor can estimate the average cost of borrowing and compare them with the existing rate to verify whether the interest paid is significantly high.

Other Areas of Internal Audit Significance

6.54 Other areas of internal audit significance are as follows:

(i) Visual Merchandising

Visual merchandising starts with the store itself. The management decides the store design to reflect that the store is going to sell the product and how to create a warm, friendly, and approachable atmosphere for its potential customers.

Many elements can be used by visual merchandisers in creating displays including color, lighting, space, product information, sensory inputs such as, smell, touch and sound, etc. as well as technologies such as, digital displays and interactive installations.

6.55 Retail professionals display the product to make the shopping more comfortable, convenient and customer friendly in the following manner:

- Making it easier for the customer to locate the desired category and merchandise.
- Making it easier for the customer to self-select.
- Making it possible for the customer to co-ordinate and accessorize.
- Informing them about the latest fashion trends.

6.56 The benefits of visual merchandising are as follows:

- Educating the customers about the product/ service in an effective and creative way.
- Establishing a creative medium to present merchandise in 3D environment, thereby enabling long lasting impact and recall value.
- Setting the company apart in an exclusive position.
- Establishing linkage between fashion, product design and marketing by keeping the product in prime focus.
- Combining the creative, technical and operational aspects of a product and the business.
- Drawing the attention of the customer to enable him to take purchase decision within shortest possible time, and thus augmenting the selling process.

6.57 Following are the techniques of enhancing visual merchandising:

(a) Planogram

A planogram allows planning the arrangement of merchandise on a given fixture configuration to support sales through proper placement of merchandise by style, option, size, price points, etc. It also enables a chain of stores to have the same merchandise displayed in a coherent and similar manner across the chain.

The main purpose is to support ease of applicability to the merchandiser while also increasing selection and enhancing the merchandise display in a neat and organised manner.

(b) Window Displays

A retailer's window is the most controllable element in relation to image and must match the merchandise's target demographic. Display windows may communicate style, content and price. They can be seductive, exciting or based on emotional stimulus through stimulation, or evocation of all five senses. Another direction taken by retailers who rely on volume sold is price-based selling. These clearly emphasize value for money with easy and obvious ticketing.

(c) Food Merchandising

Restaurants, Grocery Stores, and C-stores are using visual merchandising as a tool to differentiate themselves in a saturated market. With Whole Foods leading the way, many are recognizing the impact that good food merchandising can have on sales. If a food merchandising strategy considers the five senses, it will keep customers lingering in the store, and help them with the buying decision process. Texture can be utilised to entice customers to touch, and samples are the best form of food advertising. Especially for large quantity items, the ability to experience the product before committing to the purchase is critical. Food merchandising should educate customers, entice them to buy, and create loyalty to the store.

The internal auditor might analyse visual merchandising considering the importance of visual merchandising in the success of a store. It might include matters such as, periodic improvements that can be made or realignment/ shuffling of inventory.

Surprise Verification

6.58 If physical verification or examination is done without prior information to the management, it is called as Surprise Check. An element of surprise is experienced by management or the employee in such cases. Surprise check is used in physical verification of cash, security items, inventory, etc.

The internal auditor might use surprise checks as an effective tool for finding effectiveness and continuity of internal controls.

(ii) Managing Shrinkages

Retail shrinkage is the difference in the value of stocks as per books and the value of actual stock at the store on any given date.

Shrinkages at the stores could be on account of any one or combination of the following:

(a) Process Lapse

There could be a number of lapses that lead to shrinkages at the stores. Some of the main ones could be as follows:

- Lesser Receipts at the stores against what is transferred out of the Distribution Centre. Where receipts are not verified 100 per cent on receipt, this cannot be ruled out.
- Understatement/ accounting of damages at the stores. Stores may have a tendency to understate the damages including handling damages that are destroyed at the stores itself. This will result in shrinkages for those SKUs which were not removed from the books as damaged stocks.

- Understatement/ accounting of dump of fruits and vegetables. Understatement of dump is quite common as it reflects the operational efficiency of the store; such under accounted products get reported as shrinkages when stocks are verified.

- Non updation of manual bills into POS.

- Delayed or non accounting of returns made to the DC/ Vendors from the stores.

- Non-updation of consumer promotions in the system leading to manual intervention at the POS.

- Other cases which warrant manual intervention at the POS as manual intervention may result in wrong billing too.

(b) System Lapses

- Poor quality of scanners or stickers and duplicate SKU code would force manual intervention at the POS. Manual intervention may also amount to errors and contribute to shrinkages.

- Other system lapses due to which book stocks are reported wrongly.

(c) Vendor Fraud

Short supply by the vendor as against the quantity in the Goods Received Note (GRN) would certainly amount to shrinkages at the warehouse/ DC itself. Moreover, any such malpractice adapted by DSPs (direct supplies to stores) would also amount to shrinkages.

(d) Employee Fraud

This is one of the common means of fraud causing shrinkages. The following could be a few types of malpractices:

- Improper Invoicing – either billing lesser quantity/ non billing of certain products/ billing products with lower prices as against actual selling price of products sold.

- Theft by employees.
- Frauds in the case of products exchanged by customers.
- Fraudulent practice in handling home deliveries.

(e) Customer Shop Lifting

This is another common problem causing shrinkages. Generally, specific products including beauty products, skin care products, razors, etc. are more prone to such shop lifting by customers. It is also extremely difficult in controlling the customer theft though some measures are being taken by a few retailers based on their experience and learning.

6.59 Corrective steps taken at the right point of time would certainly help the retailers mitigate the risk to a greater extent and reduce the losses on account of shrinkage. The following could be some areas where best practices need to be deployed:

- Having clear SOPs for operations at stores.
- Ensure adherence to the SOPs.
- Avoid or minimise manual intervention at the POS.
- Ensure proper training to the staff.
- Educate the staff on the importance of reduction of shrinkages.
- Proper physical verification of stocks.
- Deployment and monitoring of CCTV at the stores.
- Employees frisking.
- Background check on staff.

6.60 The following measures would certainly help in reducing the shrinkages:

- Setting up a dedicated internal/ external team to handle stock checks at each of the stores periodically. Initially each store is covered atleast once a month.
- Creation of stock check squad that would visit each store every day and verify a few SKUs on a random basis. The scope of services to be provided by an internal auditor might also include surprise checks on a random basis.
- Surprise verification of receipts at the stores.
- Monthly/ quarterly audit of the entire operations of the stores to assess adherence to the laid down processes.
- Closely monitoring stores with huge shrinkages.
- Closely monitoring and analysing category of products that contribute to huge shrinkages.

6.61 The internal auditor may consider shrinkage as an essential part of his audit procedures. The areas that may be reviewed by the internal auditor are as follows:

- Methodology designed by management to precisely manage shrinkage.
- Control measures taken by the management.
- Sufficiency of procedures controlling shrinkage.
- Effectiveness of the steps taken by the management.
- Detecting weaknesses in the system.

(iii) Handling of Products and Disposal of Damages and Expiries/ Products nearing Expiry/ Obsolescence

(a) *Handling of Products*

Handling of products would be an important part in the activities carried by a retail industry. It involves activities such as, pushing, pulling, lifting, carrying and holding.

The internal auditor may perform assessment of each manual task and the following factors should be considered in framing his internal audit procedures:

- Nature of the objects being handled;
- Actions and movements involved in the task;
- Range of weights handled;
- Availability of lifting and moving equipment;
- Force to be applied;
- Duration and frequency of the task;
- Time and distance over which the object is handled;
- Working posture imposed by the task;
- Training and experience of the employee;
- Age of the employee doing the task;
- Work environment;
- Workplace layout and housekeeping;
- Analysis of relevant injury statistics;
- Protective clothing and equipment required to do the task; and

- Any other factor considered relevant by the employer, employees or employee representatives.

(b) ***Disposal of Damages and Expiries***

The internal auditor would assess the following in case of disposal of damages and expiries/ products meaning expiry/ obsolescence:

- Storage systems and manuals of the entity;
- Periodicity of verification of stock;
- Methodology used in identification of damages for each class of products;
- Methods to prevent damages and its sufficiency;
- Identification of the types and classes of products which are subject to damages;
- Treatment of identified damages and its disposal;
- Controls on disposal of such goods;
- Verification procedures at the time of receipt of goods from the supplier/ distributor/ manufacturer;
- Agreement with vendors in the event of such damages/ loss;
- Sufficiency of controls for accounting for such damages and disposals;
- Analysis of cost of damages and nature of goods damaged; and
- Comprehensiveness of stock taking procedures.

Maintenance of Books, Reporting, Management, Control and MIS

6.62 The internal auditor is required to verify the sufficiency of controls related to maintenance of books of accounts by the entity. The internal auditor is also required to verify the controls for allocation of costs between different departments in every store and verify whether it is adequate and reliable in the light of overall business operations.

An entity in retail industry might have various stores. Accordingly, accounting operations might be performed centralised, decentralised or may be a combination of both manner. The entity might find it best suited if the accounting system is comprehensive enough to provide a Management Information System (MIS) sufficient information for decision making and enable the entity to understand complexities of business, status of implementation of new ideas and the status of operations of the entity.

6.63 The reporting system should be comprehensive enough and should be able to provide the following information.

(i) Sales and Collection

- Daily statement of sales through cash, credit card, coupons, credit sales, debit card across individual stores.
- Reconciliation between sales and collection status with outstanding debtors.
- Trends of sales in a particular location.
- Department-wise sales.
- Consumption *vs* Sales Analysis.
- Benefits of advertisement through additional revenues and customer loyalty.

- Repetition of customers to estimate customer loyalty through customer loyalty programs.
- Highlight the growing demand of a particular product to capitalise on its sales and *vice-versa*.
- Impact of visual merchandising on different products.
- Benefit of promotional schemes as against normal sales.

(ii) Inventory Management

- Loss of inventory on account of theft, spoilage/ perishing of goods.
- Inventory at each store, warehouses and storage centres.
- Inventory ageing system.

(iii) Supplier Analysis

- Matrix of orders placed for each product across departments.
- Status of all pending orders.
- Orders that have exceed the expected due date pending receipt.
- Tracking of credit period for each distributor.

(iv) Others

- Gross Profitability Ratio across different products.
- Customer feedback review analysis.
- Sensitivity analysis for price and discounts, non-availability of key products.

6.64 Model checklist related to maintenance of accounts and documents is as follows:

S.No.	PARTICULARS	Yes	No	N/A
1	**Books of Accounts and Documents**			
1.1	Does the entity have proper accounting system commensurate with the regulatory requirements?			
1.2	Does the entity have specific books of accounts for each store located across states to enable proper declaration of turnover for statutory purposes such as VAT Returns?			
1.3	Are the control systems in place for estimating the revenue generated location-wise sufficient to ensure that proper books are maintained for the location?			
1.4	Does the entity have location-wise employee details to ensure proper allocation of payroll cost to the location?			
1.5	Are the books of accounts closed every month?			
1.6	Whether the time period for the closure of the books of accounts on a monthly basis is reasonable with regards to the operations of the entity?			
1.7	Are the controls for re-opening of books proper to ensure prevention of manipulation?			

S.No.	PARTICULARS	Yes	No	N/A
1.8	Are the books maintained in a manner to provide information to the management for decision making?			

Fraud and Management

6.65 Retail Frauds might significantly affect the revenue of the entity operating in retail industry. On an average around 3% of revenue is lost on account of frauds. *Shrinkage* or *Fraud* in retail is a key issue. Shrinkage is the *"loss in inventory on account of a combination of employee theft, shoplifting, vendor fraud and administrative error."*

In mom-and-pop stores, the owners do not feel the impact as it is believed that manning the store themselves is vigilant enough. In large-format stores, however, it is difficult to check as wares are spread out.

6.66 Various categories of fraud constitute a major component of the shrinkage. Among the factors responsible for shrinkage losses, employees and vendors are critical factors that need to be managed by retailers. Employees may resort to direct theft, under invoicing in collusion with customers, stealing cash, etc., whereas vendors can under-deliver in terms of number, size or quality of items as against the bill invoice.

The growing motivation among employees to lead a luxurious life, high reliance on skilled resources, thereby leading to weaker internal controls, and overdependence on existing systems and processes give rise to increased risk of fraud in retail sector.

Some of the most potentially costly fraud schemes operating in the retail industry happen far from the selling floor, the security cameras and the cash register. They happen when employees behind the scenes circumvent processes and take advantage of insufficient oversight. Retailers face some unique risks that can have a potentially devastating impact on the company's bottom line and reputation. Retail companies should be proactive in identifying fraud risks and implementing anti-fraud programs and controls to minimize the risk of fraud.

6.67 The common categories of fraud that affect the retail industry are as follows:

(i) Financial Reporting Fraud

It can be in many forms and is, generally, committed to make an entity or a subsidiary, branch or operating center of an entity appear to have performed better than it actually has. One of the most common issues relates to revenue recognition schemes wherein sales are boosted to mislead management, shareholders, or lenders regarding the performance of a particular entity, location, product line, or sales team. While the perpetrator might not realize an immediate benefit from the scheme, such individuals might benefit indirectly by improperly receiving commissions or other incentives such as stock awards based on fraudulent information. Perpetrators of these schemes can be anyone who has an incentive or perhaps is under significant amount of pressure to show positive results and has the opportunity to commit fraud.

There are many types of revenue recognition schemes in this type of fraud. Some of the common issues are as follows:

(a) Bill-and-hold Transactions

It occurs when a sales order is processed, but the inventory is not shipped to the customer. The inventory may be separated in the warehouse, sitting on the loading dock or shipped to a third-party warehouse or staging facility. Sometimes, this may occur because the customer is not ready, willing or able to accept delivery. Decentralized structure and weak controls around inventory make this fraud easier to accomplish. Periodic inventory reviews as well as review of sales, sales returns and accounts receivable aging reports may reveal unusual trends to merit investigation.

(b) Channel Stuffing

It includes shipping substantially more inventory to a reseller than he can reasonably use, but agrees to accept it based on unusual or extraordinary terms, like, extended payment terms, deep discounts, or allowing the return of unsold goods for full credit beyond the company's normal returns policy. Operations without formal, enforced procedures for negotiating, approving, and documenting sales agreements are often victims of this type of fraud.

(c) Side Agreements

The normal contract terms are changed or invalidated by an oral or written agreement. Side agreements, usually, accompany channel stuffing as a way to induce resellers to take on more inventory than they can reasonably resell. Lack of written policies regarding agreements are one risk factor that makes this fraud easier to perpetrate; another is a commission program based on gross sales where low margins and high returns aren't penalized.

(d) Backdating

It is another way of fraudsters misstating revenue in which sales documents make a transaction appear to have occurred in a prior period,. Again, failure to institute or enforce policies about negotiating and executing sales agreements can be a risk factor here.

Certain frauds can be identified by the internal auditor through performance of analytical procedures as described earlier. A few indications might be in the nature of following:

(i) Decreasing Gross Margins

Increasing sales are increasing could signal a side agreement for a special discount.

(ii) Unusually High Returns

It could be caused by a channel stuffing arrangement or other side agreement permitting reseller returns of unsold goods.

(iii) Unexplained Differences in Physical Inventory

It indicates a bill-and-hold fraud is taking place.

(iv) Buildup of Aged Accounts Receivable Balances

It might be caused by backdating, side agreements, or channel stuffing arrangements.

(v) An Unusual Spike in Sales

An unusual spike in sales just before the end of the reporting period could indicate any of these schemes.

(ii) Misappropriation of Assets (Theft of Cash or Inventory)

It is a second category of fraud that occurs in retail industry. The various forms of this type of fraud are as follows:

(a) Cash Skimming

It can be conducted through sales transactions and fictitious returns. Customer payments on accounts accompanied by account write-offs are another way to skim cash. A retailer with weak system security or failure to segregate sales, cash receipts and accounting functions is an easy target for cash skimming.

(b) Theft of Inventory

It can be as simple as removal of inventory from the warehouse or along the supply chain. It can include adjustment of books and records to hide the theft. This is more likely to happen in companies with multiple inventory locations or complex supply chains. Failure to properly segregate inventory and record keeping duties makes this kind of theft easy to accomplish.

(c) Marketing Fraud

It is another way of fraudsters misappropriating assets. The entity's personnel collude with customers to share rebates, discounts or promotional items. Where sales people maintain long-term client relationships and have significant latitude with terms, this type of fraud can occur.

The indicators include the following:

- Growing accounts receivable balances without sales increases.
- Lower than expected gross margins.
- Higher than expected promotional allowances.
- Unusual number of credit adjustments, customer account write-offs, or customer returns.
- Unexplained variances in inventory; larger than expected shrink percentages.

(iii) Unauthorized Receipts and Expenditures

It is a third category of fraud that strikes retailers. The areas of fraud can include the following:

(a) Improper Vendor Allowances

Customers and/or retail employees commit this fraud. This is a risk when vendor allowances are significant and not documented properly, particularly, if policies for negotiating these allowances aren't formal, and procedures for tracking them aren't strict. Retail employees may collude with a vendor's staff or create false documentation to gain allowances, discounts, or rebates. These improper benefits might be used to overstate performance for a location or product line, or pocketed by the fraudster.

This can be identified through analyzing and identifying the following:

- Unexpected variances in gross margins which could be due to fluctuations in allowance amounts or timing.
- Decrease in sales while gross margins stay steady.

(b) Bribery or Corruption

When retailers operate in several regions or countries and corporate oversight is less, this type of fraud occurs. Lack of segregation of duties between vendor approval and purchase authorisation, or new customer approval and sales contract authorisation can enable these frauds. They often take the form of kickbacks.

The internal auditor should be alert to factors such as high expenses in a particular location, sole-source contracts and perform his audit procedures accordingly to detect acts that are against the interest of the entity.

6.68 To protect the entity from fraud and misconduct in business processes, vigilant observation of financial indicators and implementation of effective anti-fraud programs and controls help in reducing risk of fraud and protect company from financial and reputation damage. With potential risks and marked instances of fraud and theft, it is imperative for retail companies to take the following steps:

(i) Adopt robust internal controls backed by strong data analytics to mitigate key fraud risks and to raise red flags at early stages.

(ii) Devise a whistle blower policy allowing employees, customers and vendors to report malpractices directly to the management.

(iii) Determine policies pertaining to prevention, detection and investigation of frauds and to have action plans defined for conducting investigation if an incident occurs.

(iv) Set-up dedicated team, internal/ external,to handle stock checks at each of the stores periodically.

(v) Collate an end-to-end study of material movement from source to destination, including counter checks and cross tallying.

With rising challenges in the sector, the key to success is staying competitive without compromising on the quality of services. Cost effectiveness is necessary to achieve this, and an effective fraud risk management will help companies to identify potential leakage points and opportunities to save.

Risks Faced by a Retail Industry

6.69 The internal auditor should make a risk assessment of the entity under audit. This is extremely important in order to ensure prevention of any non-compliance or undesirable event.

The internal auditor needs to verify whether sufficient controls are available in the entity to detect such risks and prevent its occurrence by including management to take appropriate steps in the light of overall business environment.

6.70 The risks faced by a retail industry can be broadly classified as following:

(i) Business risk

(ii) Political risk

(iii) Inventory management risk

(iv) Environment risk

(v) Brand/ reputation risk

(vi) Systemic risk

(vii) Technology and data security risk

(viii) Business continuation risk

Business Risk

6.71 Business risk comprises the following:

(i) A change in the product range based on customers changing preference needs.

(ii) A change in the legal environment that imposes new conditions, costs or restrictions upon the manner of providing the services, the means by which the services are delivered to the customer.

(iii) A change in the volume of transactions, either to:

- (a) Increase (requiring additional hiring and perhaps a change in business process) or

- (b) Decrease (resulting in sub-optimization of dedicated resources or re-allocation of resources).

(iv) Risks due to international operations.

(v) Unprecedented increase in the cost of real estate leading to increased cost of operations and strain on the profitability.

(vi) Increase in workers' compensation cost and retention of key employees.

(vii) Change in consumer confidence leading to significant locations in consumption of certain category products.

(viii) Risks on account of non-compliance with statutes.

(ix) Changing importance for locations might have a significant impact taking into consideration the initial investment required to be made at every location and higher rentals that might be paid for them in comparison to the others in the vicinity.

(x) Credit risks related to commercial business consumers.

(xi) Timely availability of information to enable decision making at the right time.

(xii) Increased competition from mass marketers and home improvement retailers.

(xiii) There is *mergers and acquisition risk* that an enterprise might change owners.

(xiv) Risks due to fraud and theft.

(xv) Risks due to acts of God such as earthquake, flood, wind storms, etc.

Political Risk

6.72 Political risk represents the degree to which social and governmental environments may change in the future. This risk may manifest itself in events over which a government has no control, such as, *riots or new elections*. Other events may be caused by a government, such as, *an embargo on imports or exports, increases in tariffs, new prohibitions on transactions with specific countries.*

In international outsourcing transactions, political risks need special attention due to the long-term nature of the relationship. There are a number of techniques that can mitigate, but not eliminate, such risks.

Further, the country makes policy for Foreign Direct Investment (FDIs) by a foreign entity in retail sector in India. This is subject to political risks and the policy viable to change which might have a significant impact on the operations and the business established in India. There might also be instances where additional duty is charged on certain products imported in India *e.g.*, *antidumping duty*. In such cases, the entity might not be able to reap the benefit of cheaper products for its customers. Moreover, the entity is affected by retail policies of the country from which the entity procures products e.g., if there is any quota for exports, it might have an impact on the prices of goods.

Inventory Management Risk

6.73 This might have a direct impact on the profitability of business. The entity's procedures with regard to mitigation of risks might be crucial to ensure business competency. The risks with regard to inventory management might include the following factors:

(i) Delay in receipt of products due to poor supply chain management/ supplier management. With the inter-connectedness and flow that has to come to make the chain work properly, the smallest disruptions can throw an organisation off course.

(ii) Inability to source products from the right source and at the right prices.

(iii) Inefficient inventory management system, wherein, the goods are not made available at the right time to the customers leading to poor branding and decline in customer loyalty.

(iv) Rapid obsolescence of inventory.

(v) Technological obsolescence of electronic products.

(vi) Shipping risks due to delicate nature of electronic products.

(vii) Improper handling of goods.

Environment Risks

6.74 Environmental risks associated with the retail industry, generally, fall into one of two categories:

(i) Site Acquisition, Development, and Construction

Considering that retailers buy and develop retail property, the retailers should develop an effective due diligence process, and manage environmental risk. The significant cost would be on account of following:

- *Cleanup Cost Cap* for "capping" the cost of cleaning up known pollution conditions.

- ***Pollution Legal Liability*** for transferring the risk of cleaning up unknown pre-existing pollution conditions, third party claims, and other related exposures.
- Loss of income due to ***delay in opening***/ scheduled completion of the project.

(ii) Store Operations

Environmental risks arising from retail store operations, generally, fall into one of two categories:

(i) *Nature of products/ services sold*— Retail operations that store and sell significant volumes of paints, solvents, chemicals, petroleum products, fertilizers, pesticides, automotive batteries, and similar products obviously have a higher degree of environmental risk.

(ii) *Store maintenance*— The risks associated with store maintenance are summarized in the table below:

Maintenance Activity	Exposure
Painting	Volatile organic vapors from paints and thinners & proper disposal of paint and/ or thinner-soaked rags and brushes.
Floor stripping	Volatile organic vapors from stripping compounds.
Renovations	Disturbing/ releasing asbestos or lead-based paint in older facilities.
Improper roofing	Growth of mold and release of mold spores.

Brand/ Reputation Risk

6.75 Enterprise viability depends on maintaining the goodwill of the enterprise brand. Damage to reputation might never be recovered, or might only be recovered at great expense and distraction. Reputational risk is significant in a retail industry.

6.76 Brand risk management techniques include the use of scripts, supervision, random audits, ongoing training and customer feedback. Legal issues in reputational risk can arise where the customer wishes to terminate a service provider, redirect its efforts or adjust the pricing to reflect a loss of goodwill.

Systemic Risk

6.77 Regulators and governments focus on the risks to the systems that support local and global economies. A systemic risk affects all participants in an economic sector or industry.

When planning any solution to the sourcing dilemma, executives and managers need to understand the nature of systemic risk and adopt appropriate risk planning strategies.

Technology and Data Security Risk

6.78 Technology risk refers to the risk that an entity faces due to change in technology or obsolescence of existing technology. In the event of change in technology, the investment made by the entity becomes futile. Technology could be in the form of purchase/ creation of software or hardware.

Data is subject to numerous and varied threats including following:

- **Insider theft** through unauthorized queries and file or report access.
- **Hacks** such as, SQL-injection, cross-site scripting, poisoning, and other OWASP listed attacks.
- **Physical theft** of servers and tapes.

Business Continuance Risk

6.79 The major risk which affect the business continuance would include improper supply chain management, damage of brand and significant changes in economic situations. The entity must be prepared to mitigate these risks and ensure successful carrying of business.

Risks Mitigation Techniques

6.80 An illustrative list of risks mitigation techniques that the management might opt for would include following:

(i) In the current environment, the entity should have complete knowledge about those risks and consider all pitfalls, understand the exposures, and develop risk management practices and programs that address this evolving exposure.

(ii) Prioritising the risks, creating a plan to strategically manage the risks, implementing the plan as necessary, and monitoring the plan's implementation for evaluation and improvement purposes.

(iii) Certain risks, such as, frauds, environmental damage might be reduced through visual inspections, carrying on surprise checks and verification, visual merchandising, just in time approach, etc.

(iv) It might be appropriate for the entity to have a comprehensive insurance policy to cover significant part of risks.

(v) Training of employees in inventory handling, especially in the case of managing open/ broken bags, containers, perishable and sensitive products.

(vi) Proper store maintenance procedure should be implemented.

(vii) A risks identification system would be required to be installed. The Management Information System should provide for certain yardsticks which would enable the management identify the critical risks and its impact on the entity.

(viii) Indemnity clauses with suppliers and external vendors would ensure that any loss arising due to suppliers and external vendors would be indemnified.

The internal auditor might be required to make a complete assessment of enterprise risks and provide an insight on methods of mitigation of risks. The internal auditor might prepare a questionnaire or a checklist for this purpose.

Mystery Audit

6.81 Mystery shopping is an objective view of a business through the eyes of a customer. A mystery shopper visits a business anonymously, posing as a regular customer, to experience and evaluate the level of customer service provided by the business. Mystery shopping provides management with a detailed assessment of employee performance and the variables that affect a customer's experience and satisfaction with the business.

It is a tool used by mystery shopping providers and market research companies to measure quality of retail service or gather specific information about products and services. Mystery shoppers posing as normal customers perform specific tasks such as, purchasing a product, asking questions, registering complaints or behaving in a certain way and then provide detailed reports or feedback about their experiences.

Tools used for mystery shopping assessments range from simple questionnaires to complete audio and video recordings. Mystery shopping can be used in any industry, with the most common venues being retail stores, hotels, movie theaters, restaurants, fast food chains, banks, gas stations, car dealerships, apartments, health clubs and health care facilities.

Methodology of Mystery Shopping

6.82 When a client company hires a company providing mystery shopping services, a survey model will be drawn up and agreed to which defines what information and improvement factors the client company wishes to measure. These are then drawn up into survey instruments and assignments that are allocated to shoppers registered with the mystery shopping company.

The details and information points shoppers take note of typically include the following:

- Number of employees in the store on entering.
- How long it takes before the mystery shopper is greeted.
- The name of the employees.
- Whether or not the greeting is friendly, ideally according to objective measures.
- The questions asked by the shopper to find a suitable product.
- The types of products shown.
- The sales arguments used by the employee.
- Whether or how the employee attempted to close the sale.
- Whether the employee suggested any add-on sales.
- Whether the employee invited the shopper to come back to the store.
- Cleanliness of store and store associates.
- Speed of service.
- Compliance with company standards relating to service, store appearance, and grooming/ presentation.

Shoppers are often given instructions or procedures to make the transaction, a typical to make the test of the knowledge and service skills of the employees more stringent or specific to a particular service issue (known as scenarios). For instance, mystery shoppers at a restaurant may pretend they are lactose-intolerant, or a clothing store mystery shopper could inquire about gift-wrapping services. Not all mystery shopping scenarios include a purchase.

While gathering information, shoppers usually blend in to the store being evaluated as regular shoppers. They may sometimes be required to take photographs or measurements, return purchases, or count the number of products, seats, people during the visit. A timer or a stopwatch may be required.

After the visit the shopper submits the data collected to the mystery shopping company, which reviews and analyzes the information, completing quantitative or qualitative statistical [analysis] reports on the data for the client company. This enables measurement against the previously defined criteria.

The internal auditor might be required to include the following into consideration for the performance of mystery audit:

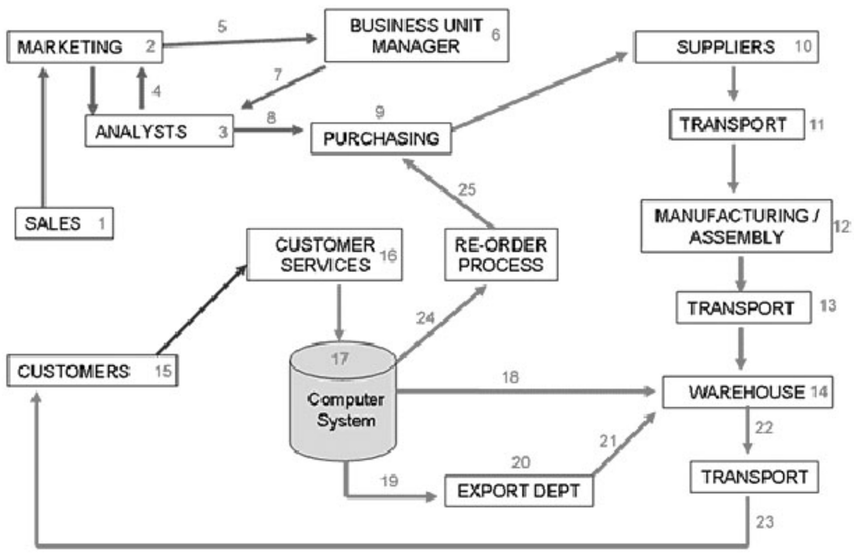
(i) The mystery audit program which details the periodicity, selection criteria, methodology of testing.

(ii) The scope of verification (such as, testing of management's efficiency of controls, implementation of entity's policies, behaviour and sensitivity of employees and their customer relations, control over inventory, and so on)

(iii) The reporting requirements by the internal auditor.

Appendix 1

A Comprehensive Supply Chain Management Process in a Retail Industry.



1. This flow chart shows a typical manufacturing supply chain work flow detailing which areas of the business are involved.

2. The sales department identifies a need for a product. The sales department tell the marketing department about their idea and provide any supporting information/ data.

3. The marketing department use business analysts to support the project and to complete the research.

4. Data and supporting evidence is passed back to the marketing department for completion of a business plan.

5. A fully detailed business plan is forwarded to the Business Unit Manager / Directors.

6. This unit comprises of the senior business directors or managers who make a decision on the project.

7. After approval the plan is passed back to the analysts to prepare and implement the manufacturing process.

8. Details of raw materials and components passed to purchasing.

9. Purchasing work with logistics and transport to plan the purchase and delivery of the materials to the manufacturing plant.

10. Suppliers receive orders for product and then despatch on agreed transport on agreed dates.

11. Carriers approved by the business transport the raw materials and components to the manufacturing site.

12. Products are received into the warehouse and then moved to manufacturing.

13. Finished products are moved from manufacturing to the finished goods warehouse which might be situated locally or in a remote location.

14. Finished goods are put into inventory awaiting orders. The company computer system is updated. Product is now available to sales.

15. Customers place orders through customer services.

16. Customer Services take orders and input them to the company computer system.

17. The central computer system maintains transaction records and provided visibility of product for sale.

18. An order is completed and a pick list sent to the warehouse.

19. A copy of the order is sent to the export department for completion of export documentation.

20. Export department manages the final despatch of the product and produces any export documents.

21. Documents are sent to the warehouse to meet up with the finished order.

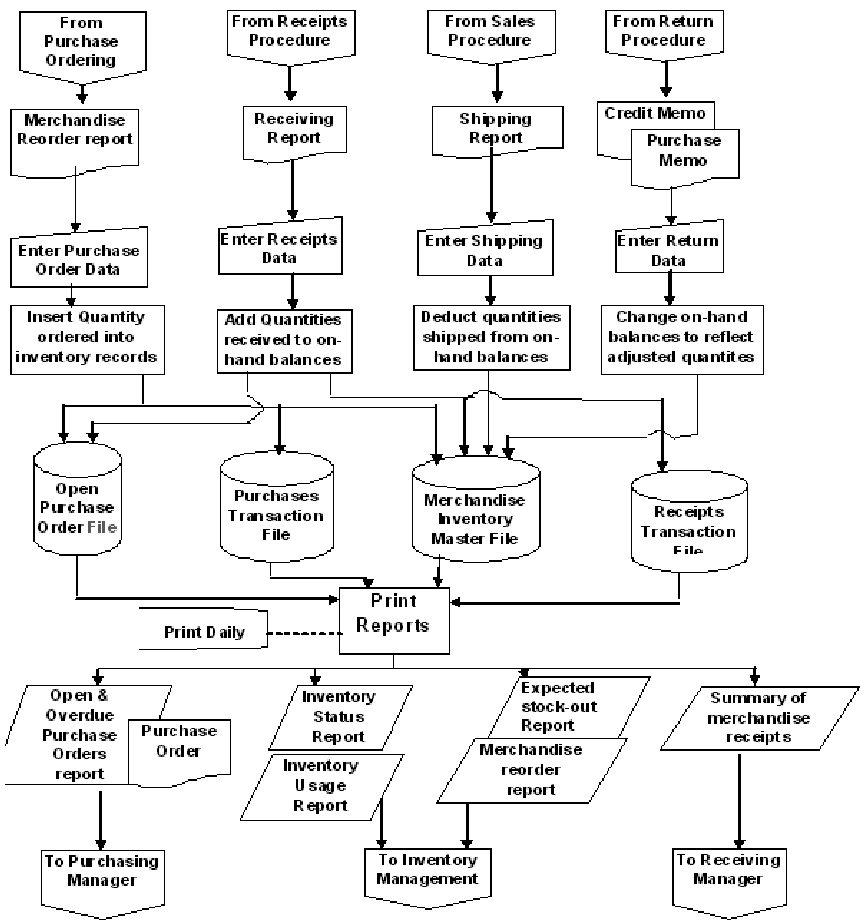
22. The order is despatched by the warehouse.

23. The transport company collects the consignment and delivers it to the customer based upon the terms of carriage.

24. As stock has now been used the computer system generates a request for new stock.

25. The re-order process generates a request to the purchasing department to place new orders with the suppliers.

A Comprehensive Inventory Management Flowchart:



Process Flow Description:

1. A retail company receives the merchandise reorder reports.

2. They take the data from those reports and key it into the computer to create a record (which is the basic process of taking data and converting it into information).

3. They then take each record and store it into different files.

4. Retail entity receives receiving report.

5. They then input the data from the report into the computer.

6. That data is then converted into information in the form of records.

7. The records are then stored into different files (one of which adds to inventory on-hand balances).

8. Retail entity receives shipping report from the sales department.

9. They then take the data from the report and input it into the computer to create information in the form of records.

10. They then take the individual records and store them into separate files (which in turn deducts from the inventory on-hand balances).

11. Retail entity received credit and purchase/ debit memo.

12. Return data is keyed into the computer.

13. That data is then converted into information in the form of records.

14. These records are then stored into different files that will update/ change on-hand balances to reflect the adjusted quantities

15. The Open Purchase Order File, Purchase Transaction File and Merchandise Inventory Master File (a permanent file) are updated when the quantity ordered are inserted into inventory records.

16. The Open Purchase Order File, Merchandise Inventory Master File and Receipts Transaction File are updated after the quantities received have been added to on-hand balances.

17. Only the Merchandise Inventory Master file is updated after the shipped quantities have been deducted from oh-hand balances.

18. Lastly, only the Merchandise Inventory Master File is updated after the changes on the on-hand balances are made to reflect the adjusted quantities.

19. Once all the information is stored and the files are updated, reports are printed (daily).

20. The Open and Overdue Purchase Orders Reports and the Purchase Order document are sent to the Purchasing Manager.

21. The Receiving Manager receives the Summary of merchandise receipts – A report which summarizes all receipts for the day.

Reporting in this model case:

Inventory Management receives 4 different reports:

- *Inventory Status Report* – A report that shows where you stand on your inventory. (how much inventory you have on hand)
- *Inventory Usage Report* - How much inventory is being used at the current output level.
- *Expected Stock-out Report* – How much and what inventory you expect to be sold out
- *Merchandise Reorder Report* – A report that shows what inventory needs to be reordered

Appendix 2

List of Organisations, On Line resources and other sources

1	Electronic Retailing Association	http://www.retailing.org
2	National Retail Federation	http://www.nrf.com/
3	International Mass Retail Association	http://www.imra.org
4	National Association of Chain Drug Stores	http://www.nacds.org
5	Association for convenience and petrol retailing	http://www.nacsonline.com
6	National Grocers Association	http://www.nationalgrocers.org

I-9
TECHNICAL GUIDE ON INTERNAL AUDIT OF LIFE INSURANCE BUSINESS

Foreword

In the current scenario, insurance market in India has witnessed dynamic changes including entry of a number of global insurers. Most of the private insurance companies are joint venturing with recognized foreign institutions across the globe. Saturation of markets in many developed economies has made the Indian market even more attractive for global insurance majors.

The Insurance Regulatory and Development Authority (IRDA) regulate and develop the insurance sector in India through calibrated policy initiatives, helps to improve disclosures. The role and importance of internal control systems in good risk management practice, with a particular emphasis on the internal audit and compliance functions within such a framework has become necessary. Introduction of mandatory quarterly internal audit for insurer is one such step taken by the Insurance Regulatory and Development Authority which would contribute towards strengthening controls and also reducing risks under volatile market conditions.

I am happy to note that the Internal Audit Standards Board is issuing this Technical Guide on Internal Audit of Life Insurance Business for guidance of the members and other readers. I congratulate CA. Rajkumar S. Adukia, Chairman, Internal Audit Standards Board and members of the Board on issuance of this Technical Guide. This Technical Guide comprehensively deals with the peculiar aspects of life insurance business, including various regulatory aspects and provides a step-wise approach for internal audit.

I am sure that this Technical Guide will assist the members and others in efficiently discharging their responsibilities.

July 11, 2011 **CA. G. Ramaswamy**
New Delhi President, ICAI

Preface

During the last two decades, the economic reforms have impacted the growth of financial sector of India significantly. As an integral part of financial sector reforms, insurance sector has emerged as regulatory development sector. Insurance Regulatory and Development Authority has issued various regulations with the objective of improving market efficiency, enhancing transparency and bringing the Indian market up to international standards. With the very same objectives, the Insurance Regulatory and Development Authority being insurance sector regulator has mandated quarterly internal audit of insurer. This would not only ensure compliance with the legal and regulatory norms but would also prove instrumental in making the system more efficient.

Internal audit is core competence area of chartered accountants. It is an important assignment being undertaken both by practising members of the Institute as well as those in industry. This demands the internal auditor to have requisite skills and high level of knowledge of the sector as well as its interrelationship with variables in its operating environment.

The Internal Audit Standards Board is issuing this Technical Guide on Internal Audit of Life Insurance Companies. This Guide would provide to the members of the Institute as well as others an in-depth understanding of the activities undertaken by the insurer and the regulatory and legal framework in which they operate.

With a view to providing appropriate guidance in a manner that is easily understood by all the readers, this publication is divided into parts, dealing with the very fundamental concepts in Life Insurance Companies, sequentially as introduction, regulatory framework and internal audit of functional areas. It gives a brief overview on various aspects like, actuarial process, underwriting, reinsurance, premium collection, claims and agency licensing, etc. It also contains detailed checklist on internal audit that would help the readers in understanding the various technicalities arising during the internal audit of life insurance companies. The Guide also contains the list of abbreviations for better understanding of the readers.

I am extremely grateful to CA. Neeta Shah and her entire team viz. CA.Venkatachalam Sekar, CA. Shailendra Kothavale, CA. Sangramjit Saranagi, CA. Ramandeep Sahni, CA. Prasanna Bharatan, CA. Kalpita Nasikkar, CA. Durga Prasad and CA. Anand Dubey for squeezing out sometime out of their professional and personal commitments and preparing the basic drafts of this Technical Guide.

I also wish to thank CA. G. Ramaswamy, President, ICAI and CA. Jaydeep Narendra Shah, Vice President, ICAI for their continuous support and encouragement to the initiatives of the Board. I must also thank my colleagues from the Council at the Internal Audit Standards Board, *viz*., CA. Rajendra Kumar P., CA. Amarjit Chopra, CA. Ravindra Holani, CA. Anuj Goyal, CA. Nilesh S. Vikamsey, CA. Vijay K. Garg, CA. Atul C. Bheda, CA. J. Venkateswarlu, CA. Shiwaji B. Zaware, CA. Abhijit Bandyopadhyay, Smt. Usha Narayanan, Smt. Usha Sankar, Shri R. P. Singh, Shri Prithvi Haldea, Shri Sidharth Birla, Dr. T. V. Somanathan for their vision and support. I also wish to place on record my gratitude for the co-opted members on the Board, *viz*., CA. Madhu Sudan Goyal, CA. Rohit Choksi, CA. Ketan Vikamsey, and CA. Pankaj Kumar Adukia, CA. Umakant Balkrishna Joshi as also special invitees on the Board for their invaluable guidance as also their dedication and support to the various initiatives of the Board.

I am certain that the readers, especially members of the Institute, working as internal auditors in insurance sector would find this technical guide immensely useful.

July 14, 2011 **CA. Rajkumar S. Adukia**
Mumbai *Chairman,*
Internal Audit Standards Board

Abbreviations

AML	Anti Money Laundering
ASM	Available Solvency Margin
AUM	Assets Under Management
BI	Benefit Illustration
CA	Corporate Agent
CIE	Corporate Insurance Executive
COI	Certificate of Insurance
CTR	Cash Transactions Report
F & U	File and Use
FLC	Free Look Cancellation
FPR	First Premium Receipt
GPM	Gross Premium Method
KYC	Know Your Customer
LOB	Line of Business
MAD	Margin for Adverse Deviations
MOU	Memorandum of Understanding
NAV	Net Assets Value
NDS	Negotiated Dealing System
NSDL	National Securities Depository Limited
OYRGTA	One Year Renewable Pure Group Term Assurance Business

PMS	Policy Management System
PTC	Pass Through Certificates
RSM	Required Solvency Margin
SOP	Standard Operating Procedures
SP	Specified Person
STR	Suspicious Transaction Report
TAT	Turn Around Time
TAT	Turn Around Time
UAT	User Acceptance Test
UIN	Unique Identification number
ULIP	Unit Linked Insurance Plan
URN	Unique Reference Number

Contents

Chapter 1

Introduction

What is Insurance?

1.1 Insurance is a form of risk management primarily used to hedge against the risk of a contingent, uncertain loss. Insurance is defined as the equitable transfer of the risk of a loss, from one entity to another, in exchange for payment of premium. Insurance is a subject matter of indemnity and is a contact of utmost good faith.

Life Insurance

1.2 Life insurance is an agreement that guarantees payment of a stated amount of monetary benefits at the end of a specified term or on the death of the life insured. Life insurance provides for financial security in the event of death or on the inability to earn due to physical disabilities. Besides providing for financial security in the case of untimely death, it can be used to accumulate a pool for future, systematically build assets, for future commitments such as child's education, marriage, etc. In the Indian context, it is also an instrument for saving taxes.

1.3 Life insurance contracts can be classified into two major categories:

(i) ***Protection Policies*** - designed to provide a benefit in the event of specified event, typically a lump sum payment. A common form of this design is term or health insurance.

(ii) ***Savings / Investment Policies*** - where the main objective is to facilitate the growth of capital by regular or single premiums. Common forms are ULIP, Whole Life or Universal Life Policies.

Evolution of the Insurance Sector

1.4 Insurance Law has its root in London (U.K.). The early London Coffeehouses were centers not only of commerce and literature but also of debate and intellectual exercise. The Coffeehouses had the advantage of being near the river Thames, thus attracting the patronage of men interested and connected with marine activities. They also had a political influence, which moved the then reigning King Charles-II to attempt their suppression, unsuccessfully. Among such seventeenth century London coffeehouses, was one called *'Lloyd's Coffee House'*, owned by Edward Lloyd situated at the Tower's Street.

1.5 In the seventeenth century, there were no corporate entities engaged in insurance activities. The practice prevalent was that individuals wrote their names below some clauses relating to guarantors who came to be called *'the underwriters'*, to conduct business informally over cups of coffee. With passage of time, Lloyds Coffeehouse became recognised as a place to find underwriters for people desirous of insurance cover. Edward Lloyd encouraged the business by providing pen, ink, paper and shipping information obtained from the waterfront to the customers in the Coffeehouse. The Coffeehouse was merely a convenient and apparently congenial place for merchants of common interest to meet and transact insurance business. The insurance activities in the Coffeehouse ultimately culminated in the formation of the Corporation of Lloyd's under the Act of 1871 A.D. The name was immortalized although Edward Lloyd passed away in the year 1713 A.D.

1.6 The first attempt to form an insurance organisation in India was made when Sir John Child, Governor of Mumbai (then Bombay) was instructed by the Court of Directors of the East India Company to set up an insurance office in Mumbai. Life Insurance in its present form came to India in the year 1818 A.D. The first insurance company in India, the Oriental Life Insurance Company, was started in Calcutta by Europeans to help widows of their own community. The year 1870 A.D heralded the birth of life insurance business through the first Indian insurance company, the Bombay Mutual Life Assurance Society.

1.7 The Insurance Act, 1938, was the first comprehensive legislation governing both the life and non-life insurance. The insurance sector in India was nationalised on January 19, 1956. Thereafter, the insurance business was conducted by the nationalised insurance companies, *viz.*, Life Insurance Corporation of India (LIC), the General Insurance Corporation (GIC) and its four subsidiaries namely, United India Insurance Ltd., Oriental Insurance Company Ltd., National Insurance Company Ltd., and New India Assurance Company Ltd. The LIC was established on September 1, 1956 under the general direction and control of the Ministry of Finance.

1.8 In order to intiate structural changes in the area *of financial sector reforms, covering banking and capital markets that aimed at creating a more efficient and competitive financial system suitable for the requirements of the economy and keeping in mind the structural changes currently underway, the Government of India, in April 1993, appointed a Committee on Reforms in the Insurance Sector headed by Shri R. N. Malhotra, former Governor of the Reserve Bank of India (RBI).* The Malhotra Committee submitted its report on January 7, 1994. The Report mentioned that the insurance regulatory apparatus should be activated and recommended structural changes in the insurance sector, such as, techniques for bringing more competition and the establishment of a strong and effective Insurance Regulatory Authority in the form of a statutory autonomous board, on the lines of Securities and Exchange Board of India (SEBI), providing more focused customer services and liberalising the investment restrictions.

1.9. The General Agreement on Trade in Services (GATS) also imposes an obligation on all member States of World Trade Organisation (WTO) to open their service industry to foreign players. The privatisation of insurance industry was a step towards fulfilling obligations imposed therein.

1.10 In order to provide better insurance coverage to the country's citizens and also to augment the flow of long-term resources for financing infrastructure, the Finance Minister in his Budget speech, in the year 1998, announced opening up of the insurance sector by providing for the establishment of a statutory regulatory authority. Accordingly, the Insurance Regulatory Authority Bill, 1998 was introduced in the Lok Sabha on December 5, 1998 which provided for setting up of a statutory Insurance Regulatory Authority and contained three schedules, incorporating amendments to the Insurance Act, 1938, the Life Insurance Corporation Act, 1956 and the General Insurance (Nationalisation) Act, 1972.

The objective of deregulating the insurance sector was to further improve the efficiency of the sector. With a view to shift from *"control"* to *"regulation"*, the Government of India decided to establish a statutory body. Accordingly, an independent authority, "Insurance Regulatory and Development Authority" (hereinafter called the Authority), was constituted in the year 1999. The aim of the Authority, as enunciated in the preamble of the IRDA Act, 1999 is:

"An Act to provide for the establishment of an Authority to protect the interests of holders of insurance policies, to regulate, promote and ensure orderly growth of the insurance industry and for matters connected therewith or incidental thereto and further to amend the Insurance Act, 1938, the Life Insurance Corporation Act, 1956 and the General Insurance Business (Nationalisation) Act, 1972."

The Authority has the duty to regulate, promote and ensure the orderly growth of the insurance and reinsurance businesses, subject to the provisions of the Insurance Regulatory Development Authority Act, 1999 and any other law for the time being in force. The powers and functions of the Authority, *inter alia* include:

(i) issue to the applicant a certificate of registration, renew, modify, withdraw, suspend or cancel such registration;

(ii) protection of the interests of the policy holders in matters concerning assigning of policy, nomination by policy holders, insurable interest, settlement of insurance claim, surrender value of policy and other terms and conditions of contracts of insurance;

(iii) specifying requisite qualifications, code of conduct and practical training for intermediary or insurance intermediaries and agents

(iv) specifying the code of conduct for surveyors and loss assessors;

(v) promoting efficiency in the conduct of insurance business;

(vi) promoting and regulating professional organisations connected with the insurance and re-insurance business;

(vii) levying fees and other charges for carrying out the purposes of this Act;

(viii) calling for information from, undertaking inspection of, conducting enquiries and investigations including audit of the insurers, intermediaries, insurance intermediaries and other organisations connected with the insurance business;

(ix) control and regulation of the rates, advantages, terms and conditions that may be offered by insurers in respect of general insurance business not so controlled and regulated by the Tariff Advisory Committee under section 64U of the Insurance Act, 1938 (4 of 1938);

(x) specifying the form and manner in which books of account shall be maintained and statement of accounts shall be rendered by insurers and other insurance intermediaries;

(xi) regulating investment of funds by insurance companies;

(xii) regulating maintenance of margin of solvency;

(xiii) adjudication of disputes between insurers and intermediaries or insurance intermediaries;

(xiv) supervising the functioning of the Tariff Advisory Committee;

(xv) specifying the percentage of premium income of the insurer to finance schemes for promoting and regulating professional organisations referred to in clause (f);

(xvi) specifying the percentage of life insurance business and general insurance business to be undertaken by the insurer in the rural or social sector; and

(xvii) exercising such other powers as may be prescribed

The Last Decade: Post Liberalization Transformation

1.11 During the last decade (year 2000 to 2010) the economic policies of India have witnessed a significant transformation. A consensus has been built up to conceive greater role for the private sector in the interplay of market dynamics with the objective of increasing the overall efficiency of the economy and enhancing the flow of investments and technology.

1.12 Post liberalisation, life insurance market in India witnessed dynamic changes including the entry of a number of global life insurers that led to increased competition in the Indian Life Insurance Market. The industry has grown from single player industry to 23 players industry in the last one decade. The Indian Life Insurance Industry is now considered fifth largest life insurance market in the world. According to the Life Insurance Council, it is USD 56 billion industry (on total premium basis) and grown at a CAGR of 25% in last 10 years.

1.13 Insurance per capita grew to ‘ 1,950 in year 2010 from ‘ 450 in the year 2000 and registered a 4.1% GDP penetration in the year 2010 against 1.2% GDP penetration in the year 2000. Insurance has become the most preferred financial instrument by contributing 20.1% of total financial savings in the year 2010. Life insurance industry has also emerged as one of the largest domestic investor in equity markets in India. The total assets under management as on March 31, 2010 amounted to ‘ 12.90 trillion. Insurance investments are also biggest contributor to nation building by holding infrastructure investment of ‘ 1.40 trillion and investment in Government and other approved securities of over ‘6.00 trillion.

1.14 The foreign direct investment (FDI) limit in the insurance space for foreign players is currently capped at 26 per cent, permissible under the automatic route subject to obtaining a license from the official regulator, i.e., IRDA. The government is planning to raise it to 49 per cent and a bill to give effect to the proposal is pending in the Rajya Sabha.

1.15 Intense competition has forced the life insurance industry to improve its underwriting and risk management abilities that has greatly benefited the policyholders. Moreover, customers today are more conscious of the need for risk mitigation and greater security for the future such as retirement plans. Life insurance companies have been quick to recognize the larger need for structured retirement plans and have leveraged their abilities of long-term fund management towards building this segment.

Insurance Products and Distribution Structures

1.16 Life insurance industry in India has witnessed varied product designs during the last 5 decades. The primary products can be traced as term or protection products which gradually moved towards the savings products, such as, endowment and pure endowment. Term and endowment products, generally referred as traditional or conventional products, ruled the life insurance market till Unit Linked Insurance Plan (ULIP), which came into existence in early years of 21st Century. In fact until privatization in year 2000, the insurance market was primarily a market with a few product categories primarily in the term and endowment space. Privatization led to a spate of new product development and thereafter ULIP products dominated the life insurance market. IRDA in the year 2006 issued guidelines to regulate and promote ULIP.

1.17 Life insurance products can broadly be categorised as follows:

(i) Term/Protection

Term life insurance is the original form of life insurance. Term insurance is generally, used for pure income replacement needs for an individual rather than wealth creation or capital gains.

Term Insurance covers the policy holder for a specific numbers of years. It pays death benefit only, if the policy holder dies during that term. Term Insurance generally offers the cheapest form of insurance. The policy holder can renew most term insurance policies for one or more terms even if his health condition has changed. Each time the policy is renewed, premiums may climb higher. Term policies cover only the risk during the selected term period. If the policy holder survives the term, the risk cover comes to an end. A Term plan is a pure risk cover plan and it meets the needs of people who are initially unable to pay the larger premium required for a whole life or an endowment assurance policy, but they hope to be able to pay for such a policy in the near future.

(ii) Endowment/Pure Endowment

A type of insurance policy which provides for the assured sum stated in the contract to be payable on a fixed date or on the death of insurer.

Endowment policies cover the risk for a specified period and at the end the sum assured is paid back to the policy holder along with all the bonus accumulated during the term of the policy. Endowment insurance policies work in two ways, i.e., one they provide life insurance cover and on the other hand, acts as a vehicle for saving. They are more expensive than Term policies and Whole life policies. Normally the bonus is calculated on the sum insured but the only drawback is that the bonuses are not compounded. Endowment insurance plans are best for people who do not have adequate saving and encourage investing habit on a regular basis. Endowment Insurance Plans can be bought for a shorter duration period.

An endowment policy provides for the payment of the sum insured only on survival to the maturity date. On earlier death, nothing is usually paid out although some contracts may provide for the premiums paid to be refunded either with or without interest, after deducting appropriate expenses incurred.

A variant of endowment policies are also called whole life policies, where the policy continues as long as the policyholder is alive. In Whole Life Insurance plan the risk is covered for the entire life of the policy holder, therefore, they are called whole life policies. The nominee of the beneficiary are paid the sum assured and the bonus on the same at the time of the death of the policy holder. The policy holder will not get any benefit during his or her own lifetime since there is no survival benefit.

(iii) Money Back Plan

Unlike ordinary endowment plans where the sum assured is payable only at the end of the endowment period, money back policies is one of the variant of endowment plan, which provides periodic payments of partial benefits during the term of the policy so long as the policy holder is alive. An important feature of this type of policy is that in the event of death at any time within the policy term, the death claim would comprises of full sum assured without deduction of any of the survival benefit amounts, which may have already been paid as money-back components. Similarly, the bonus is also calculated on the full sum assured.

(iv) Whole Life Insurance Product

It provides cover throughout the lifetime of the person. The premium could be paid for as long as a lifetime or for a limited period. Unlike endowment plans they do not carry a maturity value and sum assured is paid to the family in case of the unfortunate death of the policyholder.

(v) Unit Link Insurance Plan (ULIP)

Unit Link Insurance Plan (ULIP) is a type of life insurance plan where the cash value of a policy varies according to the current Net Asset Value(NAV) of the underlying investment assets. It allows protection and flexibility in investment. The premium paid is used to purchase units in investment assets chosen by the policyholder. ULIP has been one of the most popular form of insurance products in India since its introduction. The product is closely regulated by IRDA through various guidelines issued from time to time.

ULIP products are mainly available in life and pension variants. The popularity of ULIPs arises from the fact that they have a benefit of life insurance and also serves as an investment tool and has the flexibility and transparency. In a ULIP, there are two parts of the premium a client pays, the first part of the premium, covers the life of the policy holder and the second part, goes into investments. Almost all insurance companies give their customers a choice to select the investment mix. They can go for 100% equity funds or 100% debt funds or a mix of both. In an unlit linked insurance plan, the customers are also given the choice to switch from one fund to another. The returns from the insurance policy directly relate to the performance of the funds, which in turn depends on the market movement.

(vi) Universal Life

The product category, is a hybrid of ULIP and Traditional products. Like a ULIP ,a contract has underlying funds and like a traditional product returns (bonus) are agreed as a part of the contract.

(vii) Pension or Retirement Plans

A pension plan is retirement solution to provide an income where there is no regular income from employment. Pension plan combines income protection as well as life cover. They can take the form of a ULIP or traditional products. In this category of product, the customer decides the retirement age and agrees to pay premium up to the age of retirement and thereafter he has an option to commute a part of his fund value and take an annuity for the balance. The customer has the option to continue with the same insurer and convert his un-commuted sum into annuities or could also take an annuity from any other insurer in the market.

(viii) Annuities

Annuity contract is an agreement under which the insurer, in return for the payment of a certain sum, makes a series of agreed payments at regular intervals from a fixed date. The annuities continue until the death of the individual on whose life the annuity is bought or up to an agreed age (as per the terms agreed upon). Typically, annuity income benefits are paid monthly or annually.

(ix) Group Insurance

Group insurance is an insurance that covers a group of people, usually who are the members of societies, employees of an organisation, or professionals in a common group.

Group coverage can help to reduce the problem of adverse selection by creating a pool of people eligible to purchase insurance belonging to the group for reasons other than for the purposes of obtaining insurance. In other words, people belong to the group not because they possess some high risk factor which makes them more apt to purchase insurance (*thus increasing adverse selection*); instead they are in the group for reasons unrelated to insurance, such as all working for a particular employer. Group insurance can also take various forms, such as, pure term cover for the group or wealth management products such as *Superannuation, Group Gratuity or Leave Encashment*.

Given the market dynamics and the demographics of India, need based savings products such as Child plans and Guarantee products like premium guarantee are gaining more popularity in India.

Distribution

1.18 Util the year 2000, the insurance sector, was dominated by the agency force i.e. sale through individual agents. Post privatization, various other distribution channels were introduced primarily by the private life insurers. The newer channels included *Bancassurance, Corporate Distributors, Brokers, Direct Sale, Online sale and Upsell Models.*

1.19 The distribution mix in Indian life insurance industry has evolved significantly over the past decade and is now moving in line with mature markets, where alternate channels (non agency) contribute significant proportion of new business.

1.20 Major distribution channels in Indian life insurance industry are:

(i) Agency Force

Agency force is the primary form of insurance distribution across the globe. Individual insurance agents also referred as insurance advisors are authorised to distribute the insurance products of only one life insurer under IRDA license.

(ii) Bancassurance

As a distribution channel, bancassurance is attractive as it enjoys high credibility; provides a ready customer base and low-cost channel for selling financial products; and has a wide reach. Banks in India are all pervasive, especially public sector banks, with strong presence in under-penetrated rural and semi-urban areas that are currently being targeted by most private insurers.

(iii) Alliance (Corporate Agents and Brokers)

A Corporate Agent can sell products of only one insurer. Since distribution infrastructure is provided by the Corporate Agent, it helps the insurer to lower his distribution costs. New entrants, in partnership with retail groups, are eyeing associations with their promoters to utilize their distribution networks. Many insurers have also tied up with local NGOs in remote areas. Established Corporate Agents provides an opportunity for rapid business scale up. Corporate Agents warrant high development costs initially, but may still emerge as viable distribution channel as symbiotic relationship may develop between insurer and Corporate Agent, driven by growing trailing commissions and operational integration.

A broker can sell products of more than one insurer. The brokers seek to determine the best fit for the client. From the policyholder's perspective, a broker can recommend the most suitable product from a wide range of products. The challenge lies in establishing regulations that protect the customer and attract right players into the brokerage market, rather than creating a middleman segment that will erode premium.

(iv) Direct Sale

Another channel in existence is the direct sales force channel which comprises of employees of the insurer directly selling insurance products. Alternately, the insurer could upsell to the existing client base or sell through its website or other partner websites.

Objective and Scope of the Technical Guide

1.21 This Technical Guide is intended to assist internal auditors in carrying out internal audit of entities operating in the insurance business. The Technical Guide deals with operational areas of entities operating in this industry with emphasis on compliance mandated as per various regulations applicable to the specific industry.

1.22 Today, the scope of internal audit has increased from mere verification of financial transactions to reviewing of proper, efficient and economical usage of resources by the entity. Therefore, it is imperative that an internal auditor familiarises with various management aspects and technical aspects of the insurance industry for performing internal audit in a more efficient and effective manner.

This Technical Guide covers the following aspects:

(i) Abbreviations peculiar to insurance industry.

(ii) Scenario in the insurance industry, special features and challenges faced by entities operating in this industry.

(iii) Discussion on Internal Audit and compliance related issues.

(iv) Legal Framework for entities operating in the Indian insurance industry.

(v) Major areas of internal audit significance and risks faced by an entity operating in this industry, procedures that an internal auditor can perform.

Chapter 2

Regulatory Framework for Life Insurance Sector

2.1 The Insurnace sector went through various phases from being unregulated to completely regulated and know deregulated. It is governed by a number of acts. The Internal Auditor should refer to bare acts of these laws and regulations and study the differenct cases and judgement by competent authority.

2.2 Considering that these regulations undergo frequest amendment/ changes, the internal auditor must update himself with the amendments, pronouncements and new regulations enacted from time to time ensuring effective performance of Internal Audit.

2.3 Broadly, speaking following is the regulatory framework for Insurnace Sector :

(i) The Insurance Act, 1938

The Insurnace Act of 1938, was the first legislation governing all forms of insurance to provide strict control over insurance business. Prior to setting up of IRDA, the Act is administered earlier administered by Insurance Division of Ministry of Finance with the purpose of :

- To consolidate and amend the law relating to the business of insurance, pertaining to life as well as general and to replace the earlier Life Assurance Companies Act, 1912 and the Provident Insurnace Societies Act, 1922.
- To set up a regulatory framework for insurance companies which had grown in size and number resulting in the need for legislation that would protect policy holders' money and stop misuse of power by the insurance companies.

(ii) Life Insurance Council

Life Insurance Council is a forum that connects the various stakeholders of the sector. Constituted under section 64A of the Insurance Act 1938, the Life Insurance Council functions through several sub-committees and includes all life insurance companies in India. It develops and coordinates all discussions between the Government, Regulatory Board and the Public. In short, it is the face of the Life Insurance industry.

It is worth noting that in the case of Life Insurance Corporation of India, apart from the above mentioned legislations, the Life Insurance Corporation (LIC) Act, 1956 is also applicable. Prior to the opening up of insurance sector for private players, section 30 of the LIC Act, 1956 had granted the Life Insurance Corporation an exclusive privilege of carrying on life insurance business in India. Section 30A has been inserted by the IRDA Act, 1999 in the LIC Act, 1956, ending the exclusive privilege of the Life Insurance Corporation of carrying on the life insurance business in India.

(iii) Insurance Regulatory Development Authority (IRDA) Act, 1999

In the year 1999, the Insurance Regulatory Development Act, 1999, was passed in the parliament, giving the Insurnace Regulatory Development Authority (IRDA), which is a autonomous body regulates and develop insurance business in India. The key objectives of IRDA is :

- o to protect the interests of holders of insurance policies
- o to regulate, promote and ensure orderly growth of the insurance industry and for matters connected therewith or incidental thereto.

The Act provides provisions with respect to IRDA's composition, duties, power and functions; finance, accounts and audit etc.

IRDA holds the right to seek clarifications, issue show cause notices and penalize the insurance companies within the scope of regulations. IRDA also has the right to conduct inspection of insurance companies.

Recently, IRDA has issued Guidelines on Corporate Governance for the Insurnace Sector dated August 5, 2009 and Corporate Governance Guidelines for Insurance Companies (Amendment) dated January 29, 2010.

Chapter 3

Product Development and File and Use

Product Development

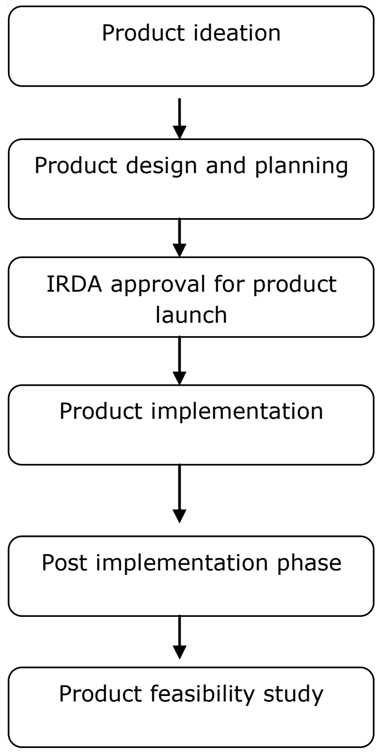
3.1 Insurance products are basically services, there is no tangible entity, as insurance companies sold a promise to pay in event of loss, which is a matter of trust and confidence i.e, the risk covered by the insurance company is *what is being marketed*. The insurance concept is very unique in nature as it has to take care not only norm process of product designing i.e., product, price, place, promotion, process and physical evidence, but do also have to take care of the regulatory aspects before finilsation of the product.

Sub-process:

The review should broadly include product ideation, product feasibility, product design and planning, product implementation and post implementation phase.

Scope and Objective:

To assess whether there is proper control over the compliance and execution of the product development process.



Following are involved in the process:

(i) ***Product Ideation*** – During this stage, the opportunity for a product development is analyzed

(ii) **Product Design and Planning** – During this stage, the final design of the product, the expected profitability and the implementation plan are finalized.

(iii) IRDA approval for product launch

IRDA has issued File and Use ("F & U") guidelines which is to be followed at the time of filing each product for approval with IRDA. The insurer needs to specify the commission range for its various sales channels.

IRDA has issued a separate circular for ULIPs in 2005 called ULIPs guidelines which are further amended recently in May

2010. It provides guidance on product design, market conduct, disclosure norms, advertisements etc. Internal Auditors are encouraged to refer the IRDA guidelines from time to time.

(iv) **Product Implementation** – All supporting systems and launch activities are in place and the Product is launched.

(v) **Post Implementation phase** – This is the phase during which the actual sales and profitability of the product is monitored. If need be, certain modifications may be done in the product features.

(vi) **Product Feasibility Study** - Product feasibility study is conducted to assess if the product is financially feasible to be launched. Product design should clearly specify the following:

- Underwriting philosophy
- Pricing structure and cost
- Sum assured
- Premium amount for various age groups
- Other product features

3.5 Illustrative checklist containing risks and internal audit procedures along with applicable regulations/guidelines/ notification/circulars:

Risks	Internal Audit Procedures
(i) Product idea not validated through adequate research by internal / external team (if required).	• Check the research reports (internal and external). • Check the sign-off done by Head-Products and Management Committee or appropriate/ empowered committee appointed by the insurer.

	Risks	Internal Audit Procedures
(ii)	Product idea, is not aligned to sales requirement or Product launch, not approved by the senior management.	Check that there is a Management Committee to:· • Document and consider the sales requirements for designing the products and • approve the products to be launched.
(iii)	Absence of a mechanism to track various milestones of the product launching process.	Check whether, there is a mechanism to monitor and track the status of various milestones of entire product development process
(iv)	Inadequate product feasibility study i.e. *not considering the potential sales volume, target customers, profitability of product etc.*	Check the feasibility reports to ensure that it covers all these aspects. Internal auditor can review the availability of the feasibility report which must consist the basic parameters.
(v)	Absence of appropriate approvals at all stages from various stake holders.	Check the sign-off from various stake holders like *Products, Sales, Operations, Actuarial, Management Committees, Information technology, Compliance, etc.*
(vi)	Compliance approval not obtained at various stage of product launch process.	Check the compliance approval obtained during product launch process.
(vii)	Launching the product without IRDA approval.	Check whether IRDA approval was obtained prior to launching the product.
(viii)	Delay in launch of product post IRDA approval.	Check the date of launch of product and match the same with IRDA approval date.
(ix)	Product features as filed with IRDA are different from the features approved by the Management Committee.	• Obtain the minutes of meetings of Management Committee or other appropriate committee appointed by the insurer. • Compare the product features approved by the committee against the features filed with

Risks	Internal Audit Procedures
	IRDA as a part of F & U application.
(x) Change in product features within 6 months from the date of filing with IRDA (F & U guidelines).	Check whether any change is made within 6 months from the date of approval. (*Product feature changed as a result of change in regulatory requirement is to be excluded*)
(xi) User Acceptance Test (UAT) not done prior to launching the product leading to operational inefficiencies.	Check whether, the UAT is properly documented and is signed-off by all the stake holders.
(xii) Commission and other payouts paid to the agents are checked to ensure compliance with IRDA regulations.	Check whether the UAT is properly documented including the scenarios test checked for payouts to agents.
(xiii) Absence of marketing material at the time of launch, leading to delayed product launch process.	• Check that there is proper coordination and Service Level Agreement (SLA) between Marketing and Products to facilitate timely availability of marketing material. • Check whether the insurer is having a multi disciplinary team comprising of *actuarial, training operations, IT, finance, marketing and sales* who are involved in introduction of products.
(xiv) Marketing material is not vetted by Compliance team.	Check compliance sign-off for adequacy of marketing material.
(xv) Adequate training not provided to the sales staff to understand the features of the new product.	• Check whether there is proper co-ordination and SLA between Training and Product Department for timely training of the trainers, so that they in turn can train the sales staff as soon as the product is launched.
(xvi) Absence of maker-checker at all the stages leading to	Check whether, the roles and responsibilities and maker-checker

Risks	Internal Audit Procedures
operational inefficiencies, re-work etc.	is documented and is effective.
(xvii) Absence of clear coordination and ownership between all the stake holders of product launch process.	Check whether, the roles and responsibilities of all the stake holders are documented.
(xviii) System not geared for those product features that kicks-in after 3 – 4 years of the product launch.	Review the UAT reports for these features to check, whether, the system is ready.
(xix) Product idea leaked out to competitors before launch resulting in similar and/or better products being launched by them causing lower market penetration than expected.	Check whether, adequate controls to maintain restricted access to the product development drive/data before launch of the product.
(xx) Product features amended but systems are not modified to comply with the amendments.	Obtain the list of amendments and review the UAT reports to check if the amendments were tested in the systems.
(xxi) Post implementation experience analysis not conducted *for claims, actuarial strain, costs, loadings etc.*	• Inquire whwther, the experience analysis is conducted. • Check whether, the 'Financial condition report' of Actuarial and other reports to confirm the experience analysis.
(xxii) Unauthorized access to product set up in the Policy Management System (PMS).	• Obtain, list of access rights product set up in PMS and check whether the rights are adequately approved. • Check whether the UAT team does not have access to production environment and vice-versa. · Also see whether review of logs pertaining to product set up is being performed on periodic basis.
(xxiii) Incorrect design of the policy document for the new product.	• Check that various components of the policy document like

Risks	Internal Audit Procedures
	Terms and Conditions, First Premium Receipt ("FPR"), Benefit Illustration ("BI"), Policy Schedule, etc. has been correctly designed in the printing application.
(xxiv) Inadequate controls for discontinuance of products	• Also ensure that the same is signed-off by product development and compliance team. • Check existence of policies and procedures. • Check availability of sign-offs and IRDA approval for discontinuance of product. • Check whether the product and related settings are disabled in the system.

File and Use ("F & U")

3.6 All the Insurers are required to comply with the File and Use procedure for each product is being offered in the market. File and Use Procedure is required to be followed by the insurer, when:

(i) A new product is being launched.

(ii) An exisiting product is being modified.

(iii) An exisiting product is being withdrawn.

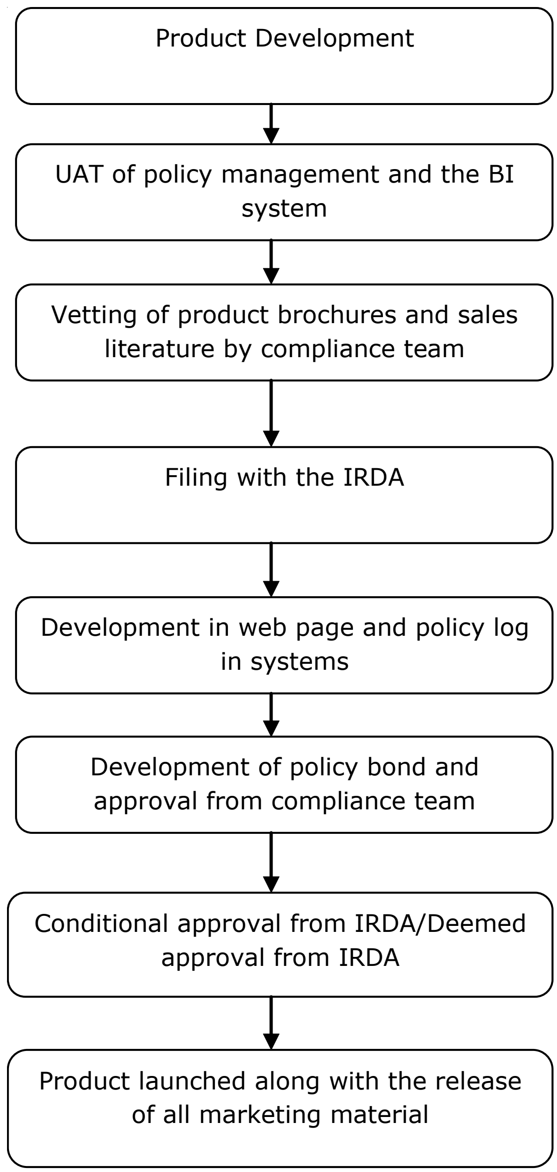
Sub-process:

3.7 The sub processes involved are demarcated in the process flowchart given below.

Scope and Objective:

3.8 The scope of the F & U review has been enunciated by the

IRDA circular No. 01/IRDA/ACTL/MC/2006-07 dated 12 July 2006. The same mandates internal auditors to provide a quarterly assessment on the compliance of File & Use procedures and communicate deviations to the Board.



3.9 Illustrative Checklist containing risks and internal audit procedures along with applicable regulations/guidelines/ notification/circulars:

Risks	Internal Audit Procedures
A. Compliance Related Risks	
(i) Risk of inadequate process note on F & U procedure leading to F & U violations.	Review the adequacy of the documented process note on F & U procedure.
(ii) Risk of incomplete F & U documents leading to rejection of product by the IRDA.	Review the completeness of the F & U documents filed with IRDA (in relation to F & U application form, sales literature, proposal form, business intelligent , policy bond, Annexure to F & U, ULIP checklist and IRR at various modal points).
(iii) Risk of incorrect premium rates published in the insurer's website leading to F & U violation.	Review the adequacy and the correctness of the premium rates published in the insurer's website in accordance with the IRDA approval letter.
(iv) Risk of inadequate checks in the product management system leading to sale of products in violation of the approved product parameters.	Review the adequacy of the policy management system (PMS) in relation to the IT controls, system adequacy to support revised/newly launched/withdrawn products, riders and funds.
(v) Risk of excessive channel partner payouts in violation of F & U.	Review the adequacy of the channel payout management system to ensure that payouts are in line with the approved rates filed with the IRDA.
(vi) Risk of inadequate and incorrect BI leading to violation of F & U .	Review the adequacy and correctness of the Business Intellegent system to ensure the generation of the same is compliant to filed parameters with respect to - disclosure of the various charges along with the fund expected over the duration of the policy with assumed gross investment rate of

Risks	Internal Audit Procedures
	6% and 10% for ULIPs and for non ULIPs disclosure of the benefits and the premium payable (*This is mandated by IRDA circular 055/ IRDA/ACTL/ULIP/2009-10 dated 24/ 09/10*)
(vii) Risk of amendments in the relevant clauses of the policy bond in violation of the policy bond filed with the IRDA.	Review the adherence of the policy document to the provisions mentioned in the IRDA circular no.32/IRDA/ACTL/FUP/VER5.0/ SEP2007dated 06/09/07.
B. Regulatory Risks :	
(i) Risk of Non-disclosure of corrent product Unique Identification Number.	Review the disclosure of correct product Unique Identification Number (UIN) in all the correspondence to the authority and the relevant documents offered to the public in adherence to the IRDA circular no.47/IRDA/ACTL/FUP/ VER 4.0/JAN 2007.
(ii) Risk of non-adherance to the conditions specified by the IRDA leading to F & U violation.	Check the adherence to the conditional approval specified by the authority in the approval letter.
(iii) Risk of used documents not in line with the filed documents leading to F & U violation.	Review the used documents i.e., BI, advertisements released, proposal form and the policy bond to ensure adherence to the F & U parameters.
(iv) Inadequate UAT scenarios leading to absence of system checks or existence of system flaws leading to F & U violation.	Review the adequacy and completeness of the UAT including the adequacy of each UAT scenarios tested.
(v) Delayed product launch leading to F & U violation and consequent penalty imposed by IRDA.	Review that the product launch date is within 3 months from the date of approval of the authority.
(vi) Risk of issuance of withdrawn products, sale of products prior to IRDA approval leading to F & U violation.	Review that the policy issuance dump has been taken from the Policy Management System (PMS) to check adherence to filed

Risks	Internal Audit Procedures
	parameters, to check whether, policy issuance has been effected for any withdrawn product and to ensure that the first policy log in date does not precede the date of the product launch/ modification communicated to the IRDA.
(vii) Risk of transactions processed in contravention of the approved product parameters.	Review the transactions effected (e.g claims, free-look cancellation, surrenders, terminations, switches, premium redirection, premium reduction and accumulator options,) to ensure adherence to the approved product parameters.
(viii) Risk of incorrect charges/ allocation rates table setup leading to charges/ allocation not in line with F & U.	Review of the IT controls over the changes made in the backend tables to the PMS, channel payout system, BI system.
(ix) Alteration of charges in the sales literature/ BI leading to F & U violation	Check the premium or charges as the case mentioned in the sales literature / BI with that posted on the insurer's website for individual and group products.

Chapter 4

Actuarial Process

4.1 The public role of actuaries in life insurance, has shifted from supervising compliance with detailed provision to certify that products and financial reports are in accordance with general regulatory guidelines.

4.2 The job of actuary or actuarial department involves detailed analysis of data to quantify risks, and act as a modelling hub of the insurer. The actuarial department is the calculation and modelling hub of the insurer. Within the department, the fundamentals of Insurance business are determined from pricing and business valuations technique. The actuariais a highly qualified function, performing complex calculations and analysis of data by developing and using sophisticated cash flow models to quantify risk.

Sub-process:

4.3 Key areas include:

(i) Product development/ Pricing and Experience analysis

(ii) Model development

(iii) Statutory valuations and reserving

(iv) Business planning

(v) Solvency management

(vi) Management reporting on various business valuation and profitability models such as Embedded Value, New Business Profit, etc.

Scope and Objective:

4.4 The abovementioned activities require specialised actuarial capabilities the scope of this process is restricted to specific input/ output controls, maker checker and other manual/system controls aspects.

4.5 As pricing, experience analysis, business planning and management reporting models are very subjective processes requiring specialised actuarial skills these have been excluded from the scope of this guide.

4.6 The scope of this guide is hence restricted to the actuarial activity of model development, actuarial reserving and solvency management.

4.7 The relevant applicable regulations governing the above mentioned key areas in processes include:

(i) Section 13 of the Insurance Act, 1938: Actuarial report and abstract

(ii) Section 49 of the Insurance Act, 1938: Distribution of Surplus

(iii) Section 55, 64V and 64 VA of the Insurance Act, 1938: Valuation of assets and liabilities and solvency margin

(iv) IRDA (Actuarial Report & Abstract) Regulations, 2000

(v) IRDA (Assets, Liabilities and Solvency margins of Insurers) Regulations, 2000

(vi) IRDA (Distribution of Surplus) Regulations, 2002.

(vii) IRDA (Appointed Actuary) Regulations, 2000.

(viii) IRDA (Qualification of Actuary) Regulations, 2004

Statutory Valuation Process

4.8 The broad activities involved in the statutory valuation process include the following:

(i) Receipt of input data (client/contract level data) from PMS

(ii) Match the input data with corroborative data (overall control checks to ensure data accuracy)

(iii) Review of actuarial assumptions for valuation of liabilities (assumptions pertain to interest rate, mortality, morbidity, expenses inflation, lapsation/ persistency, etc)

(iv) Derive policy reserves (generally non unit reserves are derived through the actuarial system and the unit reserves from the PMS)

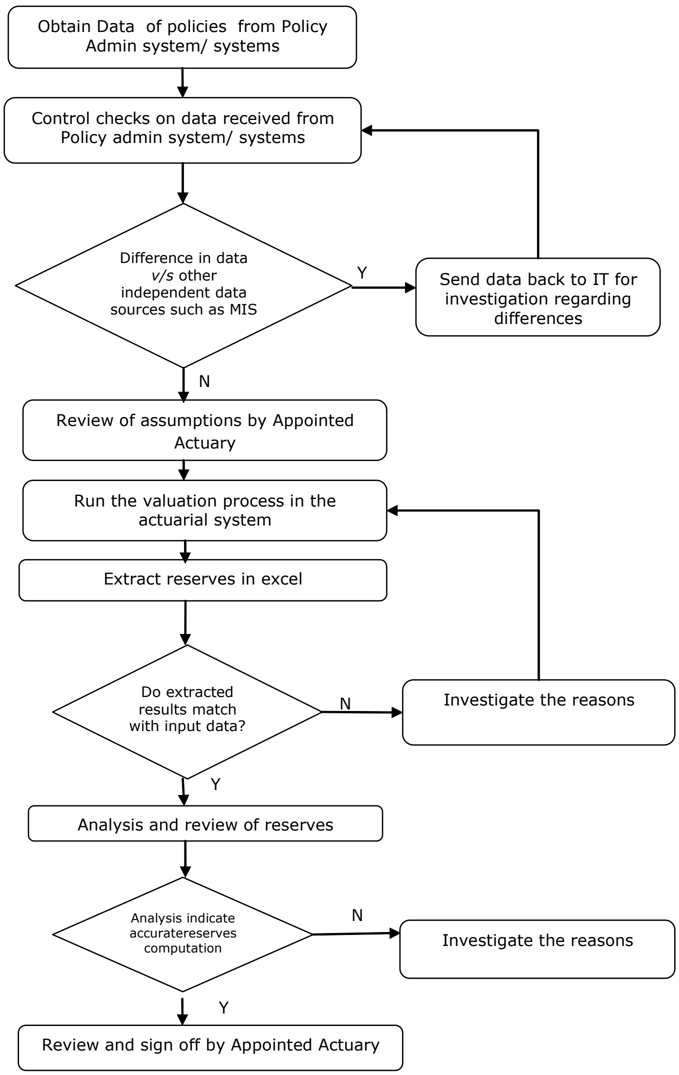
(v) Post reserving data validation (check on input v/s output data such as number of policies, sum assured, etc)

(vi) Analysis of reserves

(vii) Overall control checks on accuracy of reserves

(viii) Review and sign off of line of business (LOB) reserves by Appointed Actuary

(ix) Reporting.



Valuation process:

4.9 An insurer could be following multiple Generally Accepted Accounting Principles (GAAP) hence the below stated internal audit procedures should be applied with respect to all GAAPs. Further, there would be several inputs feeding into the financials along with the basic policy reserves (such as bonus, lapsed reserves, etc.) and hence all below controls would apply to these inputs as well.

4.10 Illustrative checklist containing risks and audit procedures along with applicable regulations/guidelines/notification/circulars:

Risks	Internal Audit Procedures
A. Modelling process	
(i) Inadequate access controls in the actuarial system Inadequate change logs in the actuarial system	• Ensure adequate segregation of rights between the modelling, pricing and valuation team. Check whether model changes are made by the master maintenance (modelling) team only on the basis of inputs from the product pricing team. • Ensure that a robust UAT process exists to check on any model changes. • Audit trail of all changes made should be available. • Review of audit logs to check unauthorised modification.
(ii) Incorrect assumptions/product features/logic updated in the actuarial system	• Check for consistency of product set up versus F & U • Check for consistency of assumptions agreed versus updated in the models • The logics being built on the actuarial system used to run policy cash flows are subject to a thorough maker checker control and a UAT process.
(iii) Lack of version controls on models	• Ensure version control over models exist to ensure that in case an older version needs to be reinstated the same is available.
B. Statutory valuation process	
(i) Non-availability of policies and procedures	• Review policy document and procedures guide including polices on reserves

Risks	Internal Audit Procedures
(ii) Incorrect policy data received from PMS for statutory valuation	• Check the controls on policy data extraction. Whether logic for data extraction in terms of period, policy status, LOB correctly defined and signed off.
Inefficient data validation process	• Ensure that the input data is validated with corroborative data like accounting data and MIS (no. of policies, sum assured, etc). • Check maker-checker on verification and validation of data. • Unit data received from the policy admin system reconciles with the unit data from the Investment Accounting System.
(iii) Incorrect assumptions defined in actuarial system	• Check whether all assumptions are signed off by appointed actuary (also reviewed on periodic basis)· Compare the assumptions signed off with the masters/ models defined in actuarial system. Compare assumptions with historical data available within and outside the company.
(iv) Incorrect data run in actuarial system	• Match the data output of run in actuarial system with input data (in terms of overall count of policies, sum assured, etc). Check the process for input and run of data in actuarial system· Confirm existence of maker-checker on the data validation process· There could be tools used to convert raw data into actuarial system readable formats – ensure that the conversion tools are write

Risks	Internal Audit Procedures
	protected and access to masters are access controlled. Ensure that conversion logics are well documented. Also ensure that all changes are subject to maker checker controls.
(v) Lack of controls on spreadsheets used in the valuation process	• Check access controls on the spread sheets used in the valuation process. • Check whether changes made in spread sheet are authorized by appropriate authority. • Check version control of spread sheets to avoid incorrect file/ working being referred. • Check whether relevant fields/ formulae are protected from changes in the spread sheet· In case multiple files are used then perform consistency checks e.g. linkages of files, formulae, etc.
(vi) Lack of standard trail for the reserving process	• Considering the complexity of the reserving process ensure that a process note exists for the reserving process. • Ensure that adequate back up procedures exist for backing up the actuarial system data and the valuation data extracted from the policy admin system.
(vii) Incorrect reserving submitted for preparation of financials	• Check whether analytical procedures are applied to validate the reserving data (i.e. reserving for the period is evaluated in line with the past

Risks	Internal Audit Procedures
	reserving trends and adequate explanation for variances exists). • Check whether the reserving is signed off by the appointed actuary. • Check whether the reserving calculated and signed off by actuary match with financials and that reported to IRDA.
C. Solvency Management	
(i) Solvency requirements not complied with in line with IRDA (Assets, Liabilities and Solvency margins of Insurers) Regulations, 2000 Risk of incorrect valuation of assets, liabilities and solvency margin	**Valuation of assets and liabilities** To ensure • Accurate asset values are used in computation of available solvency margin (ASM) (as defined in Schedule 1 titled "*valuation of assets*"). • Accurate liability values are used in computation of the required solvency margin (RSM). • The liability valuation method shall be called "Gross Premium Method' (GPM). If in the opinion of the appointed actuary, a method of valuation other than the GPM of valuation is to be adopted, then, other approximations may be used provided that the amount of calculated reserve is at least equal to the amount that shall be produced by the application of GPM. • The method of calculation of the amount of liabilities and the

Risks	Internal Audit Procedures
	assumptions for the valuation parameters shall not be subject to arbitrary discontinuities from one year to the next. • The GPM of valuation shall discount the following future policy cash flows at an appropriate rate of interest. • The valuation parameters shall constitute the bases on which the future policy cash flows shall be computed and discounted. The value(s) of the parameter shall be based on the insurer's experience study adjusted by an appropriate Margin for Adverse Deviations (MAD). • Mortality and morbidity rates to be used shall be by reference to a published table, unless the insurer has constructed a separate table based on his own experience. • Reserves in respect of linked business shall consist of two components, namely, unit reserves and general fund reserves. **Valuation of Solvency margin** To ensure: • Accurate factors are applied in the computation of the RSM. Every Insurer shall maintain an excess of the value of his assets over the amount of his liabilities not less than the amount arrived at as follows (referred to as the "required solvency margin")

<table>
<tr><th colspan="2">Risks</th><th>Internal Audit Procedures</th></tr>
<tr><td colspan="2"></td><td>fifty crores of rupees; or
the amount arrived as per the formula in section 64VA of the Insurance Act, 1938.
If, at any time an insurer does not maintain the RSM he shall submit a financial plan, of action to correct the deficiency to the Authority.
Every insurer shall furnish to the Authority his returns and a statement certified by the actuary.
Check that minimum 150% of RSM is maintained in line with the regulatory requirements at all points in time.
Ensure maker checker controls exist in computation of ASM and RSM and ensure that these numbers are signed off by the appointed actuary.</td></tr>
<tr><td>D.</td><td colspan="2">Distribution of surplus</td></tr>
<tr><td>(i)</td><td>Regulations pertaining to Distribution of surplus not complied with – Section 49 of the Insurance Act 1938 and IRDA (Distribution of Surplus) Regulations, 2002</td><td>To ensure:
For the purpose of declaring or paying any dividend to shareholders or any bonus to policy-holders only the surplus shown in the valuation balance-sheet in such form as may be specified by the Regulations shall be utilized. This would mean that any bonus or surplus distribution to shareholders or policyholders would be subject to all deficits in the revenue account being funded by shareholders.</td></tr>
</table>

Risks	Internal Audit Procedures
	• Further this surplus can be only by contributions brought in as revenue account applicable to that class or sub-class of insurance business. • The share of any such surplus allocated to the shareholders (including any amount for the payment of dividends guaranteed to them) shall not exceed such specified sum by Authority and which does not exceed ten percent of such surplus in case of participating policies and in other cases the whole thereof. • A life insurer may reserve a part of actuarial surplus arising out of valuation of assets and liabilities which shall be: ◆ 100% in the case of life fund maintained for non-participating policy holders ◆ 1/9th of surplus allocated to policy holders in case of life fund maintained for participating policy holders.
E. IRDA reporting – Actuarial report and abstract	
(i) Non-compliance of section 13 of the Insurance Act, 1938 and IRDA (Actuarial Report & Abstract) Regulations, 2000	To ensure: • An investigation is made by the actuary into the financial condition of the business including a valuation of liabilities every year and abstract of the report is made in accordance with the Regulations.

Risks	Internal Audit Procedures
	• Where an investigation into the financial conditions is made as at a date other than the expiration of the year of account, the accounts for the period since the expiration and the balance sheet as at the date at which the investigation is made shall be prepared and audited. • The Abstracts and Statements shall be furnished to the Authority, within nine months from the end of the period. The following documents need to be attached - ◆ certificate by principal officer that full and accurate particulars of every policy has been furnished to the actuary for investigation. ◆ certificate signed by the appointed actuary to the effect that, the data furnished by the principal officer has been included in the valuation of liabilities for the purpose of investigation. Further it should be ensured that- ◆ reasonable steps have been taken to ensure the accuracy and completeness of the data. ◆ the insurer has complied with provisions of the Act and guidance notes issued by the Actuarial Society of India. ◆ It should also be ensured that the mathematical reserves are adequate to

Risks	Internal Audit Procedures
	meet the insurer's future commitments under the contracts, and the policy-holders' reasonable expectations. • Abstracts and statements shall be prepared separately in respect of: ◆ Linked Business ◆ Non-Linked Business and ◆ Health Insurance Business. • The general principles followed in distribution of profits among policyholders shall be furnished, including following: ◆ A statement, showing total amount of surplus arising during the inter-valuation period, and the allocation of such surplus. ◆ A brief description of treatment adopted for negative reserves and guaranteed surrender value deficiency reserves.
(ii) Inadequate monitoring and review by the Commitee	Check whether periodic review is done by Risk or other appropriate committee formed by the insurer. In case of significant changes in the assumptions, check whether approval of the committee has been obtained.

Chapter 5

New Business

Sub-process:

5.1 Key areas include:

(i) Acceptance of proposals at various touch points.

(ii) Proposals and supporting documentation including Know Your Customer ("KYC") verified.

(iii) Proposal Deposit Receipt is generated.

(iv) Receipt of proposals at Head Office or central processing hub from various touch points for processing

(v) De-duplication check to find whether the customer is never existing one.

(vi) Client master creation / updation process.

(vii) Scanning & Data Entry of Proposals.

(viii) Verification of Data Entry.

(ix) Proposal conversion / cancellation / alteration.

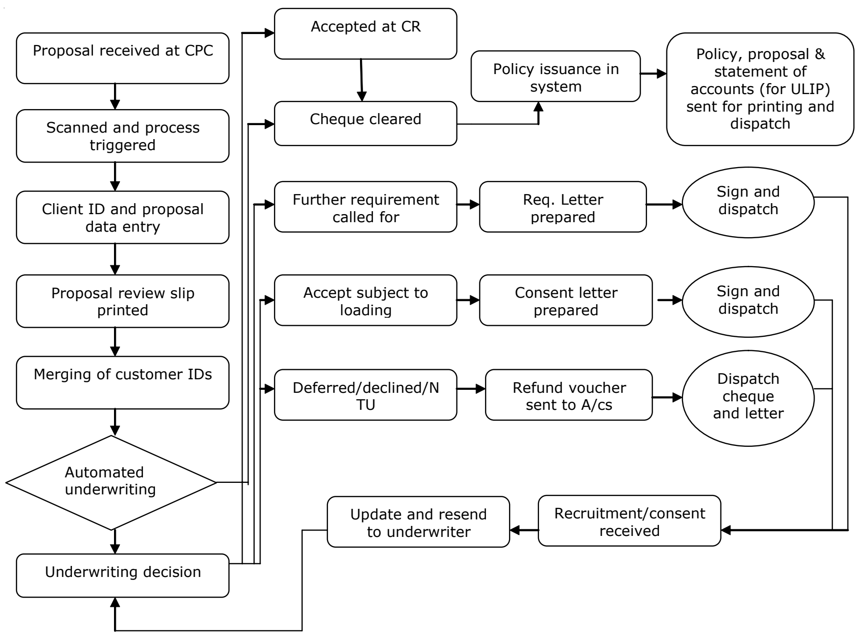
(x) Refund processing.

(xi) Policy dispatch.

(xii) Payment of Stamp Duty.

Scope and Objective:

5.2 The objective of the audit is to review the new business process, evaluate and test the effectiveness of internal controls in place to ensure timely and accurate issuance of policy, and adherence to IRDA Act, rules and regulations regarding the issuance of policy.



5.3 Illustrative Checklist containing risks and audit procedures along with applicable regulations/guidelines/notification/circulars:

Risks	Internal Audit Procedures
A. General points for group policy	
(i) Proposal form not verified/ documentation not complete while accepting proposal	Check control on acceptance of proposals and cursory checks performed at Branches.
(ii) Client ID created with wrong/ incomplete information leading to customer dissatisfaction	Obtain extract of Client IDs and check the completeness and correctness by comparing with proposal Form.

Risks	Internal Audit Procedures
(iii) Duplicate Client ID creation leading to wrong Sum At Risk calculations	Check system control to prevent duplicate ID creation. Review the client ID data for the audit period to indentify duplicate entries.
(iv) Policy on outsourcing not defined/adhered	• Evaluate the policy on outsourcing of the insurer. It should cover aspects like vendor selection, evaluation. review, training, agreements etc. • Check adherence to the policy.
(v) Inadequate controls over outsourced operations. Risks in outsourcing are as follows: • Loss of customer data • Incorrect processing/delayed processing	Evaluate the controls over outsourced operations check: • Agreements with the vendors are valid. • Service Level Agreements (SLA) are in place. • Vendors should have Standard Operating Procedures in place for all activities which should be vetted by the insurer. • Monitoring of Turnaround Time (TAT) by insurer. • Escalation matrix should be defined. • Internal audits carried out by insurer at regular intervals. • Payment made to outsourced vendor are as per agreement. • Outsource vendor should have only limited and need based access to the core system of the insurer. • Process of evaluation of Information Security controls of the vendor. • The storage & retrieval process

Risks	Internal Audit Procedures
	followed by the vendor should be evaluated and audited to ensure that there is no loss of documents.
(vi) Proposals accepted without premium receipt	• Obtain a dump of the policies logged during the audit period and check whether Premium has been received along with applications. • Check the system controls as to whether policy can be issued without application of premium.
(vii) Error in updation of proposal details leading to erroneous underwriting decision and or issuance of incorrect policies	Check the details uploaded in the system with proposal form for fields to identify error with special emphasis on details like height, weight, income, details of product and fund selected by the proposer.
(viii) Erroneous collection of stamp duty for various types of products, incorrect calculation, budgeting and filing of stamp duty, incorrect updation of the revenue receipt no and stamp duty receipt number in the policy document	• Reconcile the stamp duty collected with the total stamp duty paid to the Authority, check the stamp duty calculations for various types of products, check the stamp duty amount and the revenue receipt number printed on the Policy Document for correctness. • Evaluate the controls over budgeting of stamp duty and check whether there has been any shortfall of stamp duty during the audit period. • Check whether records are maintained for stamp duty as required under the Stamp Duty Act. Also check the registered place for policy issuance to determine incidence of stamp duty as rates vary across states.

Risks	Internal Audit Procedures
	Special rates apply for Jammu & Kashmir.
(ix) Delay in policy conversion due to requirements raised in piecemeal	Review the requirements raised for proposals to check whether they could be raised in one go for proposals during the audit period.
(x) Policy converted without checking realisation of cheque	Evaluate the controls to ensure that no policy can be converted without realisation of cheque.
(xi) Alterations made to the proposals not routed through underwriting	Evaluate the process of alteration, at proposal stage to check whether any change impacting the underwriting decision. The proposal is forwarded to underwriting before conversion.
(xii) Back dating of products – risk commencement is not as per the policy of the Company	• Check company policy on backdating and Net Asset Value (NAV) allotment. Backdating should not be allowed beyond the financial year or cash or cheque received date whichever is later. • Total NAV variation on account of backdating should not be more than 1% of fund value.
(xiii) The TAT for policy issuance is not adhered to	Ageing analysis for the policies converted during the audit period should be carried out.
(xiv) Delay in dispatch of policy documents	Check the dispatch records maintained, to check timeliness of dispatch.
(xv) Non receipt of policy documents by policyholder resulting in policyholder grievance	• Evaluate the system of obtaining proof of delivery of policy documents & check the same. • The policy document should be delivered directly to the customer and not to the intermediary to avoid any misconduct by the intermediary.

Risks	Internal Audit Procedures
	• Check the process of handling returned welcome kits at various touch points.
(xvi) Incorrect delayed processing of refund: • Refund made for cases where premium cheques have not cleared • Refund processed where the client had requested for fund transfer • Refund processed where the additional requirements raised had been received • Erroneous bank account details • Refund cheques kept on hold for client retention on the basis of sales request • Delay in processing refunds • Undelivered refund cheques not returned to the refund team • Refund cheques issued twice.	Check the process for refund to ensure that: • Refund is made only for proposals where premium cheque is cleared. • Existance of any system controls to prevent such pay outs. • Receipt of requirements raised, should be checked and processed further. Cases should not be processed for refund. • Bank account details should be pulled out from the system, check whether maker checker control are in in place. • Cheques should not be put on hold beyond the agreed timelines. • Refund is processed as per the agreed TAT. • Undelivered cheques lying at various touchpoints should be returned to the refund team after a defined time period to avoid mis-use. • The request for re-issue of refund cheque, cheque cancellation, stop payment of cheques, correction in the name, etc should be processed only after the receipt of physical cheque/ letter from the client confirming non-receipt.

Risks	Internal Audit Procedures
(xvii) Delay in refund of premium leading to policyholder grievance	Check whether the refund vouchers are processed during the audit period.
(xviii) Unidentified balances lying in premium suspense account	Obtain a policy wise break up of suspense account and review the same.
(xix) Old balances lying in Suspense account which should have been refunded to the proposer	Carry out an ageing analysis of premium suspense account.
(xx) Leakage of customer data	Evaluate controls over data security with regard to customer data by referring to data security policy.
(xxi) Errors in new business and claims reports submitted to IRDA periodically	Extract the policy and claim data from the policy administration system and compare the same with reported numbers.
B. Specific Points for Group Policy:	
(i) Non collection of the requisite business documents	Obtain and check the data of Policies issued in the audit period.
(ii) Details mentioned in the policy contract like the premium rate, cover structure, product type, special conditions etc different from the tender synopsis signed by the client	Check the details of the policy contract with the tender synopsis signed by the policyholder.
(iii) Policy contract issued on the basis of wrong rate quotation	Check that the policy contracts are issued on the basis of the rate quotations signed/approved by actuaries
(iv) Policy contract issued with rate deviation: • As per IRDA circular, deviation not reported • Deviation from rates filed with IRDA without actuarial sign off	Check that the policy contracts are issued on the basis of the rate approved by actuaries. Check whether these deviations have been reported or not.
(v) Policy contracts deviating from standard policy contract.	Obtain the data of Policies issued in the audit period and check the

Risks	Internal Audit Procedures
	same by comparing with the standard policy documents.
(vi) Waivers granted without the approval of actuaries and compliance done regarding the same	Check whether approval obtained from actuaries and compliance done in case of deviation from standard.
(vii) Delay in receipt of member data from policyholder exposing the insurer to the possibility of claim for such cases	• Check the frequency and timeliness of receipt of member data from policyholder by referring to the agreed terms *vis-à-vis* actual receipt of information • Check whether there is any process in place for obtaining no claim certification for such members from the date of insurance cover to the date of intimation to the insurer.
(viii) Confirmation not provided/ delay in confirmation of insurance cover of member in addition to the policyholder leading to policyholder grievance/ issues relating to claims	Evaluate and check the process of providing confirmation of insurance cover to the policyholder.
C. IRDA(Protection of Policyholders Interest) Regulations, 2002	
(i) Decision with regard to the proposals not communicated in writing to the proposer 15 days from the receipt of proposal by the insurer	Check the data of proposals logged during the audit period and to check whether status of perposal has been communicated i.e., acceptance decline, delay in process etc.
(ii) Copy of the proposal form not furnished to the policyholder within 30 days of acceptance of proposal/ incorrect version of Proposal Form being sent in case of Fresh Proposal obtained from proposer. In case of any change in sum Assured, the request form along with revised BI needs to be send .	Check the documents sent with the Policy Documents to find whether the correct proposal Form has been sent and also check the policy issuance date & the date of dispatch of policy.

Risks	Internal Audit Procedures
(iii) Written Proposal Form not being obtained	Understand the process for issuance of policy and Check the proposal forms for the policy documents issued during the period.
(iv) Where the proposal / connected papers are not filled by the prospect, a certificate not obtained from the proposer that the contents of the form & docs have been fully explained to him and he has understood the policy contract	Check the format of the proposal forms for the new products issued during the audit period to ascertain whether the certificate has been incorporated in the proposal form. Also check whether the certificate is being signed by the Proposer by checking of the proposal forms.
(v) Proposal forms do not have a reference to Section 45 of the Insurance Act, 1938.	Check the format of the proposal Forms for the products issued during the audit period.
(vi) Policy document not containing the details as required by IRDA Protection of Policyholder Regulations, 2002	Check the format and content of the policy document issued during the audit period.
(vii) Option of nomination not provided to the Proposer.	Check the format of the proposal forms for the products issued during the audit period.
(viii) Grievance Redressal mechanism & information in respect of Insurance Ombudsman not communicated to the policyholder along with policy document	Check the format of the policy documents and policy documents issued during the audit period.
(ix) Freelook clause of 15 days not included in the policy contract- if the insured disagrees to any terms and conditions he has option to return the policy stating the reasons	Check the format of the policy document and policy documents issued during the audit period.
(x) In case of term plans, premium on Critical illness & health riders exceeds 100% of the basic premium and	Obtain the data of all Policies issued during the audit period and check the same on an analytical basis.

	Risks	Internal Audit Procedures
	premium on other riders exceeds 30% of basic premium	
(xi)	In case of other plans, Premium on all riders exceeds 30% of the basic premium	Obtain the data of all Policies issued during the audit period and check them on an analytical basis.
D	**BI requirements:** **(i) Guidelines for ULIP dated December 21, 2005** **(ii) Circular dated January 2, 2008 on benefit illustration for ULIP products** **(iii) Guidelines for ULIP dated May 3, 2010**	
(i)	ULIP plans BI not duly signed by the proposer and not received along with proposal form	Check the BI of ULIP policies issued during the audit period. Check whether the same has been received along with Proposal Form by checking the stamp date.
(ii)	At the time of rate-up/ loading or underwriting resulting in the changes and revised benefits, the policyholder's sign not obtained on the revised BI	Obtain a dump of cases where there is a rate up/loading and check the same.
(iii)	Date on the BI table not matching with the Proposal Form date. The exception is for cases where revised BI has been procured from the policyholder by way of a requirement letter.	Obtain a dump of cases where there is a rate uploading and check the same
(iv)	The BI does not contain the commission received by the Agent for policies logged from July 1, 2010	Obtain the data of all Policies issued during the audit period and check the same.
E.	**IRDA (Micro-Insurance) Regulations, 2005**	
(i)	Micro insurance contracts exceeds the following limits: Term/ endowment - ₹ 5000 - 50000 cover, term - 5-15 years, age - 18-60 years"	Obtain the data of micro insurance contracts issued during the audit period and check the same.

Risks		Internal Audit Procedures
F.	**The Insurance Act, 1938**	
(i)	Section 41: waiver of premium granted above ₹50 at the time of issuance of policy	Understand and evaluate the system/manual controls for the same.
(ii)	Section 64VB: Risk is not assumed in books until receipt of premium	Check that the policy conversion is not taking place before the credit of premium in the insurer's account or without a deposit for the premium amount being maintained by the policyholder or without a guarantee being provided by the proposer equivalent to the premium amount (in case of Group Policy)
(iii)	Section 64VB: Refund arising due to cancellation/ policy alteration or otherwise not paid directly to the insured. The payment should be by a crossed or order cheque or by postal money order Receipt not obtained from the insured.Refund credited to the account of the agent	Evaluate the process in place for Refund of premium. Obtain the data of Refund done during the audit period and check the same Necessary controls for refund processing needs to be covered.
(iv)	Section 64J and circular on sales illustration dated April 1, 2004: policy document does not contain following policy information statement: • facility for mode and periodicity of premium payment, person or office to be contacted for any enquiry or service relating to policy, importance of advising insurer of any change of address of the policyholder or the nominee, availability of the mechanism to address complaints and grievances of policyholders and also	Check the format of policy document issued during the audit period.

	Risks	Internal Audit Procedures
	information in respect of Insurance Ombudsmen for resolution of any dispute arising from the policy	
G.	**Permanent Account Number**	
(i)	PAN not obtained from all policyholders where the contracted annual premium per policy basis exceeds ₹1 lac	Obtain the data of all policies issued with premium greater than ₹ 1 lakh and check whether PAN is obtained for the same.
(ii)	Whether declaration signed is collected from persons exempted from the requirement of PAN. The declaration should state the provisions of Income Tax Act, 1961 under which they are exempt	Obtain the data of all policies issued with premium greater than ₹ 1 lakh and check that declaration is collected from persons for cases where PAN is not obtained.
(iii)	Copy of Form 49A not obtained from customers who have applied for PAN but still not obtained the same. Form 49 should be acknowledged by agency authorized to collect applications for PAN. The same can be accepted in lieu of PAN. However an undertaking should be obtained from the proposer that the PAN shall be submitted as soon as it is received	Obtain the data of all policies issued with premium greater than ₹ 1 lakh and check the same for cases where customers have applied for PAN.
H.	**Married Women's Property Act, 1874 (MWP Act)**	
(i)	Policies flagged as MWP without obtaining written request for the same. The request should contain the name of beneficiary and the trustee should be obtained along with the Proposal Form.	Obtain the data of MWP Policies issued during the audit period & check the same.
(ii)	Trustee not appointed for policies flagged under MWP.	Obtain the data of MWP Policies issued during the audit period & check the same.

Risks		Internal Audit Procedures
(iii)	Assignment allowed for policies flagged under MWP.	Obtain the data of assignment done during the audit period and check the same.
(iv)	Change of beneficiary done in policies flagged under MWP	Obtain the data of change in nomination done during the audit period and check the same.
(v)	Proposer is either the Trustee or the Beneficiary in MWP Policies. Proposer and Life Assured are not the same person.The Proposer is not a married male.	Obtain the data of MWP Policies issued during the audit period & check the same..
I.	**ULIP Guidelines (Guidelines for ULIP dated December 21, 2005 and May 3, 2010**	
(i)	ULIP Statement is not sent along with the policy Contract in case of ULIP policies.	Obtain the data of all ULIP policies issued during the audit period and check for the same.
(ii)	Minimum Sum Assured not provided. Minimum Sum Assured is - 5 times of Premium (Regular premium), 1.25 times of single premium (where term is less than 10 years), 1.10 times of the single premium (where the term is more than or equal to 10 years)	Evaluate the system control over the same. Obtain the data of all policies issued during the audit period and check for the same.
(iii)	NAV applied is of a date, other than the date of conversion in case of ULIP Policies	Obtain th e data of all ULIP Policies issued during the audit period and check for the same.
J.	**IRDA (Licensing of Insurance Agents) Regulations, 2000**	
(i)	Proposal forms and BIs not signed by licensed agents along with the license no. The Name & License no. of the SP not mentioned in case of Corporate agents.	Obtain the data of all ULIP Policies issued during the audit period and check the proposal forms & BI.

Risks		Internal Audit Procedures
K.	**Guidelines on AML programme for Insurance dated March 31, 2006**	
(i)	Identity proof, address proof and latest photograph not collected for all policies	Check the same for policies issued during the period.
(ii)	Income Proof not obtained for premium greater than ₹ 1 lakh or Income Proof obtained not in line with AML Guidelines.	Obtain a dump of all policies issued where premium is greater than ₹ 1 lakh and check the same.
(iii)	Circular dated February 3, 2010: KYC not done in respect of the beneficial owner - natural person who ultimately controls the customer or on whose behalf the transaction is done	Obtain the data of all policies issued during the audit period and check KYC.
(iv)	Circular no. IRDA/F&I/CIR/ AML/16/02/2010:All records not maintained for 10 years from the date of cessation of contract with the customer	Evaluate the data storage policy of the insurer & check the same.
L.	**Group Policies (Guidelines on Group Insurance Policies dated Jul 14, 2005)**	
(i)	Group insurance provided to a group other than a group formed with a common purpose. The purpose of the group should not be to avail insurance.	• Check that the clients to whom policy has been issued are qualified to be a group . check the object clause of the MOA of the customer to identify the purpose of the group. • Check whether for any case where clarity is not there has been reported to IRDA and policy issued only after obtaining approval from IRDA.
(ii)	Minimum group size not adhered to.	Obtain the data of the Policies issued during the audit period and check whether initial size was in confarmity with the same. Check whether any group has fallen below

Risks	Internal Audit Procedures
	the min required limit as a result of deletions of members.
(iii) Entry into the group insurance policy is not from a clearly identifiable date i.e - Date of appointment or date of availing of loan, or date of next policy anniversary or first of next month.	Check the policy contracts to find whether the insurance is provided from a date which is clearly defined.
(iv) The insurance cover for the member continues even after the date of his exit from the group.	Check the policy contracts to check the same. The policy contract can however provide exception to this.
(v) Sale of group policies through unlicensed intermediaries.	Check that agreement/ referral arrangement/ MOU for sale of group products is entered only with licensed intermediaries by checking the validity of the license of intermediaries.
(vi) In case of Policies sold through CA certificate not being obtained from agent confirming compliance with section 64VB regarding collection and credit of premium, IRDA advertisement regulations, IRDA (Protection of Policyholders Interest) Regulations, 2002 and section 40A and section 40C of Insurance Act, 1938	Check whether certificates are being obtained from the CA on a yearly basis for the policies sold through CA.
(vii) Policy document does not clearly specify the premium charged and benefits admissible to each member are in the Group Policy.	Obtain the data of policies issued during the audit period and check the policy document..
(viii) Policy contract issued without specifying the name of members covered/ without referring to the list maintained	Check whether the list of members is attached to the policy contract. Alternatively whether the policy contract makes a reference to the

Risks	Internal Audit Procedures
in the books of the group organizer.	list list maintained in the books of the group organizer.
(ix) Group Discounts not being passed on to the members of the Group and appropriated by the Group Manager/Agent/ Broker	Check the controls in place
(x) Group Discounts given on arbitrary basis	Check that the group discounts have been granted only on the basis of valid underwriting consideration such as group size. In case where part or whole of the premium is paid by the Group employer the discount may be shared with those who paid the premium in proportion to the premium paid.
(xi) Group Manager collecting amount higher than the Premium charged by the insurer from the individual member	• If the group manager is collecting any service charge from the members to cover his cost, check if the same is disclosed separately and not clubbed with the insurance premium. • Check whether for any case Check the premium amount disclosed in the Certificate of insurance provided to the members match with the member data details of the insurer.
(xii) Certificate of Insurance ("COI") does not contain the minimum required information like details of premium, benefits, terms and conditions, claim procedure	Check the format of COI for different policyholders and also check actual COI issued.
(xiii) COI not issued to all the members of the group in case of non- employer employee Policies	• Evaluate the process of issuance of COI by the insurer or by the group organizer (where the group organizer is issuing COI for operational convenience).

Risks	Internal Audit Procedures
	• Evaluate the controls in place to ensure COI is reaching each and every member of the group.
(xiv) Required guidelines are not followed for issuance of COI by the group manager in case of non-employer employee Policies: • Underwriting guidelines for acceptance or rejection of risk should not require use of judgment • Underwriting guidelines should be such that they can be easily programmed into a computer which will review the acceptance and print COI	Evaluate whether the specified criteria has been met for cases where the group manager is issuing COI.
(xv) Insurer is not taking steps to ensure compliance by the group manager of the group guidelines – either by carrying out surprise inspection or by obtaining certificate from the auditor of the group or manager at least once a year.	Check whether the certificates are received from the auditor/ report of the inspection carried out by the insurer to ensure compliance.

Chapter 6

Underwriting

6.1 A proposal is an application for an insurance cover. The process of verifying the level of risk in each new entrant is called 'selection' or 'underwriting'.

6.2 The factors affecting risks on the life of an individual are called hazards. Hazards may be (i) physical (ii) occupational or (iii) moral.

6.3 The underwriter assesses the risk and determines the premium to be charged. The function of the underwriter is to acquire-or to "write"-business that will bring money to the insurance company, and to protect the company's business from risks that they feel will make a loss. The underwriters may either decline the risk or may provide a quotation in which the premiums have been loaded or in which various exclusions have been stipulated, which restrict the circumstances under which a claim would be accepted and paid.

Sub-process:

6.4 Key areas include:

(i) Acceptance of proposals at touch points

(ii) Scanning and data entry of proposals

(iii) Receipt of proposals from touch points to underwriting hubs/ Head Office

(iv) Client master updation process

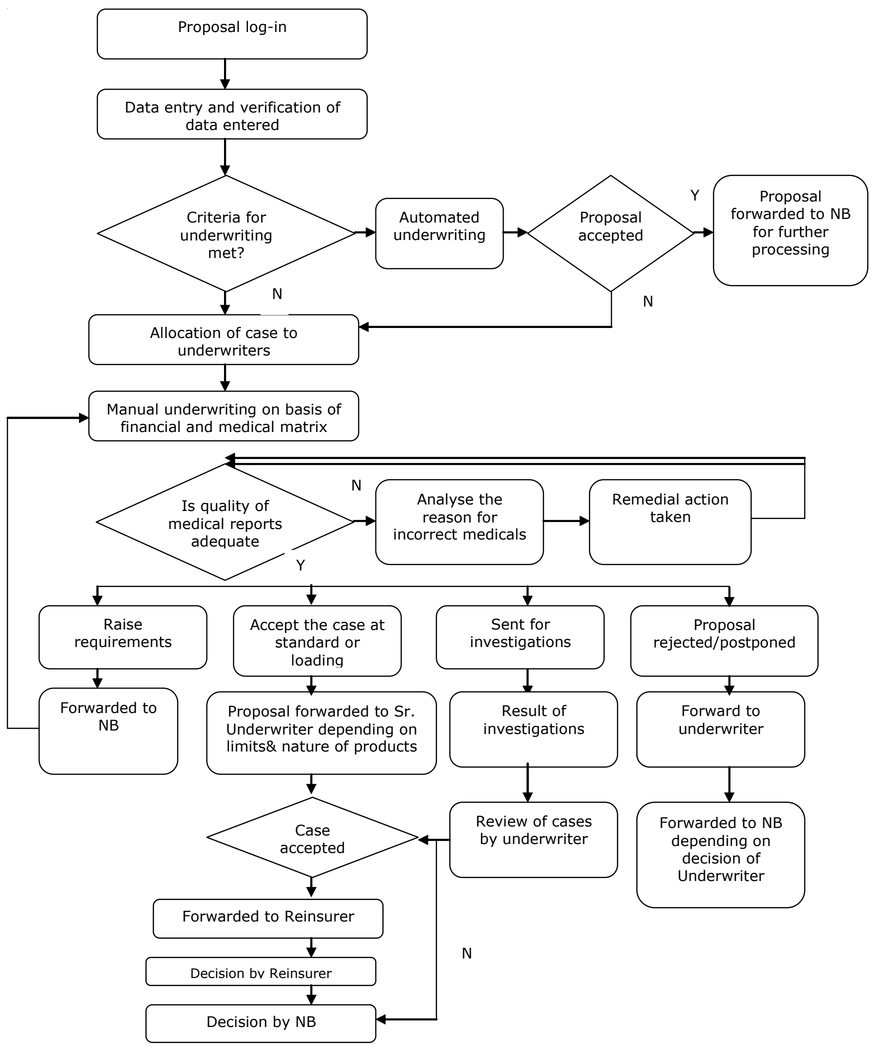
(v) Underwriting decision – Accept, Reject, Postpone

(vi) Refund processing

(vii) Policy dispatch

Scope and Objective:

6.5 The objective of the audit is to review the process of acceptance of risk through the underwriting process and evaluate and test the effectiveness of internal controls in place to ensure timely and accurate issuance of Policy, adherence to IRDA Act, Rules and Regulations regarding the issuance of policy.



6.6 Illustrative checklist containing risks and internal audit procedures along with applicable regulations/ guidelines/ notification/ circulars:

Risks	Internal Audit Procedures
(i) Acceptance of incomplete form; incorrect data entry leading to incorrect underwriting decision	• Check the controls prior to underwriting on acceptance of proposal form (including documentation and KYC checks) • Check adequate controls on data entry which would be used as an input for automated underwriting system.
(ii) Incorrect underwriting decision.	• Check adherence to the underwriting policy of the company. • Check the controls over underwriting decision. Whether any maker/ checker process is followed, cases approved by senior underwriters on the basis of sum at risk. • Check adherence to the underwriting limits fixed for underwriters for non-medical and medical cases. • Check whether there is an internal audit of the underwriting decision by seniors on a periodic basis and steps taken to rectify errors.

Risks	Internal Audit Procedures
(iii) Underwriting limits being given without proper evaluation. Underwriting limits have not been defined in the system.	• Check the process of granting underwriting limits. • There should be audit of underwriting process & the process should clearly define the criteria of evaluation. • The limits should be approved at higher levels and should not be restricted to a single position (multi approval system should be used). • A peer review process of underwriting decisions of underwriters should be in place and limits enhanced/ reduced based on the review results.
(iv) Incorrect parameters set up in the system for automated underwriting/ parameters not in sync with the parameters set for normal underwriting process • Non monitoring of the set parameters • Unauthorised changes to the parameters set up	• Evaluate the process of setting up the parameters and whether it is approved by an appropriate authority • Check whether the parameters set up are reviewed in a timely manner. • Evaluate the controls over setting of new parameters/ changing existing parameters in the system.
(v) Underwriting not done for all cases as per criteria laid down	• Evaluate the controls in the process to ensure that all policies which should have been underwritten are forwarded to the underwriting team.

Risks	Internal Audit Procedures
	• Obtain the dump of all proposals which should have been underwritten and check the same with the proposals forwarded to Underwriter.
(vi) Underwriting not done for Revival cases.	• Ensure that all revival cases are being routed through the underwriting team based on the limits set by the company.
(vii) Underwriting done by underwriters without the authority to underwrite cases (depending on Sum At Risk)	• Check the process for allocation of proposals to underwriters. Check policies to check whether the policies have been underwritten by underwriters with proper limits. Ideally there should be system controls in place.
(viii) Underwriting decision based on invalid documents	• Check that the documents on the basis of which underwriting decision are given are current and not beyond the maximum validity period prescribed. The validity of documents should be included in the underwriting process. • Also check adherence to the AML (KYC) norms of the company during underwriting.
(ix) The Sum At Risk considered by underwriters is incorrect.	• Check the accuracy of Sum at Risk calculated by underwriters. Check that ◆ Non Risk Products are not considered for SAR calculations

Risks	Internal Audit Procedures
	◆ Proposal withdrawn, Policies which have lapsed, surrendered or cancelled should not be considered. ◆ Simultaneous proposals should be included. ◆ Lapsed Policies should be included. • Check the duplication process of the company to identify past proposals/ policies of the applicant. The past underwriting decisions and sum at risk needs to be considered by the underwriter while underwriting.
(x) Underwriting decision not given on the rider component.	• Evaluate the process of ensuring that underwriting decision is obtained on all the components of the Product. • Ensure that underwriting is done in case customer opts at a later stage for change of product, increase in sum assured, etc
(xi) Sum Assured for Riders higher than the maximum allowed as per Product Specification.	• Evaluate the controls in place to ensure that the Rider Sum Assured is in line with the Product feature as per File & Use. By obtaining the data of Sum Assured of the Main Product along with that of Riders offered.

Risks	Internal Audit Procedures
(xii) Policies where the proposer is a third party premium not being considered for Financial underwriting	• Evaluate the process of financial underwriting to check the same.
(xiii) All cases which need to be accepted by Reinsurer before acceptance by KLI (Facultative Reinsurance) not forwarded to Reinsurer.	• Evaluate the control in the process to ensure that 100% of the Facultative cases are being forwarded to the Reinsurer.
(xiv) Intimation not sent to the Reinsurer for cases accepted under auto facultative cases (i.e. cases accepted by insurer without prior approval of Reinsurer as per the agreement with the Reinsurer	• Check whether the auto facultative cases are being sent to the Reinsurer at the agreed frequency and acknowledgement received from the Reinsurer regarding the acceptance of cases • Ensure that there is a process of reconciliation between Insurance Co and the reinsurer
(xv) Cases accepted by underwriters without obtaining acceptance by Reinsurer.	Ensure that all cases are being accepted only after acceptance by Reinsurer.
(xvi) Cases not forwarded to all Reinsurers for obtaining their bid.	• Check whether the cases are being sent to all Reinsurer with whom agreements have been entered into and the cases are placed with the Reinsurer providing the most competitive bid • Check whether the reason for selection of a particular Reinsurer is recorded.

Risks	Internal Audit Procedures
(xvii) Incorrect recording of the Reinsurer may lead to rejection of the claim by the Reinsurer.	Check underwriting cases to ensure that the name of the Reinsurer captured in the system is correct. i.e the name of the Reinsurer is the same as the one with whom the policy has been placed.
(xviii) Incorrect requirements raised ; calling for unnecessary medicals/ financial documents. Cases underwritten without requirements being fulfilled	• Check the requirements raised by underwriters by comparing them to the medical and financial grid laid down in the Process. • Check whether the policy has been issued by policy issuance team for pending cases without underwriting being done.
(xix) Incorrect financial under-writing leading to risk cover provided beyond eligibility thereby creating moral hazard.	Check the financial underwriting decision to confirm that the cover provided is not beyond the eligibility criteria laid down as per process.
(xx) Incorrect loading being charged to clients resulting in financial loss.	• Evaluate the process of arriving at the extra mortality charges. • Check whether the rating captured in the system is correct.
(xxi) Financial/ Medical under-writing limits set wrongly/ not reviewed on the basis of experience	• Evaluate the process of setting up of underwriting limits. Underwriting team should involve product pricing team as well as claim experience team for the same.

Risks	Internal Audit Procedures
	• There should be a process to review the limits on a periodic basis to ensure that the tisks undertaken is appropriately priced and is justified by the claims experience.
(xxii) Feedback not obtained from claims team on the quality of underwriting	• Check whether there is a process of claims team providing feedback on the quality of underwriting on the basis of their claim assessment • Check whether any action is taken against underwriters on the basis of the feedback provided.
(xxiii) Unauthorised exception provided for loading/waiver of medicals and financial documents	Check whether a process has been defined along with approval matrix for providing exceptions and the same has been adhered to
(xxiv) Non receipt of medicals leading to re-medicals.	Evaluate the controls over the process of tracking medicals. Check whether there are any cases of documents getting lost in transit.
(xxv) Medicals not scanned properly leading to delay/ incorrect underwriting.	Check whether scanning of images is proper.
(xxvi) Underwriting decision given in the absence of adequate medical/ finanical documents	Evaluate the controls over the process of document check by underwriters.

Risks	Internal Audit Procedures
(xxvii) Medical/ finanical documents received as per the requirement raised by Underwriters but proposals not forwarded to underwriters for their decision.	Evaluate the controls over the process of forwarding cases to underwriters on receipt of documents called for by underwriters.
(xxviii) Unqualified doctor being empanneled through fraudulant means	• Check whether the process of empanelment of doctors is documented and is done only after collecting appropriate certificates. • Check whether any profile checking is done independently by the insurer before the selection of doctors.
(xxix) Doctor allocation process is not objective.	Evaluate the process of allocation to ensure that the allocation is done on pre-defined criteria and exceptions are not entertained.
(xxx) Non availability of medical centers at location generating good business leading to delay in conversion of policy.	• Check the process in place to ensure that medical centres are established at all locations which allows sourcing of business. The process should also provide for reassessment of existing centres to evaluate their continuance. • Check that there is a process of empanelment/depanelment of medical centres based on Measures of Success

Risks	Internal Audit Procedures
(xxxi) Delay in response of queries from branches relating to underwriting leading to delay in conversion of policy.	Check the actual TAT *vis-à-vis* the agreed TAT for responding to queries.
(xxxii) Incorrect response being provided to branch queries resulting in erroneous medicals / financial details being provided resulting in delay in conversion.	Check the response given to queries. Check that the queries are resolved by trained staff and the quality of response is monitored.
(xxxiii) Underwriting TAT not adhered to leading to delay in issuance of policy.	Carry out an analysis of the underwriting TAT.

Compliance related risks:

Risks	Internal Audit Procedures
A. Anti-money Laundering Guidelines:	
(i) Enhanced due diligence has not been applied in cases where the policy holders are from countries like Uzbekistan, Iran, Pakistan, Turkmenistan, Sao Tome Principe, Northern Part Of Cyprus.	Understand and evaluate the process for due diligence in such case.
(ii) Due diligence not applied in case of change in customer profile.	• Understand the method of identifying such change in customer profile & the steps taken for identification • Evaluate whether appropriate steps are taken and finding recorded in the underwriiting records. Check the compliance to the process laid down.

Risks	Internal Audit Procedures
(iii) Contracts with High Risk customers concluded without the approval of Senior Management officials	• Evaluate the method of identifying high risk customers and their approval • Check whether clear cut guidelines have been prescribed for identification and the level at which such cases can be approved.
(iv) Proposals of Politically exposed persons not approved by Head Underwriter/Chief Risk Officer Level	Check the underwriting approvals.
(v) Proposals coverted without obtaining	• Check whether income proof obtained justifies the total premium to be paid by the proposer for all his Policies • Check whether there are clear cut underwriting guidelines for the same.
B. Keyman Policies	
(i) Keyman Policies issued for other than Term/Preferred Term product.	Obtain the dump of Keyman Policies issued during the audit period and check the same on an analytical basis.
(ii) Life assured is of some one other than an employee or director.	Obtain the dump of Keyman Policies issued during the audit period and check the same
C. Employer-Employee policies	
(i) In case of employer-employee policies, employee alongwith his relatives is having more than 20% stake in the employer company	Obtain the data of employer employee policies issued during the audit period and check the same.
(ii) The employee covered in the employer employee policy is holding a senior management position or involved in taking strategic business decisions in the company.	Obtain the data of employer employee Policies issued during the audit period and check the same.

Risks	Internal Audit Procedures
(iii) The proposal form has not been signed by an authorized signatory of the employer.	Obtain the data of employer employee Policies issued during the audit period and check the same.

Chapter 7
Reinsurance

7.1 Reinsurance is a risk mitigating tool adopted by Insurer whereby the risk underwritten by one Insurer is transferred partially to another Insurer. In other words, Reinsurance means one insurer purchasing coverage from a second insurance company for a risk that the first insurer is insuring.

7.2 Reinsurance is primarily of two types i.e. Quota and Facultative. In case of quota, multiple reinsurance companies accept risks at a predefined ratio. In the case of facultative, a particular risk is underwritten by multiple reinsurance companies, but finally insurance company gives the deal to the company that gives the best deal. Generally, Insurance companies have internal underwriting policies where the following limits are fixed.

(i) ***Retention limit:*** The per life limit up to which insurer does not reinsure the risk. e.g. ₹ 10 lakhs Sum At Risk

(ii) ***Quota limit:*** more than Retention limit but below facultative limit e.g. > ₹ 10 lakhs and < ₹ 20 lakhs

(iii) ***Facultative limit:*** As per limits defined e.g.> ₹ 20 lakhs

7.3 All the figures cited above are examples for better understanding. Sometimes, an individual case beyond 20 lakhs can directly go for facultative where beyond the retention limit everything else would be reinsured.

Scope and Objective:

7.4 The primary objective of the audit is to check and confirm that reinsurance premium calculation and payment is in accordance with the agreement with the reinsurer. Necessary provision has been made for outstanding reinsurance premium and is properly accounted for in books of accounts under respective heads. The internal audit in this regard would normally cover the followings:

(i) Process for entering into agreement with the reinsurer

(ii) Underwriting guidelines on different limits

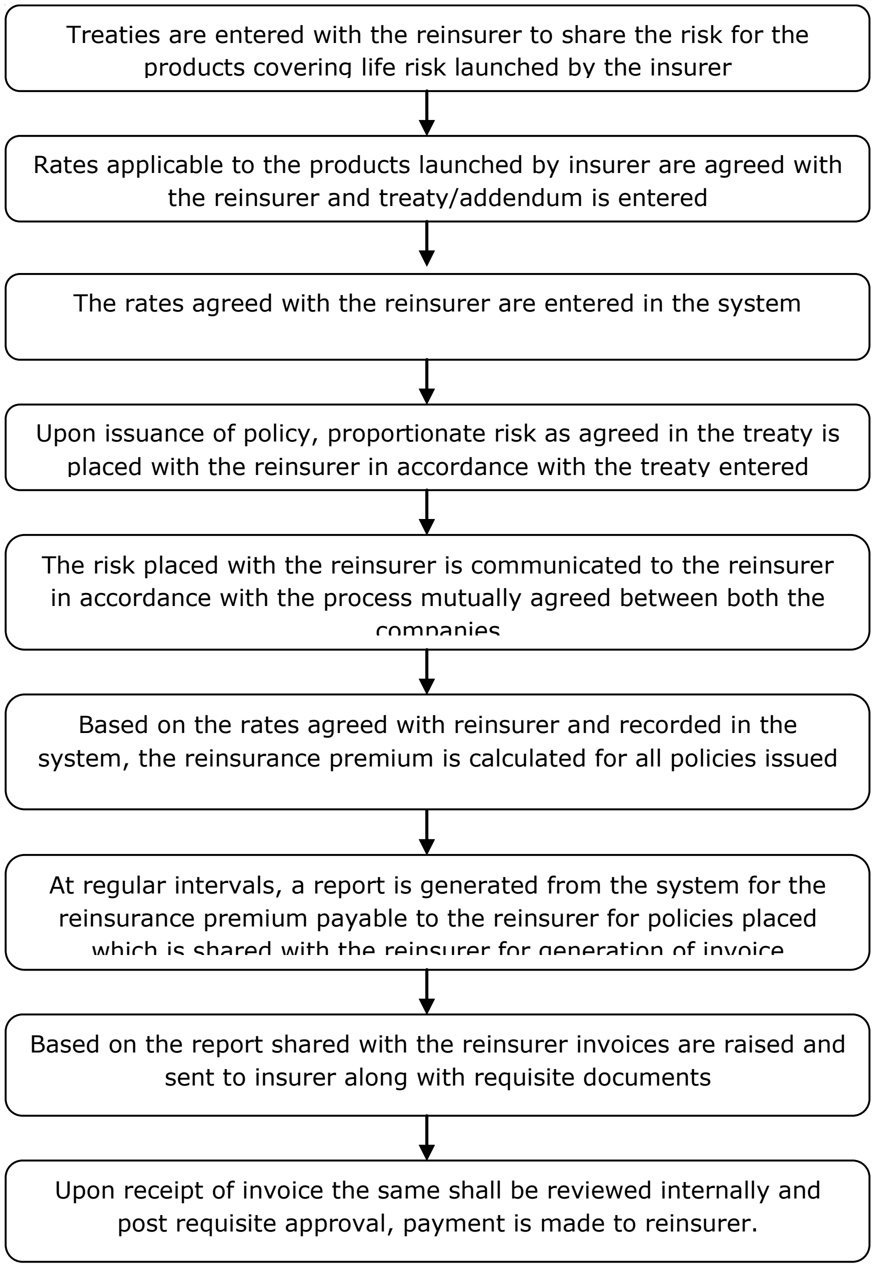
(iii) Process for updation of agreement and system upon launch of products

(iv) Adherence to terms and conditions of the agreement

(v) Process for placement of risk to the reinsurer

(vi) Process followed for reinsurance premium payment

(vii) Recording of reinsurance premium in the books of accounts.


Treaties are entered with the reinsurer to share the risk for the products covering life risk launched by the insurer
Rates applicable to the products launched by insurer are agreed with the reinsurer and treaty/addendum is entered
The rates agreed with the reinsurer are entered in the system
Upon issuance of policy, proportionate risk as agreed in the treaty is placed with the reinsurer in accordance with the treaty entered
The risk placed with the reinsurer is communicated to the reinsurer in accordance with the process mutually agreed between both the companies
Based on the rates agreed with reinsurer and recorded in the system, the reinsurance premium is calculated for all policies issued
At regular intervals, a report is generated from the system for the reinsurance premium payable to the reinsurer for policies placed which is shared with the reinsurer for generation of invoice
Based on the report shared with the reinsurer invoices are raised and sent to insurer along with requisite documents
Upon receipt of invoice the same shall be reviewed internally and post requisite approval, payment is made to reinsurer.

7.5 Illustrative checklist containing risks and internal audit procedures along with applicable regulations/guidelines/notification/ circulars:

Risks	Internal Audit Procedures
(i) The risk is placed with the reinsurer, without or before signing of agreement.	• Check whether agreement is entered with the reinsurer • Check whether any risk is placed with the reinsurer prior to signing of agreement· Check if the addendum to the agreement is signed off by both the parties
(ii) The rates mentioned in the agreement are inaccurately recorded or not recorded in the system.	• Obtain copy of agreement entered with the reinsurer • Obtain a list of products issued by the insurer. • Map the product launched with the agreement to ensure that the agreement covers the entire product launched • Obtain a dump of the system containing the rates uploaded in the system • Match the rates mentioned in the dump with the agreement to identify deviations if any.
(iii) The limit under auto/ facultative agreement is erroneously updated in the system	• Check the auto and facultative limits mentioned in the agreement entered with the reinsurer • Check the adherence to the same.
(iv) Upon launch of new product, the rates for the products launched are not agreed with the reinsurer.	• Obtain a list of all products launched during the audit period

Risks	Internal Audit Procedures
	• Check the agreement to ensure that the new products are incorporated.
(vii) In case of rates agreed with the reinsurers, the rates are not updated in the system.	• Check the rates agreed with the reinsurer (agreement or mail) with the rate applied by the system.
(viii) Delay in updation of rates in the system.	• Check the date of updation of rates in the system with the date of launch of products to identify delays if any • In case of delays, check the rates applied to the policies issued during the delayed period. • In case of erroneous calculation by the system, ensure that the same is communicated to the reinsurer and the reinsurance premium payable is accordingly adjusted.
(ix) Non adherence to terms and conditions mentioned in the agreement.	• Check the adherence of term and conditions of the agreement • In case of deviation, obtain necessary explanation from the actuarial team or concurrence of the reinsurer for the acceptance of deviation • Check if Certain allowable discounts not availed before ceding premium

Risks	Internal Audit Procedures
	• Check if the agreement has any condition for sharing of litigation expenses if any incurred by the insurer.
(x) For the risk placed with the reinsurer, the content is not obtained from the reinsurer.	• Check the process followed for placement of risk to the reinsurer • For the risk placed with the reinsurer, ensure that formal communication (decision) is obtained from the reinsurer for individual policies.
(xi) In case of multiple reinsurers (Quota), error in recording reinsurer in the system leading to erroneous payment to the reinsurers.	• Check the reinsurer recorded in the system with the content received from the reinsurer.
(xii) Upon placement of risk, the same is not communicated to the reinsurer.	• Obtain the list of policies placed with the reinsurer during the audit period • Obtain the communication sent to the reinsurer for placement of risk • Match the above records to identify policies not communicated to the reinsurer.
(xiii) Error in the system, whereby reinsurance cases are not placed with the reinsurer.	• Check the reinsurance agreement to identify the retention limit of the insurer • Obtain a list of policies sold by the insurance insurer and segregate policies with sum assured greater than retention limits

Risks	Internal Audit Procedures
	• Obtain a list of policies placed with the reinsurer • Match the above records to identify deviations.
(xiv) Error in calculation of re-insurance premium either on account of system Bug or manual data entry error.	• Check the system calculation on random basis for different products sold by the insurer
(xv) Rate applicable to one product erroneously applied to another product.	• Check the system calculation on random basis for different products sold by the insurer
(xvi) Delay in making payment to reinsurer.	• Check the timeline agreed in the agreement entered with the reinsurer • Check Penalty or interest clause in the agreement for the delayed payment • Obtain details of actual payouts to identify deviations if any.
(xvii) Error in reversal of reinsurance premium on account of lapsation or surrender of policies.	• Check the reinsurance calculation for the policy lapsed or surrendered • Ensure that proportionate reinsurance premium is claw backed for all the lapsed or surrender policies • Check if the renewal premium is getting skipped in the subsequent months.
(xviii) Multiple reinsurance entries recorded in the system.	• Check the reinsurance payment dump to identify policies wherein erroneously

Risks	Internal Audit Procedures
	multiple premium is calculated due to bug in the system.
(xix) Single customer having multiple customer ids in the system reinsured twice	• Check that each customer is reinsured only once by conducting the de-duplication activity.
(xx) Non provisioning of for unpaid reinsurance premium	• Check the details of unpaid reinsurance premium • Ensure that the same is provided in the books of the insurer.
(xxi) No verification process followed before payment of Reinsurance premium	• Check the process followed for payment of reinsurance premium. • Ensure that a maker-checker process is in place before making payment to the reinsurer. • Check if the data received from IT is verified for the purpose of accuracy and completeness.
(xxii) Reinsurance premium is paid without obtaining requisite approvals.	• Obtain understanding of the internal process laid down for approval of reinsurance premium • Check the adherence of the process laid down.
(xxiii) Non set off of Claims paid against reinsurance payment Settled claims not / shortly recovered from the reinsured on timely basis.	• Examine the process followed by the insurer for set off of claims against the reinsurance payment • In case the claims are to be

Risks	Internal Audit Procedures
	set-off, obtained a list of claims processed from the claims department. • Check the process followed for obtaining the concurrence of the reinsurer before payment of claims. • Check that in all cases, where the policies are reinsured, the claim are recovered from the reinsurer. • Check whether settled claims not are recovered from the reinsured on timely basis.
(xxiv) Non compliance with IRDA (Form LR-8) reporting	• Check that Form LR-8 (quarterly) is submitted within 35 days from quarter end
(xxv) Non compliance with IRDA (Reinsurance program) reporting	• Check that the reinsurance programme, duly certified by the Appointed Actuary, which shall include the name(s) of the reinsurer(s) with whom the insurer proposes to place business, has been filed with the Authority at least forty five days before the commencement of each financial year, by the insurer.
(xxvi) Incomplete & incorrect data used for profit sharing calculation	• Check that rates agreed in agreement for profit sharing are correctly updated in the system • Check that proper data is used for calculation of profit sharing.

Risks	Internal Audit Procedures
(xxvii) Incomplete & incorrect data used for catastrophe premium calculation	• Check that rates agreed in agreement for catastrophe calculation are correctly updated in the system • Check that proper data is used for calculation of catastrophe premium.
(xxviii) Unreconciled Inter-company balance with the reinsurer	• Check whether confirmations are called from all reinsurers for intercompany accounts balance as on 31st December/ March

Chapter 8

Policy Servicing

8.1 Policy contract is a proof of the life insurance contract between the policy holder and the insurer. Therefore it is very important for the insurer to provide adequate services to the policy holder in terms of processing of various requests and processing of premium received from the policy holders. During the life of the policy, there may be following requirements in terms of policy servicing by the policy holder:

(i) Processing and accounting of renewal premium paid by the policy holder

(ii) Processing of FLC requests

(iii) Policy Lapsation and processing of Revival requests

(iv) Processing of surrender requests

(v) Processing of change of name/address/payment mode, nomination/assignment requests

(vi) ULIP policy servicing – Fund top-up and switch-in

Renewal Premium Processing

Scope and Objective:

8.2 Renewal premium means “a premium paid to renew insurance”. It is a fixed amount that is paid for a fixed period in consideration of insurance policy. The primary purpose of life insurance is to secure the financial future of the nominees in case of death of the insured.

8.3 On the basis of the product features the customer pay premium in consideration of insurance coverage and other benefits. If the customer has opted for the premium paying term other than single, he needs to pay till the premium paying term. The Customer can choose his premium paying frequency as *Yearly/ Half Yearly/ Quarterly/ Monthly*. The customer needs to pay the premium regularly to keep the policy "in force". If the premium paying frequency is Monthly, a grace period of 15 days is allowed and if the frequency is other than Monthly, the grace period is 30 days. After the end of the grace period he needs to pay the due amount along with the interest. If the amount with interest is not received within six months from the due date the policy goes into "lapse" status. To revive the policy customer needs to pay his due amount with interest along with the other revival formalities.

8.4 ***Renewal Premium Notices:*** It is the practice of most of the insurers to send regular notices to the policyholder about the premium falling due under the policy.

Mode of Payments:

8.5 Various modes of payment of premium includes manual mode such as by cash, cheques, demand drafts and electronic mode such as credit cards, electronic clearing system ("ECS"), net banking, visa payment, bill payment, etc.

8.6 Where the premium received through cash/cheques/demand drafts, manual data entry is done in PMS and where the premium received through any other mode data entry is done by the vendor and up-loadable files are received which are then uploaded in PMS. In most of the life insurance companies, for accounting of final premiums, files are generated from PMS and uploaded in accounting system. In some cases PMS and accounting systems are closely integrated whereby the entries are passed online.

8.7 The primary objective of the audit is to check and confirm that renewal premium is received as per the due dates and has been processed in time and updated against the correct policy number in the system, appropriate Net Asset Value (NAV) has been applied while unitizing the premium received and that the necessary accounting entries have been passed in the accounting system for the premium received during the day.

8.8 The internal audit in this regard would normally cover:

(i) Process for receipt of premium through different mode and necessary updation in system

(ii) Monitoring of premium due dates and sending of notices to the policy holder

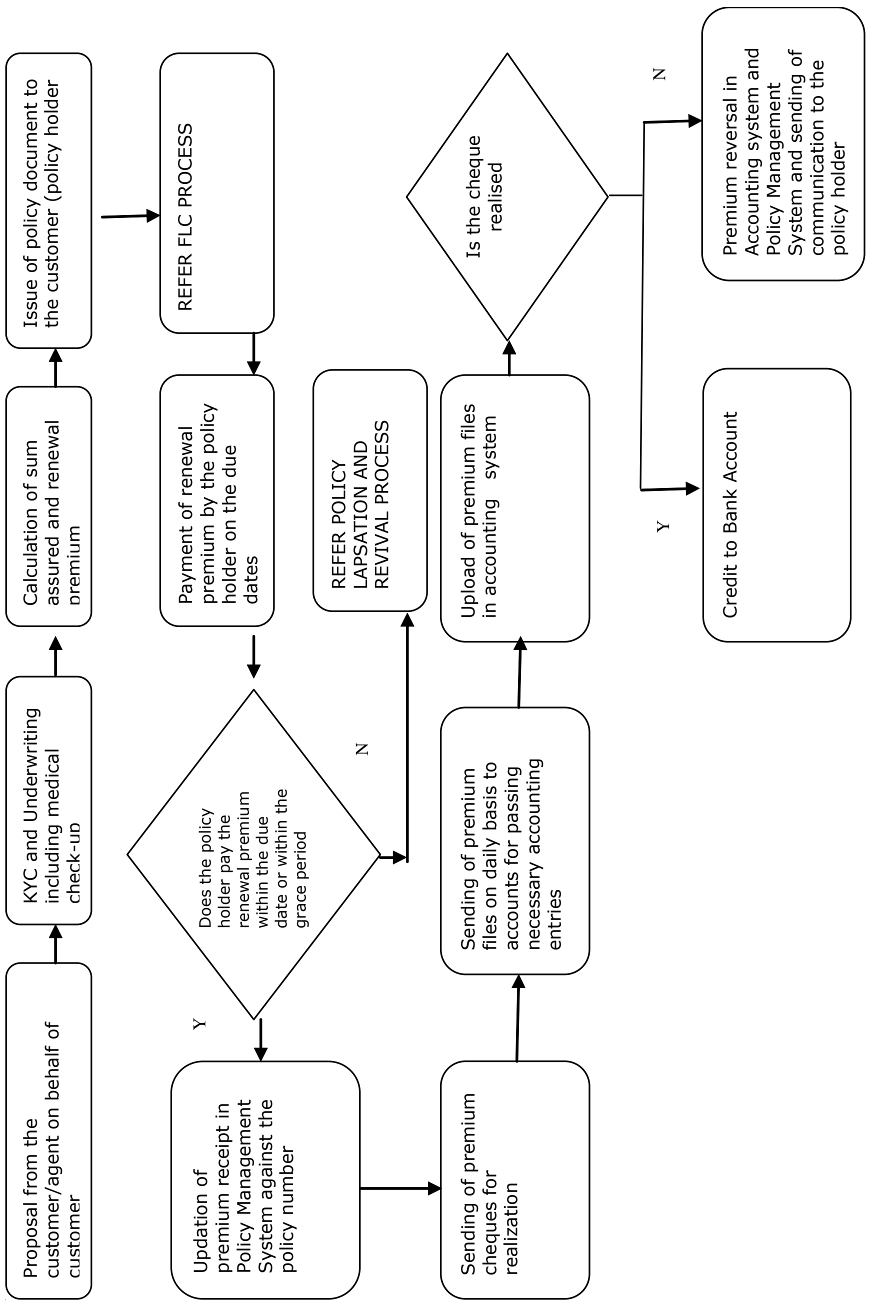
(iii) Timeliness for processing of premium proceeds received and consequent unit allocation

(iv) Application of correct NAV

(v) Process of updation of EFT/ECS against the policy number

(vi) Process for revenue recognition

(vii) Process and controls for marking lapsation in case of non-receipt of premium.


Proposal from the customer/agent on behalf of customer
KYC and Underwriting including medical check-up
Calculation of sum assured and renewal premium
Issue of policy document to the customer (policy holder
REFER FLC PROCESS
Payment of renewal premium by the policy holder on the due dates
Does the policy holder pay the renewal premium within the due date or within the grace period
Y
N
REFER POLICY LAPSATION AND REVIVAL PROCESS
Updation of premium receipt in Policy Management System against the policy number
Sending of premium cheques for realization
Sending of premium files on daily basis to accounts for passing necessary accounting entries
Upload of premium files in accounting system
Is the cheque realised
Y
N
Credit to Bank Account
Premium reversal in Accounting system and Policy Management System and sending of communication to the policy holder

8.9 Illustrative Checklist containing risks and internal audit procedures along with applicable regulations/guidelines/notification/ circulars:

Risks	Internal Audit Procedures
(i) Incorrect billing of premium	Check existence of adequate controls at new business stage for updation of correct details of the policy and accurate due dates in the system • Check whether the system generates notices based on the due dates entered • Check whether adequate monitoring is in place in the form of checklist to ensure that notices are generated with accurate due dates and premium amounts from the system • Whether these notices are verified by the policy servicing department to ensure correctness and dispatched on timely basis • Check the TAT for dispatch of notices.
(ii) Incorrect NAV application	• Check whether NAV is correctly applied.
(iii) Data entry errors/incorrect updation of renewal premium like the following may lead to incorrect "lapsation" of the policy: • Against different policy number • Incorrect amount	Check existence of adequate controls at branches/processing centers, viz.,: • Adequate checking of policy number, cheque number, signature, etc on receipt of instruments

Risks	Internal Audit Procedures
	• Check the condition of the instrument – mutilated/stale cheques, post dated cheques • Ensure adequate maker checker controls exist at the receiving point for verification of instruments • System controls for entering details – whether available only with selected employees • Existence of maker-checker control for entering the details in the PMS Also check whether the branch checklist contains all the above points and is signed-off by the maker and the reviewer.
(iv) Delays in processing of renewal premium: Since the number of transactions involving renewal premiums is voluminous, there may be delays in entering the details of the cheques received at the branches/processing centres. Also there is possibility of certain cheques missed out for entry in the PMS.	• Check whether the process for data entry in PMS is clearly defined as part of the Standard Operating procedures and is monitored on regular basis • Check whether adequate checklists are in place to monitor the daily activities in the branches • Check whether instruments received are entered in the system on the same day especially in the case of ULIPs • Check whether reconciliation is done on daily basis

Risks	Internal Audit Procedures
	between the instruments received and details entered in the system • Check whether MIS of the instruments received on daily basis is maintained and tallied with the number of instruments before sending the details to accounts team.
(v) Incorrect revenue recognition	• Premium received before due date shouldn't be recognized as premium. • Whether premium due but not received is monitored on monthly/fortnightly basis and appropriate changes in the policy status is verified • All the premium recorded in PMS to be matched with the premium account in the books of account. • Check whether daily premium reconciliation is in place for various products vis ULIP/Non-ULIP/Group products between PMS and accounting system. Ensure there is no manual intervention of data repair during this process • Check completeness of accounting of all the cheques received at branches. Whether MIS is mantained at

Risks	Internal Audit Procedures
	the branches for cheques received and the same is tallied with the entries made in the PMS and accounting system • Check the process of passing reversal entries in the system. Whether reversal entries are supported with valid reasons such as the payments rejected due to insufficient funds in the customer account, signature mismatch, invalid accounts, etc. Check whether the reversal entries are passed in both the PMS and the accounting system • Also check the impact of NAV in case of reversal • Premium received is accounted on due date • Check procedures for monitoring of Suspense Accounts i.e. partial premium received or premium received in advance
(vi) Non-receipt of premium thereby affecting the insurer's business	• Imparting of regular trainings to the agents about the product features and in turn communication with the policy holders • Rewards and recognition for the agents who are able to recover policy premiums from

Risks	Internal Audit Procedures
	the policy holder on timely basis • Check whether adequate follow-up is done by the insurer with the policy-holders on regular basis by sending letters/emails
(vii) Incorrect updation of credit card details/ credit card not in the name of policy holder	• Check whether the insurer have adequate controls in place to check whether the credit card is only in the name of policy holder and that the credit card is valid • Whether signature verification is done with the original proposal form • Whether credit card as a mode of payment is activated in the PMS only after checking the above details • Whether activation letters are sent to the policy holder on timely basis • Check whether credit card number is recorded in PMS or any other equivalent system with encryption. As per PCI DSS (Payment Card Industry-Data Security Standards), the numbers should not be captured by the merchant in an open form.
(viii) Incorrect updation of account details in case of ECS payments	• Check existence of adequate controls in place to ensure that the bank account details

Risks	Internal Audit Procedures
	provided by the policy holder are correct • Check whether there are maker-checker control to ensure that details regarding bank accounts sent to the vendor are correct
(ix) Policy premiums in case of group policies	• Check whether renewal premiums are received from the master policy holder/ authorized person within the due dates • Check whether addition/ deletion to the policy cover is signed by the master policy holder/authorized person

Free look Cancellation (FLC)

Scope and Objective:

8.10 As per clause 6(2) of IRDA (Protection of Policyholders Interest) Regulations, 2002, *"the insurer shall inform by the letter forwarding the policy that he has a period of 15 days from the date of receipt of the policy document to review the terms and conditions of the policy and where the insured disagrees to any of those terms or conditions, he has the option to return the policy stating the reasons for his objection, when he shall be entitled to a refund of the premium paid, subject only to a deduction of a proportionate risk premium for the period on cover and the expenses incurred by the insurer on medical examination of the proposer and stamp duty charges"*.

8.11 Accordingly, FLC is an option provided to the policyholder wherein he has a period of 15 days from the date of receipt of the policy document to review the Terms & Conditions of the policy and in case of disagreement to any of the terms & conditions, he/she has the option to return the policy stating the reason for policy's cancellation.

8.12 FLC requests can be received through any mode –e-mail, fax and letters depending on insurer's policy. In case of written letters the signature of the policy holder should be matched with the original proposal form. FLC request is processed only when the policy holder is not satisfied with the terms and conditions of the policy document and not for any other reasons. FLC refund is paid either by cheque or in case the policy holder wants direct credit, then consent for direct credit along with cancelled cheque for bank account details is submitted.

8.13 FLC refund is calculated as follows:

First Premium Paid (less) proportionate risk premium (less) medical charges, if incurred by the insurer

8.14 The primary objective of the audit is to check and confirm that FLC requests are received within 15 days from receipt of policy document by the policy holder, verification of signatures of the policy holder and processing of FLC request within TAT defined by the insurer. Also checking of appropriate accounting entries are recorded for refund.

8.15 The internal audit in this regard would normally cover1

(i) Process for receipt of FLC requests

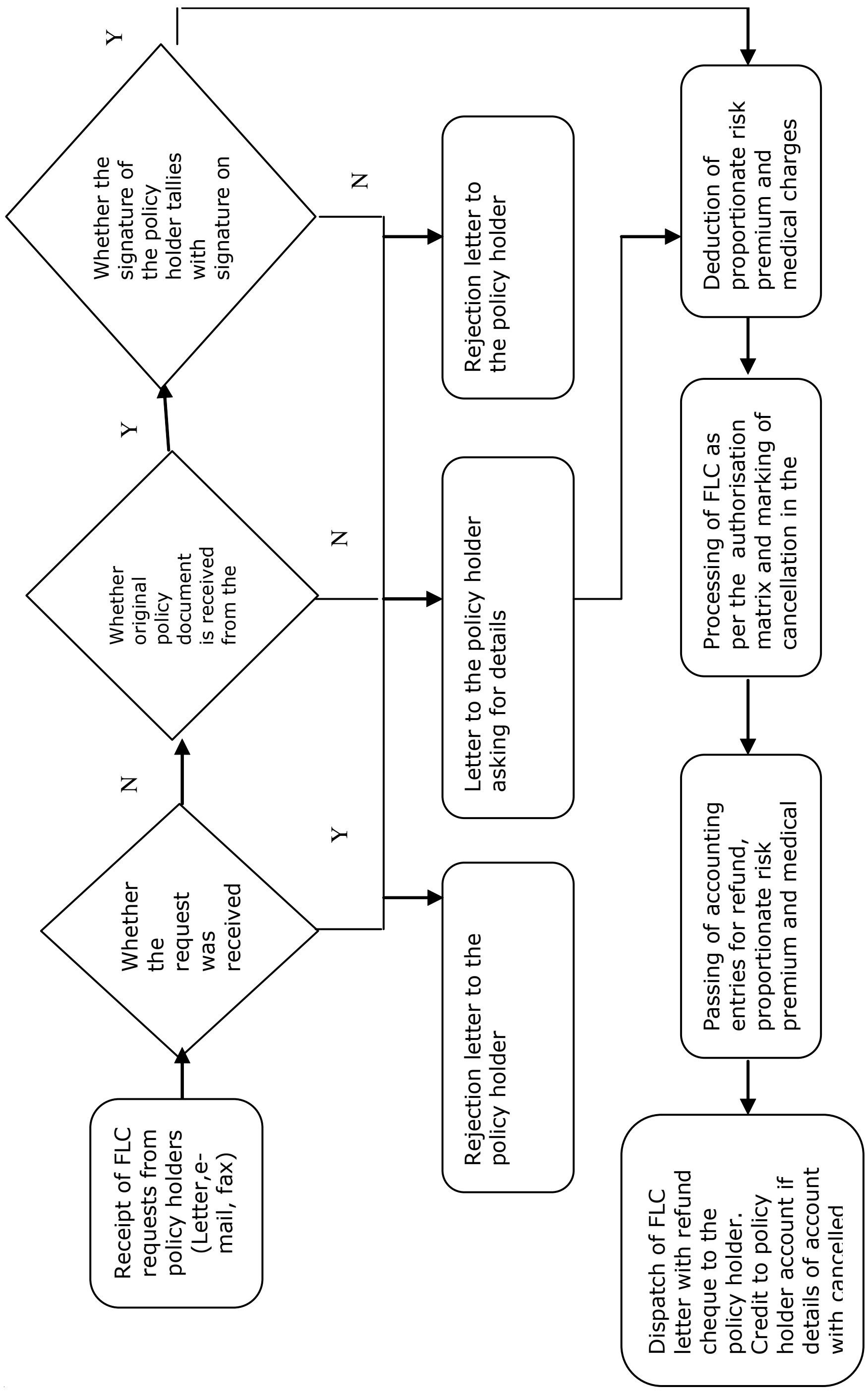
(ii) Signature verification and genuiness of request – whether it was due to non-satisfaction with the terms and conditions of the policy

(iii) Timeliness for processing of FLC

(iv) Process of updation of FLC against the policy number

(v) Process for passing accounting entries

(vi) Checking of FLC refund amount and dispatch to the policy holder


Receipt of FLC requests from policy holders (Letter,e-mail, fax)
Whether the request was received
N
Y
Rejection letter to the policy holder
Whether original policy document is received from the
Y
N
Letter to the policy holder asking for details
Whether the signature of the policy holder tallies with signature on
Y
N
Rejection letter to the policy holder
Deduction of proportionate risk premium and medical charges
Processing of FLC as per the authorisation matrix and marking of cancellation in the
Passing of accounting entries for refund, proportionate risk premium and medical
Dispatch of FLC letter with refund cheque to the policy holder. Credit to policy holder account if details of account with cancelled

8.16 Illustrative checklist containing risks and internal audit procedures along with applicable regulations/guidelines/notification/circulars:

Risks	Internal Audit Procedures
(i) FLC request is not received withn 15 days from receipt of policy documents	• Check whether stamp is affixed on the FLC requests received at the Branches • Check whether FLC is processed only if it is received within 15 days from receipt of policy document. Since in most of the situation the policy receipt date is not available, the period within which FLC request can be received should be mentioned in the insurer's policy
(ii) Forged signatures on FLC requests	• Check existence of checklists for FLC processing which would involve signature verification with the original proposal form, witness signature in case of thumb impression/ request in vernacular language • Check existence of maker checker control for FLC processing.
(iii) Duplicate FLC requests	• Check whether FLC is marked in the system immediately on verification of relevant documents and signature verification • Check whether the insurer has a system of affixing "cancelled" stamp on the

Risks	Internal Audit Procedures
	original policy document once FLC has been processed.
(iv) Delay in processing FLC request	• Whether checks are in place to ensure that in case of ULIP product, the FLC has been processed on the same day • Whether date and time of inward should be affixed on the requests and sent to CPC for further processing • Check the timeliness for processing of FLC request.
(v) Incorrect calculation of FLC amount	• Check whether adequate maker checker controls are in place for processing of FLC. If the refund amount is calculated through system, check whether system parameters for calculation of refund are reviewed on regular basis. • Whether authorization for approving the refund amount in the system is available only with few people • Check whether appropriate risk premium and medical charge are deducted from the premium amount.
(vi) Incorrect refund of FLC	• Check whether FLC refund cheques are verified for name and amount before despatch to the policy holder.

Risks	Internal Audit Procedures
(vii) Incorrect credit of FLC amount. Since FLC amount can also be directly credited to policy holder account on receipt of request from him, there is risk of the amount being credited to incorrect bank account.	• Whether the insurer has adequate checks in place to insure the account number mentioned in the FLC request form matches with the cancelled cheque provided by the policy holder • Check whether the account number mentioned is that of the agent by checking it with the agent master data.
(viii) Non-deduction of commission	• Check whether adequate information is flowing back to commission processing system for recovery • Check if FLC under processing just before commission cycle are informed separately to commission processing team to withhold commission.
Reputational risks due to misselling	• Adequate monitoring of agent-wise FLC requests, since there is a possibility that the agents may not have explained the correct policy features to the policy holder and may have got the business by misselling the product • Check action taken by the insurer on the agent having large number of FLC requests • Check whether FLC is

Risks	Internal Audit Procedures
	processed only if it is received due to non-satisfaction of terms and conditions of the policy document and not for any other reason.

Policy Lapse and Revival

Scope and Objective:

8.17 "Lapse" is the discontinuance of the policy owing to non-payment of premium dues. The term "lapse" is not defined in the insurance legislation, except stating that *"a policy which has acquired a surrender value shall be kept alive to the extent of the paid up sum assured"* - vide section 113(2) of the Insurance Act, 1938.

8.18 In order to keep a life insurance policy "in force" the policy holder is required to pay premiums when due (either monthly/ quarterly/annual/bi-annual). If payment is missed, the insurer allows a period of 15/30 days from the premium due date for making the payment. This period is termed as "grace period". If the policy holder does not make the payment within the grace period, the policy gets "lapsed". Thus, a payment within the grace period is deemed to be a payment on the due date.

8.19 Lapsation affects all the stakeholders – the policy holder, agents and the insurer. A lapsed policy ceases to provide insurance protection to the insured. It forfeits the benefits under the policy and cost of new policy is higher. Agents do not get renewal premium commission if the policy is lapsed. It is permanent and irreparable loss to the agent. Lapsation means a loss of goodwill to the insurer. With early lapse, the insurance companies are not able to recover the procuration cost. The agents' compensation in terms of high first year commission, bonuses and rewards proves unproductive.

The cash flows get impacted and hits profitability and Embedded Value.

8.20 The terms and conditions of the policy stipulate, that where the premium is not paid within the grace period, the policy lapses but may be revived during the life time of the life assured. Some insurers do not allow revival, if the policy has remained in lapsed condition for more than five years. This is because of the possibility that the arrears of premiums on such a policy would be too heavy and that it would be better to take out a fresh policy

8.21 As per clause 3 of IRDA (Treatment of Discontinued Linked Insurance Policies) Regulations, 2010 pertaining to ULIPs, *"The grace period for payment of the premium for all types of linked insurance policies shall be as follows:*

(i) Fifteen days, where the policyholder pays the premium on monthly basis;

(ii) Thirty days, in all other cases."

8.22 As per clause 1(vi) of the said regulation, *"Discontinuance means the state of the policy that could arise on account of non-payment of the contracted premium due before the expiry of the notice period."* The notice has to be sent by the insurer within a period of fifteen days from the expiry of the grace period to the policy holder to exercise the option within a period of thirty days of receipt of such notice

8.23 As per clause 1(vii) of the said Regulation, *"Lock-in-period means the period of five consecutive years from the date of commencement of the policy, during which the proceeds of the discontinued policies cannot be paid by the insurer to the policy holder or to the insured, as the case may be, except in the case of death or upon the happening of any contingency covered under the policy."*

8.24 As per clause 4 of the Regulation, *"A policyholder shall be entitled to exercise one of the following options upon the discontinuance of the policy:*

(i) Revival of the policy, or

(ii) Complete withdrawal from the policy without any risk cover.

8.25 For revival of polices, generally, following are necessary to be given by the policy holder:

(i) Arrears of outstanding premiums with interest

(ii) Proof of health

(iii) A fee for reinstatement or revival

8.26 In case of most of the insurers, if the period for which the premiums have been paid under the policy as on the date of lapse is more than 5 years and revival request is received within 12 months from the date of lapsation, the policy holder will only have to pay premium arrears and interest charges. Proof of health is not required. If the revival request is received after 12 months from the date of lapsation, proof of health is also to be given along with arrears and interest charges.

8.27 The insurer should have taken persistent measures for monitoring receipt of renewal premium within the due dates. In case of most of insurers, policy lapsation is tracked over the PMS, wherein premium due dates are monitored by the system once initial data of the policy is entered in the system.

8.28 The primary objective of the audit is to check and confirm that due dates are recorded and monitored properly and polices are marked as "lapsed" on non-receipt of renewal premium within due dates/grace period. In case of revival request, whether adequate checks are in place for receipt of outstanding amounts and adequate documents are obtained before reviving the policy

8.29 The internal audit process should cover:

(i) Process for updation and tracking due dates

(ii) Marking of "lapsed" status in the system

(iii) Process of issuance of lapse notice and records of dispatch as it is a mandatory requirement

(iv) Signature verification of revival request

(v) Timeliness for processing of revival request

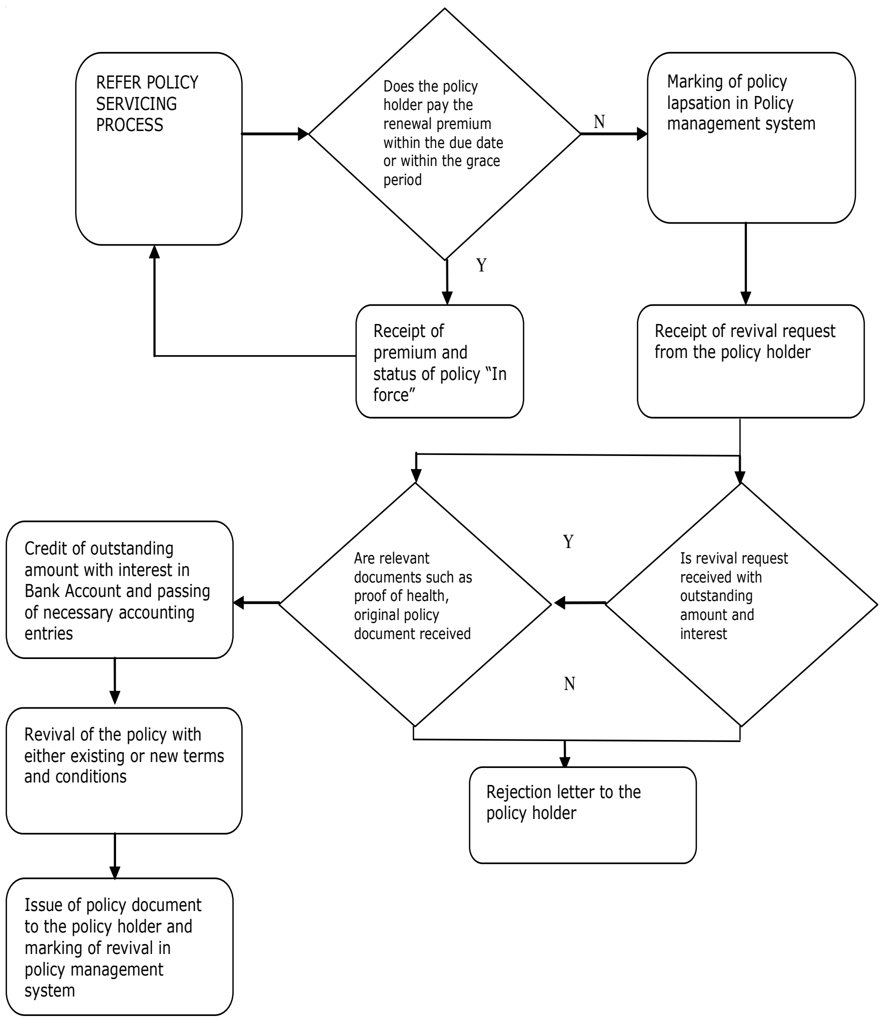
(vi) Process of updation of revival against the policy number

(vii) Process for passing accounting entries

(viii) Communication to the policy holder

(ix) Calculation of outstanding amount, interest and revival charges

(x) Agent-wise policy lapsation.



8.30 Illustrative checklist containing risks and internal audit procedures along with applicable regulations/guidelines/notification/circulars:

Risks	Internal Audit Procedures
(i) Incorrect tracking of due dates in the system	• Check whether maker – checker controls are in place for entering the details in the system when a new policy is issued to ensure that details such as premium amount, renewal premium due dates, etc are correctly updated in the system as per the policy document • Whether periodic reviews of the system is done to check whether the due date calculation is done properly • Check whether grace period of 15/30 days is given to the policy holder for payment of renewal premium. If the premium amount is not paid during the grace period also whether the policy is marked as "lapsed".
(ii) Incorrect updation of policy details	• Check the controls at the Branches and processing centre for receiving premium cheques and recording of relevant entries in the PMS for receipt of premium • Check existence of maker checker controls to ensure the premium received is updated against the correct policy number.

Risks	Internal Audit Procedures
(iii) Processing of revival request without receiving relevant documents	• Check as per the insurer's internal policies whether declaration of health is received and checked by the medical officer of the insurer. • Check whether the Proof of Health is signed by life assured/ policy holder and duly witnessed. In thumb impression cases, check whether it is witnessed by a bank manager/ gazetted officer. In the case of minor life assured becoming a major the revival request is signed by life assured only. Also check whether his/her signature is attested by a bank manager/ gazzetted officer. • Check whether all such cases are routed through underwriting or a similar department to ensure a fresh look at the health of the life assured.
(iv) Incorrect Lapsation in System	• Check whether system set up for lapsation of policy is correct. The policy should be lapsed only after grace period is over. • Check post lapsation, lapse notices are printed for all cases. • Check all the notices are dispatched and properly recorded.

Risks	Internal Audit Procedures
(v) Professionalism in marketing. High instances of surrender requests of policies sold by particular agent	• Check whether agents are provided with adequate trainings to keep updated with the policy features and recent amendments. Most of the policies get lapsed due to inadequate communication regarding policy features to the policy holders.
(vi) Processing of policy claims requests during lapsation period	• Check whether the policy is marked as "lapsed" immediately on non receipt of renewal premium within due dates • Check whether claim requests are automatically rejected by the system when the policy is in "lapsed" status.
(vii) Non receipt of interest charges for revival of policy	• Check whether all the outstanding dues along with interest amount is received before reviving the policy • In case the insurer policy refers to waiver of interest, check adherence to approval matrix.
(viii) Receipt of death claim within the grace period in the case of group policies	• Check whether due and unpaid renewal premium for the entire group is received from the master policy holder before processing of claim request
(ix) Processing of revival request received after 5 years of policy lapsation	• Check the date of receipt of revival requests *vis-à-vis* the date of policy lapsation

Risks	Internal Audit Procedures
	in the system. Revival request should not be processed if the first unpaid premium is for > 5 years as on date of revival, and rejection letters should be sent to the policy holder
(x) Incorrect accounting entry for policy surrender	• Check whether correct details are sent to accounts for recording appropriate accounting entries • Check whether correct amount is paid to the policy holder.

Policy Surrender

Scope and Objective:

8.31 Surrender of an insurance policy refers to the voluntary termination of the insurance contract before the expiry of the term of the contract. The process of surrender is initiated by the policy holder. A policy becomes eligible for surrender on completion of 3 years from the commencement of the policy provided that 3 years premium have been paid within the due dates.

8.32 The policy holder has to submit surrender request form duly signed off by him at branch/processing centre along with the original policy document and the discharge voucher. Eligibility for surrender is mentioned in the policy document. The policy can be surrendered only when the insured person is alive.

8.33 The primary objective of the audit is to check and confirm that surrender requests are received from the policy holder only, and that adequate controls are in place to ensure proper verification process for checking of request, whether premiums are paid on regular basis. Check whether surrender amount is paid only to the policy holder and is paid only as per terms and conditions mentioned in the policy document and passing of necessary accounting entries.

8.34 The internal audit should cover:

(i) Process of verification of surrender requests

(ii) Calculation of surrender amount and payment thereof

(iii) Signature verification of surrender request

(iv) Timeliness for processing of surrender request

(v) Process of updation of surrender against the policy number

(vi) Process for passing accounting entries

(vii) Communication to the policy holder

(viii) Agent-wise surrender requests.

Receipt of surrender request on daily basis at the branches/processing centres

↓

Checking of required documents: signed surrender request form, original policy document and discharge voucher

↓

Checking of signature with the original proposal

↓

In case if everything is correct, the request is entered in the system with date and time details for ULIP products (received before 3 p.m.– processed on the same day and received after 3 p.m. processed on the

↓

Passing of necessary entries in the accounting system

↓

Updation of surrender details in the PMS and retaining the surrender request with the original policy document

Receipt of cheques from accounts and dispatched to the policy holder

↓

Approval of surrender as per the authority matrix and sending request to the accounts team

8.35 Illustrative checklist containing risks and internal audit procedures along with applicable regulations/guidelines/notification/circulars:

Risks	Internal Audit Procedures
(i) Surrender request received from a person other than the policy holder/ assignee and duplicate surrender requests	• Check whether surrender requests are time stamped to ensure that all cases received 3 p.m. on any working day are processed on the same day
Forged signatures on the surrender request forms	• Check whether adequate controls are in place at the branches to check the signatures on the surrender requests vis-à-vis the actual proposal form. • In case the policy holder has signed in vernacular language then whether the same is witnessed by an English knowing person. • In case the policy has been issued on the life of a minor and at the time of surrender request, minor becomes major then the request for surrender is executed by him only as he has become the policyholder. • Whether signature of the minor turned major on the surrender request is attested by a gazzetted officer. In case of assigned policies the request for surrender should be received from assignee

Risks	Internal Audit Procedures
	with the consent of policyholder. • Check whether amount surrendered is not reinvested again in new product by the same or different advisor as customer will have to bear surrender charges.
(ii) Non receipt of original policy document	• Check whether original policy document and discharge voucher are received along with the surrender request form. In case of non receipt of original policy document whether letter asking for original policy document is sent to the policy holder and surrender request is processed only on receipt of the same.
(iii) Duplicate surrender request	• Check whether policy holder's signature is obtained on the surrender discharge form as an acknowledgement for receipt of surrender value· Check in case of assigned policy, whether policy holder consent/no objection is taken to settle the surrender value in favour of the assignee.
(iv) Processing of surrender request in policy lapsation stage	• Check whether status of the policy is verified when surrender request is received. Normally, a lapsed policy cannot be surrendered.

Risks	Internal Audit Procedures
Receipt of Surrender request without paying renewal premiums	• Check whether the insurer has authorization matrix in place for processing of surrender requests.
(v) Surrender amount paid without payment of 3 consecutive years premium amount	• Check whether adequate tracking of premium payments is done by the system. If the surrender request is received without paying 3 consecutive years' premium payments, check whether the request is rejected.
(vi) Incorrect calculation of surrender value	• Check whether adequate controls are in place in the form of maker checker controls to calculate surrender value • Ensure that surrender charges are deducted accurately • Top up surrenders are executed only after lock in period • Partial surrenders are allowed only if permitted by the product and the Sum Assured is adjusted accordingly • Check on system set up of surrender charges.
(vii) Incorrect reduction in sum assured	• Check whether required documents have been received

Risks	Internal Audit Procedures
	• Check the manner of booking such reduction in the PMS · Check whether alteration fees if any, is received • Reduced sum assured should be more than or equal to the minimum sum assured required under the plan.

Nomination/Assignment/ Change of address/ Change of payment mode/Change of name:

Scope and Objective:

8.36 Section 39 of the Insurance Act, 1938 reads*: "(1) The holder of a policy of life insurance on his own life, may, when effecting the policy or at any time before the policy matures for payment, nominate the person or persons to whom the money secured by the policy shall be paid in the event of his death:*

***Provided** that, where any nominee is a minor, it shall be lawful for the policy holder to appoint in the prescribed manner any person to receive the money secured by the policy in the event of his death during the minority of the nominee*

(2) Any such nomination in order to be effectual shall, unless it is incorporated in the text of the policy itself, be made by an endorsement on the policy communicated to the insurer and registered by him in the records relating to the policy and any such nomination may at any time before the policy matures for payment be cancelled or changed by an endorsement or a further endorsement or a will, as the case may be, but unless notice in writing of any such cancellation or change has been delivered to the insurer, the insurer shall not be liable for any payment under the policy made bona fide by him to a nominee mentioned in the text of the policy or registered in records of the insurer.

(3) The insurer shall furnish to the policy-holder a written acknowledgment of having registered a nomination or a cancellation change thereof, and may charge a fee not exceeding one rupee for registering such cancellation or change".

8.37 Accordingly, Nomination is a process through which a Life Assured nominates a person to receive the policy money in case of premature death of the Life Assured. Nomination facilitates hassle free settlement of claim.

8.38 Nomination/change of nominee takes place:

(i) On the death of the nominee

(ii) An Assignment of the policy makes the existing nomination invalid. Reassignment of the policy requires fresh nomination

(iii) At the desire of the Life Assured to change the nomination

(iv) When Minor Life assured becomes major, he needs to make a nomination.

8.39 Section 38 of the Insurance Act, 1938 read, *"(1) A transfer or assignment of a policy of life insurance, whether with or without consideration, may be made only by an endorsement upon the policy itself or by a separate instrument, signed in either case by the transferor or by the assignor or his duly authorised agent and attested by at least one witness, specifically setting forth the fact of transfer or assignment.*

(2) The transfer or assignment shall be complete and effectual upon the execution of such endorsement or instrument duly attested but except where the transfer or assignment is in favour of the insurer shall not be operative as against an Insurer and shall not confer upon the transferee or assignee, or his legal representative, any right to sue for the amount of such policy or the moneys secured thereby until a notice in writing of the transfer or assignment if and either the said endorsement or instrument itself or a copy thereof certified to be correct by both transferor and transferee or their duly authorised agents have been delivered to the insurer."

8.40 Accordingly, assignment is the process through which the policyholder transfers his rights, title and interest in a policy to another person

8.41 Assignment is done in the following circumstances:

(i) Policy holder assigns the policy to Bank or an Institution or an Individual against loan taken by him/her.

(ii) Policy holder assigns the policy to their Close Blood Relative due to Natural Love and affection

(iii) Policy holder assigns the policy conditionally to Trust/ Institution or Individual for after death disbursement of his Maturity Amount.

8.42 Assignment/Nomination are processed only on receipt of relevant documents such as original policy document, Assignee/ Nominee photo id proof, proof of address are received along with assignment/nomination form.

8.43 Once scrutiny of the documents is done, assignment/ nomination is marked against the policy number in the system. Also endorsement for assignment/nomination is done on the original policy document.

Change of Address (COA)/ Change of Payment Mode (COP)

Scope and Objective:

8.44 Policy holders are required to intimate their contact details like name, address, telephone numbers-e-mail id as & when there is change in residence, due to change in job or change in business premises.

8.45 Policy holder can change his correspondence or permanent address by sending request along with any one of the self-attested address proofs mentioned in the process.

8.46 In case of change of payment mode the policy holder has to submit a request. If the payment mode is changed from cheque payments to ECS/EFT, the policy holder will have to submit bank account proof which will be verified by the insurer before recording the change.

8.47 As per IRDA (Protection of Policyholders Interest) Regulations, 2002:

"*An insurer carrying on life or general business, as the case may be, shall at all times, respond within 10 days of the receipt of any communication from its policyholders in all matters, such as (a) recording change of address; (b) noting a new nomination or change of nomination under a policy ;(c) noting an assignment on the policy;...*"

8.48 The primary objective of the audit is to check and confirm that requests received are processed on timely basis and proper verification is done before processing.

8.49 The internal audit should cover:

(i) Process of receipt, recording and verification of requests

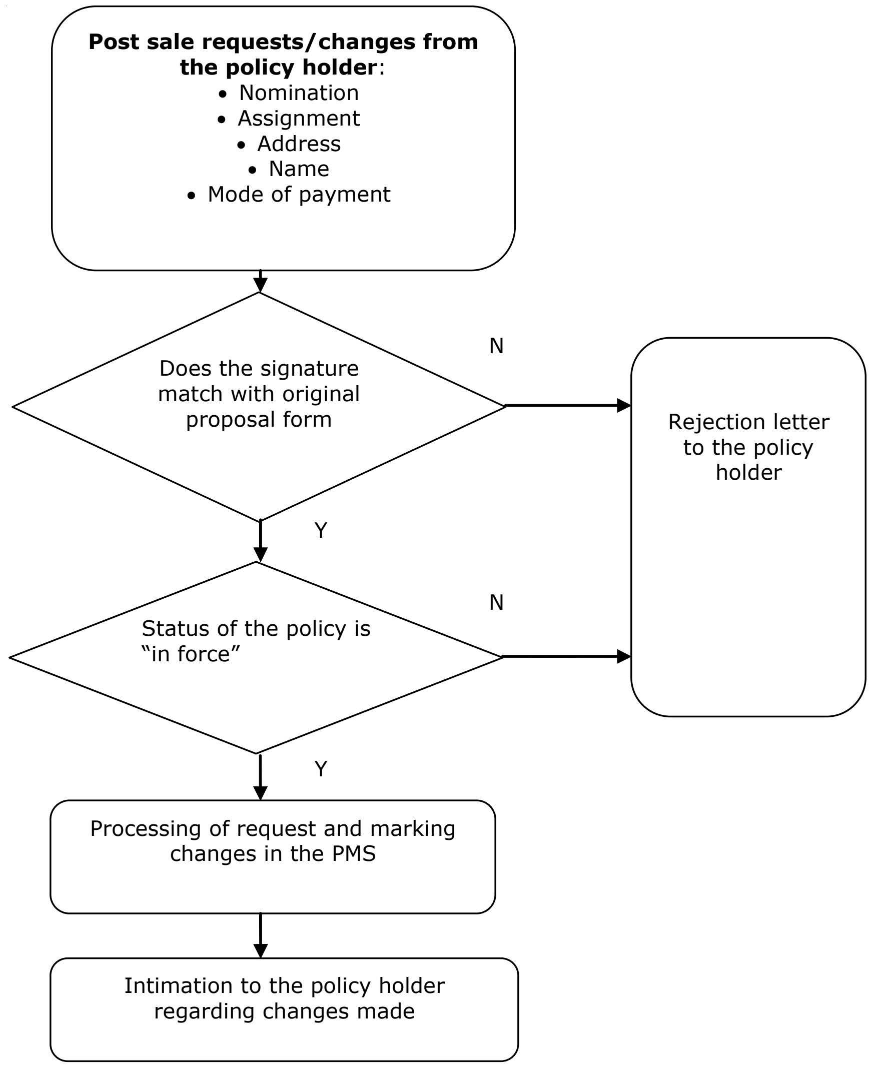
(ii) Updation in the system against correct policy number

(iii) Signature verification

(iv) Checking of endorsements

(v) Timeliness for processing of requests

(vi) Communication to the policy holder.


Post sale requests/changes from the policy holder:
• Nomination
• Assignment
• Address
• Name
• Mode of payment
Does the signature match with original proposal form
N
Y
Rejection letter to the policy holder
Status of the policy is "in force"
N
Y
Processing of request and marking changes in the PMS
Intimation to the policy holder regarding changes made

8.50 Illustrative checklist containing risks and internal audit procedures along with applicable regulations/guidelines/notification/ circulars:

Risks	Internal Audit Procedures
(i) Mismatch in signature on endorosement of assignment/ nomination/COA/COP request and original proposal document	• Check whether adequate maker checker controls are in place at the branches/ processing centers for signature verification. • If the policy holder has signed in vernacular language, then check whether declaration from witness knowing English is taken. • In case there is a thumb impression on the endorsement form, whether attestation from Banker or a public notary is taken. • In case of group insurance policy, check whether any change request given by the group member is signed by the master policy holder/ authorized person.
(ii) Non receipt of documentory proof for COA/COP	• In case of COA, check whether self attested proof of address is verified and kept on records. • In case of change of payment mode from cheque payment to ECS/EFT, check whether bank account verification is done and relevant proofs such as

Risks	Internal Audit Procedures
	cancelled bank cheque is kept on records
(iii) Incorrect assignment	• Assignment request should state the consideration • Assignment should be made only to blood relatives i.e parents, children and spouse, or in case of loan from banks/ financial institutions.
(iv) Incorrect updation of nominee/ assignee details Incorrect assignment request (*to people to whom assignment cannot be done and without correct consideration*)	• Check whether nominee/ assignee names are correctly updated in the system as per the requests received • Check whether maker checker controls are in place for updation of nominee/ assignee name in the system.
(v) Duplicate nomination/ assignment requests	• Check whether nomination/ assignment stamp is affixed on the original policy document on processing of request • Check whether system authorization for marking assignment/nomination is available only with authorized employees • Check whether maker checker controls are in place for updation in the system • Check whether "endorsement on the policy document signifying assignment/ nomination" form is signed off by the policy holder.

Risks	Internal Audit Procedures
(vi) Delay in processing of nomination/ assignment/ COA/ COP	• Check whether inward stamps are affixed on all the requests received at the branches/processing centres • Check whether requests received are processed within 10 days from the date of receipt. Delays if any are justified and communicated to the policyholder before expiry of 10 days
(vii) Change of address followed by surrender request	• Check whether change of address request is processed first and then the surrender/ claim request is processed to ensure that the cheque is dispatched to the correct address
(viii) Nomination request followed by assignment request As per section 39(4) of the Insurance Act, 1938, "*A transfer or assignment of a policy made in accordance with section 38 shall automatically cancel a nomination*".	• When an assignment request is received, check whether adequate details of the assignee are updated in the system and the nomination is cancelled.

Fund Switch

Scope and Objective:

8.51 Fund Switch is a facility which allows eligible ULIP policy holder to switch the money from one fund to another within the same policy. It is used by the policy holder to capitalize on the capital appreciation opportunities available in other funds or to minimize the risk associated with the present fund portfolio. While a specified number of switches are generally effected free of cost, a fee is charged for switches made beyond the specified number.

8.52 Switch requests are usually received at the branches wherein date and time punching is done. If the request is received before 3:00 pm, the request is to be processed on the same day. In case the request is received after 3:00 pm, the request is to be processed on the immediate next working day. (IRDA Guideline for ULIP dated December 21, 2005)

Request received Date/ Time	**Before 3 PM**	**After 3 PM**
Current day (Working day)	Insurer to take action on the same day after checking relevant documents with current day NAV	Insurer to take action on the immediate next working day after checking relevant documents with next day NAV
Current day & Market is closed	Insurer to take action on the immediate next working day after checking relevant documents	
Previous Day	Process with the NAV of previous day & if on that day market was closed then with the NAV of next working day	

8.53 The primary objective of the audit is to check and confirm that switch form is complete in all aspects and it is duly signed by the policy holder. Fields such as policy number, Scheme from, Scheme to, percentage of fund to be switched, policy holder signature has to be clearly stated in the switch request form. Adequate care is to be taken with respect to date and time of receipt of form.

8.54 The internal audit should cover:

(i) Process for receipt of form and inward date and time

(ii) Necessary updation in the PMS

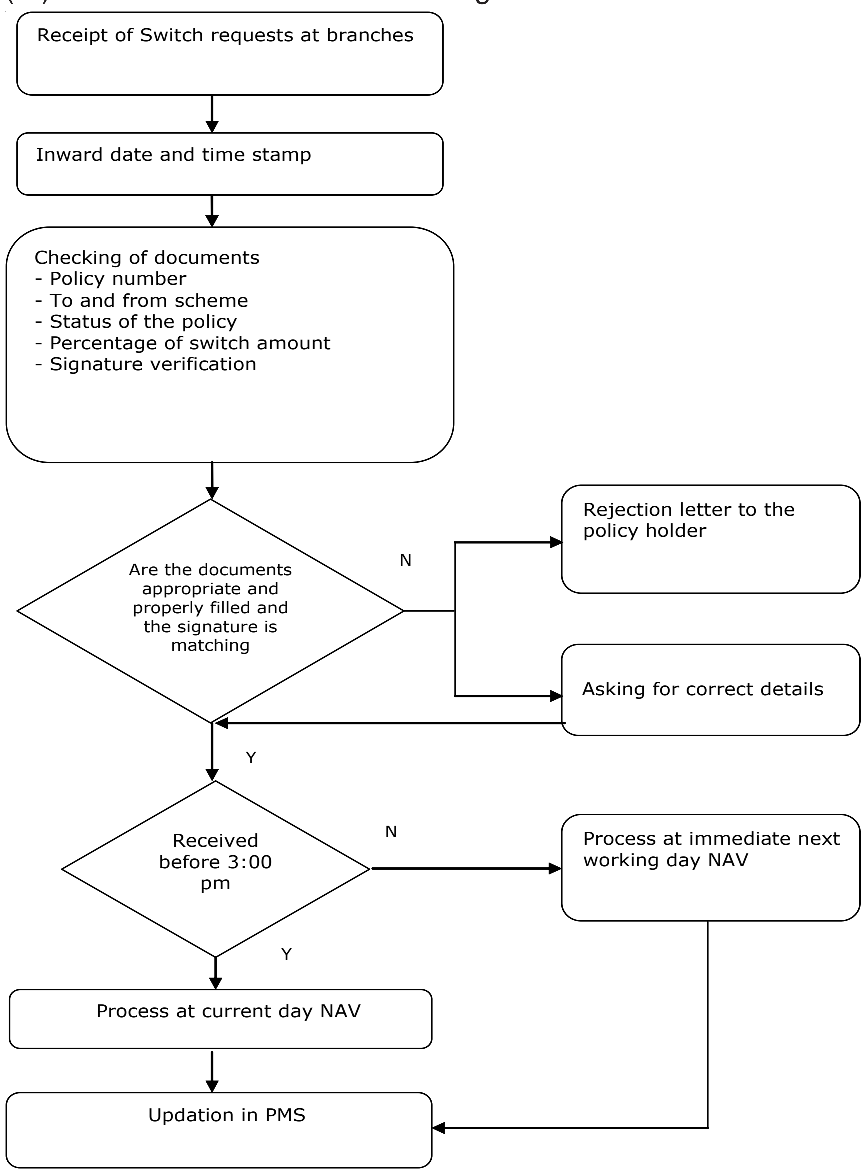
(iii) Timeliness for processing

(iv) Checking of relevant fields in the form

(v) Application of NAV

(vi) Intimation to the policy holder

(vii) Deduction of fund switch charges.



8.55 Illustrative checklist containing risks and internal audit procedures along with applicable regulations/guidelines/notification/ circulars:

Risks	Internal Audit Procedures
(i) Incorrect application of NAV/ Delays in processing	Check existence of adequate controls at branches/ processing centers, viz.,: • Whether correct inward date is mentioned on all the forms received • Whether forms received on the same day before 3:00 pm are processed on the same day NAV • With respect to forms received after 3:00 pm, whether these are processed on the immediate next working day. Also check whether the branch checklist contains all the above points and is signed-off by the maker and the reviewer.
(ii) Mismatch in signature as per policy document and switch form	• Check whether adequate controls are in place to verfiy the signature of the policy holder with the original proposal form. Check whether "signature verification" stamp is affixed on the switch request form
(iii) Incorrect processing of switch request	• Check whether maker-checker controls exist at the branches for updation of details in the PMS vis-à-vis: - policy number

Risks	Internal Audit Procedures
	- policy name (To and from) - percentage/Proportion of switch amount as per the product features - date and time of receipt - effective NAV date • Check whether checklist is signed off by the maker and checker • Check whether minimum switch amount is as per the product features • Check whether switch facility is available for the product mentioned • If the application of NAV is done through system, check the defined controls and parameters in the system.
(iv) Switch transaction processed for lapsed/ surrendered policy	• Check whether switch request is processed only when the policy status is "In force." Switch transactions should not be processed if the policy status is "lapsed" or "surrendered"
(v) Incorrect deduction of switch charges	• Check whether applicable switch charges are correctly deducted as per the product features • Check the system master if the switch charges are built-in in the system. This can also be verified at product development or can form part of system audit.

Top-up Premium

8.56 As per clause 7 of circular No. 032/IRDA/Actl/Dec-2005 dated December 21, 2005, *"A top-up premium is an amount of premium that is paid by the policyholders at irregular intervals besides basic regular premium payments specified in the contract and is treated as single premium.*

8.57 Top-up premiums can be remitted to the insurer during the period of contract only, where due basic regular premiums are paid up to date and if expressly stated in the terms and conditions of the contract."

8.58 As per circular No. IRDA/ACTL/CIR/ULIP/071 /05 /2010 dated May 3, 2010, para 7.3 of Guidelines on ULIP" issued vide circular No. 032/IRDA/Actl/Dec-2005 dated 21.12.2005 shall be substituted by *"All top-up premiums made during the currency of contracts must have insurance cover, treating it as single premium.."*.

8.59 As per paragraph 1 of circular No. IRDA/ACT/CIR/ULIP/102/06/2010 dated June 28, 2010, "*In order to meet the emerging needs of prospective insurance policyholders, this circular specifies certain elements which shall be incorporated in all ULIPs which may be offered for sale to the public commencing from September 1, 2010. 1. The three year lock-in period for all Unit Linked Products will be increased to a period of five years, including top-up premiums."*

Scope and Objective:

8.60 When a policy holder pays an extra premium over and above the regular premium in ULIP it is called as Top up premium. A top up premium gives an advantage to increase the savings by means of investing in addition to the regular premium. Top up premium option is usually given to policy holders who pay their regular premium on time

8.61 Premium allocation charge is levied if top up premium is paid. Depending on the insurance companies it varies from 1% to 3%. This also differs from policy to policy.

8.62 Some insurance companies do not have a minimum amount for the top up premium. Most of the policies have a minimum amount which starts from as low as ₹ 2000.

8.63 The primary objective of the audit is to check and confirm that top up premiums are correctly accounted for in the policy holder's account and to ensure that every top up amount has an insurance coverage and to ensure that top-up period also has a lock in period of 5 years

8.64 The internal audit in this regard would normally cover

(i) Process for receipt of top-up premium form and inward date and time

(ii) Necessary updation in the PMS

(iii) Timeliness for processing

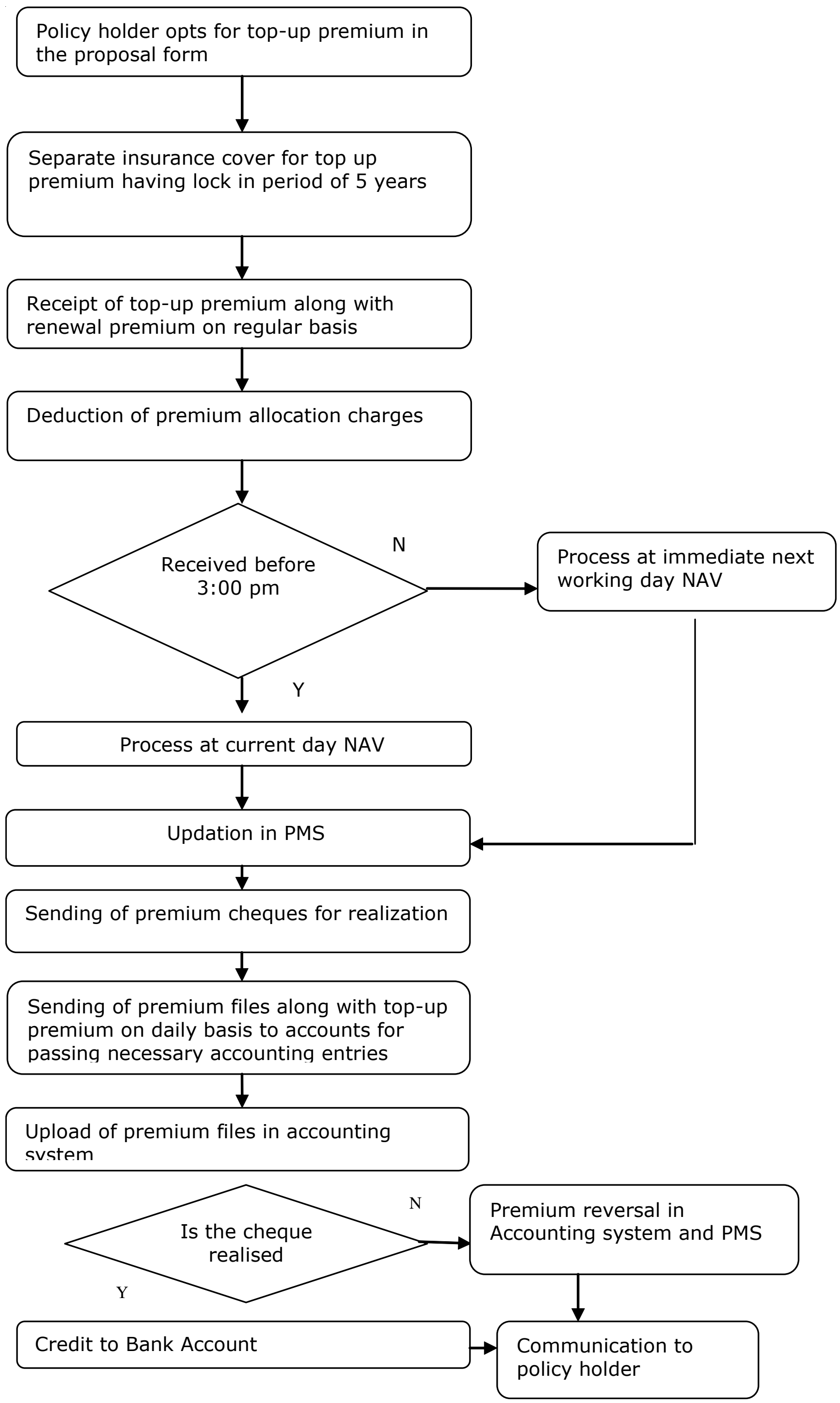
(iv) Checking of relevant fields in the form

(v) Application of NAV

(vi) Life cover for all top up premium

(vii) Deduction of premium allocation charges

(viii) Intimation to the policy holder.


Policy holder opts for top-up premium in the proposal form
Separate insurance cover for top up premium having lock in period of 5 years
Receipt of top-up premium along with renewal premium on regular basis
Deduction of premium allocation charges
Received before 3:00 pm
N
Process at immediate next working day NAV
Y
Process at current day NAV
Updation in PMS
Sending of premium cheques for realization
Sending of premium files along with top-up premium on daily basis to accounts for passing necessary accounting entries
Upload of premium files in accounting system
Is the cheque realised
N
Premium reversal in Accounting system and PMS
Y
Credit to Bank Account
Communication to policy holder

8.65 Illustrative checklist containing risks and internal audit procedures along with applicable regulations/guidelines/notification/ circulars:

Risks	Internal Audit Procedures
(i) Incorrect application of NAV/ Delays in processing	Check existence of adequate controls at branches/ processing centers, viz.,: • Whether correct inward date is mentioned on all the top – up forms received • Whether forms received on the same day before 3:00 pm are processed on the same day NAV • Controls with respect to forms received after 3:00 pm, whether these are processed on the immediate next working day Also check whether the branch checklist contains all the above points and is signed-off by the maker and the reviewer.
(ii) Mismatch in signature as per policy document and switch form	• Check whether adequate controls are in place to verfiy the signature of the policy holder with the original proposal form. Check whether "signature verification" stamp is affixed on the switch request form.
(iii) Incorrect processing of top – up premium	• Check whether maker-checker controls exits at the branches for updation of details in the PMS vis-à-vis:-

Risks	Internal Audit Procedures
	Policy number - Policy name (To and from) - Date and time of inward - Effective NAV date- Minimum amount of top up premium • Check whether the status of the policy is in force ie regular premiums are paid on timely basis, otherwise the top-up premiums should be utilised for the regular premium accounting • Checking of minimum top-up premium as per the product features.
(iv) Incorrect calculation of insurance coverage amount for top up premium	• Verfiy whether all the top-up premium have been considered as single premium and minimum insurance cover of 1. 25 times for policy holders below the age of 45 years and 1.1 times for policy holders above 45 years have been given
(v) Incorrect withdrawal of top up premium	• Check whether 5 years lockin period is adhered to.
(vi) Incorrect revenue recognition	• Check whether top-up premium is accounted in the correct policy number • Check whether reconciliation of cheques received is done with the entries made in PMS and with the entries recorded in accounting system.

Loan Against Policy

Scope and Objective:

8.66 Insurance companies not only cater valuable death cover under policy but also extend helping hand by way of granting loan under policies during life time of policyholder when he is in need of funds. As per the privileges and conditions given on the the policy documents, insurer grants loan on the security of policy document to the person who is entitled for the same.

8.67 Illustrative checklist containing risks and internal audit procedures along with applicable regulations/guidelines/notification/ circulars:

Risks	Internal Audit Procedures
(i) Loan given on in-eligible policies	• Check as per the insurer's internal policies whether the policy is eligible for loan or not • Check file & Use of different products as regards the maximum and minimum amount of loan, loan on ULIP products, minimum period post which the loan can be given.
(ii) Inadequacy of loan documents	• Check whether inward stamp is affixed on the loan requests received at the branches • Check whether adequate controls are in place at the branches/processing centre to check the signatures on the loan requests vis-à-vis the actual proposal form Also special caution needs to be taken in case of Married

Risks	Internal Audit Procedures
	Women property cases where the application should be signed by the trustee • Check whether application for loan against policy is duly filled up • Check whether the original policy document is collected and kept in safe custody till the loan is repaid • Check whether loan agreement has been executed and signed by relevant parties • Check whether last premium cheque has been cleared as it would affect the eligibility • Check whether the policy is "In force" and "Premium paying" and shouldn't be in a phase where the premium is not received by due date and the application is received in the grace period allowed..
(iii) Incorrect updation of policy details	• Check the controls at the branches and processing centres for loan processing and recording of relevant entries in the PMS for loan • Check the details entered in the system • Check existence of maker checker controls to ensure

Risks	Internal Audit Procedures
	the loan amount is updated against the correct policy number.
(iv) Incorrect amount of loan	• Check whether loan amount is calculated as per rules and it is lower than the surrender value • If customer has already availed loan previously, check whether the limit is verified on totality.
(v) Incorrect charging of interest	• Check whether interest has been charged as per applicable rate and on regular basis in the system· Check whether interest amount has been paid on timely basis.
(vi) Non-availability of loan schedule	• Check whether there is any schedule for the loan to be repaid or the option is given to the customer to repay at his discretion. The same can be paid during the tenure of the policy.
(vii) Incorrect details in letters sent/received to/from customers	• Check whether letters sent to or acknowledgment received from the customers (regarding approval/rejection of loan) contain the correct details of the loan amount and the interest details as entered into the system. Also special care needs to be

Risks	Internal Audit Procedures
	taken when the same is not paid through cheques but through direct credits.
(viii) Non assignment of policy in the favour of insurer	• Check whether an assignment has been updated in favour of insurer in the system.
(ix) Reassignment of the policy when the loan is repaid and policy document handover	• Check whether the laon is reassigned to the proposer once the loan is repaid and also the original policy document is handed over.
(x) Delay in foreclosure where loan amout is exceeding the surrender value or paid up value	• Check whether foreclosure notices are send to policy holders stating that the outstanding loan amount with interest is approaching the surrender value and hence he needs to repay the loan and interest. Also in case the policy holder fails to repay and loan value equals surrender value, the policy should be automatically foreclosed • Check if necessary declaration has been taken to foreclose the policy in case of the outstanding loan balance exceeds surrender value.
(xi) Incorrect or non adjustment of amount payble on money back plans/claims	• Check when any payment arises on policy, the entire amount of outstanding loan

Risks	Internal Audit Procedures
	is deducted from the payment.
(xii) Incorrect accounting entry	• Check whether correct details are sent to accounts for recording appropriate accounting entries • Check whether correct loan amount is paid to the policy holder.
(xiii) Incorrect amount reflected in financial statements	• Check whether correct amount of loans against policies is reflected in the financial statements . Also the interest due till that time needs to be properly accounted.

Chapter 9

Premium Collection, Accounting and Reconciliation

9.1 When an agent contacts the prospective policy holder, he explains the product features. If interested, the proposes needs to fill up the proposal form, submit necessary documents like identity proof, address proof, age proof, etc and pay the premium. The premium gets receipted by the insurer and application gets underwritten. There may be some applications that do not need any underwriting (non-underwriting cases) and some applications may need underwriting. This depends on the underwriting philosophy of the insurer towards the products. Based on underwriting decision, the policy is issued / proposal is rejected / postponed.

9.2 Premium received but not identifiable against any policy would be treated as ‘unallocated premium’ / ‘suspense amount’.

9.3 **Premium accounting** refers to recognizing the premium earned by the insurer as income in the accounting system.

9.4 Income is recognized as (1) New business premium – premium received for the first policy year and (2) Renewal premium – premium received for subsequent policy years.

9.5 New business premium should be recognized on issuance of the policy (and realization of premium). Ideally, the policy may be issued in the system and may await realization of the premium for issuance.

9.6 The fundamental principle behind accounting of new business premium is creating a contractual relation between insurer and insured (i.e. issuance of policy to the insured). Renewal income is recognized (1) on realization of the premium amount or (2) when premium is due but not received up to the end of grace period.

9.7 Auditors may also refer to IRDA (Preparation of Financial Statements & Auditors Report of Insurance Companies) Regulations, 2000 for premium accounting.

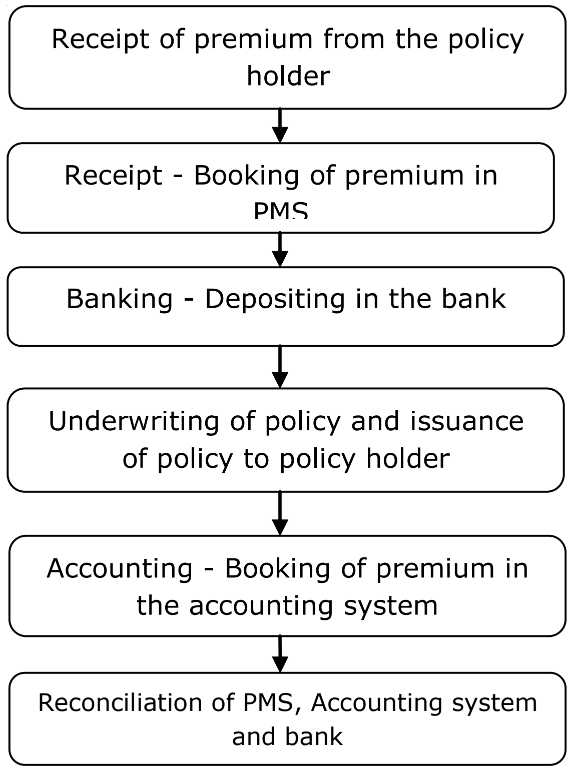
9.8 Companies may have different systems to address accounting and policy administration. In some systems, policy administration and accounting systems are integrated. In some systems, both may be different where income/expenses for policies are recognized in PMS and is interfaced with accounting system. Here, on a pre-defined periodicity (end of day frequency), the policy administration would write entries in the accounting system through an interface.

Sub-process:

9.9 There are various sub-processes ranging from collecting premium from the policy holder, booking of premium, banking, accounting and reconciliation.

Scope and Objective:

9.10 To assess whether there is proper control over the collection, accounting and reconciliation of premium received from the insured.



9.11 Illustrative checklist containing risks and internal audit procedures along with applicable regulations/guidelines/notification/ circulars:

Risks	**Internal Audit Procedures**
(i) Cash accepted from policy holder and - not entered or - incorrectly entered in PMS - not deposited in bank account. • Absence of receipting process in PMS for cash received from the policy holder • Risk of short collection of premium and revenue leakage	• Check that there is a daily reconciliation process centrally to tally the amounts collected, entered into the system and deposited into the bank • Check that there is a defined TAT for depositing cheques into the bank

Risks	Internal Audit Procedures
• Risk of cash defalcation during transfer from branches to the bank for deposit	• Check that there is a process in place to prevent payment gateway fraud for payments made through ECS/Direct Debit/Credit Card / Online through website • Check that there is a proper vault management process (including insurance)in place to ensure physical safety of the cash and cheques.
(ii) PMS calculates incorrect due dates of premium leading to revenue leakage and lapsation of the policies	• Check that system correctly calculates the premium due dates • Check that the system is tested for this feature for all the premium modes.
(iii) Incorrect mapping of the various tables configured in policy administration and accounting system leading to inaccurate calculations	Check the details of premium, charges, commission, etc from both the systems to confirm that the calculations and data flow is correct.
(v) Absence of monitoring AML norms (Cash receipt more than specified limit)	Check that the system has a capability to identify such breaches and to report to Compliance. If not, such checks should be performed manually to identify such instances.
(vi) Incorrect assignment of premium received to another existing policy	• Check that the system generates a separate policy number for a fresh receipt of premium • Check whether there is a de-duplication check in the

Risks	Internal Audit Procedures
	system for proposal numbers.
(vii) Recognition of Income before issuance of policy	Check that the recognition is only based on 'issued' policies and not on 'underwriting' dates
(viii) Incorrect recognition of premium amount, mortality charges, fund management charges	Check that system correctly allocates premium into various components. Check that the system UAT is available for this capability.
(ix) Non-accounting/ inaccurate accounting of premium in the accounting system	• Check that there is a mechanism in place to ensure that amount entered in PMS is transferred to accounting system through system (no manual intervention) • Check if there is a process of comparison/reconciliation of both the above-mentioned systems • Review bank reconciliation statement to identify instances of open items in collection accounts and reasons for the same (in most of the cases the reasons would be cashiering of premium cheques done twice/data entry errors at branches for premium amounts/cancellation entries passed twice in the PMS/ reversal entries pending/ cashiering of premium cheques received pending).

Risks	Internal Audit Procedures
(x) Back-dating the policy issuance in the system thereby recognizing income for prior period	Ensure that system does not allow any backdated policy issuance.
(xi) Premium income accounted in the PMS not properly interfaced with accounting system (applicable when both the systems are not integrated)	• Check the robustness of the interface between policy administration and accounting system • Check that all the entries posted in the PMS gets accurately posted in the accounting system • Check that the insurer conducts premium reconciliation on daily basis and reconciling items, if any are rectified/ followed up.
(xii) Advance premium entered in the system as regular premium	• Check that the system has a capability to identify regular and advance premium • Check that there is a process of applying advance premium to a contract when premium is due.
(xiii) Incorrect entry of premium, sum assured, gender, mode or any other detail updated in PMS, which can impact the premium amount	• Check if system has inbuilt controls to reflect the premium amount/ shortage/ excess based on the parameters updated • Review the extract of the system and actual proposal forms to identify incorrect data entries.

Risks	Internal Audit Procedures
(xiv) Inadequate/incorrect renewal premium entered in the system	• Ensure that the system has a validation to check if there is a short / excess premium received • Review daily reconciliations to check the correctness of renewal premium entered in the system.
(xv) Premium not reversed on cancellation of the policy due to FLC, non-realization of premium / cheque dishonour	• Check that there is a defined TAT for processing cancellation in the system and there is a mechanism to monitor the TAT adherence • Check that adequate changes are made in the accounting system for reversals, if any.
(xvi) Not defining the roles and responsibilities and timing for/ of - Receipting and accounting of the premiums received (initial and renewal) - Revenue recognition - Handling of advance premium - Accounting for the short / excess premium received - Reconciliations of Daily collection report with Bank Book - Reconciliations of Bank statement with Bank Book	• Check that the roles and responsibilities for these activities are segregated • Check that procedures are documented by way of a process note / SOP.

Risks	Internal Audit Procedures
(xvii) Cash paid by the policy holder to the sales agent may have been misappropriated.	• Check that the proposal form contains the instruction advising the policy holder not to hand over cash to the agent • Check that there is a cash authority letter signed by the policy holder, authorizing the agent to carry his cash and deposit into the branch.
(xviii) Risk of receipt of counterfeit currency note, demand draft or cheque	• Check that the 'counterfeit note detector' is used to identify counterfeit cases • Check that record is maintained of all notes with denominations of ₹ 500 and above.
(xix) Incomplete cheque scrutiny at the branch resulting in acceptance of post-dated cheque, unsigned cheque etc which result in cheque dishonour and delay in policy issuance	• Ensure that post-dated cheques are not accepted • Signature on the cheque is a scrutiny check point and undertaken manually. Ideally, there should be system validations for the same.
(xx) Absence of robust process to handle unknown / unreferenced cheques / DDs found in drop-boxes	• Check the manner of booking such amounts in the PMS • Check that there is a process to identify such cases through reconciliations and to investigate such cases • Check whether the reconciliation is reviewed by senior management/head of the department and

Risks	Internal Audit Procedures
	adequate follow-up action is taken for long pending entries, if any
(xxi) Acceptance of incomplete ECS request, Incomplete credit card details, incomplete post-dated cheques, if any	• Check that the branches follow a check list to do a complete scrutiny of all the documents • Check existence of maker-checker controls at the branches.
(xxii) Risk of refund payment without verification of receipt of clear funds from the policy holder.	• Finance will release refunds post checking of clear credits. • Refunds are investigated and are being generated from the system. • premium recognition and refund are independent processes with adequate segregation of duties among personnel.
(xxiii) Absence of matrix for authorizing refunds for high amounts	Ensure duly approved Delegation of Authority Parameters matrix is already in place for authorization limits.
Incorrect reporting of premium figures to IRDA/Management	• Check that the MIS is generated from the system and that there is no manual intervention. • Check whether the MIS is verified before forwarding it to IRDA/Management. • There needs to be a reconciliation process between premium income as per financials and as reported.

Chapter 10

Claims

Scope and Objective:

10.1 The primary objective of the audit is to check the accuracy of processing and accounting of claims lodged with the insurer. Claims payouts would include a wide variety of customer benefits including death claims, maturity claims, annuities, health claims, rider claims, policy surrenders and other survival benefits.

10.2 The claims review should primarily ensure customer focus, compliance to regulations and accuracy of accounting. The scope of review should thus include the following:

(i) Claims lodgement and processing

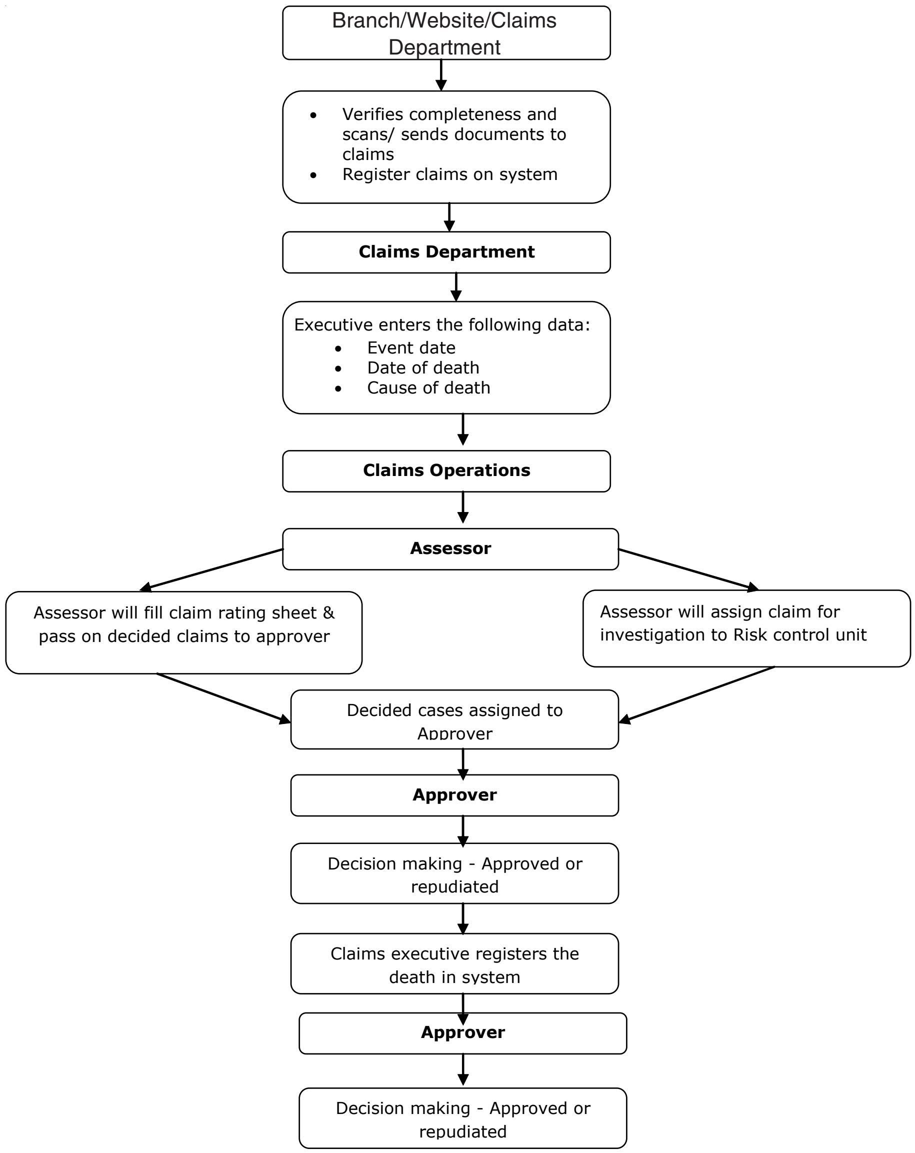
(ii) Authority matrix for approval of claims

(iii) Review of payouts and disbursements

(iv) Review of compliance to applicable IRDA Regulations, relevant sections of Insurance Act, 1938 and The Prevention of Money Laundering Act, 2002.

(v) Review of reinsurance recovery process

(vi) Review of reporting of claims (life & health) and benefits paid.


Branch/Website/Claims Department
• Verifies completeness and scans/ sends documents to claims
• Register claims on system
Claims Department
Executive enters the following data:
• Event date
• Date of death
• Cause of death
Claims Operations
Assessor
Assessor will fill claim rating sheet & pass on decided claims to approver
Assessor will assign claim for investigation to Risk control unit
Decided cases assigned to Approver
Approver
Decision making - Approved or repudiated
Claims executive registers the death in system
Approver
Decision making - Approved or repudiated

10.3 Illustrative checklist containing risks and internal audit procedures along with applicable regulations/guidelines/notification/circulars:

Risks	Internal Audit Procedures
(i) Policy document does not prescribe the minimum documents required to be filed with each claim as required by Regulation 8 of IRDA (Policyholders Interest) Regulations, 2002	Review the standard policy document template to ensure that the policy document prescribes the minimum documentary evidence needed to support a claim
(ii) Claims register as required by Section 14 not maintained	Ensure that the insurer maintains a register or record of claims, in which shall be entered every claim made together with the date of the claim, the name and address of the claimant and the date on which the claim was discharged, or, in the case of a claim which is rejected, the date of rejection and the grounds there for.
(iii) Claims intimation not recorded in system though received	Check whether all claims received are registered in system and adequate liability held – Check intimations received at touch points – call centre, website, branch walk in, etc to ensure completeness.
(iv) Queries / Requirement letter not sent to claimant within 15 days, leading to non adherence to Regulation 8 of IRDA (Policyholders Interest) Regulations, 2002	• Check whether documents required (original policy certificate; death certificate; KYC documents; claimant form, etc) have been received, if not, discrepancies triggered within 15 days of intimation

Risks	Internal Audit Procedures
	• Check difference in days between "Date of written intimation" and "Requirement Letter sent date" • Check whether "Date of written intimation" and "Requirement Letter sent date" have been captured correctly in the system when compared to physical files.
(v) Decision taken without receipt of mandatory documents, verification of standard procedure	• Check method of allotment of claims to assessors within the claims team and adherence of limits • Check overall system fields of documents and decision criterion with process
Incorrect decision on payout/ repudiation	• Check physical files and check for adherence of authority matrix for claim decision / repudiation (based on value, type of case etc) • Check whether mutiple policies exist for the same customer • Check the policy status and receipt of premiums till date • Check whether as a practice, opinions are taken from other departments (e.g. legal and underwriting) before processing / repudiating any contentious claim. Ensure investigation of early claim cases

Risks	Internal Audit Procedures
	• Check quality of investigation by external investigators and adequate verification prior to their empanelment • Check the assignment of claims to investigators in case of multiple agencies.
(vi) Risk of fictitious claims Claim amount is paid without conducting KYC tests on beneficiary (non adherence to Anti Money Laundering Regulations, 2006)	• Check claimant's identity and address proof • Ensure adequate maker checker control exists i.e. segreation of duties of claim assesment, approval and payout. (Claims team should be segregated from underwriting team) • Payouts made directly to the nominee and discharge note taken.
(vii) Non-compliance of IRDA time limits for claim settlement (Regulation 8 of IRDA (Policyholders Interest) Regulations, 2002) Non-reporting of delay in settlement cases to IRDA Non-payment of interest to customer for delays (Regulation 8 of IRDA (Policyholders Interest) Regulations, 2002)	• Check accuracy of date updation in system with physical files • Compare whether claims have been settled within 30 days of claims lodgement by comparing system dates· Check whether requirements/ investigation triggered for claims beyond 30 days (check communication) • Check whether overall timeline of 180 days adhered to • Check whether non-compliant cases reported to IRDA

Risks	Internal Audit Procedures
	• Check whether interest has been paid / provided for delays in claim processing
(viii) Incorrect claim payout processing	• Check whether claim amount is correctly calculated by the assessor / system • Check whether correct amount is processed for payouts especially in ULIP contracts where the NAV being applied may be validated • Check whether cheque is sent to correct claimant and acknowledgement is obtained • Check the system controls for payout processing – maker-checker, system computation of discharge amount, etc.
(ix) Ex-gratia payout processed without requisite approval	Check ex-gratia cases and ensure a defined approval matrix exists and is adhered to.
(x) Incorrect accounting of claims	• Check accuracy of accounting for claims processed • Check accuracy of provisioning for claims intimated but not paid • Ensure that the claims cost includes the claims settlement cost

Risks	Internal Audit Procedures
	• In case of living / survival / maturity / annuity benefits ensure that the liability is auto trigerred • In case of cashless health claims ensure that a liability is booked on the basis of the decision of the claim assesor • In case the insurer processes claim outside the PMS, ensure that regular reconciliation is carried out between claims management system and the general ledger and the same are reviewed by an appropriate official • Ensure that the claims liability is net of reinsurance.
(xi) Stale cheques	Check the process of management of claim cheques issued but not encashed.
(xii) Records of claims not maintained (non adherence to Anti Money Laundering Regulations, 2006)	Check whether all records of claims processed , as required by the anti-money laundering regulations is maintained for 10 years.
(xiii) Reinsurance not claimed	Check the procedure for ensuring claim for reinsured cases
(xiv) Claims experience not in line with the experience priced	Check whether there exists a mechanism to provide feed back of the claims experience to the product pricing team.

Risks	Internal Audit Procedures
(xv) Incorrect IRDA reporting	Check correct reporting of IRDA as required by IRDA (Preparation of Financial Statements & Auditors Report of Insurance Companies) Regulations, 2000 and of claims beyond 30 days and 180 days (with reasons).

Chapter 11

Investments

Scope and Objective:

11.1 The Investment portfolio of Life Insurance companies comprise of Shareholders' funds and Policyholders' funds. Policyholders' funds can further be segregated as linked and non-linked. Investment regulations are however prescribed separately for the following investment categories:

(i) Linked funds

(ii) Pension and Annuity funds

(iii) Controlled funds.

11.2 As Insurers essentially manage the funds for policyholders it becomes imperative for the insurer to have adequate systems and processes that should not only ensure robust internal controls, financial transparency and equity but also bring effective governance so as to serve the interests of the management, stakeholders, consumers and the society, at large.

11.3 The overall functioning of the Investment function should include the following independent functions:

(i) Investments front office / dealing desk

(ii) Investments mid office – Compliance, Risk Management, Reporting, Reconciliations

(iii) Treasury – Cash Management, Deal settlement, Broker empanelment, Custody

- Investment accounting – Fund accounting, NAV computation and declaration.

11.4 The investments review should primarily require ensuring the following:

(i) Review the Investment management structure to ensure adequate segregation of duties between Investment Front office, Mid Office and Back office

(ii) Review of insurer's Standard Operating Procedures which are prescribed by the IRDA Regulations and are required to cover the entire gamut of investment related processes and policies

(iii) Review of insurer's Investment policy

(iv) Review of functioning and scope and minutes of Investment Committee

(v) Compliance of all Investment regulations, various other circulars specified by IRDA and other regulations specified in the Insurance Act, 1938

(vi) Review of insurer's Disaster Recovery, Backup and Contingency Plan

(vii) Review of access Controls, authorization process for Orders and Deal execution, etc

(viii) Review of insurer's Cash Management System to track funds available for Investment considering the settlement obligations and subscription and redemption of units, etc. The system should be validated not to accept any commitment beyond availability of funds and restrict Short Sales at the time of placing the order. Further insurer's system should be able to determine the amount of Investible surplus

(ix) Ensure that the system is be able to automatically monitor various Regulatory limits on Exposure and Rating of debt instruments

(x) Review of fund wise reconciliation with Investment Accounts, Bank, and Custodian records

(xi) Ensure that there is split between Shareholders' and Policyholders' funds, and earmarking of securities between various funds namely Life (Participating & Non-Participating), Pension & Group (Participating & Non-Participating) and Unit Linked Fund

(xii) Review the arrangements and reconciliations of holdings with the insurer's custodian

(xiii) Review and check insurer's Investment Accounting and valuation policy and the controls around this process

(xiv) insurer's risk management policies and processes to manage investment risk such as Market risk, Liquidity risk, Settlement risks, etc

(xv) Determine the extent of activities outsourced and the controls over such activities

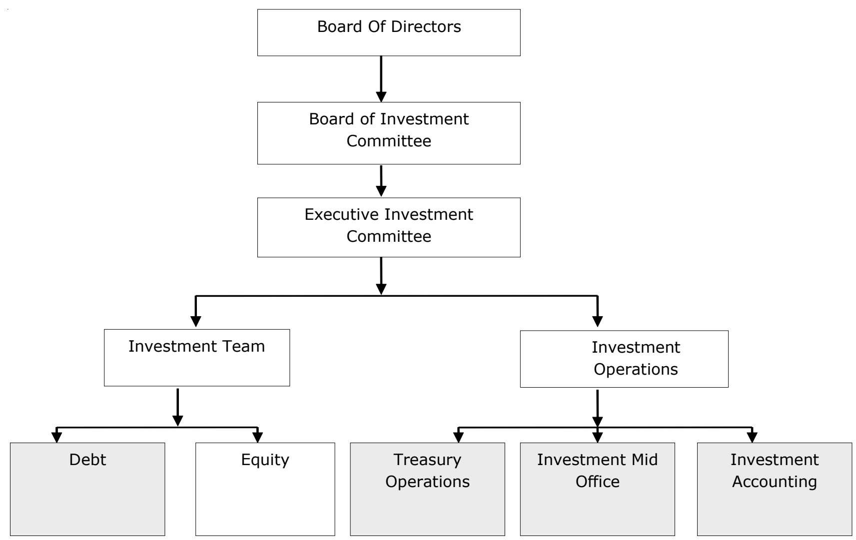
(xvi) Controls over NAV computation and declaration

(xvii) Controls over various system interfaces such as Seamless integration of data, between front office and back office, in the Investments accounting system

(xviii) Flow of data from PMS to the Investment Accounting system

(xix) Controls around personal dealings, insider trading and front running.

11.5 The chart below indicates the prescribed structure of the Investments function of an insurer:

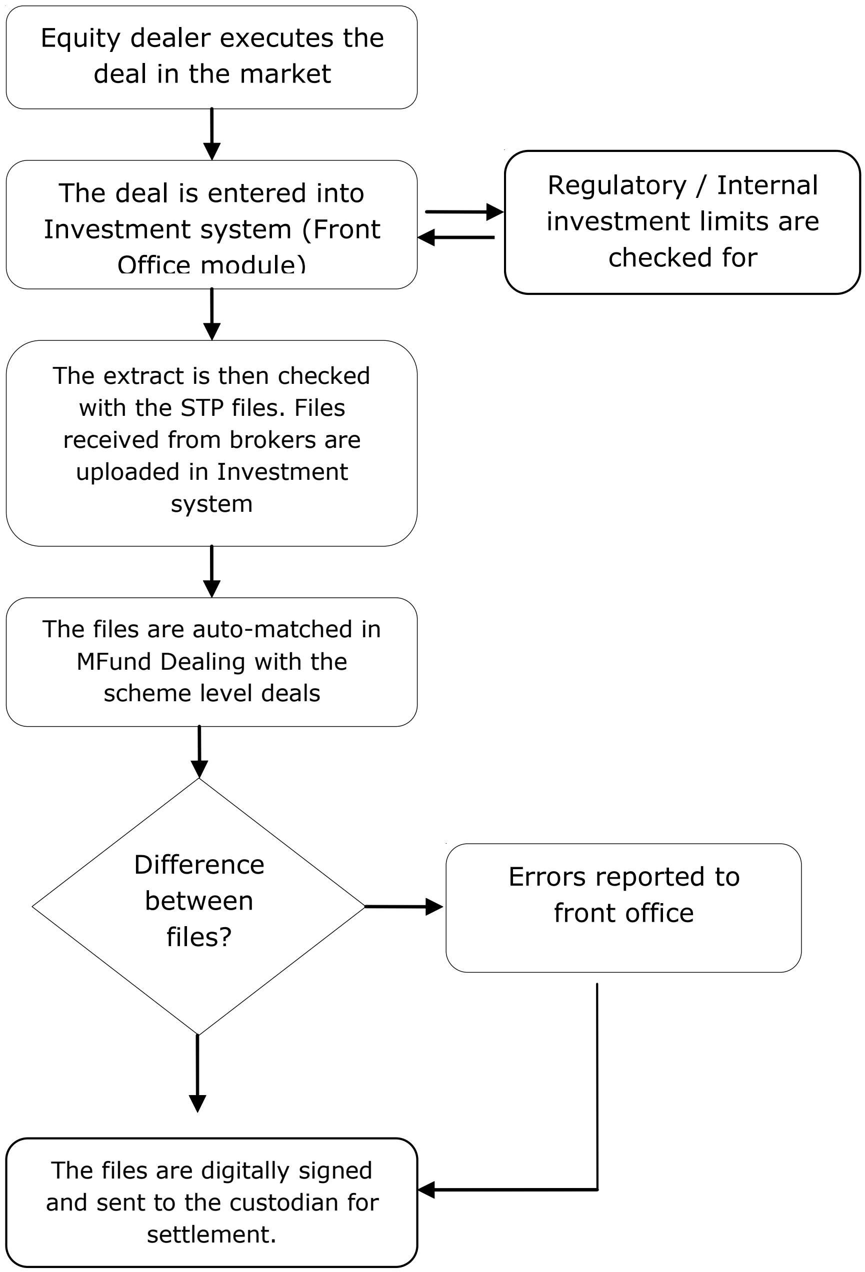


11.6 In addition to the segregated functions as prescribed above, the insurance regulations further prescribe the following segregation of activities:

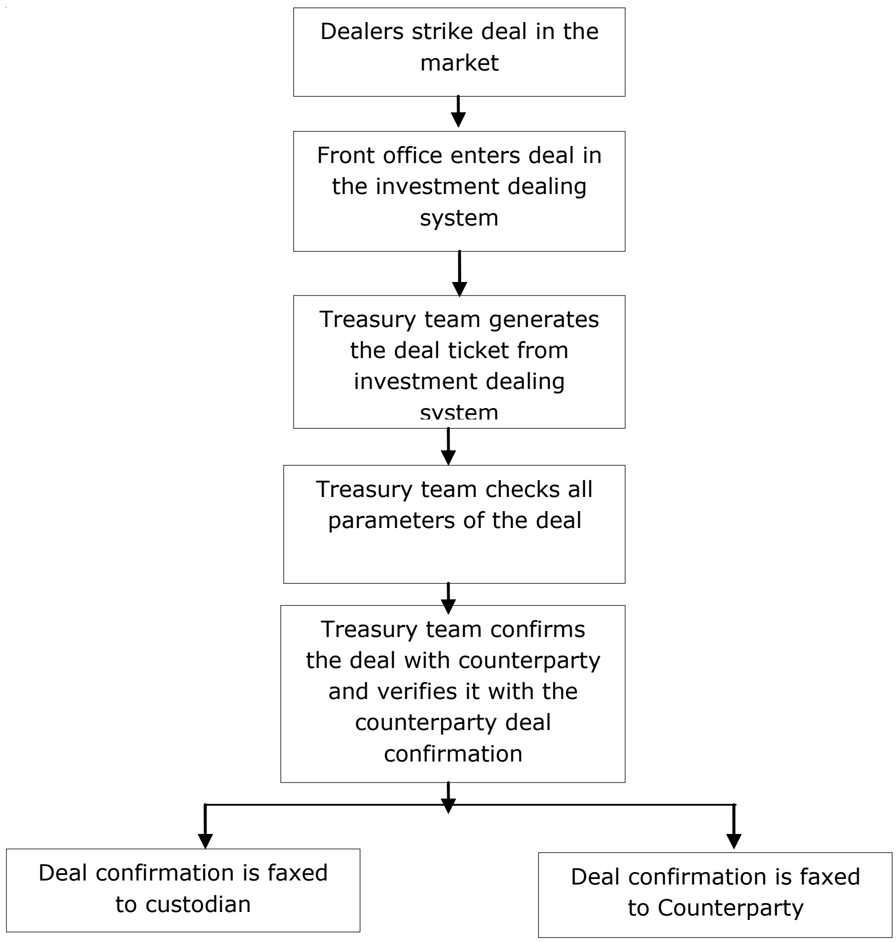
(i) The Front Office shall report through the Chief Investment Officer ('CIO') to the Chief Executive Officer ('CEO'). The Mid Office and Back Office, to be headed by separate personnel, shall be under the overall responsibility of Chief Financial Officer ('CFO') who shall independently report to the CEO

(ii) Separate dealers and fund managers for both the debt and the equity portfolio.

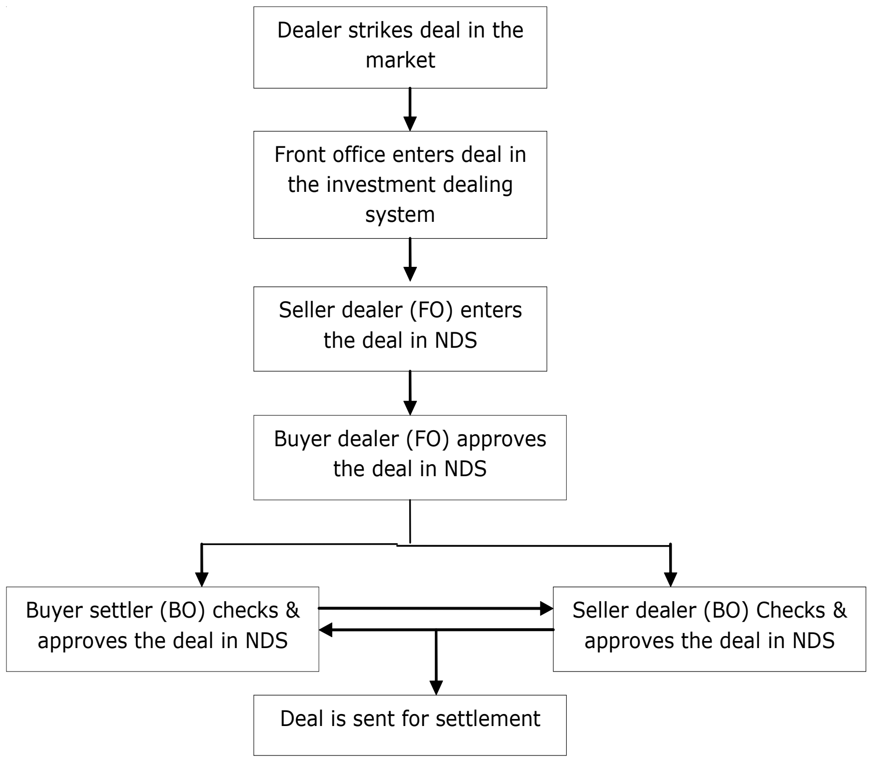
11.7 Settlement of Equity transaction is depicted below:



11.8 Dealing & settlement of Non SLR trades are as follows:



11.9 Dealing and settlement of government securities and money market instruments on the negotiated dealing system (NDS):



Regulations Pertaining to Investment Process

IRDA (Investment) Regulations, 2000

Regulation 3 – Pattern of Investment

11.10 Without prejudice to section 27 or section 27A of the Act, every insurer carrying on the business of life insurance shall at all times invest and keep invested fund in the following investment pattern:

Controlled F`unds

Type of Investment	Percentage
(a) Government Securities	25%
(b) Government Securities or Other Approved Securities	Not less than 50% (including (i) above)
Approved Investments as specified in section 27A of Insurance Act, 1938 and Schedule I of this Regulation, subject to Exposure / Prudential Norms specified in Regulation 5:	
Approved investments & other investments [out of '(3) a' 'other investment' specified under section 27A(2) of the Act, shall not exceed 15% of the fund)	*Total* *Not exceeding 35%*
Investment in Housing and Infrastructure & Social Sector Investments by way of subscription or purchase of :	-----------------
Bonds, Debentures of HUDCO and National Housing Bank	
Bonds, Debentures of Housing Finance Companies either duly accredited by National Housing Bank, for house building activities, or duly guaranteed by government or carrying current rating of not less than 'AA' by a credit rating agency registered under SEBI (Credit Rating Agencies) Regulation, 1999	
Asset backed securities with underlying housing loans, satisfying the norms specified in the guidelines issued under these regulations.	

Type of Investment	Percentage
(c) Investment in Infrastructure: *Explanation –* *Subscription or purchase of Bonds/ Debentures, Equity and Asset Backed Securities with underlying infrastructure assets would qualify for the purpose of this requirement.* *For the purpose of this requirement, Infrastructure shall have the meaning as given in Regulation 2(h) of Regulations, 2000 IRDA (Registration of Indian Insurance Companies) Regulations, 2000*	*Not less than 15%[{3} b and c taken together]*

Pension and General Annuity Business

Type of Investment	Percentage
Government Securities	*Not less than 20%*
Government Securities or Other Approved Securities *Balance to be invested in Approved Investments, as specified in Schedule I, Exposure / Prudential norms specified in Regulation 5.*	*Not less than 40% (incl (i) above)* *Not exceeding 60%*

Note:

For the purposes of this sub-regulation, no investment falling under 'Other Investments' category shall be made. However, funds pertaining to Group Insurance Business, except One Year Renewable pure Group Term Assurance Business (OYRGTA) shall form part of Pension and General Annuity Fund. OYRGTA funds shall follow the pattern of Investment of Life Business.

Unit Linked Life Insurance Business

11.11 Every Insurer shall invest and at all times keep invested his segregate fund of unit linked life insurance business as per the pattern of Investment offered to and approved by the policy-holders.

11.12 Total investment in other investments shall not exceed 25% of the fund.

Note – *For the purpose of the above Regulations:*

1 All investments in assets or instruments, which are capable of being rated as per market practice, shall be made on the basis of credit rating of such assets or instruments. No investment shall be made in instruments, if such instruments are capable of being rated, but are not rated.

2 The rating should be done by a credit rating agency registered under SEBI (Credit Rating Agencies) Regulations 1999.

3 Corporate bonds or debentures rated not less than AA or its equivalent and P1 or equivalent ratings for short term bonds, debentures, certificate of deposit and commercial paper, by a credit rating agency, registered under SEBI (Credit Rating Agencies) Regulations 1999 would be considered as 'Approved Investments'.

4 The rating of a debt instrument issued by All India Financial Institutions recognized as such by RBI shall be of 'AA' or equivalent rating. In case investments of this grade are not available to meet the requirements of the investing insurance company, and Investment Committee of the investing insurance company is fully satisfied about the same, then, for the reasons to be recorded in the Investment Committee's minutes, the Investment Committee may approve investments in instruments carrying current rating of not less than 'A+' or equivalent as rated by a credit rating agency, registered under SEBI (Credit Rating Agencies) Regulations 1999, would be considered as 'Approved Investments'.

5 Approved Investments under points 3 and 4 above, which are downgraded below the minimum rating prescribed should be automatically re-classified under 'Other Investments' category for the purpose of pattern of investment.

6 Investments in equity shares listed on a registered stock exchange should be made in actively traded and liquid instruments viz., equity shares other than those defined as thinly traded as per SEBI Regulations and guidelines governing mutual funds issued by SEBI from time to time.

7 Not less than 75% of debt instruments excluding Government and Other approved Securities - fund wise, in the case life insurer and Investment Assets in the case of general insurer - shall have a rating of AAA or equivalent rating for long term and P1+ or equivalent for short term instruments. This shall also apply to Unit linked fund(s).

8 Notwithstanding the above, it is emphasized that rating should not replace appropriate risk analysis and management on the part of the Insurer. The Insurer should conduct risk analysis commensurate with the complexity of the product(s) and the materiality of their holding, or could also refrain from such investments.

Regulation 5 of IRDA (Investment) Regulations, 2000:

Exposure / Prudential Norms

11.13 Without prejudice to anything contained in section 27A and 27B of the Insurance Act, 1938, every insurer shall limit his investment based on the following exposure norms.

11.14 Exposure Norms for Life insurance (including Unit Linked business), General Insurance (including re-insurance Business) for both approved investments as per the Insurance Act, 1938, Schedule 1 and 2 of these regulations and other investments as permitted under 27A(2) and 27B(3) of the Insurance Act, 1938:

Type of Investment	*Limit for 'Investee' Company*	*Limit for the entire Group of the Investee Company*	*Limit for Industry Sector to which Investee Company belongs*
(1)	*(2)*	*(3)*	*(4)*
(a) *Investment in 'Equity', Preference Shares, Convertible Debentures*	*10% of Outstanding Equity Shares (Face Value) or 10% of the respective fund in the case of Life insurers / investments assets in the case of General Insurer (including Re-insurer) whichever is lower.*	*Not more than 10% of the respective fund in the case of Life insurers* *The above percentage shall stand at 25% in case of Unit Linked Funds.*	*Investment by the insurer in any industrial sector should not exceed 10% of its total investment exposure to the Industry Sector as a whole.* *The above percentage shall stand at 25% in the case of Unit Linked Funds.* *(Classification of Industrial sectors to be done on the lines of classification of Industries by National Industrial Classification Code for Extra Territorial Organizations and Bodies in India (NIC) or any other system which adopts NIC classification.)*
(b) *Investment in Debt / Loans and any other permitted Investments as per Act / Regulation other than item (a) above.*	*10% of the Paid-up Share capital, Free reserves and Debentures / Bonds of the 'Investee' company or 10% of respective Fund in the case of Life Insurer / investments assets in the case of General Insurer / Re-insurer whichever is lower*		

Note:

1 *Investments in Equity including Preference Shares and Convertible part of debentures should not exceed 50% of above exposure norms as mentioned in the above table.*

2 *Investment in Immovable Property covered under section 27A (1) (n) of the Insurance Act, 1938 shall not exceed 5% of (a) Investment Assets in the case of General Insurers and (b) Investment Assets of funds relating to life funds, pension and general annuity funds in the case of life insurer.*

3 *Subject to exposure limits mentioned in the Table above, an insurer shall not have investments of more than*

- o *5% in aggregate of its total investments in companies belonging to the promoters' groups, if invested out of Life, Pension and General Annuity funds or General insurance funds and;*

- o *12.5% in aggregate of its total investments in companies belonging to the promoters' groups, if invested out of Unit linked funds.*

11.15 For the purpose of Regulations "group" will have the same meaning as defined under these regulations.

(i) *In the case of Life, Pension and General Annuity Business the percentage and General insurance business 10% of group and industry exposure shall be raised up to 15% with prior approval of Investment Committee. The Investment Committee should exercise due care keeping in view the possible concentration and other related risks in the interest of the policy holders. Exposure norms applicable for investments for which specific circulars/guidelines are issued shall be guided by such circulars/guidelines.*

(ii) *The exposure limit for financial and banking sector shall stand at 25% investment assets for all insurers.*

(iii) *Investment in Fixed Deposits (FDs) / Term Deposits (TDs) and Certificate of Deposit (CDs) of a Scheduled Bank shall be made within the provisions of section 27A (9) & section 27B (10) of the Insurance Act 1938. Such investments would not be deemed as exposure to Banking Sector. However, investments in such FDs / TDs and CDs in a Bank falling under the Promoter Group of the Insurer shall be subject to Promoter Group Exposure Norms.*

Section 27A of The Insurance Act, 1938

11.16 Consider extracting section 27(1) also since it is referred to in section 27A(3) and 27A(G).

Section 27A (3):

11.17 "An insurer shall not, out of his controlled fund invest or keep invested in the shares of any one banking company or investment company more than—

(a) two and a quarter per cent of the sum referred to in sub-section (1) of section 27, or

(b) ten per cent of the subscribed share capital, debentures and free reserves of the banking company or Investment Company concerned, whichever is less.

Section 27A (4):

11.18 An insurer shall not out of the controlled fund invest or keep invested in the shares or debentures of any one company other than a banking company or investment company more than-

(a) two and a quarter per cent of the sum referred to in sub-section (1) of section 27, or

(b) ten per cent of the subscribed share capital, debentures and free reserves of the company, Whichever is less:

11.19 "Paid-up share capital, free reserves and debenture / bonds, taken as per the audited balance sheet not more than one year old of the investee company"

Section 27A (5):

11.20 No Investment out of controlled fund shall be made in shares and debentures of any private limited company

Section 27A (9):

11.21 An insurer shall not keep more than 3% of the controlled fund in fixed deposit, term deposit and certificate of deposit of a Scheduled Bank. Such investments would not be deemed as exposure to banking sector. However, investments in such fixed deposits, term deposit and certificate of deposit in a bank falling under the promoter group of the insurer shall continue to be subject to promoter group exposure norms.

Limits for Mutual Fund – Approved and Unapproved Investments:

11.22 Investment shall be restricted to schemes of Mutual Funds comprising of Liquid, Gilt, G Sec or Debt / Income funds as defined under SEBI Regulations.

11.23 Investment in Gilt, G Sec and Liquid Mutual Funds at any point of time, under the Approved Investment category shall be as under:

Fund Size	Limit
Above ₹ 50000 Crores in the case of Life Company and above ₹ 2000 Crores in the case of General Insurance Company.	1.5 % of the Fund in the case of Life Company and 1.5% of Investment Assets in the case of General Insurance Company.
Up to ₹ 50000 Crores in the case of Life Company and up to ₹ 2000 Crores in the case of General Insurance Company.	5% of the Fund in the case of Life Company and 5% of Investment Assets in the case of General Insurance Company.

11.24 In addition to the above, the maximum investments in Mutual Funds falling under 'Other Investments' Category, shall be as follows:

Nature of Business	Private Sector		Public Sector	
	Life Fund	ULIP	Life Fund	ULIP
Life	7.5%	12.5%	3%	5%
Non-Life	12.5%		5%	

11.25 The percentage in the above table refers to in the case of life companies to individual Fund Size – life fund, pension fund and linked fund(s)

Venture Fund Investment [Circular – INV/CIR/ 007/ 2003-04]

Classification:

11.26 The Investment shall fall under "Other Investments" as per IRDA (Investment) Regulations, 2000 as amended from time to time.

Maximum Investment Limit:

11.27 3% of respective fund size or 10% of Venture Fund's Size, whichever is lower

Investment in Perpetual Instruments [IRDA/INV/ CIR/ 005/ 2006-07]

11.28 The RBI has allowed banks to raise capital through issue of Hybrid instruments as under:

1. Innovative Perpetual Debt Instruments for inclusion as Tier 1 Capital
2. Debt Capital Instruments eligible for inclusion as Tier 2 Capital
3. Perpetual Non-Cumulative Preference Shares for inclusion as Tier 1 Capital; and
4. Redeemable Cumulative Preference Shares eligible for inclusion as Tier 2 Capital

Classification:

11.29 The Authority has decided that the above Instruments may be deemed as a part of 'Approved Investments' for the purpose of section 27A of the Insurance Act, 1938, subject to the following conditions:

(a) The Debt Instrument shall be rated:

– not less than 'AAA' for those issued by Banks in Private Sector, and

– not less than AA for those issued by Banks in Public Sector.

(b) Preference shares issued by the Banks shall satisfy the conditions specified under section 27A (1) (i) and 27A (1) (j) of the Insurance Act, 1938. (Please refer flowchart 4)

Re-classification:

- *If the Hybrid Debt Instrument is downgraded below AAA, in the case of Private Sector banks and (below AA in the case of Public Sector Banks), such investments shall be re-classified as 'Other Investments'*

- *In case the Interest on the Instrument is not serviced on due dates, the Investment in such Hybrid instruments are to be re-classified as 'Other Investments' from such date for reporting to the Authority through FORM 3A (Part A) of IRDA (Investment) Regulations, 2000*

Investment in asset backed securities, PTC's & SR's - [IRDA (Investment) (Fourth Amendment) Regulation, 2008 – INV-CIR-008-2008-09 – Annexure 2]

11.31 Asset Backed Securities, but only with underlying Housing loans and infrastructure assets would be reckoned to be part of Approved Investments subject to exposure norms, under Housing, Infrastructure Sector Investments for the purpose of Regulation 3 and 4 of IRDA (Investment) Regulations, 2000

11.32 Pass Through Certificates (PTCs), Asset backed Securities (ABS) and Security Receipts (SRs) may be deemed as part of "Other Investments" for the purpose of Regulation 3 and 4 of IRDA (Investment) Regulations, 2000 subject to following exposure and prudential norms:

11.33 The securitized assets must be rated and shall have highest rating by a reputed Credit Rating Agency, registered under SEBI (Credit Rating Agencies) Regulations, 1999.

11.34 The investment in Asset Backed Securities with underlying Housing and / or Infrastructure assets shall at 'all times' not exceed 10% of respective fund(s) in the case of Life Insurance Companies and not more than 5% of Investment Assets in the case of General Insurance Companies.

11.35 If the Asset Backed Securities with underlying Housing and / or Infrastructure assets are downgraded below AAA, or the highest rating, such investment shall be re-classified as 'Other Investments'.

11.36 In case the cash-flows from such instrument are not received on due dates, the investment in such assets are to be re-classified as "Other Investments" from such date for reporting to the Authority through FORM 3A (Part A) of IRDA (Investment) Regulations, 2000.

11.37 The investments in securitized assets, both under Approved and Other Investments, taken together shall not exceed 10% of fund size in the case of Life Companies and not more than 5% of Investment Assets in the case of General Insurers.

11.38 The Insurer shall lay down internal guidelines for investment in securitized assets (ABS, PTCs and SRs) to avoid concentration with regards to issuer, tenor and type of underlying and any other criteria to achieve diversification.

11.39 All guidelines of Classification, Income Recognition and Valuation of Assets issued by the Authority shall be applicable to such investments.

Inter-scheme transfer of funds

11.40 All inter-scheme transfer of funds are to be done in compliance with the circular of IRDA dated April 29, 2007 (IRDA/FA/02/10/2003-04).

Sr. No.	Buy Scheme	Sell Scheme	Transfer Value	As per IRDA
1	Policy Holders	Shareholders		Allowed
	Debt		Net Amortized Cost of the previous day	
	Other than debt securities		Lower of Cost or Market value	
2	Policy Holders other than Linked	Policy Holders		Not allowed Allowed
3	Linked Policy holders	Linked Policy Holders	At Market Value	
		- if maturity is less than 182 days,	Transfers carried out at net amortized cost of previous day In case of Money market* instruments, transfers are done at amortized cost of previous day	
	Debt	- if maturity is more than 182 days,	In case of debt instruments other than Money market*, transfers carried out on the basis of broker note of the security on that day	
	Other than debt securities		At Market Value as per Bloomberg quote	

Risks and Internal Audit Procedures:

11.41 IRDA vide its circular INV/CIR/023/2009-10 has mandated Internal and Concurrent Audit of Investment transactions and related systems and further directed all insurers having assets under management ("AUM") not more than ₹ 1000 crores to have its investment functions audited on a quarterly basis through internal audit (either through internal resources or through firms of Chartered Accountants) and Insurer with AUM of over Rs. 1,000 crores to appoint a firm of Chartered Accountants as Concurrent Auditor to have its Investment transactions and related systems audited on a concurrent basis.

11.42 Further, the minimum scope of this internal / concurrent audit is detailed in the "Technical Guide on Internal / Concurrent Audit of Investment Functions of Insurance Companies". The insurer could include additional scope depending upon their need for control systems. The internal / concurrent audit is expected to cover 100% of transactions of all funds as per the periodicity prescribed.

11.43 The Authority has, in addition to the above mentioned concurrent audit, vide circular INV/CIR/008/2008-09 dated August 22, 2008 advised that a Chartered Accountant firm should certify on the Investment Risk Management Systems and Processes of the insurer in line with the 'Technical Guide on Review and Certification of Investment Risk Management Systems and Process of Insurance Companies'. The circular also prescribes that all insurers shall have their systems and processes audited at least once in three years.

11.44 It may be noted that both the 'Technical Guides' as referred above have been issued by the Institute of Chartered Accountants of India (ICAI) in consultation with IRDA and cover almost the entire gamut of control aspects of an Investment function of any insurer.

11.45 In the light of the above requirements prescribed by the insurance regulations, the Guidance Note suggests that the internal auditor may, while evaluating the adequacy of internal controls of an investment function relies upon compliance aspects prescribed by ICAI in the two technical guides referred to above.

Chapter 12

Legal Framework and Compliance

12.1 This Chapter basically deals with the legal framework within which the companies carrying on life insurance business, ordinarily operate, viz., the relevant Act(s), Rules and Regulations made there-under. It includes the IRDA Regulations issued for life insurers. The important provisions required to be looked into by a auditor in respect of the Insurance Act, 1938, the Income Tax Act, 1961, the Companies Act, 1956, the Service tax and other relevant enactments have been touched upon. The Guidelines issued by the IRDA for life insurers such as ULIP Guidelines and Anti-money Laundering Guidelines have been dealt with under this chapter. This Chapter also deals with the enactments introduced to ensure Corporate Governance, such as the Corporate Governance Guidelines for Insurance Sector issued by IRDA on August 5, 2009 and Amendment No.1 dated January 29, 2010).

Scope and Objective:

12.2 Auditors are also required to be aware of the important judicial decision relating to audit/auditors liability etc. Hence common giving brief gests of notable decision of atleast the Supreme Court to enhance the view of the guide.

12.3 The primary legislations that deal with the insurance business in India are the Insurance Act, 1938 (hereinafter referred to as the Act) and the IRDA Act, 1999 (hereinafter referred to as the IRDA Act). Various aspects relating to audit of companies carrying on life insurance business are influenced by the framework of following the Insurance statutes, rules and regulations made thereunder.

(i) The Insurance Act, 1938 (including Insurance Rules, 1939);

(ii) Insurance Regulatory and Development Authority Act (IRDA), 1999; and Regulations, Circulars & Notifications issued there under from time to time.

12.4 The aspects relating to preparation and presentation of financial statements of insurance companies carrying on life insurance business and the auditor's report thereon are dealt with under the IRDA (Preparation of Financial Statements and Auditor's Report of Insurance Companies) Regulations, 2000. The detailed analysis of the provisions under the Regulations is given in this chapter.

12.5 The IRDA Act, 1999 has established the Insurance Regulatory and Development Authority (the Authority) and has also provided for establishment of the Insurance Advisory Committee to advise the Authority on various matters.

12.6 The IRDA Act, 1999 has also made amendments to the Insurance Act, 1938, the Life Insurance Corporation Act, 1956 and the General Insurance Business (Nationalization) Act, 1972 by insertion of the First, Second and Third Schedules to the IRDA Act, 1999. These Schedules contain amendments to rationalise the provisions of the Insurance Act, 1938 and other statutes with the IRDA Act, 1999 and the Regulations.

12.7 In exercise of powers conferred under various sections of the IRDA Act, 1999 various IRDA Regulations made there under covering important aspects relating to insurance business have also come in force. The Authority, as on date, in consultation with the Insurance Advisory Committee, has fraud the following regulations pertaining to life insurance business:

Relevant IRDA Regulations

Sr. No.	Regulations	Relevant Provisions in the Insurance Act, 1938
1	IRDA (Registration of Indian Insurance Companies) Regulations, 2000	Sections 3, 3A, 3B
2	IRDA (Appointed Actuary) Regulations, 2000 & (Qualification of Actuary) Regulations, 2004	——
3	IRDA (Licensing of Insurance Agents) Regulations, 2000IRDA (Licensing of Corporate Agents) Regulations, 2002 IRDA (Insurance Brokers) Regulations, 2002	Section 40 to 44A
4	IRDA (Assets, Liabilities and Solvency Margin of Insurers) Regulations, 2000	Sections 64V & 64VA
5	IRDA (Actuarial Report and Abstract) Regulations, 2000	Sections 13, 15
6	IRDA (Insurance Advertisements and Disclosure) Regulations, 2000	——
7	IRDA (Preparation of Financial Statements and Auditor's Report of Insurance Companies) Regulations, 2000	Section 11, 12
8	IRDA (Investments) Regulations, 2000 amended by Investment (Fourth Amendment) Regulations, 2008	Sections 27 to 28B
9	IRDA (Life Insurance – Reinsurance) Regulations, 2000	Section 101 A
10	IRDA (Obligations of Insurers to Rural Social Sectors) Regulations, 2002	Sections 32B, 32C
11	IRDA(Protection of Policyholders Interest) Regulations, 2002	——
12	IRDA (Distribution of Surplus) Regulations, 2002	Section 49
13	IRDA (Manner of receipt of premium) Regulations, 2002	Section 64VB
14	IRDA (Micro-Insurance) Regulations, 2005	——

Regulation for Commencing Insurance Business

12.8 An Applicant would be eligible to apply for registration if such an applicant upon registration will be an Insurance Company as defined in section 2(7A) of the Insurance Act, 1938.

12.9 An Applicant, whose application has been accepted, may make an application in Form IRDA/R2 for grant of Certificate of Registration.

Grant of Certificate of Registration

12.10 The Authority may require further information or clarifications during the processing of the application for registration.

12.11 The Authority, after making such enquiries as it may require and after obtaining information or clarifications, may grant the Certificate of Registration to the applicant in Form IRDA/R3;

12.12 The applicant to whom a Certificate of Registration is granted is required to commence the insurance business within twelve months from the date of registration. However, an extension of time can be sought for by way of an application to the Authority. No extension of time is granted beyond 24 months from the date of grant of Certificate of Registration.

Rural and Social Sectors

12.13 The Obligations of Insurers to the Rural and Social Sector are governed by IRDA (Obligations of Insurers to Rural or Social Sector) Regulations, 2002. Every insurer, shall for the purposes of sections 32B and 32C of the Act, ensure that it undertakes the following obligations, during the first five financial years, pertaining to the persons in rural sector.

Rural Sector Obligation

12.14 Certain specified percentage of the total policies retain by the insurer orign to be in respect of person in the rural sector. The yearwise percentage is as under:

(i) *Seven per cent in the first financial year;*

(ii) *Nine per cent in the second financial year;*

(iii) *Twelve per cent in the third financial year;*

(iv) *Fourteen per cent in the fourth financial year;*

(v) *Sixteen per cent in the fifth financial year;*

(vi) *Eighteen per cent in the sixth financial year*

(vii) *Eighteen per cent in the seventh financial year*

(viii) *Nineteen per cent in the eighth and ninth financial year*

(ix) *Twenty per cent in the tenth financial year.*

12.15 The obligation with respect to tenth financial year shall also be applicable in respect of financial years thereafter.

12.16 “Rural Sector” means the places or areas classified as “rural” while conducting the latest decennial population census.

Social Sector:

12.17 In request of the social sector the social sector the yearwise number of persons to be are as under:

(i) *Five thousand lives in the first financial year;*

(ii) *Seven thousand five hundred lives in the second financial year;*

(iii) *Ten thousand lives in the third financial year;*

(iv) *Fifteen thousand lives in the fourth financial year; Twenty thousand lives in the fifth financial year;*

(v) *Twenty five thousand lives in the sixth financial year* *(vi) Twenty five thousand lived in the seventh financial year*

(vii) Thirty five thousand lives in the eighth financial year

(viii) Forty five thousand lives in the ninth financial year

(ix) Fifty five thousand lives in the tenth financial year

12.18 The obligation towards social sector for the tenth financial year shall also be applicable in respect of the financial year thereafter

12.19 "Social Sector" includes unorganized sector, informal sector, economically vulnerable or backward classes and other categories of persons, both in rural and urban areas. The meaning of unorganized sector, informal sector, economically vulnerable or backward classes and other categories both in rural and urban areas shall be construed as defined in the IRDA (Obligations of Insurers to Rural or Social Sectors) Regulations, 2002. "Lives" refers to new lives insured during the financial year and in force as on 31st March of the year.

12.20 It may be noted that all micro-insurance policies may be reckoned for the purposes of fulfilment of social obligations by an insurer pursuant to the provisions and regulations made in this regard.

12.21 Where a micro-insurance policy is issued in a rural area and falls under the definition of social sector, such policy may be reckoned for both rural and social obligations separately.

12.22 In terms of the circular issued by the Authority, insurers are required to ensure that compliance with the rural and social obligations is uniformly spread over a given financial year. Review by the Authority shall be done on a quarterly basis.

12.23 Any contravention of this Regulation amounts to contravention of the provisions of Sections 32B and 32C of the Insurance act, 1938.

12.24 Penalty for failure to comply with section 32B: Penalty not exceeding five lakhs rupees for each such failures is leviable berides imprisonment which may extend to three years or with fine for each such failure.

12.25 Penalty for failure to comply with section 32C: Penalty not exceeding twenty-five lakh rupees for each such failure and in the case of subsequent and continuing failure, the registration granted to such insurer shall be cancelled.

Corporate Governance

12.26 The guidelines address the following major structural elements of Corporate Governance in insurance companies

(i) Governance structure

(ii) Board of Directors

- o The Board of Directors is required to have a significant number of "Independent Directors" (as laid down in the Listing Agreement).

- o Where the Chairman of the Board is non-executive, the Chief Executive Officer should be a whole time director of the Board.

- o With a view to ensuring that the Directors comply with the above requirement, a due diligence enquiry should be undertaken on the person to be appointed as Director or for the continuance of the existing Directors only after obtaining a declaration from the proposed/existing Directors in the prescribed format placed at Annexure 2 in corporate governance guidelines, at the time of their appointment/re-appointment.

- o The Directors are required to enter into a Deed of Covenant as per the prescribed format placed at Annexure 3 in corporate governance guidelines, with the insurance company, duly approved by the Board, pursuant to their terms of appointment to ensure that there is a clear understanding of the mutual role of the company, the Directors and the Board in Corporate Governance.

(iii) **Control Functions:** Policy framework to be put in place for:

- o robust and efficient mechanisms for identification, assessment, quantification, control, mitigation and monitoring of the risks;
- o appropriate processes for ensuring compliance with the Board approved policy, and applicable laws and regulations;
- o appropriate internal controls to ensure that the risk management and compliance policies are observed;
- o an internal audit function capable of reviewing and assessing the adequacy and effectiveness of, and the insurer's adherence to its internal controls as well as reporting on its strategies, policies and procedures; and
- o Independence of the control functions, including the risk management function, from business operations demonstrated by a credible reporting arrangement.

(iv) **Delegation of Functions**: With a view to providing adequate Board time for discharge of the significant corporate responsibilities, the Board can consider setting up of various Committees of Directors by delegating the overall monitoring responsibilities after laying down the roles and responsibilities of these Committees to the Board.

The company can establish several Committees to undertake specific functions

(v) **Audit Committee (mandatory)**

- o The Audit Committee shall oversee the financial statements, financial reporting, statement of cash flow and disclosure processes both on an annual and quarterly basis.

- o The Chairman of the Audit Committee should be an independent Director of the Board and should ideally be a professional Chartered Accountant or a person with strong financial analytical background.

(vi) **Investment Committee (mandatory)**

- o Investment Committee shall comprise of at least two Non-Executive Directors, the Chief Executive Officer, Chief of Finance, Chief of Investment Division and wherever an appointed actuary is employed, the Appointed Actuary

- o The constitution of the Investment Committee should be approved by the Board of Directors and any new appointment or removal of any member of the Investment Committee shall also be approved by the Board and be communicated to the Authority within 30 days.

- o The members of the Committee should not be influenced solely by the credit rating agencies.

- o The IC shall meet at least once in a quarter and look into various aspects of investment operations and monitor them.

- o The IC shall furnish a report to the Board on the performance of Investments atleast on a quarterly basis and provide analysis of its Investment portfolio and on the future outlook to enable the Board to look at possible policy changes and strategies.

(vii) **Risk Management Committee (mandatory):** The risk management function shall be organized in such a way that it is able to monitor all the risks across the various lines of business of the company and the operating head has direct access to the Board. Conventionally this function is under the overall guidance and supervision of the Chief Risk Officer (CRO) with a clearly defined role.

(viii) **Asset Liability Management Committee (mandatory for life insurers)**

(ix) **Policyholder Protection Committee (mandatory):** The Committee should put in place systems to ensure that policyholders have access to redressal mechanisms and shall establish policies and procedures, for the creation of a dedicated unit to deal with customer complaints and resolve disputes expeditiously.

(x) **Remuneration Committee (not mandatory)**

(xi) **Nomination Committee (not mandatory)**: In line with the international and domestic norms, the Directors of insurance companies have to meet the "fit and proper" criteria. The criteria to be satisfied, at a minimum, would relate to integrity demonstrated in personal behaviour and business conduct, soundness of judgment and financial soundness. The Insurance Act prohibits (i) a life insurance agent to be the Director of the life insurance company; and (ii) the common directorship among life insurance companies. Currently, the 'fit and proper' requirements seek to ensure that the Director should not have been convicted or come under adverse notice of the laws and regulations involving moral turpitude professional misconduct. With a view to ensuring that the Directors comply with the above requirement, a due diligence enquiry should be undertaken on the person to be appointed as Director or for the continuance of the existing Directors only after obtaining a declaration from the proposed/existing Directors in the format given in Annexure 2, at the time of their appointment/re-appointment. It is desirable that the Boards constitute a Nomination Committee to scrutinize the declarations of intending applicants before the appointment/ reappointment/election of directors by the shareholders at the General Meetings. The Nomination Committee could also make independent/ discreet references, where necessary, well in time to check the accuracy of the information furnished by the applicant. The insurance companies are further advised that they should obtain an annual declaration from the Directors that the information provided in the declaration at the time of appointment/ re-appointment has not undergone any change subsequently and the changes, if any, are appraised by the concerned Director to the Board.

(xii) **Disclosure Requirements:** IRDA (Preparation of Financial Statements & Auditors Report of Insurance Companies) Regulations, 2000 have prescribed certain disclosures in the financial statements and the Authority is in the process of finalizing additional disclosures to be made by insurers at periodical intervals.

(xiii) **Outsourcing:** Each proposal to outsource any function of the insurer as permitted by the Authority (e.g., as in the case calculation of NAV of Investments) shall be reported to IRDA before entering into the arrangement.

- o All outsourcing arrangements of the company shall have the approval of the Board.

- o Every outsourcing contract shall contain explicit safeguards regarding confidentiality of data and all outputs from the data, continuing ownership of the data with the insurer and orderly handing over of the data and all related software programmes on termination of the outsourcing arrangement.

- o The arrangement shall be for a defined duration of not more than 3 years and should have provision for premature cancellation without attracting penalties.

- o The Company shall monitor and review the performance of agencies to whom operations have been outsourced at least annually and report findings to the Board.

(xiv) **Reporting to IRDA:** Insurers should examine as to what extent they are currently complying with these guidelines and initiate immediate action to achieve compliance (where not already) within a period of six months from the date of these guidelines. It is expected that all the arrangements would be in place to ensure full compliance with the guidelines from the financial year 2010-2011. Where such compliance is not possible for any specific reason, the insurer should write to the IRDA for further guidance. Each insurer should designate an officer as the Compliance officer whose duty will be to monitor continuing compliance with these guidelines.

(xv) **Whistle Blowing Policy:** The insurers are well advised to put in place a “whistle blowing” policy, whereby mechanisms exist for employees to raise concerns internally about possible irregularities, governance weaknesses, financial reporting issues or other such matters. These could include employee reporting in confidence directly to the Chairman of the Board or of a Committee of the Board or to the external auditor. The appointed actuary and the statutory/internal auditors have the duty to ‘blow the whistle’, i.e., to report in a timely manner to the IRDA if they are aware that the insurer has failed to take appropriate steps to rectify a matter which has a material adverse effect on its financial condition. This would enable the IRDA to take prompt action before policyholders’ interests are undermined.

(xvi) **Anti-Money Laundering**

The insurer/agents/corporate agents are required to maintain the records of types of transactions mentioned under Rule 3 of PMLA Rules 2005 as well as those relating to the verification of identity of clients for a period of 10 years

12.27 The AML program promotes submission of Suspicious Transaction Reports (STR)/Cash Transactions Reports (CTR) to the Financial Intelligence Unit-India.

Maintenance of records for insurance companies

(i) Customer information may be allowed to be shared between different organizations on request

(ii) Procedures must be implemented for retaining internal records of transactions both domestic and overseas

(iii) Companies should retain the records of those contracts, which have been settled by claim, surrender or cancellation, for a period of at least 10 years after the settlement

(iv) records relating to ongoing investigations, or transactions, which have been the subject of a disclosure, should be retained until it is confirmed that the case has been closed

(v) Customer identification data obtained through the customer due diligence process, account files and business correspondence should be retained for at least 10 years after the business relationship ceases.

Monitoring cash transactions for insurance Companies

(i) It should be ensured that premiums are paid out of clearly identifiable sources of funds, and remittances of premium by cash should not exceed Rs. 50,000/-

(ii) Premium/proposal deposits beyond Rs. 50,000 should be remitted only through cheques, demand drafts, credit card or any other banking channels.

Illustrative list of Suspicious Transactions for insurance Companies

(i) Customer insisting on anonymity, or providing minimal, seemingly fictitious information

(ii) Frequent FLCs by customers

(iii) Assignments to unrelated parties without valid consideration

(iv) Request for a purchase of policy in amount considered beyond his apparent need

(v) Cash based suspicious transactions for premium and top ups over and above Rs. 5 lakhs per person per month. It should also consider multiple DDs each for less than Rs. 50,000/-

(vi) Policy from a place where the progress does not reside or is employed

(vii) Unusual termination of policies and refunds

(viii) Frequent request for change in addresses

(ix) Borrowing the maximum amount against a policy soon after buying it

(x) Inflated or totally fraudulent claims

(xi) *Overpayment of premiums with a request for a refund of the amount overpaid*.

Due Dates of reporting for Insurance Companies

(i) Cash transaction reports shall be submitted by the 15th day of the succeeding month

(ii) Suspicious transaction reports shall be submitted in writing or by fax or electronic mail within 7 working days from the date of occurrence of such transactions.

IRDA guidelines

(i) Customer Identification

- o Establish customer identity consistent with risk profile in respect of all new insurance contracts
- o Due diligence to be exercised for premium above ₹ 1 lakh
- o PAN card to be collected for verification for premium above Rs. 1 lakh
- o Customer information should be collected from all relevant sources, including from agents.
- o Insurance premium paid by persons other than the

person insured should be looked into to establish insurable interest.

- o No criminal background
- o at the claim payout stage and at times when additional top up remittances are inconsistent the customer known profile.

(ii) KYC – When?

- o For new customers- at the time of entering into contract
- o For existing customers- based on the limits fixed for new policies on all contracts/relevant transactions in case of the existing polices
- o Checking at the time of claims also forms part of KYC

(iii) KYC- Risk Profile

Companies are advised to classify the customer into high risk and low risk, based on the individual's profile and product profile, to decide upon the extent of due diligence.

12.28 Illustrative checklist containing risks and internal audit procedures along with applicable regulations/guidelines/notification/circulars:

Risks	Internal Audit Procedures
(i) Certificate of Registration not renewed	• Check whether renewal application has been made within timeliness, fees computation to be reviewed.
(ii) Appointment of Actuary	• Check whether the actuary has been appointed and the board resolution have been filed with IRDA • Check whether the actuary possess qualifications as

Risks	Internal Audit Procedures
	mentioned by IRDA under regulation 3.
(iii) Rural and Social Sector obligations Non-compliance with sections 32 B and 32C	Check the number of policies sourced as rural vis-à-vis total number of policies and total number of lives covered under social sector vis-à-vis total lives covered
(iv) Policies wrongly marked as Rural / Social	Check policies for ensuring that the policies marked as Rural / Social meets all the criterias mentioned by IRDA and that the classification as Rural / Social is correct
(v) Wrong MIS to IRDA	Check the number of policies marked as Rural / Social and numbers reported to IRDA on quarterly/annual basis.
(vi) Policies cancelled included in reporting	Check that policies cancelled are not included in the numbers considered as Rural and Social. Also check the types of cancellations that is used to treat the policy as cancelled.
(vii) Policy without cover marked as Rural	Check that such policies are not included in calculations. Also check that product sold as rural/social policy is in compliance with schedule II of Micro Insurance Regulations, 2005 (circular no. 356/GI/2008 dated February 11, 2008)

Risks	Internal Audit Procedures
(viii) In case of Renewal old members are considered again for arriving at the count of Policies	Check that the count contains only newly added members and renewal case are excluded.
Corporate Governance (Guidelines for Insurance Sector issued by IRDA on August 5, 2009 and Amendment No. 1 dated January 24, 2010	
(i) Non Compliance of guidelines on Significant Owners, Controlling Shareholders and Conflict of Interest	Following needs to be verified • The shares of the promoters have not been transferred within 5 years from the date of commencement of business of an insurer • FDI limit does not exceed 26% • Transfer of shares to be in compliance with the IRDA circular dated 25th August 2005 • Key transactions have been reviewed at the Board level and disclosure of conflict of interests if any has been made.
(ii) Non Compliance to Governance Structure	Following needs to be verified • Senior Management – Two positions are not held by a single person • Check the Constitution of the Board of Directors to ensure that it is line with guidelines relating to number of independent directors. CEO should be a whole time

Risks	Internal Audit Procedures
	director if Chairman is non-executive. • Check declaration under section 24AA of the Insurance Act wherein all the relatives are disclosed to ensure that no relatives are directors of the company • Check declaration under section 297, 299 of the Comapnies Act and Form 3A stating that he is not acting in the capacity of director in other insurance company • Check that declarations have been obtained and filed with IRDA at the time of appointment/reappointment of directors • Check that all the Directors have entered into a Deed of Covenant and have been familiarized with the background of the Company's governance philosophy, duties and responsibilities.
(iii) Non-compliance of Control Functions	Check the following: • Processes are in place for ensuring compliance with Board Approved policies and applicable laws & regulations. • Internal Audit (internally or outsourced) of business process is done to validate internal controls, etc. In case

Risks	Internal Audit Procedures
	of group company the group company's risk policy to have an overall monitoring of the risk that framework in the insurance company
(iv) Non-compliance of Delegation of Functions	• Check that the formation, constitution, frequency of meeting and business transacted (through minutes) for the following committees are in line with the Corporate Governance Guidelines • Audit Committee • Investment Committee • Asset Liability Management Committee • Risk Management Committee • Policyholder Protection Committee • Remuneration Committee (Not Mandatory) • Nomination Committee (Not Mandatory) • Ethics Committee (Not Mandatory)
(v) Non-Disclosure	Check the financial statements to ensure that disclosures as mentioned in Corporate Governance guidelines have been made.
(vi) Outsourcing not in accordancewith norms of Corporate Governance	Check the following: • List of Outsourced Activities • SLA with Vendors • Reportings to IRDA

Risks	Internal Audit Procedures
	• Review and feedback mechanism • As per IRDA guidelines, period of the contract should not exceed three years.
(vii) Whistle Blower Policy not in place	Check that policy is in place and covers the following • Process to increase awareness among employees • Process to handle the incidents reported and taking actions on the same.
Anti Money Laundering	
(viii) Non-compliance of KYC requirement	Check the documents collected at following stages • New Business stage • Assignment • Fund Transfer • Claims • Top up.
(ix) Record Keeping not as per laid down guidelines	• Check the record retention policy and to check the original documents collected at various stage of policy • Check whether records are maintained for 10 years from the date of closure of policy
(x) CTR Reporting not being done/ Cases not being reported in CTR	• Check the process for ensuring that premium beyond Rs. 50,000 per month per customer are not received in cash, to check the

Risks	Internal Audit Procedures
	data for new business and renewal premium • To check the process for identification and reporting of CTR • Check whether CTR are being reported within the stipulated timeliness
STR Reporting not being done	
(xi) Refund in case of premium received in cash beyond 1 lakh not reported	Check total refunds for the period along with the mode of receipt of premium. Check at customer ID level the cases where premium is received through different modes but it is refunded through one mode.
(x) Policies taken from different branches	Check PDR data to detect such cases.
(xi) Customer insisting on anonymity, or providing minimal, seemingly fictitious information not reported	Check the process for identification and reporting of such cases.
(xii) More than 3 freelook cancellations in a year and refund >Rs.2 lakh	Check request of FLC for the period.
(xiii) To check if Assignment is for valid consideration	Check the assignment request for the period.
(xiv) Request for a purchase of policy for an amount considered beyond his apparent need	Check the process for identification and reporting of such cases.
(xv) Cash based suspicious transactions for premium and	Check top up requests for the period.

Risks	Internal Audit Procedures
top ups over and above Rs. 5 lakhs per person per month	
(xvi) Policyholder borrows a maximum amount against a policy soon after buying it	Check loan cases for the period.
(xvii) 5 or more address changes in a year and aggregate premium exceeds Rs. 2 lakhs	• Check address change request for the period. • Check whether system is able to retain the record of last five address change.
(xviii) More than 3 terminations/ NTU during the quarter and aggregate refund Rs.5 lakhs	• Check cancellation and Not taken up cases for the period at customer ID level.
(xix) Integrally related transactions (combined roles of proposer, life assured, assignee) above Rs. 50k in a calendar month	Check data policyholder ID wise to detect such cases
(xx) Internal training is done for internal employees and agents	Check training register.
(xxi) To check copy of board approval program for AML (resolution)	Check the minutes of the board.
(xxii) To check that the AML policy is filled with IRDA and also to see the AML Policy covering the aspects of Customer acceptance policy, Customer identification procedure, monitoring of transaction, RMF	Check the filing and the contents is in line with the circular issued.
(xxiii) STR not filed / delay in filing	Check the date of identification and date of filing.

Risks	Internal Audit Procedures
(xxiv) Non-compliance with Customer Identification guidelines	• Check the process for abiding with the guidelines. • Check the quality of identity proof, address proof and income proof where premium received (regular, single and top up) exceed ₹ 1 lakh
Classification of customers based on Risk Profile not done / incorrectly done	Check the cases to ensure that the process for finalization of Risk profile is adhered, review being done on regular intervals
Micro-Insurance	The provisions governing Micro-Insurance are dealt with in the IRDA (Micro-Insurance) Regulations, 2005. As discussed earlier in Chapter 2, all micro-insurance policies may be reckoned for the purposes of fulfilment of rural and social obligations by an insurer pursuant to the provisions and regulations made in this regard. An Insurer carrying on life insurance business may offer life micro-insurance products as also general micro-insurance products subject to the conditions mentioned in the regulations.

Returns to ROC

Particulars	*Timeline*	*Form*
Appointment/ resignation of directors	Within 30 days from the date of appointment/ resignation/retirement	Form 32
Appointment of Managing Director	Within 30 days after passing of resolution : Section 192	Form 23 - Registration of resolution and agreement
Transfer of funds from shareholders account to policy holder account	Within 30 days after passing of resolution : Section 192	Form 23 - Registration of resolution and agreement.
Filing of annual return by the company having share capital	Within 60 days from the day on which Annual General Meeting of the Company is held : Section 159	Form 20B
Filing of balance sheet and other documents with the Registrar	Within 30 days of Annual General Meeting of the Company - Section 220	Form 23AC
Filing of P & L and other documents with the Registrar	Within 30 days of Annual General Meeting of the Company - Section 220	Form 23ACA

Return/report	**Circular reference**	**Due date**
Monthly		
New Business Data	028/IRDA/F & A/Oct 05 and 102/1/F & A/Online/ 122/Nov 06	5th of succeeding month
Exposure of Insurance Companies to capital markets	8/RBI/05-06 dated 5-Jul-05	7th of succeeding month
Reporting of places of business/ office hours	017/IRDA/CIR/LIFE/June 07 dated 8-June-07	10th of succeeding month

Return/report	Circular reference	Due date
Quarterly		
Investment returns	IRDA (Investment) Regulations, 2008 IRDA (Investment) Regulations, 2008	Within 45 days of end of quarter Within 45 days of end of quarter
Furnishing of quarterly business statistics	015/IRDA/CIR/LIFE/ May 07	Within 15 days of end of quarter
Return of shareholding pattern	IRDA/F & A/064/Jan 05 dated 12th January, 2005	Within fortnight of end of quarter
Reinsurance returns - Form LR 8 and Form KT – Q	IRDA (Life Insurance Reinsurance) Regulation 2000	45 days from end of the quarter
Statement of assets and liabilities and Solvency report	056/IRDA/ACTL/Solvency Margin/ February 07 dated February 23, 2007	45 days from end of the quarter
Public Disclosure of financial statements	IRDA/F&I/CIR/F&A/012/ 01/2010 dated January 28, 2010	Website publication – within 45 days from the quarter
Premium awaited policies	IRDA/LIFE/MISC/37/ Sep/2009 dated 15 September 2009	15th of the month following the next quarter end
List of persons sponsored for training and examination IRDA	42/IRDA/Agency/Oct 2007 dated October 15, 2008	N/A N/A
NAV certificate	Circular No 21/IRDA/ ACTL/ULIP/Oct-08 dated 27 October 2008	Within a fortnight of end of quarter
Handling of Complaints/ Grievances: Micro Insurance Agents	Regulation 16 of IRDA (Micro Insurance) Regulation 2005	N/A
Quarterly Group Business Report	064/IRDA/ACTL/March 2008 dated 18-March 2008	N/A
Training details	42/IRDA/Agency/Oct 2007 dated October 15, 2007	N/A

Return/report	Circular reference	Due date
Half yearly		
Public Disclosure of financial statements	IRDA/F&I/CIR/F&A/012/ 01/2010 dated January 28, 2010	Website and print publication –within 2 months after half year or within 15 days of approval by the Board
Details of business generated through Bancassurance Channel and payouts	IRDA/F&I/CIR/F&A/008/ 01/2010 dated January 21, 2010	Within 45 days from the end of half year
Licensing of Corporate Agents	017/IRDA/Circular/CA guidelines/ 2005 dated 14-July-2005	N/A
Training Details		N/A
Annual		
New business data of the company for the year	028/IRDA/F & A/Oct 05 and 102/1/F & A/Online/ 122/Nov 06	3 months from the close of financial year
Actuarial report, statement of assets and liabilities	IRDA (Actuarial report and abstract) regulations 2000 IRDA/ACTL/AAAR/ ver. 1/Aug 2002 dated August 1, 2002	Within 6 months from the end of financial year
Reinsurance returns		Within 45 days from the end of the financial year
7 copies of accounts and balance sheet	Section 15 of the Insurance Act, 1938	Within 6 months from the end of the period to which it belongs
Annual financial statements	IRDA/F & A/013/2005-06 dated 9-June-05	Within 6 months from the end of the period to which it belongs
Public Disclosure of financial statements	IRDA/F&I/CIR/F&A/012/ 01/2010 dated January 28, 2010	Website and Print publication–within 6 months of the close of

Return/report	Circular reference	Due date
		financial year or within 30 days from the date of adoption of final accounts by the Board of Directors
Statement of allowable expenses	Section 40B of the Insurance Act, 1938 read with rule 17D of the Insurance rules 1939	N/A
Renewal of registration	018/IRDA/ORD/October 2008 dated October 17, 2008	31-Dec
Premium awaited policies	IRDA/LIFE/MISC/37/Sep/ 2009 dated 15 September 2009	30-Sep
Compliance on advertisements	IRDA (Issuance of advertisements and disclosure) regulations 2000	N/A
Training details		N/A
Rural sector obligation	In response to IRDA letter dated 14-Sep-09	N/A
Chart of accounts		
Proceedings of General Meeting	Section 19 of the Insurance Act, 1938	Within 30 days from holding of meeting
Reinsurance program	IRDA (Life Insurance Reinsurance) Regulation 2000	Within 45 days prior to the commencement of financial year
Others - Event based		
Reconstitution of Investment Committee	Clause 7.2 of the Corporate Governance Guidelines	Within 30 days of Board approval
Information on Statutory Auditors and other auditors	004/IRDA/F & A/CIR/ Apr 09 dated April 22, 2009	Within a week of appointment/reappoint-ment

Return/report	Circular reference	Due date
Revision in AML Policy	30/IRDA/AML/Cir/Aug 09 dated 24 August 2009	N/A
Premium and claims details of the Central and state government sponsored insurance schemes	In response to IRDA letter dated August 17, 2009	N/A

Meeting requirements

Committee	Required under	Frequency
Audit Committee	Mandatory Committee under Companies Act, 1956, IRDA	At least once in a quarter
Investment Committee	Mandatory Committee under IRDA	At least once in a quarter
Risk Management Committee	Mandatory Committee under IRDA	Atleast 4 meetings in a year and gap between 2 meetings should not be more than 4 months
Asset Liability Management Committee	Mandatory Committee under IRDA	Atleast 4 meetings in a year and gap between 2 meetings should not be more than 4 months
Policy holders protection committee	Mandatory Committee under IRDA	Atleast 4 meetings in a year and gap between 2 meetings should not be more than 4 months
Compensation committee	Recommended by IRDA	As and when required
Nomination committee	Recommended by IRDA	As and when required

Members & Directors register:

12.29 Details appearing in Directors Registered maintained under Section 303 of Companies Act, 1956

(i) The Present Name or Names and Surname in full

(ii) Any former Name or Names and Surname in full

(iii) Father's/Husband's Name in full

(iv) Usual Residential Address

(v) Nationality and Nationality of origin (if other than present nationality)

(vi) Business, Occupation and Particulars of other Directorship, manager ship and secretary ship held

(vii) Date of Birth (in case of individuals only)

(viii) Date of appointment

(ix) Remarks

Chapter 13

Relationship and Complaint Handling

Scope and Objective

13.1 *As per IRDA circular* 3/CA/GRV/YPB/10-11 dated July 27, 2010, "*There shall be a uniform definition of "Grievance or Complaint". Grievances shall be clearly distinguished from Inquiries and Request."*

13.2 **Grievance/Complaint:** *A "Grievance/Complaint" is defined as any communication that expresses dissatisfaction about an action or lack of action, about the standard of service/deficiency of service of an insurance company and/or any intermediary or asking for remedial action.*

13.3 **Inquiry**: An "Inquiry" is defined as any communication from a customer for the primary purpose of requesting information about a company and/or its services.

13.4 **Request:** A "Request" is defined as any communication from a customer soliciting a service such as a change or modification in the policy.

13.5 As per clause 5 of IRDA (Protection of Policyholders Interest) Regulations, 2002, "*Every insurer shall have in place proper procedures and effective mechanism to address complaints and grievances of policyholders efficiently and with speed and the same along-with the information in respect of Insurance Ombudsman shall be communicated to the policyholder along-with the policy document and as may be found necessary."*

13.6 Accordingly every insurer should have well defined relationship and complaint handling department wherein all the complaints received through various modes will be logged in and resolved within the time schedule as decided by the insurer not exceeding the time schedule prescribed by as per IRDA Regulations.

13.7 The main objective of Relation and Complaint handling department of an insurer is to ensure timely resolution of grievance/ complaint and maximum satisfaction to the policy holder.

13.8 Also this department will be responsible for speedy resolution/ escalation of all the complaints received and for various reporting to IRDA and the management

13.9 Complaints may be of varied nature and needs to be classified depending on source, nature and criticality of the complaints.

13.10 Complaints can be received at various touch points, namely call centre, branches, senior management, IRDA and Insurance Ombudsman. Insurer should have a well-defined framework to report and address all possible complaints received.

13.11 Various types of complaints include the following:

(i) Mis-selling, fraud, forgery & misrepresentation related complaints from the policy holder

(ii) Commission and recovery related complaints from the intermediaries

(iii) General policy related complaints/queries such as:

- o Change in Address
- o Incorrect accounting of renewal premium amount
- o Product feature related
- o Premium payment history

- o Non-receipt of renewal premium receipt
- o Non-receipt of proof for fund switch
- o Non-receipt of unit statement
- o Surrender payment query
- o Non receipt of top up premium receipt.

13.12 Complaints may be received through any of the following modes:

(i) Letters/mails

(ii) Insurer's call-centre

(iii) Walk-in customer

(iv) Managing Director/Higher authorities of the insurer

(v) IRDA

(vi) Insurance Ombudsman.

13.13 Complaints of the following types come within the purview of the Ombudsman's

Consideration:

(i) Repudiation of liability under claims

(ii) Delay in settlement of claims

(iii) Any dispute regarding premiums paid or payable in respect of the policy

(iv) Any dispute regarding the legal construction of the policies in relation to a claim; and

(v) Non-issue of insurance document to customer after receipt of premium.

13.14 Every insurer should have well defined escalation matrix and turnaround time (TAT) for resolution of complaints. Most of the insurance companies use Complaints Management System (CMS) where all the complaints received other than major complaints such as IRDA/Ombudsman complaint are logged. The escalation matrix and TAT for resolution of various types of complaints should be well defined in SOP of the insurer.

13.15 The relation and complaints department should also provide periodic ageing analysis of all the complaints received to the management.

13.16 General complaints/enquiries are mostly received at various branches, processing centres and call centres which are then logged in CMS and necessary action is taken depending on case to case.

13.17 Most of the insurers have Grievance Redressal Committee consisting of senior members of the Management and external experts who are involved in monitoring and resolution of various complaints depending on its source, nature and criticality. This committee meets at regular intervals to review MIS for complaints.

Closure of grievance:

(*IRDA circular* 3/CA/GRV/YPB/10-11 dated July 27, 2010)

13.18 "*A complaint shall be considered as disposed of and closed when*

(a) the company has acceded to the request of the complainant fully.

(b) where the complainant has indicated in writing, acceptance of the response of the insurer.

(c) where the complainant has not responded to the insurer within 8 weeks of the company's written response.

(d) where the Grievance Redressal Officer has certified that the company has discharged its contractual, statutory and regulatory obligations and therefore closes the complaint."

13.19 As per IRDA circular 028/IRDA/CIR/LIFE/ April-08 dated April 3, 2008 on Updated Formats for Furnishing Statistics by Life Insurers, the deadline for furnishing the above statistics to the Authority is as indicated below: (Complaints statistics forms part of overall business statistics of the insurer

(i) "The audited data for the financial year ended 31st March, 2008 is to be furnished latest by 30th June, 2008

(ii) The quarterly data is to be furnished as before, within fifteen days of the end of every quarter."

13.20 The primary objective of the audit is to check and confirm that all the complaints received by whichever mode are logged in CMS and necessary action is taken within TAT defined by the insurer; and to ensure whether complaints are escalated as per the escalation matrix. Audit should also include checking correctness and completeness of all the MIS and reports presented to Management and IRDA.

13.21 The internal audit in this regard would normally cover:

(i) Process for receipt of complaints at branches/processing centres/call centres

(ii) Checking of complaint letters (signature verification in case of letters)

(iii) Necessary updation in CMS

(iv) Timeliness for processing the complaints

(v) Classification of complaint

(vi) Escalation matrix and necessary approvals

(vii) Appropriate action taken

(viii) Intimation to the complainant

(ix) Recurrence of complaints

(x) Complaints received from IRDA/Ombudsman

(xi) Reporting of complaints to IRDA and various MIS reporting to Management

(xii) Reporting of major complaints/suspicious transaction to FIU-INDIA. (Will be covered separately in Legal and Compliance area)

13.22 Illustrative checklist containing risks and internal audit procedures along with applicable regulations/guidelines/notification/circulars:

Risks	Internal Audit Procedures
(i) Absence of proper procedures and effective mechanism to address complaints and grievances of policyholders efficiently expenditiously. (clause 5 of IRDA (Protection of Policy holder's interest) Regulations, 2002)	• Check whether insurer has relation ship and complaints department who would be responsible for logging of complaints and speedy resolution • Check whether the insurer has in place defined processes and effective mechanism in place for resolving complaints and the same is forming part of SOPs • Check whether escalation matrix for different types of complaints is defined in SOPs.
(ii) Non-availability of Grievance Redressal Policy (*IRDA circular* 3/CA/GRV/YPB/10-11 dated July 27, 2010)	• Check whether Grievance Redressal Policy is filed with IRDA.

Risks	Internal Audit Procedures
(iii) Absence of Grievance Officer (IRDA circular 3/CA/GRV/YPB/ 10-11 dated July 27, 2010)	• Check whether the insurer has a designated Grievance Officer of a senior management level. Senior Management would mean either the CEO or the Compliance Officer of the insurer. • Every office other than the Head/ Corporate/ Principal officer of an insurer shall also have an officer nominated as the Grievance Officer for that office.
(iv) Non availability of minimum software requirement (IRDA circular 3/CA/GRV/YPB/10-11 dated July 27, 2010)	• Check whether insurer has automated system that enables online registration, tracking of status of grievances by complainants and periodical reports as prescribed by IRDA.
(v) Delay in logging of complaints/Failure to log compliants received thereby leading to policy holder taking legal action	• Check the process at branches/processing centres/ call centres for logging of complaints • Check whether unique ID is created for each complaint received • Check whether insurer has a practice of affixing every complaint received with inward stamp • Check whether the complaint is logged in CMS on the date of receipt.

Risks	Internal Audit Procedures
(vi) Non availability of Grievance Redressal procedure on insurer's website	• Check whether insurer has publicized its Grievance Redressal Procedure and ensure that it is specifically made available on its website.
(vii) Abscence of Policy Holder Protection Committee and Grievance Redressal Committee	• Check whether insurer has formed Policy Holder Protection Committee and meetings are held regularly • Check whether insurer has Grievance Redressal committee consisting of senior management and external experts to monitor the resolution of complaints and reporting to IRDA. Check whether the meetings are held regularly.
(viii) Incorrect classification of complaints	• Check whether correct classification of complaints is done.
(ix) Manual errors in logging queries in the CMS module, mentioning incorrect problem description in the CMS module	• In case of complaints received through letters check whether signature of the policy holder matches with the original policy document • Check whether correct details such as name of the policy holder, policy number , type of complaint, etc are correctly entered in the system.

Risks	Internal Audit Procedures
(x) Treating complaint as a query, resulting in customer resorting to legal proceedings. Escalation of query into a complaint leading to additional work performed in solving the query	• Check whether there is a clear demarcation between enquiries and grievances. Check whether there are defined parameters to differenciate between normal enquiries and grievance • Check whether complaints received from Ombudsman/ IRDA/directly addressed to Managing Director are classified properly as major complaints and are segregated from general complaints/enquiries
(xi) Delay in resolution of complaint/intimation to policy holder Absence of defined procedure for grievance Redressal (Grievance Redressal System/ Procedure - IRDA (Protection of Policy holder's interest) Regulations, 2002)	• Check whether the insurer has sent a written acknowledgement to a complainant within 3 working days of the receipt of the grievance • Check whether the acknowledgement contains the name and designation of the officer who will deal with the grievance • Where the grievance is not resolved within 3 working days, an insurer shall resolve the grievance within 2 weeks of its receipt and send a final letter of resolution • Check whether the insurer has informed the complainant about how he/she may

Risks	Internal Audit Procedures
	pursue the complaint, if dissatisfied. The insurer shall inform that it will regard the complaint as closed if it does not receive a reply within 8 weeks from the date of receipt of response by the insured/policyholder.
(xii) In case of wrong decesion belated resolution or resolution leading to reputation loss for the organization	• Check whether complaints are resolved within IRDA prescribed TAT • Check repetitive complaints and the reasons for the same • Check IRDA correspondence file for notices from IRDA for not addressing the complaints • Check on insurer's process for tracking news in media pertaining to the insurer and the action taken • Check whether proper resolution of the complaint is done.
(xiii) Non resolution of complaint/Long pending complaints	• Check whether ageing analysis of the complaints is prepared and adequate follow-up is done for long pending complaints.
(xiv) Incorrect MIS/ report to IRDA/ Audit Committee/ Policy Holder Committee/ Grievance Redressal Committee	• Check whether correct details are entered in the MIS and reports/statistics sent to IRDA and various committees • Check MIS/Reports are directly generated from the system.

Risks	Internal Audit Procedures
(xv) Delay in sending report to IRDA (As per IRDA circular 028/IRDA/CIR/LIFE/ April-08 dated April 3, 2008"	• Check whether quarterly complaints statistics is sent to IRDA within 15 days from end of the quarter • Check whether annual complaints statistics is sent to IRDA within last day of close of subsequent immediately following quarter • Check whether the format is as per the IRDA circular referred above.

Chapter 14

Agency Licensing

Sub-process:

14.1 Tied Agency: Tied Agents

Scope and Objective:

14.2 A person who desires to act as an insurance agent can apply for the same to the Designated Person of the insurer who is authorized by IRDA to issue or renew license. An agent could be an individual, a firm or a company formed under the Companies Act (including banking company).

14.3 The Designated Person on being satisfied that the applicant possesses the required qualification, has undergone practical training, has passed the examination as per the Regulation, has the requisite knowledge to solicit and procure insurance business and is capable of providing necessary service to the policyholders will grant or renew the license.

14.3 The Agent can thereafter procure business on behalf of the insurer.

14.4 The objective of the audit is to check

(i) Appropriate Fees collection

(ii) Verification of commission payments

(iii) Adherence to IRDA norms regarding Agency Licensing.

14.5 IRDA has issued the following Regulations with regard to Agency Licensing:

(i) IRDA (Licensing of Insurance Agents) Regulations, 2000

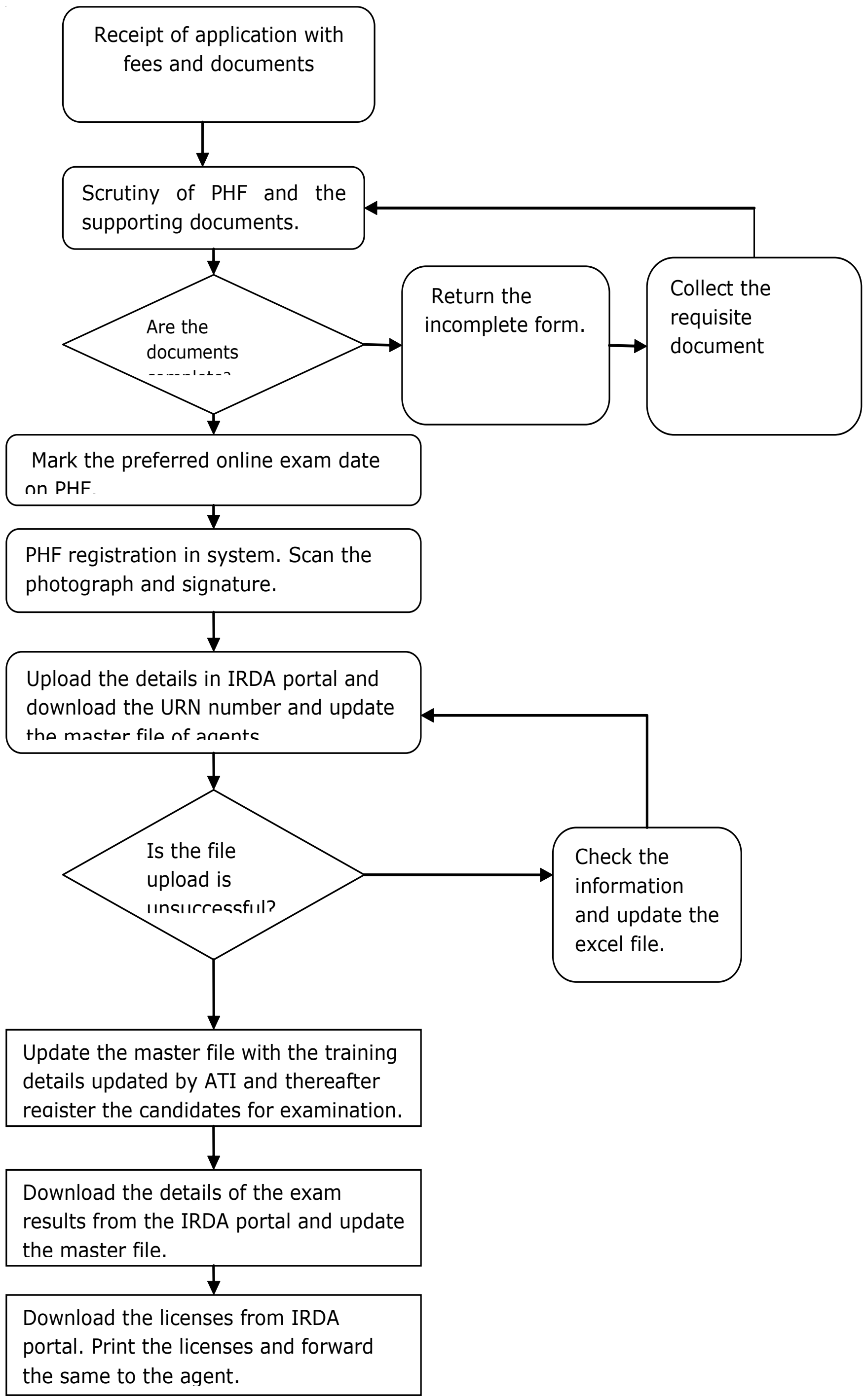
14.6 The circulars issued on Agency are listed below:

(i) Circular dated 2nd September, 2009 31/IRDA/CA/CIR/Sep-09 on Transfer of Agency/Corporate Agency from one Insurer to another

(ii) Circular Dated 11th June, 2010 IRDA/F&I/CIR/Data/91/06/2010 on Requirement of Information under Section 31B(2) of the Insurance Act, 1938

(iii) Circular dated 17th May, 2010 on Transfer of individual agent to SP/CIE and vice versa

(iv) Circular dated 25th August, 2010 IRDA/CAD/CIR/AGN/137/08/2010 on Disclosure of agency details on policy document


Receipt of application with fees and documents
Scrutiny of PHF and the supporting documents.
Are the documents complete?
Return the incomplete form.
Collect the requisite document
Mark the preferred online exam date on PHF.
PHF registration in system. Scan the photograph and signature.
Upload the details in IRDA portal and download the URN number and update the master file of agents
Is the file upload is unsuccessful?
Check the information and update the excel file.
Update the master file with the training details updated by ATI and thereafter register the candidates for examination.
Download the details of the exam results from the IRDA portal and update the master file.
Download the licenses from IRDA portal. Print the licenses and forward the same to the agent.

14.6 Illustrative checklist containing risks and internal audit procedures along with applicable regulations/ guidelines/notification/ circulars:

Risks	Internal Audit Procedures
Tied Agency	
(i) Fees not collected as per process for · new · renewal · transfer · duplicate · name correction	Obtain the data of fees collected for new/renewal cases and check whether the fees collected is as per the Process laid down including the provision for waiver/ deferment.
(ii) Process of User ID creation and deletion & process of role assignment to User IDs in the Insurer Licensing System	Take downloads of all user IDs from the application owner and review the application forms, roles assigned, sign off etc.
(iii) Short collection of fees from agents	• Evaluate the costing of new/ renewal license which include training, exams and license download fees to check that there is no short collection of fees • Evaluate individual fee waiver cases and review overall objective of waivers vis-à-vis outcome i.e. are fee waivers productive for the organisation and is the organisation achieving its overall goals of codification
(iv) Delay in code creation/ termination	Evaluate the process including timeliness for creation and termination of code in system.
(v) Log in of Business before download of license	• Evaluate the controls over log in of proposals

Risks	Internal Audit Procedures
	• Compare the code creation date and date of license issuance.
(vi) Log in of business after license expiry	Evaluate the controls over log in of proposals
(vii) Non performing agents on board	Check whether there is any review mechanism to evaluate the performance of agents & whether action is taken on the basis of findings.
(viii) Code created before licensing	Check controls to ensure system does not enable creating of codes without license. Code creation date shall be on or after licensing date.
(ix) Code created without getting the required documents	• Check completeness of agent application form • Check whether all the documents required to be submitted along with the application form like age proof, education proof, address proof, PAN card copy etc have been collected before creating the license.
(x) Process of creating the Agency set-up on the system for Commission calculation.	• Check the process note for the set-up for the Agencies (Corporate agents and Brokers) • Check the process of information flow between the departments for this set-up on the system.

Risks	Internal Audit Procedures
(xi) Agent authorized to sell before ULIP training, (violation of IRDA circular on ULIP training)	Agent may not be authorized to sell (which means no contract entered with a Licensed agent, unless he completed AML, KYC & ULIP training.
(x) Inadequate controls for process of approval and printing of Agent license from IRDA website (original)	• Check process of generating licenses • Check instances wherein license numbers are not available in the Agent database. • Check MIS of cases wherein duplicate copy of the license has been extracted from IRDA website and the reason for such duplicate copies.
(xi) Monitoring of TATs for licensing	Check timelines for the various activities (cash receipting, sending agent application forms to vendor, URN Creation, training commencement, exam scheduling and payment of exam fees, and quote management system ID activation)
(xii) Reconciliation and monitoring of agent fee advance paid to IRDA.	• Check the reconciliation of fees paid in advance to IRDA *vis-à-vis* the adjustment made against these advances for agents licensed must be monitored • Check if these are being correctly reflected in the Financial Statements.

Risks	Internal Audit Procedures
(xiii) Process of payment of fees to Insurance Institute of India (III) and NSE IT (manual and online trainings)	• Check existence of documented process. • Check existence of controls prior to making payments to the respective institutes. • Check existence of MIS showing the overall status of the payments made vis-à-vis exams scheduled
(xiv) Complaints from Insurance Institute of India (III) and/or NSE-IT pertaining to agent practices etc.	• Check whether there have been instances of complaints from the regulator • Check steps taken to arrest malpratices
(xv) Process of appointment and bill settlement of vendors - • Outsourced training institute/ Trainer • File storage vendor	Check instances of: • Loss / damage to files • Inadequate Fire / safety measures at the Vendor's place. This should be made part of the agreement. • Review the process of monitoring of TATs • Review comparative quotes of pertaining to charges for file storage and retrieval
(xvi) Agent termination and its effect on commission	Check system control over payment of commission for agents who are either inactive or terminated (for reasons other than fraud) in the system.
(xvii) Reinstatement without approval • Reinstatement of agents terminated due to fraud	Check the Reinstatement process to ensure that • Reinstatement is done only after obtaining necessary approvals

Risks	Internal Audit Procedures
	• The reason for termination should be checked.
(xviii) Incorrect updation of PAN number	Check whether the PAN numbers submitted by agents are compared with the National Securities Depository Limited ("NSDL") site before updating the agent master.
(xix) Incorrect updation of bank account details	Check that bank account is created after checking the details with the identity proof submitted by the agent and on receipt of adequate proof like a cancelled cheque/ bank statement or bank welcome letter. Duplicity should be checked before creation.
(xx) Controls on Modifications/ updations to sensitive agent data such as bank details.	Reasons for changes in Bank account must be checked thoroughly especially where commission is being paid to agents through physical cheques.
(xxi) Duplicate codes created for Agents	Review agent's data dump.
(xxii) Employee becoming an agent	Check the employee database with the agent data base on the basis of common factors like PAN no, bank account no, etc to identify such cases
(xxiii) Non issuance of receipt for the amount collected	Check the format and declarations made on the receipts issued to the candidate on collection of the fees.

Risks	Internal Audit Procedures
(xxiv) Incorrect payouts done for the printing the licenses	Check whether there is any reconciliation process for the following: • License printed and code created. • Payment for the license printed
(xxv) Agents transferred to meet individual business targets of the sales managers	Evaluate the process of transfer to check that it is done for genuine reason and with appropriate approvals.

Compliance related risks

Risks	Internal Audit Procedures
(i) Agent acts as an agent for more than one Life Insurance Company and/ or one General Insurance Company	IRDA Portal has a check feature for the same.
(ii) The Designated person grants/ renews license beyond 3 months from the date of application	Obtain the Agent Register and compare the date of Proposal Deposit Receipt (Receipt issued to Agents for fees paid by them) with the date of download of license and the date of dispatch of license. The date of license download can be checked with IRDA Portal MIS.
(iii) Designated Person not informing the applicant within 60 days of receipt of application if the issuance of license is going to be delayed, with reasons for delay and the likely time it would take	Check the process for intimation

Risks	Internal Audit Procedures
(iv) Insurance agent has solicited insurance business without holding a valid license.	Check the process of business log in by Agents to ensure that appropriate controls are in place.
(v) Insurance agent is or has become a director of any insurance company.	Check whether any declaration has been obtained to this effect.
(vi) Non remittance of premium collected by the agent to insurer within 24 hours of collection excluding bank and postal holidays	Check the process/controls for ensuring the remittence without delays.
(vii) Agent does not have the minimum Educational qualification as per Regulation.	Check education proof submitted by agents.
(viii) Agent has not completed the training requirement as per Regulation	IRDA Portal has a check feature for the same.
(ix) Agent has not passed licensiate exam in life/ general insurance	IRDA Portal has a check feature for the same.
(x) Insurance agent is minor	Check age proof submitted by agents.
(xi) Insurance Agent has applied for fresh license within 5 years from the date of cancellation of license by the Designated Person.	Check whether insurer has a process in place to check the name of the agents against the database of cancelled agents at the time of recruitment
(xii) License not issued to agent within 15 days of passing the exam. License withheld without justfiable reasons which are recorded	Check the date of passing the exam (date of result) & license issue date for fresh PHF compare the same with dispatch details.

Risks	Internal Audit Procedures
(xiii) Application for renewal received atleast 30 days before the date of expiry of license/ more than 3 months before the date of expiry. Failure to collect additional fees of Rs. 100 if the application is not received 30 days prior to the date of expiry of license.	For renewal cases, plot the date of license expiry against the date of PDR issued for renewal fees/date of receipt of request to check the same.
(xiv) Agent has not undergone 25 hours training at the time of renewal	IRDA Portal has a check feature for the same.
(xv) Defaulting agents who have exposed insurer to AML related risks not terminated	Check whether a process is in place to indentify and terminate such agents.
(xvi) Agent not trained in AML on annual basis	Check the training records and the training material of agents.
(xvii) Renewal of agency license after expiry of one year from the due date of renewal without the agent undergoing examination again	IRDA Portal has a check feature.
(xviii) Any agent aged 75 years or above seeking renewal of agency without a life certificate from a Gazetted Officer	Check from Agent Register.
(xix) Agency details not disclosed in the Policy Document.	Check whether the Agency Code, Agency Name and contact details are displayed prominently on the first page of the policy

Sub-process:

14.7 Corporate Agents

Scope and Objective:

14.8 A Corporate Agent is a person as defined in clause (k) of IRDA (Licencing of Insurance Agents) Regulation 2000and licensed to act as such. Person includes a firm, company, a banking company, a corresponding new bank, a regional rural bank, a co-operative society including a co-operative bank, a panchayat or local authority, a Non-government organization or micro lending finance organization, any other institution specifically approved by IRDA.

14.9 A corporate agent sells, solicits and procures business through "Specified Person" (SP). SP means a director or partner or one or more of its officers or other employee, the chief executive in case of any other person who has undergone the practical training, exams and certification requirement as per the Regulation.

14.10 A CA is represented by "Corporate Insurance Executive" (CIE) who can be any of the persons (ie. Partner, director etc) as defined above and who possess the requisite qualification and practical training and who has passed the examination as required under the Insurance Act, 1938.

14.11 The objective of the audit is to evaluate:

(i) Process for selection/renewal of Corporate Agents

(ii) Review Mechanism of Corporate Agents

(iii) Verification of commission payments

(iv) Adherence to IRDA norms regarding Corporate Agency Licensing.

14.12 IRDA has issued the following Regulations with regard to Corporate Agency Licensing:

(i) Licensing of Corporate Agents Regulations, 2002

(ii) Amendment to Licensing of Corporate Agents Regulations, 2010

(iii) Guidelines on Licensing of Corporate Agents

(iv) Appropriateness of commission payments

14.13 The circulars issued on Agency are the following:

(i) Circular dated 2nd September, 2009 31/IRDA/CA/CIR/Sep-09 on Transfer of Agency/Corporate Agency from one Insurer to another

(ii) Circular dated 10th March, 2010 Guidelines on Licensing of Corporate Agents

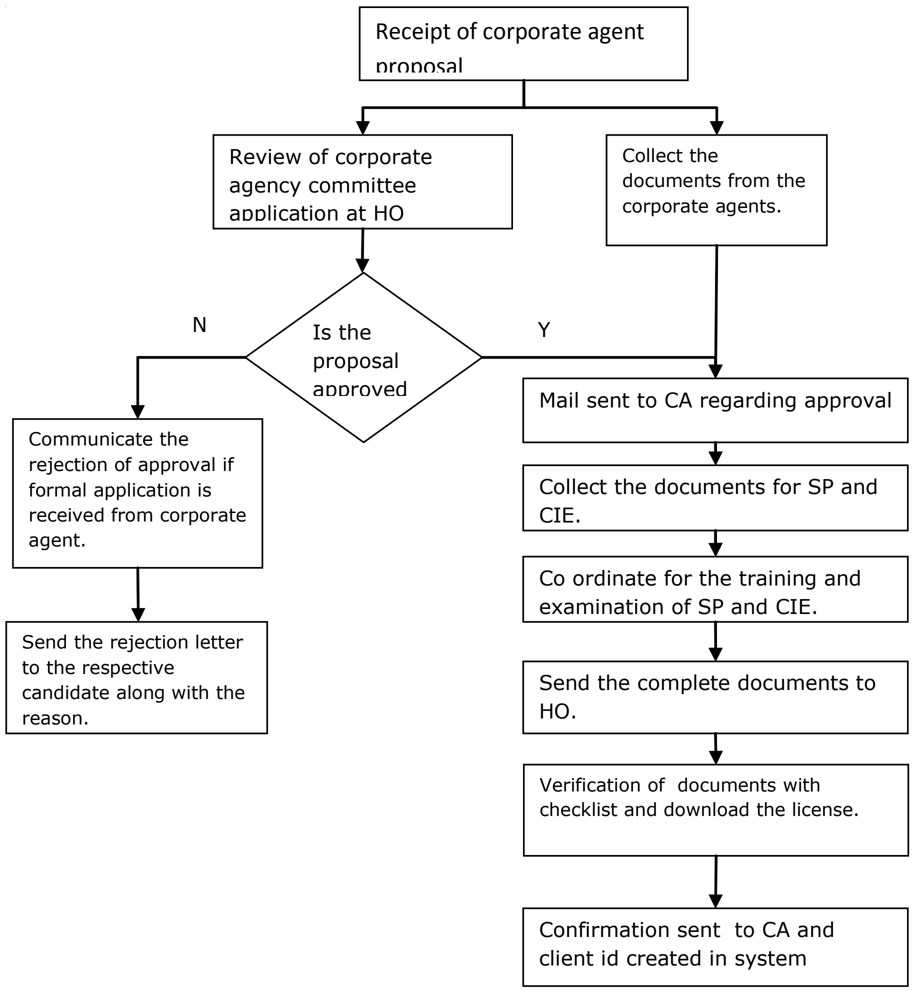
(iii) Circular dated 17th May, 2010 IRDA/CAGTS/CIR/LCE/82/5/2010 on Transfer of individual agent to SP/CIE and vice versa

(iv) Circular dated 7th June, 2010 IRDA/CAGTS/CIR/LCE/92/6/2010 on Transfer of Corporate Agency from one Insurer to another

(v) Circular Dated 7th June, 2010 IRDA/CAGTS/CIR/LCE/93/06/2010 on inspection of Corporate Agency by the Insurer

(vi) Circular Dated 11th June, 2010 IRDA/F&I/CIR/Data/91/06/2010 on Requirement of Information under Section 31B(2) of the Insurance Act, 1938

(vii) Circular dated 25th August, 2010 on Disclosure of agency details on policy document


Receipt of corporate agent proposal
Review of corporate agency committee application at HO
Collect the documents from the corporate agents.
Is the proposal approved
N
Y
Communicate the rejection of approval if formal application is received from corporate agent.
Send the rejection letter to the respective candidate along with the reason.
Mail sent to CA regarding approval
Collect the documents for SP and CIE.
Co ordinate for the training and examination of SP and CIE.
Send the complete documents to HO.
Verification of documents with checklist and download the license.
Confirmation sent to CA and client id created in system

14.14 Illustrative checklist containing risks and internal audit procedures along with applicable regulations/guidelines/notification/circulars:

Risks	Internal Audit Procedures
(i) Selection/renewal/ reinstatement of corporate who agents ("CA") are not eligible	Check the process with regard to the following: • Who can recommend corporate agent • Documents obtained for evaluation of CA • Background checking of proposed agent, its promoters and management • Review of proposed sales organisation & process to evaluate compliance.
(ii) CA acting for more than one insurer	Check whether a declaration has been obtained from the CA regarding the same.
(iii) Sourcing of business through agents without valid agreements, before entering into agreement or after expiry of agreement period	• Check whether agreements have been executed with all CAs & agreements are valid. • CA Code should be created only after all the requisite documents have been obtained & agreements have been entered into
(iv) Fees not collected as per process for new/renewal license	Check the data of fees collected for new/renewal cases.
(v) Non-inclusion of performance/ persistency related clause in the agreement with agent	Check the format of standard agreement.
(vi) Absence of controls incase of transfer of license in	Check whether a process has been set up for such transfer

Risks	Internal Audit Procedures
following scenarios: Individual agent to CIE/SP Transfer of SP certificate from previous insurer	and adherence to the Process
(vii) Log in of Business by agent after expiry of license	Evaluate the controls over log in of proposals
(viii) Non performing agents on board	Check whether there is any review mechanism to evaluate the performance of agents & whether action is taken on the basis of findings.
(ix) Incorrect payment of commissions	Check the following: • Proposals for which payment is made are actually logged in by the CA • No payment other the commission has been made to the CA.
(x) Incorrect termination	• Check process of termination. • Check whether NOC was issued as per steps laid down in Circulars ref no. IRDA/CAGTS/CIR/LCE/092/06/2010 dated 07th June, 2010 and 031/IRDA/CA/CIR/Sep-09.

Compliance related risks:

Risks	Internal Audit Procedures
(i) Corporate agency applicant is not a person as defined in Regulation 2(k) of IRDA Licensing of Corporate Agents Regulations, 2002. If it does not	Check whether the applicant is a Firm, Bank, company formed under the Cos Act 1956, cooperative society, panchayat or a local authority, NGO,

Risks	Internal Audit Procedures
fall within the ambit of Regulation 2(k) i to viii; the applicant company should have obtained specific approval from IRDA.	micro lending/ finance organization or any other institution which has been specifically approved by IRDA from the documents submitted.
(ii) Application in Form 1 has not been received in completely filled along with the applicable fees	Check the application form and the amount of fees collected.
(iii) The MOA/ Partnership deed does not contain soliciting or procuring insurance business as one of the main objects.	Check the MOA/Partnership deed.
(iv) The CA is not authorized to do insurance agency with the insurer.	Check the partnership deed/ board resolution etc to check the same.
(v) Risk with regard to CIE & SPs: • CIE & SP are minors • Education proof not submitted/ Min Educational Qualifications not met (atleast 12th pass in case of population of 5000 or 10th pass in case of population of less than 5000) • Copy of PAN not submitted • Does not have the requisite knowledge to solicit, procure insurance business and providing service to the policyholders • have not completed the requisite training of 50 hours (75 hours in case of Composite License) from a recognized Institute	• Check the documents submitted. • CIE & SP should be questioned on a random basis for product features, AML guidelines etc. For training and exams IRDA Portal has a check feature. • Check whether a declaration is obtained for adherence to the code of conduct.

Risks	Internal Audit Procedures
• Examination passing proof not available • Part time employee/ outsourced staff of the CA. • Not complying with the code of conduct specified by the Licensing regulations	
(vi) Corporate ID Card is not available in Form IRDA Corporate Agents-ID 1	Check the corporate ID card.
(vii) SP have not applied for Certificate in Form A2 to the insurer along with applicable fees	Check the application form and the amount of fees collected.
(viii) Copy of Certificate to SP is not available in Form L2.	Check whether CA has a copy of certificate available.
(ix) Commission paid is higher than that prescribed in section 40A of which Act? Payment of any amount other than Commission	Check that there are no payments other than commission. Check whether commission payout is within limits.
(x) Corporate agent does not remit premium from the policy-holder within the stipulated time	Evaluate the process for intimation of premium remittance at the agency
(xi) Director of the company/ a partner of the firm/ the chief executive or corporate insurance executive or SP holds a similar position with another Corporate agent of any other insurance company	Check the process for adherence to the requirement. Whether any self-declaration obtained/ independent verification
(xii) Non-compliance with Regulation 10 at the time of effecting renewal.	Check the renewal process to ensure that renewal has been done on the basis of

Risks	Internal Audit Procedures
	application along with appropriate fees, completion of the required hours of training by CIE and SP. The renewal should be for a period of three years.
(xiii) Agreement with CA is not valid.	Check whether the contract is signed by authorized signatories of both agent & insurer. Check the date of agreement and the stamp date and stamp value. It should be for a term of atleast 3 years.
(xiv) The SP has not surrendered his certificate to the designated person of the insurer on resignation.	Check the HR related record to ascertain whether any SP has resigned and check whether certificate has been surrendered.
(xv) Register of SPs is not maintained.	Register should contain details of their name, contact details, photograph, date of commencement of employment, date of leaving the service and salary details.
(xvi) The principal business of Corporate Agent is distribution of insurance products.	Check the object clause of the Memorandum of Association/ partnership deed etc.
(xvii) Insurance is the only business as per the MOA. The exception allowed is in respect of the following: • a public ltd company having a share capital of ₹15 lakhs • Share capital has been	Check the MOA to ensure that insurance should not be the only business. If insurance is the only business the criteria laid down for allowing exception is met.

Risks	Internal Audit Procedures
maintained in a bank account. • The amount of share capital is not utilized for any purpose without the permission of insurer. • A record of the Sales process is maintained. • No amount of the share capital has been advanced to any Director/ shareholder or any other entity as a loan or advanceIn case of Corporate agents doing only insurance business, then it should have an entity within the group which is regulated by RBI or should be part of a group having an Indian insurance company. The license of corporate agency should be approved by IRDA	
(xviii) CA does not have atleast one person who is a Fellow/ Associate of the Actuarial Society of India.	Check the certificate of employee of the CA.
(xix) Check the sales process : • The sales process is supervised by persons other than whole time employees, directors, partners • Sales done by person other than SP. CA should not be using modes like introducers,	• Check the process followed by CA by interview or referring to the documented processes. • Check Proposal Forms to confirm that no person other than SP is signing on behalf of Corporate Agent. Check

Risks	Internal Audit Procedures
finders or sub agents for procuring business • CA Should not represent himself as an insurer. • Non-compliance of group guideline • Compulsion to buy insurance products • Employees other than SP rewarded on the basis of success of referral made by such employees to the SP.	the financials to see if any commission is paid • Inspect the website, sales literature, premises of the CA to ascertain the same. • Check the compliance of group guidelines if the CA is sourcing group Policies. • To check number of policies sold v/s the source business • Check the salary details of employees other than SP to ascertain whether any payment made for reference.
(xx) Check the post sales process to ensure the following: • CA is carrying on underwriting • CA not providing complete set of records in respect of the business done, including completed proposal forms, copies of policies or certificates of insurance and a premium register with particular details of payment to the insurer, daily or at the most on weekly basis. • Non-disclosure of the premium amount/ charging premium higher than the premium charged by the insurer.	• The agreement should not authorize CA to carry out underwriting. Check the underwriting records of the insurer for Policies sourced by CA to check whether the underwriting decision has been made by the insurer. • Check whether CA is maintaining a tracker with regard to the Policies sourced by him. Check the frequency of sending the records. • Check if any complaint received • Check the records of claims settled for Policies sourced by the CA to ensure that the cheques are issued in the

Risks	Internal Audit Procedures
• Charging any kind of administrative/service charge from the Policyholder· Settling claims on behalf of the insurer • Procuring more than 50% of the total business during the financial year from one client or group of clients	name of the client and not the CA. • Check what from the details of the Policies maintained by the CA.
(xxi) Non submission of the following documents to the insurer • monthly statistics of business • annual audited accounts within 6 months from the close of the financial year	Check the records of the insurer.
(xxii) In case of application for Composite license (both life and general) only one application provided. Not desclosing the name of the other insurer	Check whether two separate applications received for Composite Agents. The Agent should provide the name of the general insurer along with his application.
(xxiii) Non-compliance with the Agency transfer process. Check if Corporate Agency License is transferred from /to another insurer. If so, Check whether transfer is effected as per steps laid down in Circular IRDA/CAGTS/CIR/LCE/092/06/2010 dated 07th June, 2010 and 031/IRDA/CA/CIR/Sep-09.	Obtain the details of the Agents transferred from/to another company and check the adherence t the circular for transfer.
(xxiv) Another entity in the group holds an insurance broking license	Obtain the financials of the group companies and check the same.

Risks	Internal Audit Procedures
(xxv) The insurer has not obtained prior approval of IRDA before giving CA license if CA has another entity within the group doing insurance business i.e. corporate agent, referral etc. In this case, the CA should be regulated by RBI and should be having substantial database of its own - atleast 500 customers In case, the CA is not regulated by RBI, then it is should have substantial client base or access to data atleast 500 customers and should have net worth, income/ turnover of atleast Rs.15 crores	Check the approval letter.
(xxvi) Non submission of sales support material, such as prospectus, sales brochures, sales illustrations and publicity write up to insurer.	• Check whether the sales material used by the CA heve been submitted to the insurer by verifying the advertisement records of the insurer. • Carry out an inspection of the agency premises to ascertain the same
(xxvi) Employees of CA not being trained on the Products of the insurer.	Check the process of training the staff of CA and the training material for the products launched by the insurer.
(xxvii) Non-compliance with the Code of Conduct as specified in Regulation 9 of the Licensing of Corporate Agency Regulations, 2002	• Check whether in case of new applicant an undertaking to this effect has been obtained by the insurer.

Risks	Internal Audit Procedures
	• In case of renewals, whether insurer has confirmed compliance with Regulation 9 by CA during currency of license.
(xxviii) Non-compliance with micro-insurance guidelines by NGOs and SHGs working as CA.	Check the compliance with micro insurance guidelines if CA is an NGO or SHG.
(xxix) The insurer has not carried out regular, on-site inspections of corporate agents with whom they have entered into agreement, before 30th September every year in terms of circular no : IRDA/CAGTS/CIR/LCE/093/06/2010 dated 07th June, 2010. Insurer has not submitted the copy of report along with violations noted to IRDA.	Check the reports of inspection of all CAs and IRDA filing of the same.
(xxx) Non submission of list of Terminated Agents to IRDA by insurer.	Check the correspondence with IRDA.

Chapter 15

Commisson

Scope and Objective:

15.1 The primary objective of the audit is to check and confirm that commission has been processed and paid to all the eligible agents of the insurer accurately and in time. Necessary provision has also to be made for unpaid commissions and properly accounted in the books of account under respective segments and products. It should cover the following:

(i) Commission payment process

- o Data synchronization between Premium System and commission processing system
- o Rate Structure creation and Maintenance
- o Commission processing
- o Commission data synchronization with payout methodology
- o Activation/deactivation of agents in the commission processing system

(ii) Payment is within the limit prescribed under the Insurance Act, 1938 Timeliness of commission paid

(iii) Deduction of Income tax

(iv) Process of intimating commission credit to agents

(v) Actions taken on commission recoverable

An agent who has successfully passed the examination held by IRDA is eligible to be appointed as Agent of Insurer

Post passing the examination, the insurer usually generates agent ID and the agent can log in business for the insurer

Proposals are converted into policies and over the life of the policies, renewal premium is collected

Commissions get generated out of new business conversion and renewal premium settlement

The commission processing team at regular interval (15/30 days) generates a report for commission due to agents for all the policies converted and renewal received during the period

Necessary deduction is made for any reversal of premium collection

The details are sent to accounts for making necessary payout to the Agents

In case of cancellation of policy proportionate commission shall be clawed back in the next payment cycle.

15.2 Illustration checklist containing risks and internal audit procedures along with applicable regulations/ guidelines/ notification/ circulars:

Risks	Internal Audit Procedures
(i) Rates are not in line with F&U documents and/ or appointment letter issued to agents.	• Obtain F&U documents of products launched during the same period • Check that the commission paid to agents is as per the F&U documents • Commission rates to be checked with appointment letter issued to different types of agents.
(ii) Delay/inaccurate updation of rates in the system	• Obtain a log from the commission processing system for the data of updation of commission rates for new product launched • In case of delay, check whether any commission is paid during the said period
(iii) Commission not processed for all the premiums booked for that period	Two scenarios: Where Premium System and Commission system is • Closely Integrated: One time checking of flow of information between both the Systems including the reconciliation mechanism and existence of maker checker controls for these systems • Manual data Synchronization: All the premium records to be macthed with the books

Risks	Internal Audit Procedures
	of account. Reconciliation to be in place for upload and download. Ensure that there is no manual intervention of data repair during this process. • In case of manual calculation of commission, verify whether employees processing commission payouts can change the master rates in the excel sheets. • Check whether fields in master rates sheet are protected cells. • Check the authority to change the master rates and formulas in excel sheets and name of agent for calculation of commission.
(iv) Inaccurate commission processing. Commission is paid beyond the cap mentioned under section 40A the Insurance Act, 1938.	• Check the cap laid down in section 40A of • Obtain a Rate Master sheet from the commission system and ensure adherence to the same • Identify the access rights for the rates master. Check if audit log is created for changes made in the rate master.
(v) The commission for procurement of business has been paid to non licensed insurance agents.	• Check if the system allows enrolment of agents without valid license. Only valid license holders should be allowed to procure business.

Risks	Internal Audit Procedures
`	• Also in payment file, valid license numbers should be checked • A list of agents associated with the insurer to be obtained along with the policies converted during the same period • Match both the lists to identify deviations • Identify the process of activation/deactivation of agents in the system and ensure adequate controls are in place • Check the names of officials having access rights for creation of masters for agents • Check whether list of agents associated with the insurer does not include active agents transferred to other life insurance companies.
(vi) Commission is paid on non converted/cancelled policies	• Check the system and process followed for ensuring that only converted policies move to the commission processing system • Also reconcile the premium figure with the books of account.
(vii) The Agent is also an employee of the same insurer	• Obtain a list of employees of the insurer and list of Agents as on date along with PAN details

Risks	Internal Audit Procedures
	• Match the PAN number to identify active Life agents ID's in the system
(viii) Commission payout is made without obtaining the PAN number of Agents	• Obtain the list of agents with PAN details from the system • Check whether the PAN details are matched with the official site • Where the PAN details are missing, check whether any commission is paid to such agent. Also check if paid, TDS is deducted at a higher rate.
(ix) Duplicate / erroneous PAN details & bank account updated in the system	• Obtain the PAN details of Agents from the system • Check for the duplicate entries in the list • Ensure that the PAN details consist of 10 digits • Ensure that there are no same bank account/PAN for different agents • Check the PAN details with the details on NSDL website.
(x) Commission is not accurately claw-backed for all cancelled policies.	• Check the policies cancelled during the audit period • Check the commission claw-backed on such policies with the commission paid at the time to conversion to ensure that the same is accurately claw-backed by the system • Check the completeness for period under audit.

Risks	Internal Audit Procedures
(xi) Inaccurate recording/ provisioning of commission entries in the books of account.	• Match the commission pay out details sent to the accounts team with the details recorded in the system • Check the amount withheld due to FLC or any other reason and whether they have been properly provided for if the corresponding premium has been accounted for.
(xii) Upon promotion of LA to SM, the LA ID is not terminated and commission is still paid to the agent	• Obtain a list of employees of the insurer and list of agents along with PAN details • Match the PAN details to identify active LA ID's in the system • Check whether commission is paid to such agent post promotion to SM.
(xiii) For all resigned LA, the renewal commission is paid to the agent who has not 5 completed years of service with the insurer.	• Obtain a list of resigned agents along with date of joining and resignation • Check the same with commission pay out file to ensure that commission is paid only for renewal commission for terminated agent serving 5 years with the insurer.
(xiv) Commission is not paid to terminated or resigned agents who have completed 5 years of service as per section 44 of the Insurance Act, 1938	• Obtain a list of terminated agents along with date of joining and termination • Check the same with commission pay out file to

Risks	Internal Audit Procedures
	ensure that commission is paid only for renewal commission for terminated agent serving 5 years with the insurer • Check compliance to the Section 44 of the Insurance Act, 1938.
(xv) Commission is paid to the agents who were terminated on account of fraud.	• Obtain a list of agents terminated on account of fraud and policies converted during the period for the agents terminated • Check whether any policy is issued under the name of agent post termination • In case policy is issued, check whether the commission is paid on the policy to the terminated agent.
(xvi) If policy is cancelled post free look period, proportionate commission is not claw-backed from LA.	• Obtain the list of policies cancelled during the free look period • Check with the commission processing system that the commission originally booked at the time of policy issuance has been accurately and timely reversed by the system.
(xvii) Commission is not clawed-back in case of premium alteration as per IRDA Circular no. 41 /IRDA/Actl/ULIP/2008-09 dated 5^{th} March, 2009	• Check all the cases where premium reduction has happened for more than 25% during that period. Check commission claw-back.

Risks	Internal Audit Procedures
(xviii) Commission is paid to an agent other than who has procured the business (Other than Servicing Agents)	• Take a report on Change of Agents. Anything other than fixing any data entry error is not permitted • In case of Servicing Agent under Orphan Policy Assignment, check if the conditions mentioned under section 40 (2A) of the Insurance Act, 1938 are fulfilled.
(xix) Business login is permitted during the lapsation of the agent's license	• Select agents whose license has lapsed for the same period on random basis • Obtain the data of the policies issued during the period and Check whether the policies are logged in the system post lapsation of license. • Also check the premium system set up in this regard.
(xx) Commission of an agent is withheld on account of unjustified reasons (section 44 of the Insurance Act, 1938)	• Obtain the details of commission payable along with ageing and justifications. • Analyze the reasoning provided.
(xxi) Delays in settlement of commission to agents	• Check the internal TAT set for payment of commission • Check whether the commission is paid within the TAT defined.
(xxii) Non adherence to TDS provisions under the Income-Tax Act, 1961.	• Check the adherence to TDS provision laid down under the Income-Tax Act with regard to commission.

Risks	Internal Audit Procedures
	• Also check necessary approval from IT to deduct nil/lower tax.
(xxiii) Non adherence to Service tax related requirements	• Check the service tax laws relating to the insurer with regard to applicability, set off, payment and filing of Service Tax returns.
(xxiv) Commission released for the period between termination and reinstatement	• Check Management decision on this and its adherence.
(xxv) Long outstanding balance in commission payable account in the books of account of the insurer	• Obtain the details of commission payable along with ageing and justification for long outstanding • Check the policy of the insurer with regard to the write back of commission payable and ensure adherence to the same.
(xxvi) Long outstanding commission recoverable from the agents	• Obtain ageing analysis for commission recoverable account from the accounts team along with justification for long outstanding • Check whether any agent appearing in this list is an active agent and commission is paid without set off of commission recoverable • Check the internal policy of the insurer with regard to the write off of commission recoverable and ensure adherence to the same.

Chapter 16

Rewards and Recognition

Sub-process:

(i) Scheme design

(ii) Roll out of the scheme

(iiii) Data compilation

(iv) Finalizing the list of winners

(v) Procurement of gifts

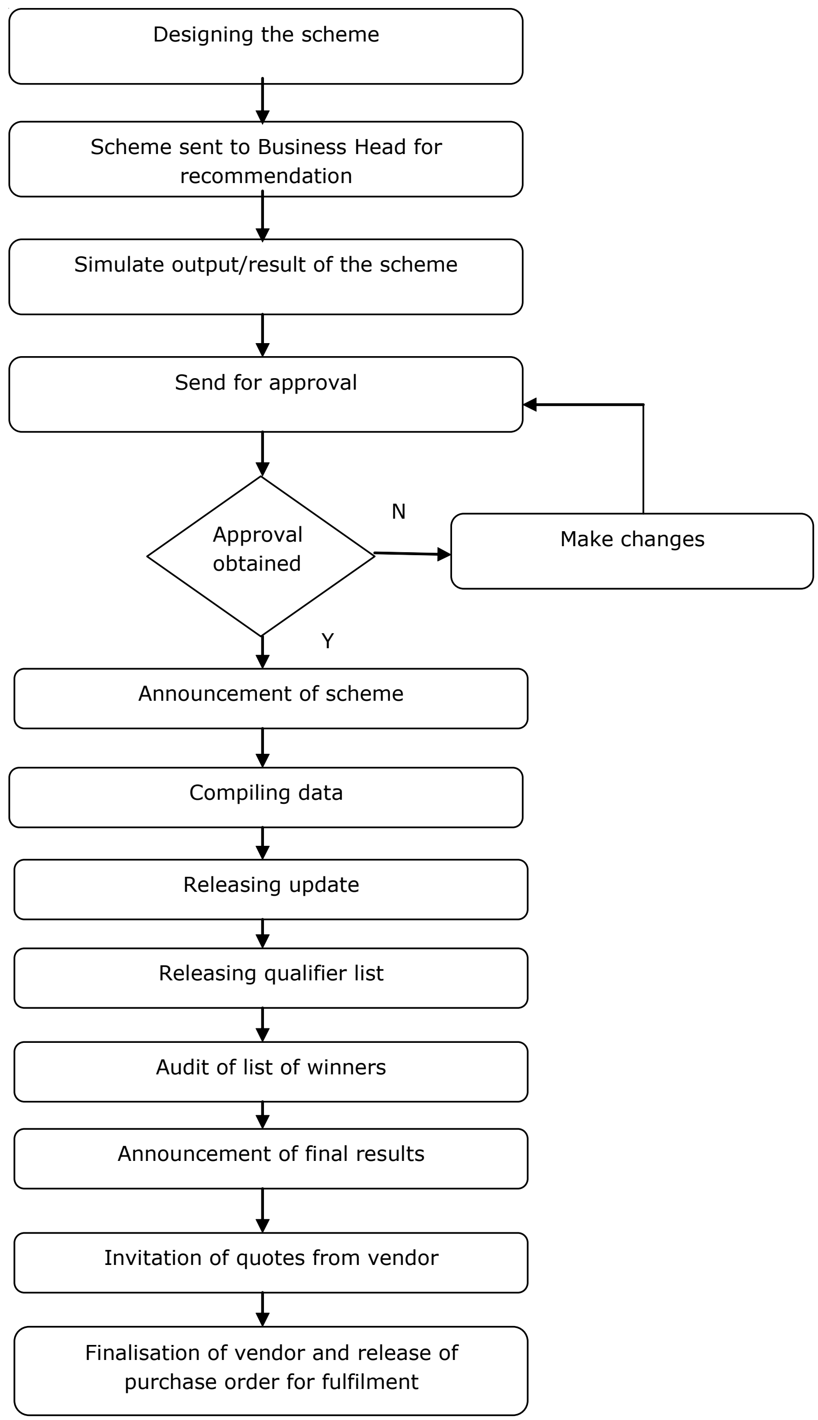
(vi) Distribution of gifts

(vii) Scheme analysis

(viii) Monthly Provision of Payouts

Scope and Objective:

16.1 The objective of the audit is to review the Reward and Recognition (R & R) process and evaluate and test the effectiveness of internal controls in place to ensure that the desired objective is achieved and there is no revenue leakage.


Designing the scheme
Scheme sent to Business Head for recommendation
Simulate output/result of the scheme
Send for approval
Approval obtained
N
Make changes
Y
Announcement of scheme
Compiling data
Releasing update
Releasing qualifier list
Audit of list of winners
Announcement of final results
Invitation of quotes from vendor
Finalisation of vendor and release of purchase order for fulfilment

16.2 Illustrative checklist containing risks and internal audit procedures along with applicable regulations/guidelines/notification/circulars:

Risks	Internal Audit Procedures
(i) Scheme design is not effective	Evaluate the process of scheme design to ensure that the scheme is designed on the basis of clearly laid down qualification parameters, eligibility criteria, specific targets, milestones, costs and associated rewards. The design should be approved by Business Heads to ensure that it is effective.
(ii) Incorrect budgeting of the scheme	Evaluate the data used for simulation of output results to ensure that the data used is of a proper representative period and/or the assumptions used are valid and reasonable.
(iii) Scheme is launched without proper approval	Check the schemes launched during the audit period to ensure that the schemes are approved by appropriate authority depending on the budget of the scheme . There should be a clearly defined approval matrix for the schemes.
(iv) The list of winners may be incorrect/changes made to the list without proper approval.	• Evaluate the process of arriving at the final list of winners. Check whether there is any independent verification of the list of winners.

Risks	Internal Audit Procedures
	• Check the correctness of the list of winners of major schemes run during the audit period. If possible the base data should be extracted independently and the list of winners should be determined by applying the terms and conditions of the scheme. The same should be compared with the list arrived at by the insurer and discrepancies if any, should be investigated. • Check that no change to the list of winners has been done by over looking the terms and conditions of the scheme. For minor changes check whether, appropriate approvals have been obtained • Check the status of the policy pertaining to particular agent selected for rewards.
(v) Improper selection of vendor	Evaluate the process of vendor selection based on the following parameters: • Bids should be obtained from multiple vendors. • Final selection should be done on the basis of various factors like cost offered, warranty or guarantee time attached to each product, delivery capabilities etc.

Risks	Internal Audit Procedures
	• The reason for selection of a particular vendor should be well documented. • The vendor selection should be approved at appropriate levels depending on the likely cost involved. • There should be periodic evaluation of performance of the vendor.
(vi) Incorrect calculations of contest payout Agents not meeting the contest criteria are paid	• Check whether insurer has proper system in place to identify the number of agents earning in the contests and calculate payouts for such agents. • Check whether the contests to be launched are approved by Head-Sales & Marketing– Incorporated however covered separately • Check whether details of the contests are sent to all agents • Check selection of the agents based on the criteria for contests-Incorporated however covered separately • Check calculation of contest payouts and maker-checker controls for the same • Check whether rewards are paid only to "insurance agents" and not to any other

Risks	Internal Audit Procedures
	person procuring insurance business for the insurer (Section 40 of the Insurance Act, 1938)
(vii) Payments to Agents exceeding the limits under section 40A	Evaluate the process to ensure that the total payment to agents by way of commission and scheme pay outs together with remunerations in any other form if paid to the agents does not exceed the limits set under Section 40A of the Insurance Act 1938.
(viii) Gifts not reaching the actual winners	• Evaluate the process of disbursement of gifts. • Check whether there is any acknowledgement obtained from the winners on receipt of gifts.
(ix) Unclaimed gifts being misused/ not returned to the vendor/ not accounted for	• Evaluate the control over the receipt and storage of unclaimed gifts. • Verify whether the same is recognised as inventory in hand in the Balance sheet. • Evaluate the process of valuation of such gifts and the method of utilising such gifts.
Excess payment to vendors due to incorrect billing	• Evaluate the process for settlement of bills to vendors. • Check whether the quantity as per the bill is cross verified

Risks	Internal Audit Procedures
	with the number of winners and the number of items as per the purchase order released to the vendors.
The experience of the scheme is not analysed thereby the learnings of the scheme are not used for the benefit of the insurer.	Check whether scheme performance analysis is carried out. The purpose of such an analysis should be to check whether the objective of the scheme was achieved. A comparison of the actual versus etimated figures of various scheme parameters like number of winners, cost etc should be done.
Incorrect provisioning of scheme expenses	Evaluate the process of providing provisional figure to Accounts on month end and year end. Evaluate the estimates used to acsetain whether correct provisioning is being done.
Incorrect reporting	Check whether MIS for expenditure incurred on rewards and recognition is accurate and placed to the top management
Schemes run for Corporate Agents-payments over and above agency commission	Ensure that no payment either in cash or kind is given to Corporate Agent –Guidelines on Licensing of Corporate Agent bars the insurer from paying any amount other than the permitted agency commission.

Chapter 17

Advertisement

Sub-process:

(i) Deciding upon the advertisement to be rolled out

(ii) Budget for advertisement to be cleared

(iii) Selecting the outdoor agency

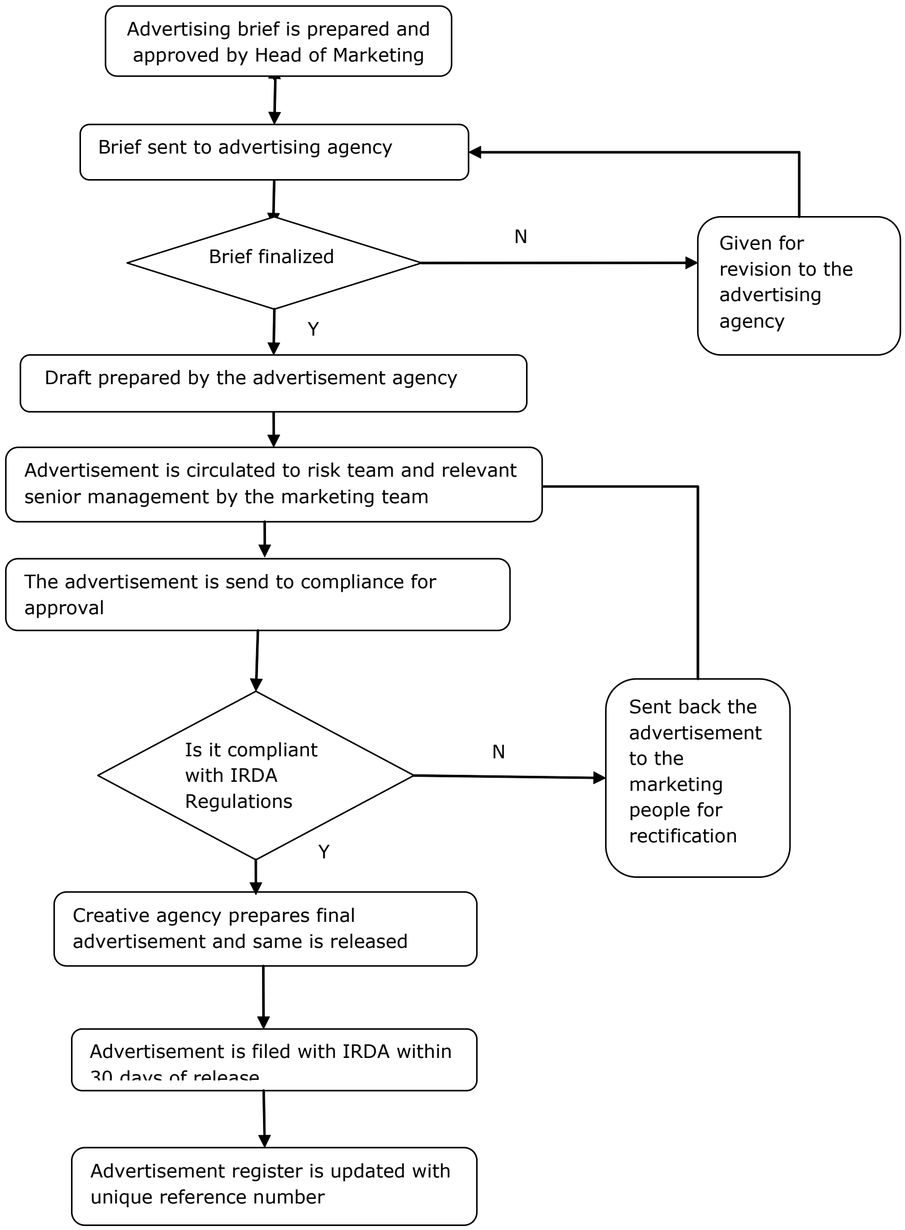
(iv) Selecting the Media

(v) Checking compliance aspects of both print and non-print advertisements with respect to IRDA regulations Filing the advertisement with IRDA

(vi) Monitoring of the effectiveness of the advertisement

Scope and Objective:

17.1 The objective of the audit is to review the advertisement process and evaluate and test the effectiveness of internal controls in place to ensure timely and accurate issuance of advertisement, adherence to IRDA (Insurance Advertisements and Disclosure Regulations) 2000, Guidelines on Advertisement, Promotion & Publicity of Insurance Companies, 2007 and the Insurance Act, 1938


Advertising brief is prepared and approved by Head of Marketing
Brief sent to advertising agency
Brief finalized
N
Given for revision to the advertising agency
Y
Draft prepared by the advertisement agency
Advertisement is circulated to risk team and relevant senior management by the marketing team
The advertisement is send to compliance for approval
Is it compliant with IRDA Regulations
N
Sent back the advertisement to the marketing people for rectification
Y
Creative agency prepares final advertisement and same is released
Advertisement is filed with IRDA within 30 days of release
Advertisement register is updated with unique reference number

17.2 Illustrative checklist containing risks and internal audit procedures along with applicable regulations/guidelines/notification/circulars:

Risks	Internal Audit Procedures
(i) The assumptionis that there is no yearly plan. If that be so how the auditor can check the plan for the advertisements to be released during the financial year	The assumption is that there is no yearly plan. If that be so how the auditor can check the plan for the year. Also whether there is an adherence to the same and justifications for any deviations
(ii) Preparation of Advertising budgets without prior approval along with adequate supporting	• Advertising budgets preferably approved in the board meetings should be verified along with the assumptions for preparation of the same • Review of actual expenditure vis-à-vis the budgeted amount
(iii) No criteria set for selection of media type	The process for selecting the media should be verified. The parameters considered for selection and finalization are to be verified
(iv) Non-competitive rates being selected	To check the process • For inviting quotation from various vendors • Parameters for selection of vendors • Selection process and related documents • Authorizations for selection of vendors

Risks	Internal Audit Procedures
(v) Advertisements are not screened/ viewed (quality check)	The hard copies of the advertisements which are filed in the advertisement register should be reviewed to see whether there is a sign off from the maker and checker. Also at the time of audit, the same should be viewed from all the disclosures angle to ensure that nothing is missed out .In case of print ads, the relevant newspaper cuttings for screening of ads should be reviewed. In case of hoardings, check the accuracy of rates and photographs for display of ads across the country locations. An independent check needs to be done
(vi) Non monitoring of the effectiveness of the advertisements	Review mechanism for analyzing the effectiveness of advertisement and actions taken on the same to be checked
(vii) Brand names of the product as proposed in the F & U application and the product are adhered to norms	File and use of the products should be seen and the advertisements should be compared to whether the same is complied
(viii) Control on sales literature across sales locations	The marketing department responsible for distributing this literature across the sales locations should maintain a register for having effective control.

Risks	Internal Audit Procedures
(ix) Payment of advertising bills in case of television	Check the process for verification of media bills (since advertisements are screened across various channels and in different time slots, hence check correct rates are charged). Also TAM reports (independent reports) for release of advertisements can be verified

Compliance related risks:

Risks	Internal Audit Procedures
(i) To identify whether the advertisement is institutional advertisement which just advertises the insurance company or insurance advertisements which are further classified into invitation to inquire where the advertisement is just meant for inquiry or invitation to contract which are meant for inducing the public to purchase, increase, modify, reinstate or retain a policy.	To see the definitions of this and the compliance requirement for each advertisement should be adhered to which is also given in detail further
(ii) To have a Compliance Officer in place for the purpose of overseeing the advertisement program	Check whether the appointment of compliance officer has been filed with IRDA.
(iii) Whether a system of control over the content, form and method of dissemination of all advertisements concerning its policies has been set up.	Check the controls in place for the process of issue of advertisements

Risks	Internal Audit Procedures
(iv) Advertisement register needs to be maintained	Check the register and compliance to IRDA guidelines Check whether all the advertisements contain unique reference number and records are maintained in the register
(v) Specimen of every advertisement disseminated, issued and record of any broadcast or telecast should form part of the advertisement register.	Check the advertisement register
(vi) A notation has been attached to each advertisement indicating the manner, extent of distribution and form number of any policy advertised.	Check the notation for each advertisement stating all the disclosures
(vii) A specimen of all the advertisements filed during the last 3 years should be available.	Advertisement register should be taken for last 3 years and the specimens of them should be verified
(viii) A copy of each advertisement has been filed with the authority as soon as it is first issued and the required information is also made available with the IRDA. • Identification no. for the advertisement • Form no. of the policies advertised and when the products were approved by the authority • Description of advertisement and how it is used	Check the copy of advertisement filed with IRDA

Risks	Internal Audit Procedures
• Method or media used for dissemination of advertisement.	
(ix) A certificate of Compliance has been filed with the Annual statements stating that insurer has complied with Advertisement regulations and advertisement code.	Check the certificate of compliance filed with annual accounts
(x) A change in advertisement has been duly informed to the Authority	Check the filings in case any changes are done
(xi) All the advertisements contain full particulars of the Insurer and not just brand name and logo	Check the advertisements
(xii) Where benefits are more than briefly described, the form no. of the policy and the type of coverage should be disclosed fully.	Check the advertisements which are in the nature of invitation to contract and Check the form no. of policy and type of coverage
(xiii) Every advertisement by Insurance agent is approved by insurer in writing prior to its issue (Does not apply to advertisement developed by insurer and provided to agents, advertisement consisting of simple & correct statements not referring to specific products, benefits costs or insurers)	To check agent's website for advertisements and to check approvals. Also agreement entered with agent to be checked for this clause

Risks	Internal Audit Procedures
(xiv) Only properly licensed intermediaries may advertise or solicit insurance through advertisements	Approvals to be checked for confirming whether the same is given to licensed intermediaries
Advertising on the internet	
(i) Check whether the website of insurer and agent contains the registration/license no. of insurer.	Check the web site of the insurer and intermediaries
(ii) To check whether the website of insurer and agent contains specific policies of the site for maintaining the privacy of information of the customer and insurers own business.	Check the web site of the insurer and intermediaries
(iii) Each advertisement should • State clearly that insurance is the subject matter of the solicitation. • Disclose the full registered name of insurer/ intermediary/insurance agent • Contain the reference no. provided by Compliance Daptt.	Check the advertisements
(iv) Whether the A uthority has complained about any advertisement not being in accordance with the regulations.	Check IRDA / Advertisement Standards Council of India correspondence files
(v) Every insurer or intermediary to follow recognized standards of professional conduct as prescribed by Advertisement Standards Council of India	Check the process followed by intermediaries

Risks	Internal Audit Procedures
(vi) Every proposal for an insurance product shall carry the following stipulation, as prescribed in section 41 of the Insurance Act, 1938 (4 of 1938):— "No person shall allow or offer to allow, either directly or indirectly, as an inducement to any person to take out or renew or continue an insurance in respect of any kind of risk relating to lives or property in India, any rebate of the whole or part of the commission payable or any rebate of the premium shown on the policy, nor shall any person taking out or renewing or continuing a policy accept any rebate, except such rebate as may be allowed in accordance with the published prospectus or tables of the insurer."	Proposal forms should be verified for this disclosure
(vii) Brand names of the products mentioned in the advertisement should be as per the file & use application	Check the advertisements and file & use.
(viii) Specific requirements for an "invitation to contract" • In case attention is drawn to past financial performance, it should indicate that the past performance is not an indication of future performance.	Check the advertisements for compliance

Risks	Internal Audit Procedures
• any statement of fact, benefit to be provided, promise or projection discloses all assumptions and significant limitations/ criteria on which any special offers are available	
(ix) Contents of an Invitation to Contract advertisement: • Traditional/ULIP & Type - health, pension, annuity etc. • Risks involved - limitations / exclusions if any • Illustrations indicating the exact costs and charges & reasonable projections of benefits; and full disclosures of basis and sources of information (eg disclose date of NAV) • Min prem., min & Max SA, lock in period.	Check the advertisements
(x) The advertisements should not highlight the positive financial condition of the parent (or promoting partner) company without mentioning the financial condition of the insurer and/or indicate that the assets of the parent company can be banked upon when desired.	Check the advertisements
(xi) **Invitation to inquire** • Mandatory disclosure - “For more details on risk factors, terms and conditions please	Check the advertisements

Risks	Internal Audit Procedures
read sales brochure carefully before concluding sale" • In case of a rating or an award - the source of such rating has to be disclosed. Check the advertisements	
(xii) The advertisements released have to be filed with the Authority within 30 days from date of release. (This pertains to all types of advertisements issued through whatever media)	Date of release of advertisement as per the register of marketing should be compared with the date of filing with IRDA
(xiii) **Internet advertisements** • The text of the key features, terms and conditions are viewable. • In case of online insurance, undertaking to be taken from the policyholder that they have understood the terms and conditions and product features while applying for the policy. • Mandatory provision of a helpline or help number has been made on the internet to provide further information to policyholder • Do not call registry to be referred to on the website	Check the website of the insurer
(xiv) In case of email communication there should be provision to unsubscribe from the mailing list	Check whether the insurer has adequate process for compliance

Risks	Internal Audit Procedures
Telephonic advertisements	
(i) Promotional activities through Cold-calls shall be preferably by a licensed intermediary. In case it is done by other than licensed intermediary, responsibility of compliance with advertisement regulations and the guidelines vests with the insurer/ intermediary that has outsourced this activity.	The log of the calls made and by whom should be reviewed for the same. Also the recorded advertisements should be heard. The intermediaries should be trained for this. The training records whereby they have undergone training should be viewed for this
(ii) The telephone caller shall take necessary steps to ensure that they do not intrude into the privacy of the receiver. They should disclose their identity and proceed to converse only after permission.	Recorded advertisements (Audio) should be heard.
(iii) A reference on the access to full information about the available products and the importance of financial need analysis along with the contact phone numbers which can provide such information shall be placed before closing the call.	Recorded advertisements should be heard.
(iv) Every insurer shall facilitate an access to 'do not call registry' with the contact numbers of the persons who wish not to be contacted, which should be referred to, before every call.	The process of calling should be viewed from the branches or the telecallers.Complaints can be viewed to see whether any complaints are received pertaining to DNC to conclude whether they are trained or they are following the process

Risks	Internal Audit Procedures
Joint Sale Advertisement	
(i) JS advertisement, between insurer & Corporate agent, where the logo of both the parties are displayed jointly, can be issued with the prior approval of IRDA	Check the advertisement for this disclosure. Check whether prior approval is obtained from IRDA
Branding with third parties: (ii) It can be used on any advertisement of insurance company / intermediary **only when it does not urge** the prospect or a policyholder to purchase, renew, increase, retain or modify a policy of insurance	Check the advertisement for this disclosure
(iii) Mandatory disclosures in all advertisements to be clear and conspicuous and occupy at least 10% of the total space utilized in the ad in print/visual media with minimum font of Times New Roman -7	Check the advertisements for this disclosure
(iv) All advertisements to have unique Reference number	Check from the advertisement register whether there are any repetitions in the reference no. provided
(v) **Other disclosures :** • When an advertisement is issued in vernacular language, the mandatory disclosures are also in the same vernacular language	Check the advertisements for this disclosure

Risks	Internal Audit Procedures
• Where material is filed in other than English/Hindi language, true translation of the same in English/Hindi duly certified by an authorized officer of the insurer, is to be enclosed • Advertisements should not draw attention to favourable tax treatment without stating that they are subject to changes in tax laws	
Disclosures as per ULIP guidelines for ULIP policies	
(i) The following disclosures are required to be made in the Sales Brochures, prospectus of Insurance products and all promotional material: The various funds offered along with the details and objective of the fund.The minimum and maximum percentage of the Investments, investment strategy so as to enable the policyholder to make an informed investment decision. "No statement of opinion as to the performance of the fund shall be made anywhere." The definition of all applicable charges, method of appropriation of these charges and the quantum of charges that are levied under the terms and conditions of the policy	Check the advertisements for this disclosure

Risks	Internal Audit Procedures
should be disclosed and should be uniform The maximum limit up to which the insurer reserves the right to increase the charges subject to prior clearance of the Authority The fundamental attributes and the risk profile of different types of investments that are offered under various funds of each unit linked product	
(ii) On top of each document including the proposal form mentionthe following disclaimer *"IN THIS POLICY, THE INVESTMENT RISK IN INVESTMENT PORTFOLIO IS BORNE BY THE POLICYHOLDER"*	
(iii) The policy holder should be given the full details, using the same font, related to the investments, as an annual report, covering the fund performance during the preceding financial year in relation to the economic scenario, market developments etc. which should include particulars like: The investment strategies & risk control measures adoptedthe changes in fundamentals, such as interest	Whether this information on any mode of advertisement has been verified.

Risks	Internal Audit Procedures
rates, tax rates etc, affecting the investment portfoliothe composition of the fund (debt, equity etc.) analysis within various classes of investment, investment portfolio details, sectoral exposure of the underlying funds and the ratings of investments made. Analysis according to the duration of the investments held.Performance of the various funds over different periods like 1yr, 2 yrs, 3 yrs, 4 yrs, 5 yrs & since inception along with comparative benchmark index.	
(iv) To inform that Unit Linked products are different from the traditional Life Insurance products Check that the advertisement discloses the risk factors associated with specific reference to fluctuations in investment returns and the possibility of increase in charges. The advertisements should disclose that the premiums and funds are subject to certain charges related to the fund or to the premium paid. Contingency on which the guarantee, if any, is payable and the exact quantum of such guarantee.	Check the advertisements for this disclosure

Risks	Internal Audit Procedures
(v) Where financial information is being presented, the following points should be kept in mind: • Compounded annual returns (shall adopt standardized computations) for the previous five calendar years, expressed as a percentage rounded to the nearest 0.1% • Where last five calendar years data are not available, data for as many years as possible must be given. • Where data is not available for at least one calendar year, past performance shall not be shown • The life insurers shall not be permitted to demonstrate a link between the past performance and the future • It should clearly state, in the same font, that the past performance is not indicative of future performance • Corresponding benchmark index performance, if any, shall be included • Unit Linked Life Insurance products should disclose risk factors along with the warning statements	Check the advertisements for this disclosure

Risks	Internal Audit Procedures
• Unit Linked Life Insurance products are different from the traditional insurance products and are subject to the risk factors. • The premium paid in Unit Linked Life Insurance policies are subject to investment risks associated with capital markets and the NAVs of the units may go up or down based on the performance of fund and factors influencing the capital market and the insured is responsible for his/her decisions • ___________is only the name of the Insurance Company and______ is only the name of the unit linked life insurance contract and does not in any way indicate the quality of the contract, its future prospects or returns • Obtain knowledge on the associated risks and the applicable charges, from your Insurance agent or the Intermediary or policy document the insurer • The various funds offered under this contract are the names of the funds and do not in any way indicate the quality of these plans, their future prospects and returns	Check the advertisements for this disclosure

Risks	Internal Audit Procedures
• In view of the paucity of time and space, on the advertisements in the hoardings and posters and in audio visual media, wherever the unit linked life insurance contract has been advertised, point no (1.4.2) and (1.4.3) should have a place invariably - (point "the premium paid in ulip...." & "....... is only......")	
(vi) The advertisements shall not compare funds offered by one insurer with funds offered by another insurer, implicitly or explicitly. ULIP advertisements to emphasize life cover - i.e the risk cover and not sold as pure investment product	Check the advertisements for this disclosure
(vii) Check that Sales illustrations are available for all the products	Take the list of all the products and check whether illustrations are there for all the products either on the website of any other source
(viii) No claim of ranking as regards its position in the insurance market based on any criteria (like premium income or number of policies or branches or claims settlements, etc) permissible in any advertisements	Check the advertisement for this disclosure

Risks	Internal Audit Procedures
(ix) UIN of the product to be mentioned in every product specific advertisement.	Check the UIN of each product from the website and compare the same with the advertisement
(x) There is a reconciliation in place between Compliance and Marketing to ensure that all advertisements are routed through Compliance and released with prior approval of Compliance	Cross Check the number of advertisements for both the departments
(xi) DISCLOSURES IN PRODUCT BROCHURES AS REQUIRED UNDER PROTECTION OF POLICYHOLDERS INTEREST REGULATIONS The following points should be disclosed: • Scope of benefits, extent of insurance cover • Warranties, exceptions, exclusions and conditions of the insurance cover (including riders) • Participating/ Non-participating • Allowable riders with their scope of benefits	Check product brochures for disclosure
(xii) Norms on size of disclaimer (for print ads) and time for which disclaimer will be aired (for TV/ radio ads)	Check whether the same has been adhered too

Risks	Internal Audit Procedures
GROUP INSURANCE ADVERTISEMENTS	
(i) All Group sales material and prospectus comply with Regulations on Insurance Advertisement and Disclosures	Check the advertisement pertaining to group products and ensure compliance of the same.

Chapter 18

Management Expenses

18.1 "Expenses of management" means all charges wherever incurred whether directly or indirectly, and include-

(i) Commission payments of all kinds,

(ii) Any amount of expenses capitalized,

(iii) In the case of an insurer having his principal place of business outside India, a proper share of head office expenses which shall not be less than such percentage as may be prescribed of the total premiums (less re-insurance) received during the year in respect of life insurance business transacted by him in India, but does not include in the case of an insurer having his principal place of business in India any share of head office expenses in respect of life insurance business transacted by him outside India.

Sub-process

(i) General Operating Expenses

(ii) Operating expenses peculiar to insurance business

(iii) Allocation of Operating Expenses amongst Policyholders and Shareholders

(iv) Allocation of Operating Expenses amongst Policyholders' Segments

Scope and Objective

18.2 The objective of the audit is to review those operating expenses that are peculiar to insurance business only. For other operating expenses which are common across all the industries, the ICAI's Technical Guide on Internal Audit if any may be referred to.

18.3 All operating expenses incurred in carrying out the insurance business, i.e., which have direct nexus with the insurance business are to be classified into various heads such as employee' s remuneration, travel, legal, interest charges, etc. An item of expenses in excess of one percent of the net premium or Rs. 500,000, whichever is higher, is required to be shown as a separate item. The nexus of an expense and the insurance business is to be checked by applying auditor's own judgment. Other expenses which cannot be specified under this broad head but have a direct nexus should be disclosed under a separate head under the Revenue Account.

18.4 The operating expenses cover the following broad heads of expenditure:

(i) Employees' remuneration and welfare benefits

(ii) Managerial Remuneration: Since nothing is prescribed under the Insurance Act, 1938 on the managerial remuneration, the provisions of the Companies Act, 1956 would apply

(iii) Travel, conveyance and vehicle running expenses

(iv) Repairs

(v) Printing and stationery

(vi) Communication

(vii) Legal and professional charges: Attention is drawn to the head 'claims incurred' in Schedule 4 where it is clearly stated under Note 'b' that legal and other fees and expenses would form part of claim cost. Hence these are not to be included under the head Legal and Professional charges. All other expenses which are not covered under the claims cost are required to be included under this head.

(viii) Medical fees: Reimbursement of medical expenses or premium in respect of health cover are covered under the employees' remuneration and welfare. Any medical fees incurred towards maintenance of health care policies are required to be debited under this head.

(ix) Auditors Fees, expenses, etc.,

(x) As auditor

(xi) As adviser or any other capacity in respect of

(xii) Taxation matters

(xiii) Insurance matters

(xiv) Management services and

(xv) In any other capacity

(xvi) Advertisement and Publicity

(xvii) Interest and Bank Charges: This would include all expenses incurred towards maintenance of bank account, interest and other charges levied by bankers in the normal course of business other than bank expenses relating to investments (interest, bank charges, custodial charges, etc.). Any other interest charged on the borrowings which could not form part of the Revenue Account is not required to be included under this head.

(xviii) Depreciation: In respect of depreciation, the rates of depreciation should be applied as per the Companies Act, 1956. Other aspects like depreciation on re-valued amount of assets should also be looked into appropriately by the auditor.

18.5 The auditor has to check that the expenses of management have been properly classified and that common expenses are properly shared as per the policy of the insurer. It may be verified that the expenses of management not part of policyholders' account are accounted only under the shareholders' account. In case of Revenue Account (operational expenses), the basis of apportionment of those expenses under different classes of business should be verified and it should be ensured that the expenses have been apportioned in equitable and justified manner depending upon the services rendered by each department.

Circulars/Acts/Regulations

Circulars/Act/Rules	Regulations
The Insurance Act, 1938	
(i) Section 40B(1)	Insurer to submit a statement in the prescribed form certified by an actuary on the basis of premiums currently used by him in regard to new business in respect of mortality, rate of interest. Expenses and bonus loading.
(ii) Section 40B(2)	• No insurer shall spend by way of Management Expenses in any calendar year any amount in excess of the limits prescribed and any excess amount spent within the limits fixed in respect of the year by the Executive committee of life insurance council. IRDA/F&I/ORD/EMT/145/08/2010 • On the recommendation of the Life Insurance Council vide letter dated August 18, 2010 and in exercise of the powers

Circulars/Act/Rules	Regulations
	vested with the Authority under the proviso to section 40B(2) of the Insurance Act, 1938, and having regard to the fact that where the life insurance companies listed at Annexure are in excess of the prescribed limits of expenses of management in the first five years of their operations, they shall be deemed to be not in violation of the requirements of section 40B of the Insurance, 1938 read with Rule 17D of the Insurance Rules, 1939 during the said period. • The period of five financial years shall be in addition to the first partial financial year which the individual insurer commenced operations.
(iii) Section 40B(4)	Insurer shall incorporate in the Revenue account a certificate signed by Chairman, two directors and a principal officer and auditor's certificate certifying that all management expenses relating to life insurance have been debited to the revenue account and in case of other class of insurance business have been debited to the respective revenue accounts.
(iv) Rule 17 D of Insurance	After the 31^{st} day of December,

Circulars/Act/Rules	**Regulations**
Rules,1939	1950, no insurer shall, in respect of the life-insurance business transacted by him in India, spend as expenses of management in any calendar year an amount exceeding in the mentioned format.
(v) IRDA circular 067/1/IRDA/F&ACIR/Mar-08,	Following heads may be disclosed as part of “Notes to Accounts” : Outsourcing Expenses, Business Development and Marketing Support • If there is any regrouping of previous year’s figures, it is advised that disclosure should indicate the line item in the final accounts which have been regrouped and the reasons for the same.
(vi) Section 3 of IRDA (Preparation of Financial Statements and Auditors’ report of Insurance Companies) Regulations, 2000	Prescribes the line items to be presented in the Financial Statement. Auditor has to check whether the requirement of Schedule 3 is complied. Items of expenses and income in excess of one percent of the total premiums (less reinsurance) or ₹ 5,00,000 whichever is higher, shall be shown as a separate line item.

Operating expenses peculiar to Insurance Business

Expenses	Internal Audit Procedures
(i) IRDA Registration Fees payment	Check whether the payment is as per section 3A of the Insurance Act, 1938 and as per the prescribed format mentioned: Higher of the following: I- ₹ 50,000 II- Lower of (a) and (b) a) One tenth of one percent of total gross written premium b) ₹ 5 crores.
(ii) Training expenses	Check whether the Agents training expenses are in line with the number of agents trained during the period.
(iii) Medical Fees	Check whether the medical fee is in line with the number of medical cases received during the period.
(iv) Stamp Duty on Policies	Check whether the stamp duties on policies are in line with the increase/decrease in sum assured and also the stamp duty is paid as per the Indian Stamp Act.
(v) Use of Services of Other Organizations	• Outsourcing of services plays a significant role in the operations of insurance companies. Several administrative functions may be outsourced i.e. the distribution network - based on arrangements and agreements with agents and other

Expenses	Internal Audit Procedures
	organisations for a commission/fee based charge, custody / accounting of investments, premium & other reconciliations, payroll processing, policy issuance, printing & dispatch, etc. The outsourcing of these functions requires a review of the organisations' working to whom the functions are assigned • Surprise visits to the locations, audits and controls through periodic reports in the desired formats would enable the determination of existence and effectiveness of the controls.
(vi) Proper allocation of Operating Expenses amongst Policyholders and Shareholders	As per IRDA circular IRDA/CIR/ F&A/088/Mar-05 dated 30th March, 2005, the depreciation expense should be allocated between the Revenue/Profit & Loss account based on the "use" of the assets by the insurer.All insurers give a declaration to the effect that all management expenses relating to life insurance have been debited to the revenue account and in case of other class of insurance business have been debited to the respective revenue accounts. The auditors should check that all expenses relating exclusively to the management of capital and

Expenses	Internal Audit Procedures
	dealings with shareholders are debited to profit and loss account. For example: Expenses related to management of shareholders' fundsExpenses related to Shareholders' reportingBoard meeting related expenses.
(vii) Proper allocation of Operating Expenses amongst Policyholders' Segments	Operating expenses that are directly attributable and identifiable to the business segments need to be checked whether they are allocated to the correct segment. Other operating expenses, which are not directly identifiable and attributable need to be checked whether they are allocated based on the predefined keys. <u>For example</u> Operating expenses related to claims department can be broadly allocated amongst segments based on no of claims intimated/ reported product wise/segment wise Operating expenses related to underwriting department can be broadly allocated amongst segments based on underwriting cases reported product wise/ segment wise.
(viii) Correctness of calculation and reporting of expense over run	Correct calculation of expense overrun as prescribed by IRDA. Process of capturing expenses

Expenses	Internal Audit Procedures
	under various heads used for calculating overrun should be robust as to ensuring accurate calculation. Process of classification of expenses under various heads should be robust. Adequate controls over reviewing expense classification and passing re classification entries to be in place.

18.6 Illustrative checklist containing risks and internal audit procedures along with applicable regulations/guidelines/notification/ circulars:

Risks	Internal Audit Procedures
General Operating Expenses	
(i) Verification of Delegation of Authority	Check the management guidelines issued to cover authorization levels of employees/managers for ordering goods and services and whether the same is followed for all expenses Should we mention that Delegation of authority to be approved by Board.
(ii) Expenses without proper supportings	Check whether all expense statements are supported by proper/ original bills or vouchers.
(iii) Limit on expenses breached	• Ensure expense limits are adhered to • Check whether the insurer have adequate controls in

Risks	Internal Audit Procedures
	place to monitor various expense limits.
(iv) Payment without delivery of services	Check whether the invoices/ delivery challans are approved by a proper authority in the department which has received the products or services, evidencing that the products/ services have been delivered.
(v) Vendor selection without Proper bid / tender process	Check whether the vendors for the main goods and services are selected on the basis of bids/tenders and the same are reviewed periodically. Check whether insurer has a system of getting quotations from 3-4 vendors before selection of a vendor.
(vi) Claiming of non-business related expenses	Ensure that the concept of proprietorship has been followed and ensure only business related expenditures are claimed
(vii) Overspent of Expenses	• Check whether management expenses are estimated appropriately during the budget preparation process and significant variance between actual and budgeted expenses are investigated and explained • Check whether regular review of work processes and the operating expenses

Risks	Internal Audit Procedures
	are performed by the management and explanation is obtained for unusual costs.
(viii) Improper provisioning of expenses	• Check whether the invoices are logged/recorded when received by the accounting department and the aforesaid log/register is used to accrue for unpaid invoices • Check whether provisioning amount is supported by appropriate invoices/details • Vendor balance confirmation has to be obtained which should reflect accurate position of creditors
(ix) Non deduction of tax	Check whether taxes (service tax, income tax etc) are properly calculated at applicable rate and ensure standard accruals are established for recurring expenses.
(x) Duplicate payments	• Check whether the supporting document is stamped as paid to avoid the risk of duplicate payment • Check whether the payments generally made on the basis of original documents. Photocopies/ duplicate bills may be used to support payments only in exceptional cases.

Risks	Internal Audit Procedures
(xi) Improper Vendor Creation	• Check whether the vendor accounts are created with proper approved request submitted for new vendors established on the vendor system and the same should be approved by a responsible official. The system should permit payments only to approved vendors • Check authorizations for creation/deletion of vendor codes in system • Check duplicate vendor codes.
(xii) Improper payment process	• Check whether the cheques in respect of the payments are made on the basis of requisition of authorized signatories and the cheque preparers have a list of the authorized signatories to confirm their authority • Check whether the cheques are released directly to the payee and not returned to the requisitioners • Check whether the authorized signatories review the supporting documentation to confirm that the cost is valid • Check whether payments are made within the credit period (maximum being 45

Risks	Internal Audit Procedures
	days to ensure compliance with Micro, Small and Medium Enterprise Development Act, 2006 in case of suppliers covered under the Act) • Check if one amount recorded in the accounting system tallyies with the invoices and is charged to appropriate head.
Non-compliance with the insurer internal policy	Check whether the insurer's internal policy regarding travel and entertainment expenses is set out in clear and precise terms in a policy statement and expense account approvers check employees' compliance with the aforesaid policy.
Improper allocation of costs	Check whether an approved policy exists for allocation of costs over various lines of business & controls exist to ensure that actual allocation is as per the agreed policy.
Improper classification of expenses	Auditors have to check whether expense classification as OPEX / CAPEX is proper.

Chapter 19

Financial Closing Process

19.1 Every insurer shall, in respect of insurance business transacted by it and in respect of its shareholders' funds, at the expiration of each financial year prepare with reference to that year, a balance sheet, a profit and loss account, a separate account of receipts and payments (revenue account) and Management Report in accordance with the Regulations made by the Authority. Every insurer shall keep separate accounts relating to funds of shareholders and policy-holders. The main components of the final accounts of an insurer shall include the Revenue Account (Policyholders' Account), Profit and Loss Account (Shareholders' Account), and the Balance Sheet. These are to be prepared in the formats prescribed under Form A-RA, Form A-PL and Form A-BS, respectively (refer annexure I). The insurance companies are also required to prepare the Cash Flow Statements according to the Direct Method prescribed by Accounting Standard 3 issued by the Institute of Chartered Accountants of India.

19.2 The system of recording, classifying and summarizing the transactions in life insurance companies is, in substance, no different from the other entities. However, in case of insurance companies, the ledger accounts, specifically those of premium, claims, commissions & actuarial reserving need to be given more attention.

19.3 Where the insurer carries on the business of life insurance, all receipts due in respect of such business, shall be carried to and shall form a separate fund to be called the life insurance fund the assets of which shall, be kept distinct and separate from all other assets of the insurer and the deposit made by the insurer in respect of life insurance business shall be deemed to be part of the assets of such fund. The life insurance fund shall be as absolutely the security of the life policy holders as though it belonged to an insurer carrying on no other business except life insurance business and shall not be liable for any contracts of the insurer for which it would not have been liable had the business of the insurer been only that of life insurance and shall not be applied directly or indirectly for any purposes other than those of the life insurance business of the insurer.

Sub Processes:

(i) Data collation from various sub systems

(ii) Consolidation

(iii) Compliance checks – form, disclosures, analytical procedures

(iv) Reporting.

Scope and Objective:

19.4 The objective of the audit is to review the closing procedures. The main aim of internal audit is to evaluate the internal controls in place to ensure that the financial results of the insurer reflect the true and fair position on the date of reporting.

19.5 A normal process of account closure as followed in other non-insurance companies is followed in life insurance companies as well. The general practice to be followed for preparation of accounts is as under :

(i) Corresponding amounts for immediately preceding financial year for all items to be given in Balance Sheet, Revenue Account, Profit and Loss Account, and Receipts and Payments Account and in case of quarterly financials, it would include For the Quarter and Year to Date.

(ii) The figures should be rounded off to nearest thousands.

(iii) Interest, dividends and rentals receivable in connection with investments should be stated at gross value and the tax deducted at source in respect thereof should be included under 'advance taxes paid'

(iv) Extent of Risk retained and reinsured shall be separately disclosed

(v) Any debit balance of Profit and Loss Account should be shown as a deduction from uncommitted reserves and the balance, if any, should be shown separately.

(vi) Reclassifications need to be separately disclosed in the notes

(vii) Debtors / creditors not to be netted off but shown gross

(viii) Material transactions to be shown separately

19.6 Another important report forming part of Financial Statements of an insurance company is the management report. The management report contains the prescribed confirmations, declarations, certifications and disclosures. The management report places significant responsibility on the management of the insurer. Auditors have to check whether all the requirements of the Management Report are satisfied.

19.7 Illustrative checklist containing risks and internal audit procedures along with applicable regulations/guidelines/ notification/ circulars:

Risks/Audit areas	**Internal Audit Procedures**
(i) Continuity of Insurance Business and validity of Insurance License verification	Confirmation regarding continuing validity of registration, where the management has to ensure continuous compliance with IRDA (Registration of Indian Insurance Companies) Regulations, 2000 and the provisions of section 3 of the Insurance Act, 1938, read with other relevant provisions.

Risks/Audit areas	Internal Audit Procedures
(ii) Non-payment of statutory dues	Check whether all the statutory dues have been correctly paid and are in accordance with the presented provisions.
(iii) Whether or not the expenses are correctly amortized over aperiod of time	The basis of amortizing the prepaid expenses has to be ascertained. Check whether these expenses have been correctly amortized.
(iv) Authorization of Final Accounts	Sub-section (2) of section 11 of the Insurance Act, 1938 provides that the accounts and statements should be signed, in the case of a company, by the chairman, if any, and two directors and the principal officer of the company.
(v) Valuation of investments, and provision for diminution in value thereof.	Check the basis of valuation of Investments. The same has to be in confirmation with the provisions laid down by the regulator.
(vi) Accounting for re-insurance transactions	Check whether the re-insurance transactions are in confermily with the re-insurance treaty.
(vii) Provision for Taxation	Check that the calculation of Tax is in conformity with the provisions of the Income tax Act, 1961.
(viii) Fixed Assets	• Check that the purchase of Fixed Assets is with proper authorization as may be specified by the insurer in its Delegation of Powers

Risks/Audit areas	Internal Audit Procedures
	• Check whether the insurer has undertaken physical verification of Fixed Assets on a periodical basis and the reconciliation is in place. • Check whether the fixed assets are grouped under appropriate block of assets • Check whether appropriate rate of depreciation has been applied • Check whether process related to disposal / writing off of fixed assets are followed • Check whether Capital Work in Progress has been disclosed separately in the Schedule. Check the movement of capital work in progress.
(ix) Investment Income Recognition	Check that the insurer has recognized the interest income on loans and advances and dividends on investments and realized gains on sale of investments as per the IRDA guidelines and interest on deposits on accrual basis. Check that they are stated at gross amount.
(x) Share Capital	Check the minimum share capital requirement. Preliminary expenses incurred are to be deducted from the share capital.

Risks/Audit areas	Internal Audit Procedures
(xi) Loans and Advances	• Check whether loans and advances granted are not in contravention of section 29 of the Insurance Act, 1938 • Whether the Loans and Advances have been determined correctly • Check authorizations and confirmations.
(xii) Cash and Bank Balances	• Check whether the actual cash tallies with that reported. Bank balances to be supported with the Bank confirmations and proper bank reconciliations. Check open items in bank reconciliations • Check whether ageing analysis is prepared and follow up for long pending items is done • Check whether Bank Reconciliation Statement is prepared on a monthly basis and follow up action is taken up regularly • Cheques issued but not presented for more than six months to be transferred to Stale cheque account and proper control on the reissuance of cheques from stale cheques account to be verified.

Risks/Audit areas	Internal Audit Procedures
(xiii) Current Liabilities	• The current liabilities specific to an Insurer will include credit balance in agents accounts, amounts payable to other insurance companies, deposits held with the re-insurers to whom the business is ceded, premium received in advance from the policyholders, unapplied premium, claims outstanding and other common type of current liabilities, viz., sundry creditors, outstanding balances to the officers/ directors and others • In respect to the above, the auditor shall perform checks to validate the existence of these liabilities such as balance confirmation, enquiry, Vouch unapplied / advance premium cases, etc.
(xiv) Contingent liabilities	• Contingent liabilities involve financial estimation and it is an item requiring disclosure in every company, including insurance companies • Check whether the management has certified the contingent liability. Obtain basis of valuation of contingent liability on account of legal cases • Seek legal advice in valuing

Risks/Audit areas	Internal Audit Procedures
	significant contingent balances.
(xv) Books of Account	• Check whether all the books of account that are required to be maintained as per statutory requirement have been maintained or not • Check whether proper controls are in place for creating accounts and deactivation of accounts in the system.
(xvi) Actuarial Valuation	The actuarial liability for policyholder has to be determined by the Appointed Actuary of the insurer. The auditor may check whether the actuarial assumptions have been consistently followed. Whether these assumptions are in sync with the economic conditions. Whether the valuation is in confirmation with actuarial standards laid down by the Actuarial Society of India. Check compliance with IRDA (Asset, liability and solvency margin of insurer) Regulations, 2000.
(xvii) Provisions	The various types of provisions can be classified as provision for operating expenses at branches, provision related to employee benefits, provisions related to marketing, Claim provision etc. Auditors have to check whether

Risks/Audit areas	Internal Audit Procedures
	adequate provisions are made and also the rational of calculation has to be verified.
(xviii) Segmental Report	Check whether the allocation to various segments is on a pre-approved basis and the manner of deciding the basis of allocation. Also allocation of expenses between Revenue Account and Profit & Loss Account has to be verified.
(xix) ULIP Disclosures	IRDA requires the life insurance companies to prepare accounts also at the fund level. This may also be verified by the auditor.
(xx) Transfer of Funds	Check whether the funds have been correctly transferred based on IRDA guidelines from the shareholders account to the policyholders account to make good any losses that may be incurred in any segment of life insurance business carried out by insurer.
(xxi) Reconciliation between PMS, Treasury Management System, Channel Management System and Accounting System	• Check for the control over interface between PMS, Treasury Management System, Channel Management System and Accounting System • Check whether proper reconciliation of figures between all the systems is done periodically.

Risks/Audit areas	Internal Audit Procedures
(xxii) Disclosures in Financial Statement	As per IRDA circular 067/1/IRDA/F&ACIR/Mar-08, • Heads that may be disclosed as part of "Notes to Accounts": Outsourcing Expenses, Business Development and Marketing Support • If there is any regrouping of previous year's figures, it is advised that disclosure should indicate the line item in the final accounts which have been regrouped and the reasons for the same.
(xxiii)Balance confirmation process	Check whether balances of debtors and creditors are confirmed periodically
(xxiv) Related party confirmation process	Check whether related party balances are confirmed periodically
(xxv)Proper allocation of Operating Expenses amongst Policyholders and Shareholders	• As per IRDA circular IRDA/CIR/F&A/088/Mar-05 dated 30th March, 2005, the depreciation expense should be allocated between the Revenue/Profit & Loss account based on the "use" of the assets by the insurer • All insurers give a declaration to the effect that all management expenses relating to life insurance have been debited to the revenue account and in case of other

Risks/Audit areas	Internal Audit Procedures
	class of insurance business have been debited to the respective revenue accounts • The auditors should check that all expenses relating exclusively to the management of capital and dealings with shareholders are debited to profit and loss account. For example: • Expenses related to management of shareholders' funds • Expenses related to Shareholders' reporting Board meeting related expenses
(xxvi) Public Disclosure	Check the compliance of IRDA circular IRDA/F&I/CIR/F&A/012/01/2010 **Disclosures** The disclosures will be effective from the period ended March 31, 2010. **Publication in News Paper** • Insurers shall publish the Balance Sheet, Profit & Loss Account, Revenue Account and Key Analytical Ratios on an half yearly basis in the forms as prescribed in at least one English daily newspaper circulating in the whole or substantially the whole of India and in one newspaper

Risks/Audit areas	Internal Audit Procedures
	published in the regional language of the region where the registered office is situated or in Hindi • The publication should be in font size of atleast 10 points. • The publication must be made within 2 months from end of the half year period or within 15days from the date of approval by their Board of Directors, whichever is earlier. **Publication on Website** Insurers shall host all the forms including Revenue Account, Profit & Loss Account, Balance Sheet, segmental reporting, schedules to accounts and other forms, on their website on quarterly/half yearly/ yearly basis as prescribed. Receipt and Payment Account may be displayed along with year-end disclosures • The forms should be displayed on the web-site under advise to IRDA not later than o 45 days from the quarter ending June, September, December and March, o For the half year ending September – within 2 months of the close of the half year or 15 days from the date of approval of the accounts by the Board of

Risks/Audit areas	Internal Audit Procedures
	Directors, whichever is earlier o For the annual account ending March – within 6 months of the close of the financial year or within 30 days from the date of adoption of final accounts by the Board of Directors, whichever is earlier. o In order to have uniformity, the Authority has standardized the key analytical ratios mandated for life and non-life insurance companies. o Disclosures for the earlier quarters should be available under archives for a minimum period of 5 years. • In case of disclosures where the un-audited quarterly financial results are published, they shall be approved by the Board of Directors of the insurer or by a Committee thereof Provided that when the quarterly financial results are approved by the Committee they shall be placed before the Board at its next meeting: Provided further that while placing the financial results before the Board, the Chief Executive Officer, Chief

Risks/Audit areas	Internal Audit Procedures
	Financial Officer and Appointed Actuary (life insurance company only) of the company, shall certify that the financial results do not contain any false or misleading statements or figures and do not omit any material fact which may make the statements or figures contained therein misleading • The half yearly accounts will be subject to limited review by the auditors. The limited review report shall be placed before the Board of Directors or by a Committee thereof. • Where there is a variation between the un-audited published results and the audited results and (i) the variation in surplus / deficit or net profit / net loss after tax is in excess of 10% or Rs.5 crores, whichever is higher, (ii) variation in exceptional or extraordinary items is in excess of 10% or Rs. 1 crore, whichever is higher – the insurer shall submit to the Authority an explanation stating reasons for variations, along with the annual financial statements. The explanation of variations so submitted shall be approved by Board of Directors.