

# Technical Guide on Internal Audit of BPO Industry



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

# Technical Guide on Internal Audit of BPO Industry

**DISCLAIMER:**

The views expressed in the Technical Guide are those of the author(s). The Institute of Chartered Accountants of India may not necessarily subscribe to the views of the author(s).



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## FOREWORD

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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 'boundary-less' 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  
New Delhi

**CA. Amarjit Chopra**  
*President, ICAI*



## PREFACE

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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, " <i>Related Parties</i> ":<br><br>"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<sup>1</sup>

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).   |

---

<sup>1</sup> 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.

|  |  |
|--|--|
| 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. |
| 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                     | The protocols that govern the exchange of  |



|                                     |  |
|-------------------------------------|--|
| Protocol/Internet Protocol (TCP/IP) | 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.  |

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## 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

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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.

# About The Indian BPO Industry

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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



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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.

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- (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 transcription services; Knowledge processes related services like, Analytics, 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.



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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. For 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.

# Legal Framework

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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

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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 :

$$\text{Positive NFE} = A - B > 0$$

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-



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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. For 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

# Statutory Laws Applicable to Indian BPO Industry

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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.

### ***Statutory Laws Applicable to Indian BPO Industry***

- (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.

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- 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 or collection.

#### ***(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:

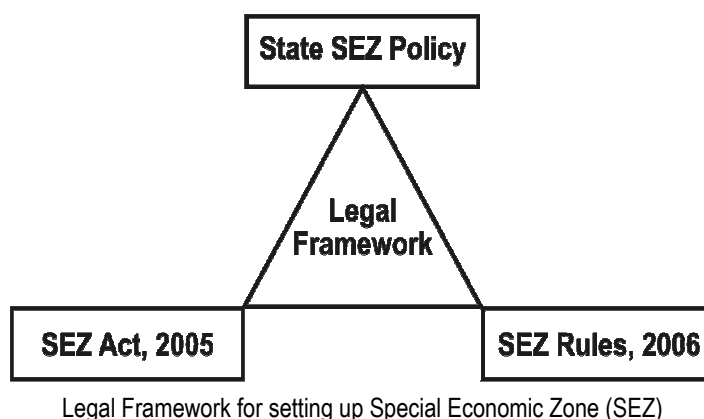
- Change of name
- Change of location
- Expansion of STP unit
- Domestic Tariff Area (DTA) Entitlement permission

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- 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.



### **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.

### ***Statutory Laws Applicable to Indian BPO Industry***

- 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.



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- 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

### ***Statutory Laws Applicable to Indian BPO Industry***

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.

### ***Statutory Laws Applicable to Indian BPO Industry***

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.



# Internal Audit

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### 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

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- 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

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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 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*".



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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

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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.

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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.

# Major Areas of Internal Audit Significance

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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.

### **Major Areas of Internal Audit Significance**

- (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

### **Major Areas of Internal Audit Significance**

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:

| <b>S.No</b> | <b>PARTICULARS</b>   | <b>Yes</b> | <b>No</b> | <b>N/A</b> |
|-------------|--|------------|-----------|------------|
| <b>1</b>    | <b>Client Service Agreements</b>   |            |           |            |
| 1.1         | Does the entity enters into agreements with all clients – existing and proposed? |            |           |            |

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| <b>S.No</b> | <b>PARTICULARS</b>   | <b>Yes</b> | <b>No</b> | <b>N/A</b> |
|-------------|--|------------|-----------|------------|
| 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?  |            |           |            |
| 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? |            |           |            |

**Major Areas of Internal Audit Significance**

| <b>S.No</b> | <b>PARTICULARS</b>  | <b>Yes</b> | <b>No</b> | <b>N/A</b> |
|-------------|---|------------|-----------|------------|
| <b>2</b>    | <b>Verification of Billing Mechanism</b>  |            |           |            |
| 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?   |            |           |            |
| 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?               |            |           |            |

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| <b>S.No</b> | <b>PARTICULARS</b>   | <b>Yes</b> | <b>No</b> | <b>N/A</b> |
|-------------|--|------------|-----------|------------|
| 2.14        | Have there been significant fluctuations in billing during every invoicing period?   |            |           |            |
| 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 services rendered with their contract so as to ensure compliance of minimum service criteria?   |            |           |            |

**Major Areas of Internal Audit Significance**

| <b>S.No</b> | <b>PARTICULARS</b>  | <b>Yes</b> | <b>No</b> | <b>N/A</b> |
|-------------|---|------------|-----------|------------|
| 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?  |            |           |            |
| 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 21<sup>st</sup> November to 20<sup>th</sup> 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.



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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

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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.

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6.17 The following is a model checklist related to payroll process:

| <b>S.No.</b> | <b>PARTICULARS</b>  | <b>Yes</b> | <b>No</b> | <b>N/A</b> |
|--------------|---|------------|-----------|------------|
| <b>1</b>     | <b>Specific Areas of Payroll Processing</b>   |            |           |            |
| 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   |            |           |            |
| 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?   |            |           |            |

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| <b>S.No.</b> | <b>PARTICULARS</b>  | <b>Yes</b> | <b>No</b> | <b>N/A</b> |
|--------------|---|------------|-----------|------------|
| 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 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.

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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 |
|----------|---|-----|----|-----|
| <b>1</b> | <b>Internal Audit of Communication and Logistics related Expenses</b>   |     |    |     |
| 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? |     |    |     |
| <b>2</b> | <b>Internal Audit of Sub-contracting of Work</b>  |     |    |     |
| 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?  |     |    |     |

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| S.No. | PARTICULARS  | Yes | No | N/A |
|-------|--|-----|----|-----|
| 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     | <b>Internal Audit of Fixed Assets</b>   |     |    |     |
| 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?  |     |    |     |
| 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

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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:

| <b>S.No.</b> | <b>PARTICULARS</b>  | <b>Yes</b> | <b>No</b> | <b>N/A</b> |
|--------------|---|------------|-----------|------------|
| <b>1</b>     | <b>Internal Audit of Related Party Transactions</b>   |            |           |            |
| 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          |            |           |            |

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| <b>S.No.</b> | <b>PARTICULARS</b>   | <b>Yes</b> | <b>No</b> | <b>N/A</b> |
|--------------|--|------------|-----------|------------|
|              | controls to ensure fair allocation between them?   |            |           |            |
| 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 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

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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.

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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 |
|----------|--|-----|----|-----|
| <b>1</b> | <b>Internal Audit of Computer Environment</b>  |     |    |     |
| 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.

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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

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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

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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

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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.

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- (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:

| <b>S.No.</b> | <b>PARTICULARS</b>  | <b>Yes</b> | <b>No</b> | <b>N/A</b> |
|--------------|---|------------|-----------|------------|
| <b>1</b>     | <b>Books of Accounts and Documents</b>  |            |           |            |
| 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 month?   |            |           |            |

**Technical Guide on Internal Audit of BPO Industry**

| <b>S.No.</b> | <b>PARTICULARS</b>   | <b>Yes</b> | <b>No</b> | <b>N/A</b> |
|--------------|--|------------|-----------|------------|
| 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.

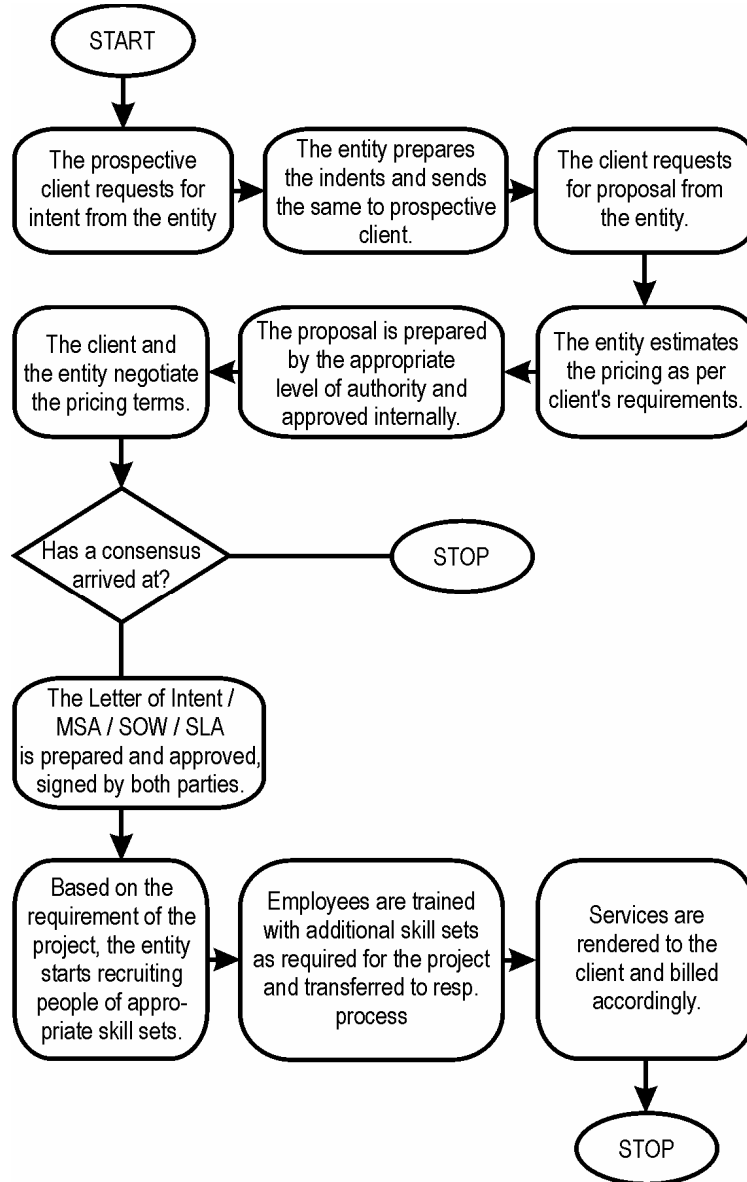
6.47 The following is a model checklist related to compliance with regulations :

| <b>S.No.</b> | <b>PARTICULARS</b>   | <b>Yes</b> | <b>No</b> | <b>N/A</b> |
|--------------|--|------------|-----------|------------|
| <b>1.</b>    | <b>Compliance with Various Statutes</b>  |            |           |            |
| 1.1          | Has the client obtained registration from various statutory authorities:<br>- Software Technology Park of India<br>- Customs Authorities<br>- Special Economic Zone<br>- Service Tax |            |           |            |

**Major Areas of Internal Audit Significance**

| <b>S.No.</b> | <b>PARTICULARS</b>   | <b>Yes</b> | <b>No</b> | <b>N/A</b> |
|--------------|--|------------|-----------|------------|
|              | <ul style="list-style-type: none"> <li>- VAT</li> <li>- Central Excise Authorities</li> <li>- Reserve Bank Of India.</li> </ul>  |            |           |            |
| 1.2          | Has the client renewed its registration with the statutory authorities as regards to : <ul style="list-style-type: none"> <li>- Software Technology Park of India</li> <li>- Customs Authorities</li> <li>- Special Economic Zone</li> <li>- Service Tax Authorities</li> <li>- VAT</li> <li>- Central Excise Authorities</li> <li>- Reserve Bank Of India.</li> </ul> |            |           |            |
| <b>2.</b>    | <b>Internal Audit of Statutory Provisions</b>  |            |           |            |
| 2.1          | Has the internal auditor verified the different provisions as applicable to the entity?  |            |           |            |
| 2.2          | Has the entity been able to maintain a positive net foreign exchange earnings?   |            |           |            |
| 2.3          | Has the entity ensured renewal of 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)?  |            |           |            |

## A Typical Process in a BPO Industry



## APPENDIX 2

### Indicative Compliance Due Dates

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(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) | 30 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 10 <sup>th</sup> of the next month*.                 |                                      |
| 5.    | STPI Scheme    | Quarterly Progress Report                  | 10 <sup>th</sup> 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                  | 30 <sup>th</sup> April every year                           |                                      |
| 8.    | STPI Scheme    | Audited Annual Performance Report          | 30 <sup>th</sup> June every year                            |                                      |

\* Varies from state to state. Some states have 7<sup>th</sup> and some states have 5<sup>th</sup> as due date.

# Varies from state to state.



# APPENDIX 3

# SOFTWARE EXPORT DECLARATION (SOFTEX) FORM

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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

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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 through data communication link)

8. Name of authorised datacom service provider STPI/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 |
|---|----------|
| <input type="checkbox"/> Data Entry jobs and Conversion<br>Software Data Processing | 9 0 6    |
| <input type="checkbox"/> Software Development                                       | 9 0 7    |
| <input type="checkbox"/> Software Product, Packages                                 | 9 0 8    |
| <input type="checkbox"/> Others (Please specify)                                    | 9 0 9    |
- (b) Other Software
- |  |       |
|--|-------|
| <input type="checkbox"/> Video/TV Software       | 9 1 0 |
| <input type="checkbox"/> Others (Please specify) | 9 1 1 |
10. Analysis of Export Value
- |  | <u>Currency</u> | <u>Amount</u> |
|--|-----------------|---------------|
| (a) Full export value  |                 |               |
| of which :-  |                 |               |
| i) Net value of exports without<br>transmission charges                    |                 |               |
| ii) Transmission charges<br>included in invoice                            |                 |               |
| (b) Transmission charges (if payable<br>separately by the overseas client) |                 |               |
| (c) Deduct: Agency commission,<br>at the rate of .....%                    |                 |               |
| (d) Any other deductions as<br>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 \_\_\_\_\_  
Authorized Dealer  
(b) Authorized Dealer Code No. \_\_\_\_\_
- (b) Bank Guarantee (a) Name and address of \_\_\_\_\_  
Authorized Dealer  
(b) Authorized Dealer Code No. \_\_\_\_\_
- (c) Any other arrangement (a) Name and address of \_\_\_\_\_  
Authorized Dealer  
e.g. advance payment, etc. including transfer/remittance  
to bank account maintained overseas (Please specify) (b) Authorized 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/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. Calculation of royalty amount \_\_\_\_\_  
(Enclose copy of communication  
from the foreign customer)
15. Name and address of designated Authorized  
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. due date for payment or within 180 days from the date of invoice/date of last invoice raised during a month, whichever is earlier), in the manner prescribed in Rule 9 of the Foreign Exchange Regulation Rules, 1974.

Place: \_\_\_\_\_  
Date: \_\_\_\_\_  
Stamp  Signature of the Exporter  
Name: \_\_\_\_\_  
Designation: \_\_\_\_\_

- =====  
Enclosure:  
(1) Copy of Export Contract [7(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: \_\_\_\_\_  
Stamp  (Signature of Designated Official of STPI on behalf of Department of Electronics)  
Name: \_\_\_\_\_  
Designation: \_\_\_\_\_

## Reference:

|    |   |   |
|----|---|---|
| 1  | NASSCOM   | <a href="http://www.nasscom.in">www.nasscom.in</a>  |
| 2  | BPO India   | <a href="http://www.bpoindia.org">www.bpoindia.org</a>                                      |
| 3  | BPO Watch   | <a href="http://www.bpowatchindia.com">www.bpowatchindia.com</a>                            |
| 4  | Software Technology Parks of India  | <a href="http://www.stpi.in">www.stpi.in</a>  |
| 5  | An ASSOCHAM Initiative on the Indian Outsourcing Industry                                       | <a href="http://www.assochem.org/bpo/index.html">http://www.assochem.org/bpo/index.html</a> |
| 6  | Department of Information Technology, Ministry of Communication and Information Technology, GOI | <a href="http://www.mit.gov.in">http://www.mit.gov.in</a>                                   |
| 7  | Department of Telecommunications, Ministry of Communication and Information Technology, GOI     | <a href="http://www.dot.gov.in">http://www.dot.gov.in</a>                                   |
| 8  | National Informatics Centre   | <a href="http://www.nic.in/">http://www.nic.in/</a>   |
| 9  | Directorate General of Foreign Trade, Ministry of Commerce and Industry, GOI                    | <a href="http://dgft.delhi.nic.in/">http://dgft.delhi.nic.in/</a>                           |
| 10 | Telecom Regulatory Authority of India   | <a href="http://www.trai.gov.in">http://www.trai.gov.in</a>                                 |
| 11 | Working group on Information Technology for Masses  | <a href="http://itformasses.nic.in">http://itformasses.nic.in</a>                           |