Technical Guide on Internal Audit of Infrastructure Industry

The Institute of Chartered Accountants of India

(Set up by an Act of Parliament)

New Delhi

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Internal Audit Standards Board

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Foreword

Infrastructure development has a key role to play in economic growth. Investors, policymakers and citizens alike acutely feel the constraint of physical infrastructure on economic growth. The importance of infrastructure for sustained economic development is well recognized. High transactions costs arising from inadequate and inefficient infrastructure can prevent the economy from realizing its full growth potential regardless of the progress on other fronts.

Challenges in infrastructure provision are not unique to India. Uncertainty, scarcity of available funds for investment, and competing priorities present challenges to infrastructure planning and delivery. Effective internal audit provides a tool to ease out all the complexities, ensures that systems and processes are adequate to support the growth and are adapted to the changes in various applicable regulations, thereby ensuring sustained growth and development. With a solid understanding of the organization, its objectives and inherent risks peculiar to infrastructure industry, internal auditors can surely help to assess the possible impact of various risks on the achievement of business objectives.

I am happy to note that the Internal Audit Standards Board is issuing this Technical Guide on Internal Audit of Infrastructure Industry for guidance of members and other readers. I congratulate CA. Rajkumar S. Adukia, Chairman, Internal Audit Standards Board and members of the Board on issuance of this Technical Guide. This Technical Guide comprehensively deals with the peculiar aspects of Infrastructure Industry, including various regulatory aspects and provides a step-wise approach for internal audit.

I am sure that this Technical Guide will assist the members and others in efficiently discharging their responsibilities.

February 8, 2012 | CA. G. Ramaswamy
New Delhi | President, ICAI

Preface

Infrastructure Industry in India has been witnessing rapid growth in its different sectors due to growing urbanization and increasing rate of foreign investments in this field. The Indian government has taken various initiatives to develop the infrastructure sector with major emphasis on construction, engineering, IT, entertainment, textiles, food, and utility to name some. Liberalisation of Foreign Direct Investment (FDI) regulations, extended tax holiday periods and introduction of Public Private Partnerships (PPP) are some of the factors that have led to the growth of infrastructure sector in India.

Despite the high growth potential, the industry is subjected to more risk and uncertainty than many other industries. Many of the risks emerge over time and are linked to the life cycle of the project. Thus, the potential for improving the management for infrastructure projects is significant. Internal auditors who understand the basic structure and processes of infrastructure project management and tailor their internal audit work to the unique time and organisational framework can play a meaningful role. They can assist in implementing controls that provide reasonable assurance of mitigating cost, schedule and technical risk to an acceptable level.

Keeping this in mind, the Internal Audit Standards Board is issuing the Technical Guide on Internal Audit of Infrastructure Industry as a part of series of the industry specific technical guides. The Technical Guide will help the readers to understand the basic operations undertaken in the industry, the regulatory and legal framework in which they operate and also peculiar internal audit aspects relating to the same.

The Technical Guide gives guidance on the internal audit of the companies engaged in development of infrastructure facilities on ‘Build operate and Transfer’ basis and has been divided into various chapters. These chapters deal with technical and operating aspects of the infrastructure industry as well as covers internal audit procedures. It gives a brief overview on various aspects likes receipt of material, storage, material movement, fixed assets, revenue and operating costs, maintenance of books of accounts, risks faced by the entity, etc. The Guide explains the internal audit processes. It contains detailed checklist on internal audit that would help the readers in understanding the various technicalities arising during the internal audit of Infrastructure industry. It contains the list of laws and statues applicable to the industry for providing valuable guidance to the readers. The Guide also contains Glossary of terms used in the infrastructure industry for enhancing understanding of the readers. In addition to this Guide, the Board has already issued "Technical Guide on Internal Audit in Construction Industry" to help the members in understanding the basic concepts and peculiarities of the industry concerned.

At this juncture, I am grateful to CA. Manoj Fadnis and his entire team *viz.*, CA. Sanjay Gupta, CA. Vikas Guru, CA. Vikram Gupte, CA. Chirayu Agrawal, CA. Arpit Mahajan, CA. Vikas Jain, CA. Sunil Maheshwari, CA. Kemisha Soni, CA. Manoj Sharma, CA. R. Ganeshan, CA. Amit Jain and CA. Satpal Khanuja for sharing their experience and knowledge with us and preparing the draft of this Technical Guide.

I also wish to thank CA. G. Ramaswamy, President and CA. Jaydeep N. Shah, 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. P. Rajendra Kumar, Vice Chairman, CA. Amarjit Chopra, CA. Shiwaji B. Zaware, CA. Ravi Holani, CA. Anuj Goyal, CA. Nilesh S. Vikamsey, CA. Vijay K. Garg, CA. Atul C. Bheda, CA. J. Venkateswarlu, CA. Abhijit Bandyopadhyay, Shri Prithvi Haldea, Smt. Usha Narayanan, Smt. Usha Sankar, Shri Manoj Kumar and Shri Sidharth Birla for their vision and support. I also wish to place on record my gratitude for the co-opted members on the Board, *viz*., CA. Madhu Sudan Goyal, CA. Rohit Choksi, CA. Ketan Vikamsey, and CA. Pankaj Kumar Adukia as also special invitees on the Board, *viz*., CA. Anil Kumar Jain, CA. Ajay Minocha, CA. Sumit Behl and CA. R. Subramaniam for their invaluable guidance as also their dedication and support to the various initiatives of the Board. I also wish to express my thanks to CA. Jyoti Singh, Secretary, Internal Audit Standards Board and her team of officers for giving final shape to this publication.

I firmly believe that this publication would serve as basic guide for the members and other readers interested in the subject.

February 9, 2012
Mumbai

CA. Rajkumar S. Adukia
Chairman
Internal Audit Standards Board

Glossary

Applicable Laws	Laws, promulgated or brought into force and effect by the Union Government or concerned State Government, including regulations and rules made there under, and judgements, decrees, injunctions, writs and order of any court of record, as may be in force and affect service concession agreement.
Appointed Date	The date 180 days from signing of Concession Agreement.
Borrowing Costs	The costs incurred by the operator in acquisition of requisite funds for the operation services, as elaborated in para 4 of the Accounting Standard 16 (or para 5 read with para 6 of Ind AS 23) "Borrowing Costs" issued by the Institute of Chartered Accountants of India.
Commercial Operation Date (COD)	The date on which the Independent Consultant has issued the final Completion Certificate or the Provisional Certificate certifying Project Completion of the Project.
Concession Agreement	An arrangement involving government authority or any other public sector body granting the authorisation to a private sector entity to construct the infrastructural facilities used or proposed to be used to provide the public service or upgrading, operating and maintaining those infrastructural facilities for a specified period of time, on the given terms and conditions.
Construction Period	The period beginning from the Appointed Date and ending on the COD.
Cure Period	The period specified in Concession Agreement for curing any breach or default

	of any provision of this Agreement by the Party responsible for such breach or default and upon failing of which the Agreement may be terminated by the other party.
Development Period	The period from the date of the Agreement until the Appointed Date.
Entity	Includes Companies, Partnership Firms, Limited Liability Partnerships, Cooperative societies, Trusts, Hindu Undivided Families and any other legal form under which business operates.
EPC Contractor	Engineering, Procurement and Construction Contractor
Escrow Account	An Account which the Operator shall open and maintain with a Bank in which all inflows and outflows of cash on account of capital and revenue receipts and expenditure shall be credited and debited, as the case may be, in accordance with the provision of Concession Agreement.
Financial Closure	The date on which the Financing Documents providing for funding by the Lenders have become effective and the operator has immediate access to such funding under the Financing Documents.
Financing Package	It means the financing package of the Project furnished by the Operator along with its Bid indicating the Total Project Cost and the means of financing thereof and shall be deemed to have been modified to the extent as submitted to the Lenders and as approved by the Lenders for the purposes of funding of the Project.
Grantor	Generally a public sector entity, including a governmental body, which authorizes a private entity to Build, Operate and Transfer

	or in any other similar mode on Infrastructural Facilities.
Infrastructural Facility	The facilities used or proposed to be used for general public utility such as Roads, Airports, Ports, Dams, Water Distribution facilities, Hospitals etc. which is subject matter of the service concessionaire agreement.
Intangible Asset	An intangible asset is an identifiable non-monetary asset without physical substance, as elaborated in para 6 of the Accounting Standard 26 (or in para 8 of Ind AS-38) issued by the Institute of Chartered Accountants of India.
Operator	The person who enters into a service concessionaire agreement with the grantor to Build or Operate or Build and Operate the Infrastructural Facility.
Operation Services	The services provided by the Operator to the users of the infrastructure facility.
User Fee	Charges levied by the operator from users of the infrastructure facility.
Viability Gap Funding	The consideration paid either upfront or on recurring basis or in any other mode by the Grantor to the Operator pursuant to the service concessionaire agreement on the agreed upon terms and conditions.

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Chapter 1
Introduction

1.1 The objective of internal audit is to help the business sustain and grow. Infrastructure Entities are the entities engaged in any of the infrastructure design, development, operation and maintenance.

1.2 Infrastructure is treated as a top priority and expenditure allocation in the Budget of Central and State is testimony to the deliberate policy of the government to create infrastructure facilities. The fund starved exchequer with zeal to build infrastructure facilities, has given rise to Public Private Partnership. It started somewhere in 1992, when privatization was tried for its workability and few pilot projects were undertaken. The initial success was encouraging and it grew significantly thereafter which all of us are witnessing these days. This participation by private sector in infrastructure has given new frontiers to the traditional contractors who were engaged in payment based works for State/ Central Government organizations, for small projects. Due to these macroeconomic changes brought in by the government in the economic environment, business has also to undergo a transformation for better participation in the initiatives taken by the Government. There are large outlays that we have been noticing in every budget towards infrastructure and we need to focus on this segment aligning our priority set up to that of government intentions. Our role as a Chartered Accountant is to convert conveniently these large outlays to the outcomes at the business unit level. The privatization in various infrastructure activities would not have attained success, without there being matured professionals.

1.3 At the outset, to set a proper perspective, it is necessary to understand, what constitute "Infrastructure". In general parlance, we all understand that basic amenities for general public benefit are infrastructure. However, infrastructure is defined differently by different regulating agencies, like RBI, Income tax, Service Tax, FDI, etc.

1.4 There is no uniform definition of the word "infrastructure". It has been defined differently in various statutes. Infrastructure services for public services such as roads, bridges, tunnels, prisons, hospitals, airports, dams, water distribution facilities, energy supply and telecommunication networks have traditionally been constructed, operated and maintained by the public sector and financed through public budget appropriation.

Definition of Infrastructure

1.5 While Infrastructure is recognised as a crucial input for economic development, there is no clear definition of infrastructure according to the current usage of the term in India. For policy formulation, setting up of sectoral targets and monitoring projects, a clear understanding of what is covered under the rubric of "infrastructure" is necessary to ensure consistency and comparability in the data collected and reported by various agencies over the time. The National Statistical Commission headed by Dr. C. Rangarajan, attempted to identify infrastructure based on some characteristics.

1.6 The definitions of infrastructure from various reports/notifications of different agencies are compiled below which concluded with decision taken by the Empowered Sub-Committee of the Committee on Infrastructure on this subject in the meetings held on 11th January, 2008 and 2nd April, 2008 under the chairmanship of Deputy Chairman, Planning Commission.

Dr. C. Rangarajan Commission's Notion of Infrastructure (2001)

1.7 The Rangarajan Commission indicated six characteristics of infrastructure sectors:

(a) Natural monopoly,

(b) High-sunk costs,

(c) Non-tradability of output

(d) Non-rivalness (up to congestion limits) in consumption,

(e) Possibility of price exclusion, and

(f) Bestowing externalities on society.

1.8 Considering all of above six characters together, the Commission recommended inclusion of following in infrastructure in the first stage:

(i) Railway tracks, signaling system, stations,

(ii) Roads, bridges,

(iii) Runways and other airport facilities,

(iv) Transmission and distribution of electricity,

(v) Telephone lines, telecommunication network,

(vi) Pipelines for water, crude oil, slurry, etc.,

(vii) Waterways, port facilities,

(viii) Canal networks for irrigation,

(ix) Sanitation or sewerage.

1.9 The Commission further recommended that considering the characteristics outlined in (b), (d) and (e), the above list may be extended to include the following in the second stage:

(i) Rolling stock on railways

(ii) Vehicles

(iii) Aircrafts

(iv) Power generating plants

(v) Production of crude oil, purification of water

(vi) Ships and other vessels.

However, the Rangarajan Commission recommended that the list of infrastructure activities should be finalised by the Ministry of Statistics and Programme Implementation (MOSPI) on the basis of the characteristics recommended by them for identification of infrastructure.

Reserve Bank of India (RBI)

1.10 The Reserve Bank of India (RBI) has issued a circular on Definition of Infrastructure. As per the RBI, a credit facility is treated as "infrastructure lending" to a borrower company which is engaged in developing, operating and maintaining any infrastructure facility that is a project in any of the following sectors, or any infrastructure facility of a similar nature:

- A road, including toll road, a bridge or a rail system;
- Highway project including other activities being an integral part of the highway project;
- A port, airport, inland waterway or inland port;
- A water supply project, irrigation project, water treatment system sanitation and sewerage system or solid waste management system;
- Telecommunication services whether basic or cellular, including radio paging, domestic satellite service (i.e. a satellite owned and operated by an Indian company for providing telecommunication service), network of trunking, broadband network and internet services;
- An industrial park or special economic zone;

- Generation or generation and distribution of power;
- Transmission or distribution of power by laying a network of new transmission or distribution lines;
- Construction relating to projects involving agro-processing and supply of inputs to agriculture;
- Construction for preservation and storage of processed agro-products, perishable goods such as fruits, vegetables and flowers including testing facilities for quality;
- Construction of educational institutions and hospitals;
- Any other infrastructure facility of similar nature.
- For raising external commercial borrowings funds, the RBI has defined infrastructure to include (i) power, (ii) telecommunication, (iii) railways, (iv) roads including bridges, (v) sea port and airport, (vi) industrial parks and (vii) urban infrastructure (water supply, sanitation and sewage projects) vide circular dated 2nd July, 2007.

Insurance Regulatory and Development Authority (IRDA)

1.11 The IRDA (Registration of Indian Insurance Companies) (Second Amendment) Regulations, 2008 defined infrastructure to include following:

- a road, including toll road, a bridges or a rail system.
- a highway project, including other activities being integral part of the highway project.
- a port, airport, inland waterway or inland port.
- a water supply project, irrigation project, water treatment system, sanitation and sewerage system or solid waste management system.
- telecommunication services whether basic or cellular including radio paging, domestic satellite services (i.e. a satellite owned and operated by an Indian company for providing telecommunication services), network of trunking, broadband network and internet services.
- an industrial park or special economic zone.
- generation or generation and distribution of power.
- transmission or distribution of power by laying a network of new transmission or distribution lines.

- construction relating to projects involving agro-processing and supply of inputs to agriculture.
- construction for preservation and storage of processed agro-products, perishable goods such as fruits, vegetables and flowers including testing facilities for quality.
- construction of educational institutions and hospitals.
- any other public facility of similar nature as may be notified by the Authority in this behalf in the Official Gazette.

World Bank

1.12 The World Bank treats power, water supply, sewerage, communication, roads & bridges, ports, airports, railways, housing, urban services, oil/gas production and mining sectors as infrastructure.

Economic Survey

1.13 The Economic Survey considers power, urban services, telecommunications, posts, roads, ports, civil aviation, and railways under infrastructure sector.

Decision of the Empowered Sub-Committee of the Committee on Infrastructure, Planning Commission on Definition of Infrastructure

1.14 The Empowered Sub-Committee of the Committee on Infrastructure in its meetings held on 11th January, 2008 and 2nd April 2008 under the chairmanship of Deputy Chairman, Planning Commission discussed the subject matter. There was consensus on including the following in the broad definition of infrastructure:

- Electricity (including generation, transmission and distribution) and R&M of power stations,
- Non-conventional Energy (including wind energy and solar energy),
- Water supply and sanitation (including solid waste management, drainage and sewerage) and street lighting,
- Telecommunications,
- Roads & bridges,
- Ports,
- Inland waterways,

- Airports,
- Railways (including rolling stock and mass transit system),
- Irrigation (including watershed development),
- Storage,
- Oil and gas pipeline networks.

About the Indian Infrastructure Industry

1.15 The infrastructure industry has driven economic activities to enormous wealth creation in the nation. It has a pervasive impact which prevails in every corner of the society, the reason for which is its products which most importantly are buildings, roads and bridges, utility distribution systems, railways, airports, harbours, etc. serving as a magnet to the investments in the nation, has its future dependent upon its capacity to evolve on business, technological and environmental fronts.

1.16 Governments have introduced contractual service arrangements to attract private sector participation in the development, financing, operation and maintenance of such infrastructural facilities. An arrangement within the scope of this Technical Guide typically involves a private sector entity (an operator) constructing an infrastructural facility used to provide the public service or upgrading it (for example, by increasing its capacity) and operating and maintaining those infrastructural facilities for a specified period of time.

1.17 The operator is compensated for its services over the period of the arrangement by way of transfer of right to collect the 'user fee' from the users of such facilities. The arrangement is governed by a contract that sets out performance standards, mechanisms for adjusting prices, and arrangement for arbitrating disputes. Such an arrangement is often described as a 'build-operate-transfer', a 'rehabilitate-operate-transfer', a 'public-to-private' or 'design-build-operate-transfer' service concession arrangement.

1.18 The contract price sets the initial prices to be levied by the operator for utilization of infrastructural facilities and regulates price revisions over the period of the service arrangement. The operator is obliged to hand over the infrastructural facilities to the grantor in a specified condition at the end of the period of the arrangement, for little or no incremental consideration, irrespective of which party initially financed it.

1.19 Internal audit, indeed has a key role to play in this Industry, is a necessary requirement after the multi-dimensional challenges faced by this industry like project risk, funding strategies, cost reduction, project monitoring, etc. Auditing is a peculiar skill, which demands the Auditors to have strong understanding of the basic concepts and sensitive areas of this industry.

Scope of Technical Guide

1.20 This Technical Guide gives guidance on the Internal Audit of the companies comprising the Infrastructure Industry in the country which are engaged in development of infrastructure facilities on 'Build, Operate and Transfer' basis:

(i) This Technical Guide applies to both private and public sector.

(ii) The grantor controls or regulates what services the operator must provide with the infrastructural facilities, to whom it must provide them, and at what price.

(iii) The grantor controls-through ownership, beneficial entitlement or otherwise-any significant residual interest in the infrastructural facilities if remaining at the end of the term of the arrangement.

(iv) This Technical Guide applies to both:

- Infrastructure facilities that the operator constructs or acquires from a third party for the purpose of the service arrangement; and
- Existing infrastructural facilities to which the grantor gives the operator access for the purpose of the service arrangement.

1.21 This Technical Guide does not specify the accounting for infrastructural operations that were held and recognized as property, plant and equipment by the operator before entering the service arrangement.

1.22 This Technical Guide is not applicable to construction contracts for which separate Technical Guide on Internal Audit of Construction Industry is available.

Chapter 2
Legal Framework

2.1 The legal framework under which an infrastructure entity operates is no different from the legal framework under which other business entities operate in Indian economic environment. However, there are peculiarities associated with roads, ports, power, water works, urban infrastructure, etc.

2.2 The broad legal frame work which needs to understand from the point of view of internal audit function may be categorized as under:

Legal Framework Associated with Its Constitution

2.3 Some of the Legal Framework is Companies Act, Partnership Act, etc. Limited Liability Partnerships (LLP) is also a new legal form in the process gaining popularity. These legal forms of doing business are linked to the contractual aspects, Tax Laws, FDI Regulations, etc. For example National Highways Authority of India (NHAI) permits Concession Agreement only with a Company. An LLP has not been recognized so far as an entity with whom NHAI can enter into agreement. Also NHAI asks for Special Purpose Vehicle (SPV) to be created for each separate project. SPV is an entity solely established for undertaking a specific project and it is restrained from engaging in any other activity. This is due to the reason that NHAI requires that Company's financial position should not be influenced by various other activities, which if undertaken would distort the total picture.

Contractual Framework Associated with Agreements for the Projects Entered with Awarder of the Project

2.4 Contractual Framework associated with agreements for the projects entered with Awarder of the Project are as follow:

(i) Dispute Resolution Framework like Arbitration and Conciliation Act, 1996.

(ii) RTI Act for giving information and gaining information from others.

(iii) Competition Act relating to infrastructure entities.

(iv) FDI Regulations.

(v) Public Interest Litigation aspect in development of infrastructure project.

(vi) Planning Commission (Secretariat for Infrastructure).

Other Applicable Indian Acts to the Industry

Governance Laws

2.5 The Various acts enacted by the Government to govern any industry and so also applicable to the infrastructure industry are as follow:

(i) The Companies Act, 1956

(ii) The General Clauses Act, 1897

(iii) The Land Acquisition Act, 1894

(iv) The Indian Easements Act, 1882

(v) The Indian Stamp Act,1899

(vi) The Negotiable Instruments Act, 1881

(vii) The Indian Penal Code,1860

(viii) Consumer Protection Act, 1986

Economic Laws

2.6 There are various economic laws to which the infrastructure industry may be subject to. The major amongst them is Income Tax Act, 1961.

Contract Laws

2.7 The various contract laws to which the infrastructure industry may be subject to include:

(i) The Indian Contract Act,1872

(ii) Securities Contracts (Regulation) Act, 1956

Labour Laws

2.8 There are a number of labour laws governing the construction industry. A few of the important ones are as follow:

(i) Employees Provident Fund Scheme, 1952

(ii) Employee State Insurance Act, 1948

(iii) Payment of Gratuity Act, 1972

(iv) Payment of Bonus Act,1965

(v) Professional Tax Enacted by the respective states

(vi) The Trade Union Act, 1926

(vii) The Minimum Wages Act, 1948

Other Laws as Applicable to the Industry

2.9 The other laws as applicable to the Industry are as follow:

(i) Securities Exchange Board of India Act,1992

(ii) Foreign Exchange Management Act,1999

(iii) Arbitration and Conciliation Act,1996

The internal auditor is also expected to be aware of various circulars issued by the RBI towards foreign currency transactions.

A Reference to Statutory Laws Applicable to the Industry

Income Tax Act, 1961

2.10 For an infrastructure company, Section 80 IA of the Income Tax allows deduction of 100% profit from its income during initial 5 years of operation and then 30% deduction of profit from income during another 5 years. For the purpose of this section infrastructure covers electricity, water supply, sewerage, telecom, roads and bridges, ports, airports, railways, irrigation, storage (at ports) and industrial parks/SEZ.

Chapter 3
Internal Audit

3.1 Almost all the undertakings in this sector in India are by the Big Business Houses. They are being operated on a very large scale, thereby leaving for very less scope of any disorganization in the management. With the increase in scale of operations, increases the scope of fraud or any flaw that may have an adverse effect on the company as well as the investors. Effective internal audit provides a tool to ease out all the complexities, ensures that systems and processes are adequate to support the growth and are adapted to the changes in various applicable regulations, thereby ensuring sustained growth and development.

3.2 *Preface to Standards on Internal Audit,* issued by the Institute of Chartered Accountants of India defines the term ‘Internal Audit’ as follows:

“*Internal Audit is an independent management function, which involves a continuous and critical appraisal of the functioning of an entity with a view to suggest improvements thereto and add value to and strengthen the overall governance mechanism of the entity, including the entity’s strategic risk management and control system.”*

The above mentioned definition highlights the following facets of an internal audit:

- Internal Auditor should be independent of the activities he audits. The internal audit function is, generally, 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, utilization of resources, compliance with laws, management information system, etc.
- Internal auditor’s role should be a dynamic one, continually changing to meet the needs of the organization there is often a need to change the 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 a board to discharge its governance responsibilities. Thus, it contributes in accomplishment of objectives and goals of the organization 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 control 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 assignments.

Factors Contributing to the Evaluation of Internal Audit

3.3 General Guidelines on Internal Audit, issued by the Institute of Chartered Accountants of India, describes the factors contributing the evolution of Internal Audit in India, which 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 tab global capital. This has thrown up compliance with the laws of the home country as well as 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 a 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 requirement, etc.

(v) Unconventional Business Models

Businesses today use unconventional models and practices, for example, outsourcing of non-core areas, such as accounting, collection of user fee etc.

(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 globalization 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 customers. This in turn, has lured more and more players in the existing markets, thereby, stiffening the competition.

Methodology for Internal Audit

Standards on Internal Audit

3.4 The Institute of Chartered Accountants of India has till date issued seventeen standards on Internal Audit (SIAs), which aim to codify the best practices in the area of internal audit and also serve to provide a benchmark of the performance of the Internal Audit Services. While formulating SIAs, the Internal Audit Standards Board set up by ICAI takes into consideration the applicable laws, customs, usages, business environment and generally accepted internal auditing practices in India. The list of Standards on Internal Audit (SIAs) is given below:

SIA 1	Planning an Internal Audit
SIA 2	Basic Principles Governing Internal Audit

SIA 3	Documentation
SIA 4	Reporting
SIA 5	Sampling
SIA 6	Analytical Procedures
SIA 7	Quality Assurance in Internal Audit
SIA 8	Terms of Internal Audit Engagement
SIA 9	Communication with Management
SIA 10	Internal Audit Evidence
SIA 11	Consideration of Fraud in an Internal Audit
SIA 12	Internal Control Evaluation
SIA 13	Enterprise Risk Management
SIA 14	Internal Audit in an Information Technology Environment
SIA 15	Knowledge of the Entity and its Environment
SIA 16	Using the Work of an Expert
SIA 17	Consideration of Laws and Regulations in an Internal Audit

Some important aspects on Internal Audit have been discussed in the following paragraphs:

Terms of Internal Audit Engagement

3.5 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 the engagement before commencement. Standard on Internal Audit (SIA) 8, "*Terms of Internal Audit Engagement*" establishes standards and provide guidance in respect of terms of engagement of the internal audit activity whether carried out in house or by an external agency.

3.6 The engagement letter should generally include reference to the following:

- Objective of internal audit;

- Management's responsibilities;
- Scope of Internal audit (including reference to the applicable legislation, regulation and various pronouncements of ICAI);
- Access to records, documents and information required in connection with internal audit;
- Expectation to receive management's written confirmation in respect to representation made in connection with the audit;
- Basis on which fees shall be computed and the billing arrangements thereof;
- References received from the parent company, if any; and
- Undertakings to be covered.
- Disclaimers regarding any anticipated change or contingency.

3.7 The scope of terms of 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.

3.8 The terms of 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 internal auditor should not be distributed or circulated by the auditee for 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

3.9 Before the commencement of audit assignment the internal auditor should have or obtained the knowledge of the business and its environment. The internal auditor should acquire sufficient knowledge to enable him to identify and understand the events, transactions and practices that can have significant effect on the internal audit process. Knowledge regarding the suppliers, dealers, nature of raw materials used in construction, governing laws applicable, standards of measurability of the constructed asset etc is must. The management's procedures and map of the work flow has to be thoroughly scanned. 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 procedure. Knowledge of the business helps 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.

3.10 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 the stages of the internal audit process.

3.11 The internal auditor should prepare the flow of events, transactions, processes and practices within the organization. This will help in gaining better understanding of the processes and the existence of the internal audit control.

Using the Work of an Expert

3.12 The Standard on Internal Audit (SIA) 16, "*Using the Work of an Expert*" is established to provide assistance to the Internal Auditor. The Internal Auditor should obtain technical advice and assistance from competent experts if the internal audit team does not possess the necessary knowledge, skills, expertise or experience needed to perform all or part of the internal audit engagement. An expert can be a person, firm or other association of persons possessing special skill, expertise, knowledge and experience in the Infrastructure based field. In Infrastructure Industries, it may involve professionals like Architects, Engineers, and Designers etc.

Audit Planning, Materiality and Sampling

3.13 After acquiring the knowledge of business and various laws and regulation applicable to the construction industry the internal auditor should plan out the internal audit activity. Planning helps in achieving the objective of internal audit function. Adequate planning ensures that:

- Appropriate attention is devoted in significant areas of audit
- Potential problems are identified.
- Skills and time of the staff are appropriately utilized

- Work is carried out in accordance with the applicable pronouncements of ICAI
- Work is carried out in conformity with the applicable laws and regulation.

3.14 In preparing an internal audit program, an internal auditor should obtain an undertaking and internal control system prevalent within the entity, exercise preliminary judgment regarding the critical areas to be considered during the internal audit. It also helps the internal auditor in determining the audit materiality, nature and extends of audit procedures to be adopted. While designing the sample the internal auditor should consider the specific audit objective, materiality, population from which the internal auditor wishes to select the sample, area of audit significance and the sample size.

Internal Audit Evidence

3.15 The Internal Auditor should, based on his professional judgment, obtain sufficient appropriate evidence to enable him to draw reasonable conclusions therefrom on which to base his opinion or findings. The evidence may be obtained with the help of an expert. It may involve documents like the work-completion certificates from engineers in case of valuation of work-in-progress, supplier's bills, quotations, market prices for the same materials etc. The legal status too needs proper verification in order to ensure no-obligation in its working. It includes legal documents, returns, filed papers etc.

Internal Control

3.16 Internal controls are the system consisting of specific policies and procedures designing to provide management with reasonable assurance that the Goals and objectives it believes important to the entity will be met.

3.17 Internal control system means all the policies and procedures 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, the timely preparation of reliable information. The internal audit function is carried out with the objective of determining whether internal controls are well designed and are in operation.

3.18 Internal control system consists of following inter- related components:

(i) Control (or Operating) Environment

(ii) Risk assessment

(iii) Control Objective Setting

(iv) Event Identification

(v) Control Activities

(vi) Information and communication

(vii) Monitoring

(viii) Risk Response

3.19 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

3.20 The internal auditor should obtain an understanding of the significant processes and internal control system sufficient to plan the internal audit engagement and develop an effective internal 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 attitude, awareness regarding internal controls and their importance in the entity.

3.21 The internal auditor should examine the continued effectiveness of the internal control system through evaluation and make recommendations, if any, for improving that effectiveness.

3.22 The importance of the internal controls in a construction entity need not be over- emphasized. Internal audit plays a major role in determining the effectiveness of internal controls and highlights areas for improvement. The internal auditor may also refer to Standard on Internal audit (SIA) 12, *"Internal Control Evaluation"* for a detailed discussion on internal control.

Internal Audit in an Information Technology Environment

3.23 Computer Information System (CIS) environment exists when one or more computer(s) of any type of 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.

3.24 The overall objective and scope of Internal Audit does not change in a CIS environment. However, the use of computer changes the processing, storage and retrieval and communication of financial information and may affect the accounting and internal control systems employed by the entity. Moreover the risk involved in audit may undergo a change. The internal auditor should have sufficient knowledge of the CIS environment to plan, direct, supervise, control and review the work performed. The use of the Computer Assisted Audit Techniques (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.

3.25 The internal auditor should consider the CIS environment in designing audit procedures to reduce the audit risk to an acceptable level. The internal auditor should also document the audit plan, the nature, timing and 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.

Overview of Compliance

What is Compliance

3.26 Compliances mean ensuring conformity and adherence to acts, rules, laws, regulations, directives and circulars. Standard on Internal Audit (SIA) 17, *"Consideration of Laws and Regulations in an Internal Audit"* issued by the Institute of Chartered Accountant of India requires that when planning and performing audit procedures and in evaluating and reporting the result thereof, the internal auditor should recognize that non compliance by the entity with laws and regulation may materially affect the financial statement. The requirement 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 limitation 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.

3.27 The term "*non-compliance*" refers to acts of omission and commission by the entity either intentional or unintentional, which are contrary to the prevailing laws and 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 and employees. Non -compliance does not include personal misconduct (unrelated to the business activity of the entity) by those charged with governance, management and employees of the entity.

Understanding of Laws and Regulations

3.28 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 regulations 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, litigations, etc. It may also, in extreme cases, have a potential effect on going concern as an entity.

3.29 The internal auditor should plan and perform the internal audit reorganizing 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 auditors should obtain an understanding of the legal and regulatory framework applicable to the entity and how the entity is complying with that framework.

3.30 To obtain the understanding of laws and regulation, the internal auditor would ordinarily:

- Use his 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.

3.31 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, and balances or disclosures.

Significance of Compliance

3.32 The significance of compliance is as follows:

(a) 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.

(b) Benefits to stakeholders

- Ensures risk containment and safer market place.
- Better investor practices.
- Uniform practices.
- Better image, hence, better value for the investor.

Chapter 4
Major Areas of Internal Audit Significance

4.1 Procedural aspect of the Internal Audit in the Infrastructure industry is very much similar to any other Industry. However, there are some specific areas which need special focus and attention as regard to the nature and complexity of the business. The audit procedures mentioned herein are illustrative in nature and only for reference. The procedure may vary according to the nature and size of the business and also according to the terms and conditions mentioned in the service concessionaire agreement executed with the grantor agency. The Internal Auditor is required to perform audit on different geographical locations of the client entity, including the head office or the principal office. Accordingly the audit plan is required to be prepared.

Financial Aspect of Service Concession Agreement

4.2 One of the peculiar features with which infrastructure building is associated is huge capital cost and for a long very long maturity, as long as 10 to 20 Years. Companies entering into Service Concession Agreements for development of infrastructure facilities are substantially funded by institutional finance from banks/ financial institutions. The permitted Debt Equity Norms for Infrastructure Project is as liberal as 3 to 4. Generally, 66% to 75% of the capital cost is funded through Debt. Typical Cost structure also suggests that Interest is the major expenditure component in the Profit and Loss Account, affecting the bottom line of Infrastructure Entities. The other notable feature of financial canvass of Infrastructure Entities is requirement of large Bank Guarantees which is required to be given to Grantor during various phases of Project like during Construction Period/ during Operation and Maintenance which attract annual charges in the form of commission. Some of the Entities have also procured material against Letters of Credit (LCs) issued in favor of suppliers during construction / development phase of Project.

4.3 In view of its predominance in Balance Sheet/ Off Balance Sheet items as well as Profit and Loss Account it is an important area wherein Internal Audit can play a vital role in strengthening the management with close and informed supervision of this area. From the view point of principle of Materiality it deserves merit and this fact should be highlighted to the Management. However, it all depends on the terms of reference or appointment letter provided to the internal auditors as to what is the actual scope of work and Internal Auditors should perform their function having regard to the Scope. However, even if the same is not elaborately covered, it is necessary to gain basic information, which may be found useful, otherwise.

4.4 Following outgo on account of finance may take place which may be visited by the internal auditors:

(i) Upfront Processing Charges (For Fund Based Facility and For Non Fund Based Facilities depending upon Bank Policy).

(ii) Interest (Fixed or Floating linked to any Benchmark Rate; If Benchmark rate change the effective rate to borrower automatically change).

(iii) Escrow Banking Charges.

(iv) Cash Handling Charges (Ex. For daily deposit of Toll Collection in small denomination).

(v) Review/ Reset Date Processing Charges.

(vi) Supervision/ Inspection Charges.

(vii) Bank Guarantee Commission, usually 1-3% of BG Amount (For Financial and Performance Guarantees, Charged in advance in lumpsum or on periodic basis) .

(viii) Bank Guarantee Margin, usually 10% to 100% in the form of FDR under lien with the Bank.

(ix) Penal Interest, if any, for non compliance of material terms of the Agreement.

4.5 The infrastructure finance is long term in nature and Banks may find it challenging from the view points of their Asset Liability Mismatch, as most of the deposits through which the fund is augmented are essentially having average tenure of 5 years. With a view to handle this situation, IIFCL has been created to offer TAKE OUT Financing. Take Out financing is an arrangement in which Bank keeps the loan for say 5 years and later transfers the same to the Financial Institutions realizing the money lent. Many of the Infrastructure Entities securitize their future receivables for securing a higher loan outlay. Here the loan is based on the present value of future receivables say for example toll receivables during the Concession Period of a Road Project. The Loan may be taken from a single Agency, i.e., Bank/ FI or it may be arranged from multiple agencies. When the loan is arranged from more than one agency, it may be Consortium or multiple banking. Under Consortium, all member Banks have to follow the mandate of the Leader. Earlier for big loan Consortium was compulsion as per the policy of RBI but such a compulsion has been abolished.

4.6 As against the conventional way of borrowings, other forms such as Foreign Currency denominated Loans, External Commercial Borrowings (ECB) and FCCB have also been tried by some Entities. These exotic forms may involve foreign currency risk for which appropriate mitigation tools like Forwards, Futures, Options or swaps are available.

4.7 Infrastructure Loan may be fixed rate or may be linked to any Benchmark. LIBOR (London Inter Bank Offered Rate) or MIBOR (Mumbai Inter Bank Offered Rate) are major Benchmark Rates. Prime Lending Rates was the benchmark rate specific to the particular Bank. The Banks were allowed to take 1-4% more or less depending upon credit rating of borrowers. With effect from 1st May, 2011, PLR System has been replaced with Base Rate. Base Rate is a Rate below which the Bank is not allowed to lend money to the Borrowers. Bank can charge more say BR Plus 2% depending upon risk assessment.

4.8 Internal Auditor should collect basic documents including the following:

(i) Request for Proposal and Concession Agreement to gain idea about any imposition of Debt Equity Norms and whether the same has been adhered to or not and also if there is any reference to any benchmark interest rate and its implications. Project Report containing various quantitative and non quantitative details to gain the knowledge of future inflows.

(ii) Sanction Letters.

(iii) Master Circular dated July 1, 2011 on - Loans and Advances – Statutory and Other Restrictions - issued by RBI.

(iv) Loan Agreement / Hypothecation Agreement.

(v) Circular of Charges by respective Bank.

(vi) Changes in Base Rate/ PLR from time to time (Available at the website of respective bank).

(vii) Drawdown Schedule i.e. points at which funds will be released to Borrower.

(viii) Repayment Schedule.

(ix) List of Bank Guarantee in force together with various details like maturity Date and purpose thereof like Bid Security/ Performance Security/ Maintenance Security.

(x) Check List of various documents / Statements to be submitted to Bank like Audited Balance Sheet. Material Events to be communicated or for seeking prior permission like material change in shareholding. Failure to furnish may attract penal interest.

(xi) Details of Charges registered with ROC (can be verified from MCA Website).

4.9 Financial Closure is a term that finds place in various Service Concession Agreements. Achieving Financial Closure means that funds required for the entire project have been arranged for through Equity/ borrowings. Financial Closure is an important step. If the same is not achieved, consequences may go up to forfeiture of the rights conferred by Concession Agreement.

4.10 Repayment Schedule is very important. It should be closely linked to the future inflows from the Project. Normally in the initial years the revenue is small and in the later years with the increase in rate or volume of business it increases progressively. The installment should be so designed as to keep pace with the revenue. This type of pattern is known as ballooning installments wherein installments are small (as little as interest only) in initial years and higher is later part of the project period. The schedule so designed at the time of sanction of loan may be redesigned based on the experience gained in the recent past and trend noticed for future installments.

4.11 Spread Over Base Rate is linked to the Credit Rating of the Borrowers. Credit Rating is dependent on credit Score arrived on Credit Rating Parameters such as DSCR (Debt Service Coverage Ratio) Credit Rating parameters of the specific Bank need to be thoroughly undergone and it should be ensured that specific features of the entity is properly considered in determining the allotment of marks. If there is no proper appreciation of the qualities of the Borrower Entity, the same may result into biased rate of interest otherwise than that of the interest rate to which the Entity is legitimately entitled to. If the same is not properly appreciated during Sanction process, it can be stressed upon during Review/ Reset Date.

4.12 After ensuring the proper rating and proper spread over the Bench Mark like Base Rate, it is important to check Interest Debited by the Bank. Base Rates change from time to time and may change as much as 5-6 times during a year in volatile times. It should be checked whether changes from time to time have been given effect to. It has been noticed that due to error in Master Data set up error creeps into the process of calculation of Interest.

4.13 On the Non Fund Based Finance front, Bank Guarantees are often furnished to the Grantor for adherence to the quality and time frame. Bank Guarantees should be read so as to arrive at the judgment as to whether it is financial or performance. Reading of Master Circular of the RBI is also suggested. Financial Guarantee may be expensive and margin requirement could also be higher. Earlier Inter Bank guarantees were not permitted under the impression that Bank should not lend on the basis of other Banks Guarantee but take its individual judgment. This policy has changed and now Inter Bank Guarantees for Infrastructure project is permitted subject to certain restrictions. A reading of Master Circular is suggested for proper appreciation of policy in facts and circumstances involved. Charges on Bank Guarantees can be paid in advance or at annual/ bi annual rest. This frequency has impact over cash flow.

4.14 Bank Guarantee Commission is levied on quarterly basis by most of the Banks. Certain Banks charge for minimum two Quarters. Here fraction of quarter is counted as quarter. Infrastructure Companies need to submit tender along with Bid Bond Guarantee, the process of tender may last for more than 3 months and therefore any charge for say two quarters will burden the entity. Representation can be made to Bank in view of specific considerations for waiver as per Bank Policy. Even otherwise, Bank Guarantee Commission so debited by Bank needs to be checked with the duration of BG and Commission rate stipulated in the Sanction Letter.

4.15 Bank Guarantee attracts margin which has to be kept in the form of FDR under Lien. The FDR so made is entitled to interest at the appropriate rate. The Bank may be instructed to credit interest to the Current Account or it may be allowed to accumulate with the original FDR value. The internal auditor should check the accuracy of interest earned on these FDR.

4.16 Expired Bank Guarantees should be cancelled forthwith with request to the Bank to refund the Margin with held for the period of Guarantee. Banks ask for the original Bank Guarantee which may not be possible for the Operators to produce. In view of this Bank may be requested to send a letter to the beneficiary informing it that the tenure of Guarantee has expired and that no claim has been lodged. The bank's letter should also mention that In case there is no response from the beneficiary within 15 days, it shall be presumed that there is no liability on account of the guarantee. After lapse of these 15 days, FDR is released and maturity amount credited to the Operator's account with the Bank.

4.17 The peculiar feature of Infrastructure development under PPP Model is collection of user fee.

4.18 EXTERNAL CREDIT RATING DUE TO BASEL NORMS: If the size of Advance exceeds Rs.5 Crores, the Company is required to get its BLR (Bank Loan Rating) from specified Credit Rating Agencies like CRISIL, ICRA, CARE, etc. If Rating is below a specified level, the Bank is required to set apart higher capital for lending the money. The capital for Bank is costly. In case of a poor rating, the Bank is required to keep say 75% capital. In that case the Bank is likely to pass on this cost to the Borrower and the rate of interest would also be high. If a proper rating to reflect various parameters is obtained it will enable infrastructure entity to enjoy appropriate rate of interest.

4.19 The infrastructure development consist of two major activities:

- Development of the infrastructure facility.
- Provision of the Services.

4.20 The development activity consist of following major areas:

Control Over Execution of Project

4.21 Entities use different strategies to control execution of project and ensure timely completion of project.

4.22 One of the strategies used is CPM (Critical Path Method). Under CPM, the whole project is broken down into different tasks. Some of these tasks can be carried out together while some tasks can only be carried out after the completion of another task. In this way, time required to complete each chain of tasks is estimated and the chain/s of task that is/are estimated to take longest time to complete is/are called the Critical Path/s. It is endeavored to complete Critical Path in time to ensure timely completion of project.

4.23 An entity can use any one of the many strategies for timely completion of the project. The internal auditor needs to understand the strategy used by the entity he audits. He also needs to understand the controls in place to ensure adherence to the strategy.

4.24 The internal auditor gathers evidence in support of adherence to strategy and any gaps found need to be reported.

Procurement

4.25 While executing a service concessionaire agreement, an entity needs to procure several kinds of services like labour, security, sub contractors etc.

Along with services an entity may have to procure material like cement, bricks, iron, steel, sand and gravel etc. Also, in some cases the operator may go for an EPC contract, in which all the activities relating to development or construction of the Infrastructure facility are entrusted to an EPC Contractor. The same is explained below:

Procurement

EPC Contract	In-house Construction
- Appointment of an EPC	Contractor
- Material	
- Quality Control	Labour
- Operation and Management	Services
- Services	

EPC Contract

4.26 EPC stands for Engineering, Procurement and Construction. When an entity goes for the option of EPC Contract option most of the functions relating to the development are transferred to the EPC Contractor. The Operator decides for an EPC contract for several vital reasons. Some are:

- The owner puts in minimum efforts for his project and, so, has less stress. EPC contract gives the owner one point contact. It is easy to monitor and coordinate.
- It is easy for the owner to get post-commissioning services.
- EPC way ensures quality and reduces practical issues faced in other ways.
- Owner is not affected by the market rise.
- Investment figure is known at the start of the project and so as the profit and ROI figure so that it is easy to determine the user fee also.

4.27 In such contracts, the operator usually defines the following:

- Scope and the specifications of the Infrastructure facility
- Quality of the work
- Project duration, and
- Cost of the infrastructure facility.

4.28 In case of multiple EPC contracts, where an owner divides the complete project into smaller projects, several EPC contractors may come into play. In such cases, coordination among the contractors becomes a major issue. The Operator in such cases has to continuously monitor and maintain the progress of the work and iron out differences or coordination issues among EPC contractors, if any.

4.29 The operator is required to regularly monitor the progress of the work with respect to the predefined scope and specifications, quality, time line for completion of the project, etc.

4.30 Internal Auditor needs to verify the following aspects with respect to the EPC contractors:

- Running bills issued by the EPC contractor.
- Whether the payments made to the EPC with respect to the completed work are in line with the contract executed.
- Whether contracts with EPC contractors LD or penalty clauses which match with LD or penalty clauses in the contract between the Operator and the Grantor.
- Whether LD or penalty charged have been deducted in case of delay in project completion. If not, the reasons thereof.
- Whether statutory requirements regarding TDS, PF etc have been complied with.

Operations and Management

4.31 Operations and management team is also a vital resource in the development of the Infrastructure facility. This may include project implementation consultants, quality control engineers and financial consultants. They play a vital role in the financial and social success of the project.

4.32 Internal Auditor needs to verify the following processes and make the observations, if any, as regards material procurement:

(i) Vendor Management

  - Vendor Selection Process
  - Vendor Database
  - Vendor Coding System
  - Contracts for main raw material like, steel, cement, sand and aggregates periodic evaluation of vendor- How often enterprise

is doing its vendor evaluation with regard to cost, quality of material supplied and timing of supply.

- Periodic review of vendor selection policy- How often enterprise is reviewing its vendor selection policy.

(ii) Material/Service Requisition Process

- Process of identifying the requirement of material.
- Whether it is within limits of budget, if not then obtain planning department approvals.
- Whether it is raised by an authorized person.

(iii) Purchase Order

It should be reviewed with respect to following aspects:

- Vendor: Whether vendor is out of approved vendor list.
- Requisition: Whether requisition is approved.
- Whether cost comparison statement is made and approved.
- Whether terms of delivery and payment are as per approval and according to policy.
- Whether the purchase order format includes the information relating to Date and location of delivery, requisition number, material code with detailed description and quantity, agreed rate and total amount, payment terms, other terms and conditions.

(iv) Receipt of Material

- Review of procedure on receipt of material.
- Material received matches with purchase order raised.
- Ensuring whether goods received note (GRN) is issued only after receipt of material acceptance from quality department and store-in-charge.

(v) Supply Chain Management

- Verify the steps followed by the enterprise to ensure the availability of material at all the times.
- Generally, the enterprise shall cover the following in its supply chain management::
  - o Identify materials with high price volatility.
  - o Identify materials with seasonal nature.
  - o Identify alternative products.

(vi) Cash Purchases at Site

- Review the company policy and controls for cash purchases at the site. Such policy should define the materials which can be purchased at the site, limits up to which purchase orders can be placed, etc. Generally, the enterprises provide cash at the site to meet any immediate requirement or unplanned material.

(vii) Other Services

- Review the procedure adopted by the enterprise to acquire services, such as, security service, consultancy services, travel Services and courier services.
- Identification of suitable service and vendor is done by procurement department.
- A contract is entered with the vendor which provides for:
    - Date of commencement and completion of work.
    - Exact outcome expected.
    - Any specific conditions to be complied with by the contractor.
    - Monitoring and evaluation of arrangements.
    - Support and supervision arrangement.
    - Penal clauses.
    - Financial arrangement - payment methods and timing.
    - The copy of agreement will be provided to accounts and administration departments. Procurement department shall review performance of vendors periodically.
    - The Internal Auditor needs to understand the payment authorisation process for services procured.

(viii) Scrap Identification and Disposal

- Review the procedure to identify scrap material.
- Procedure of disposal of sale.
- Periodic interval of scrap sale.

(ix) Internal auditor needs to review the following MIS reports and verify that the top management is reviewing these reports as per the enterprise's standard procedures:

- Purchase order track sheet.
- Project cost analysis – variance report.

- Cash purchase report.
- Quotation tracker.

4.33 In addition to above the internal auditor may perform various analytical procedures including:

(i) Number of Delays in Receipt of Material

The number of delays in receipt of material helps the internal auditor in analyzing whether the materials are purchased/ procured on time. There may be instances where the entity may have to stop its construction activity awaiting receipt of critical material.

(ii) Ageing of Material Procured

An internal Auditor must go through the ageing analysis of the material procured at the project site and verify the time gap between material actually procured and material actually used in the project site. If there is any abnormal time gap between the two, the reasons need to be analysed and reported to the management.

(iii) Number of Labours Employed

The internal auditor can analyze the average number of employees working over a period of time, process-wise and verify whether the process is consistently sufficiently staffed. This helps the internal auditor to assess the delays in schedule due to lack of workers and report accordingly.

(iv) Interest Cost to Loans

Interest cost to loans provides a basis for the estimation of the average cost of borrowed funds in the entity. The internal auditor can estimate the average cost of borrowing and compare them with the existing rate to verify whether the interest paid is significantly high. These ratios should also be compared to the previous periods and explanations for any significant fluctuations need to be obtained.

(v) Material Consumed to the Budgeted material

The DPR (Detailed Project Report) of the Project generally contains Budgeted Quantities for various materials. This budgeted material consumption is a major cost determinant. And hence an auditor should compare the material consumed with budgeted quantities and obtain explanations for any significant variances.

Model Checklist Related to Procurement Process

S. No.	Particulars	Yes	No	N/A
Audit of Procurement Process				
1.	Materials			
1.1	Does the entity have a written policy for the procurement process?			
1.2	Is the written policy sufficient and complete in all aspects?			
1.3	Is the policy updated on a frequent basis?			
1.4	Is there a proper requisition note with approval from the appropriate level of authority sent from the concerned department?			
1.5	Does the entity raise an approved request for quotation (RFQ) within reasonable time across various suppliers?			
1.6	On receipt of various quotations, are there sufficient processes to ensure that the right quotation is approved as regards quality, reliability, price and other factors?			
1.7	On selection of the supplier, has an approved purchase order been placed with the supplier within reasonable time?			
1.8	Are there sufficient controls to trace the purchase order and its status within the entity to ensure receipt of materials without delay?			
1.9	Does the entity ensure penal clauses in case of delays in receipt of critical material to ensure timely supply?			
1.10	Are there any contracts entered by the entity with suppliers for critical materials to ensure adequate supply at a reasonable price?			
1.11	Are there sufficient procedures to inspect materials as regards to specification and quantity, received by the entity at the site before unloading and signing of the			

S. No.	Particulars	Yes	No	N/A
	delivery note?			
1.12	Are there sufficient documentary controls such as Gate pass for entry of goods?			
1.13	Has a sample check for compliance of procedures performed?			
1.14	Is the process of receipt of material properly co-ordinated to the Finance department to ensure proper accounting?			
1.15	Does the material receiving department maintain sufficient records of receipt and inspection of material?			
1.16	Has the delivery note been approved by the appropriate level of authority before making the entry?			
1.17	In cases where materials are supplied by client, has the internal auditor ensured that there has been appropriate accounting of such material?			
1.18	Does the entity have proper control for materials received from the client? Are they separately identified and demarcated?			
1.19	In case of critical materials or slow moving material does the entity transfer the materials from one site to another rather than from purchasing them from external sources?			
2.	Labour			
2.1	Does the entity have a written policy for the process?			
2.2	Is the written policy sufficient and complete in all aspects?			
2.3	Is the policy updated on a frequent basis?			
2.4	Is there a proper requisition note as regards the skills and educational qualification required for the concerned department?			

S. No.	Particulars	Yes	No	N/A
2.5	Has the same been approved by the appropriate level of authority?			
2.6	Does the entity raise an approved request for quotation across various service providers?			
2.7	Are there significant delays in raising the request for quotations?			
2.8	Are there sufficient attendance records, in-time and out-time records, and other records maintained?			
2.9	Does the attendance record match with the order placed for labour?			
2.10	Does the entity comply with various regulations with relation to procurement of labour?			
2.11	Are there sufficient controls to ensure that the service is provided without delays?			
2.12	Once the service is provided, has it been approved by the appropriate level of authority?			
2.12	Are proper and appropriate entries made in the books of accounts?			
3.	Service Contracts and Sub-contracts			
3.1	Does the entity have a written policy for the process?			
3.2	Is the written policy sufficient and complete in all aspects?			
3.3	Is the policy updated on a frequent basis?			
3.4	Is there a proper requisition note with approval from the appropriate level of authority sent from the concerned department?			
3.5	Is there a valid, proper contract with the service provider/ contractor?			
3.6	Does the entity raise an approved request for quotation across various service providers?			

S. No.	Particulars	Yes	No	N/A
3.7	Are there significant delays in raising the request for quotations?			
3.8	On receipt of various quotations, are there sufficient processes to ensure that the right quotation is approved as regards quality, reliability, price and other factors?			
3.9	On selection of the service provider, has an approved Work order been placed with the Service Provider within reasonable time?			
3.10	Are there sufficient controls to ensure that the service is provided without delays?			
3.11	Once the service is provided, has it been approved by the appropriate level of authority?			
3.12	Are proper and appropriate entries made in the books of account?			

Material Handling and Storage

4.34 Material handling and storage is a vital part in case of a Service Concessionaire Operator. Handling and storing materials involves diverse operations such as, hoisting tons of steel with a crane; driving a truck loaded with concrete blocks; carrying bags or materials manually; and stacking palletized bricks or other materials such as drums, barrels, kegs, and lumber.

4.35 The efficient handling and storing of materials are vital to industry. In addition to raw materials, these operations provide a continuous flow of parts and assemblies through the workplace and ensure that materials are available when needed. Improper handling and storing of materials often result in costly injuries. It is extremely important to store materials in a proper manner to ensure that proper usage is possible.

Model Checklist Related to Material Handling and Storage

S. No.	Particulars	Yes	No	N/A
1.	Material Handling and Storage			
1.1	Does the entity have a proper location for storage of critical materials?			

S. No.	Particulars	Yes	No	N/A
1.2	Does the entity ensures utilisation of materials on First in First Out basis?			
1.3	Are there controls in the entity pertaining to ageing of materials to ensure that proper valuation of non-moving inventory is done?			
1.4	In cases of write-off of inventory are proper considerations given to excise duty implications?			
1.5	Are materials requested only in accordance with the requirements?			
1.6	In case of materials such as, cement, steel, iron, etc, proper storage facilities exist to prevent spoilage of material?			
1.7	In cases of availability of critical material/non–moving material in a location, is it transferred to another location to ensure proper and efficient utilisation of material?			
1.8	In cases of transfer from one location to another location are there sufficient controls to ensure accounting of transfer of material and at the right value?			

Fixed Assets

4.36 Fixed Assets in case of a Service Concessionaire entity may be of two types depending upon their function. The fixed assets used for construction or development of the Infrastructural Facility, or the other fixed assets used for providing the services to the public. The fixed assets used for construction of the Infrastructural Facility are generally, heavy construction equipment like roller, mixer, motor vehicles, quality testing equipment, earthmoving equipment etc. and the fixed assets used for provision of services are generally, computers, furniture and fixtures, and other specific equipments related to the service being provided.

4.37 In some of the cases wherein the entity does not get the ownership on the Infrastructural Facility even during the agreement period, it cannot show the Infrastructural facility as its Asset. In such case, the contractual right to collect the user fee should be capitalized in form of an intangible asset and the accounting procedure laid down by the ICAI in the "Guidance Note on Accounting for Service Concession Arrangements" should be followed.

Fixed Assets

For Construction of infrastructural facility

For provision of Services

4.38 There are three important processes related to the Fixed Assets:

(i) **Purchase and Maintenance**: Fixed assets are very important to enable the enterprise run its activity. Hence, it is very essential to organize the purchases of such fixed assets. With passage of time, the asset may require remodeling to suite the requirements of the entity. Periodic maintenance activities need to be performed to ensure proper working and life of the asset.

(ii) **Disposal:** Over a period of time, an asset depletes or becomes obsolete due to usage or improvement of technology. Assets needs to be disposed off/ scrapped and an alternative asset may be required to be procured.

(iii) **Transfer:** Transfer of asset is an internal arrangement unlike sale and purchase which are external. Transfer involves movement of the asset from one department to another, or from one site to another. It is basically movement of asset from one location to another involving a change in the charge of responsibility.

4.39 Internal auditor needs to check the following to evaluate the internal control systems with regard to fixed assets:

(a) Whether there is proper system of segregation of duties with regard to:

- Authorization of acquisition, disposal and transfer of fixed assets
- Execution of transactions relating to acquisitions and disposals
- Recording of transactions
- Physical custody of items.

(b) Review the entity's procedure to identify the asset requirement.

(c) Review the entity's procedure for deciding the asset procurement or hiring.

(d) Whether the particular capital expenditure is included in capital budgeting? If not, whether the necessary management approvals have been obtained for execution?

(e) Whether there is a well laid down procedure for acquisition of fixed assets with regard to invitation of quotations, selection of suppliers, negotiation of prices, payment terms, technical specifications and delivery schedule?

(f) Whether the necessary approvals from appropriate level of authority been obtained for transfer of fixed asset from one location to another?

(g) Whether the date of installation is rightly identified and recorded?

(h) Check the reasonability of identification of depreciation method with regard to useful life of the asset.

(i) Are there adequate controls over disposal of fixed assets with regard to:

- Decision of particular asset being retired from use or scrapped;
- Invitation of quotations, approval of prices;
- Proper documentation of fixed assets.

(j) Whether the fixed asset register is maintained and updated with regard to:

- Owned assets, leased assets and hired assets
- Fully written-off assets
- Disposable assets.

(k) Whether the physical verification of assets done at periodic intervals?

(l) Whether the proper coding of asset is done and each asset is identified with that code?

(m) Whether the fixed assets are adequately/properly insured?

(n) Procedures to ensure proper compliance with the following Accounting Standards issued by the ICAI:

- AS 6: Depreciation Accounting
- AS 10: Accounting for Fixed Assets
- AS 16: Borrowing Costs
- AS 26: Intangibles
- AS 28: Impairment of Assets

Model Checklist Related to Fixed Assets

S. No.	Particulars	Yes	No	N/A
Audit of Fixed Assets				
1.	Purchase of Fixed Assets			
1.1	Does the entity have a written policy for the procurement process?			
1.2	Is the written policy sufficient and complete in all aspects?			
1.3	Is the policy updated on a frequent basis?			
1.4	In case, the entity has an option to manufacture the asset, does it evaluate the make option and buy option?			
1.5	Is there a proper requisition note with approval from the appropriate level of authority sent from the concerned department?			
1.6	Does the entity raise an approved request for quotation (RFQ) within reasonable time across various suppliers?			
1.7	On receipt of various quotations, are there sufficient processes to ensure that the right quotation is approved as regards features, price, after sales service and other factors?			
1.8	On selection of the supplier, has an approved purchase order placed with the supplier within reasonable time?			
1.9	Are there sufficient controls to trace the purchase order and its status within the entity to ensure receipt of fixed assets without delay?			
1.10	Are there sufficient procedures to inspect and test the assets as regards to its condition and compliance with the specifications placed by the entity before approving the delivery note?			
1.11	Are there sufficient documentary controls such as gate pass for entry of assets			

S. No.	Particulars	Yes	No	N/A
1.12	In case of commissioning of assets, has a commissioning certificate obtained from the suppliers?			
1.13	Is the receipt of assets properly co-ordinated to the Finance department to ensure proper accounting?			
1.14	Are the assets tagged and coded in accordance with the firm's methodology?			
1.15	Has the delivery note been approved by the appropriate level of authority before making the entry?			
1.16	Has the fixed asset purchased been entered in the fixed asset register?			
2.	Maintenance of Fixed Assets			
2.1	Are there processes in the entity to ensure proper and periodic maintenance?			
2.2	Is it in accordance with the nature of the asset?			
2.3	Does the entity enter into Annual Maintenance Contracts (AMC) for its maintenance?			
2.4	Is there a record of the maintenance performed by the entity for all major assets?			
3.	Disposal of Fixed Assets			
3.1	Are there procedures in the entity to determine whether the asset can be disposed off?			
3.2	In case the asset is sold, is a disposal requirement note sent by the concerned department?			
3.3	Does the entity request for quotation before making the sale?			
3.4	Is there a proper valuation process of fixed assets before the price is finalised?			
3.5	Have appropriate approvals been obtained before disposal of fixed assets?			

S. No.	Particulars	Yes	No	N/A
3.6	Have the sale of assets properly co-ordinated to the Finance department to ensure proper accounting?			
3.7	Have the fixed asset register been updated for the sale?			
3.8	In case of scraping of the asset, has the maintenance department confirmed scrapping of the asset?			
3.9	Is there a separate log book maintained by the entity for the assets scrapped along with the location where the scrap is located and is it frequently updated?			
4.	Transfer of Fixed Assets (From Site to Site)			
4.1	Has there been an approved requisition note by the concerned department?			
4.2	Has there been an approved outward note for transfer of asset from its existing location issued?			
4.3	Has there been an approved inward note issued?			
4.4	Has the fixed asset register updated for the transfer on a timely basis?			
4.5	Does the entity have the policy of evaluating the availability of idle fixed assets at other project sites before hiring of equipment?			
4.6	Does the entity have a process of preparing a cost benefit analysis of such transfers before the decision to transfer is taken?			
4.7	Does the entity identify the assets of the sub-contractor separately?			
4.8	Does the entity verify its fixed assets on a frequent basis considering its size and level of operations?			
4.9	Does the entity deals with all the deviations noted on physical verification of assets appropriately?			

4.40 The internal auditor can perform various analytical procedures over a period of time and compare them for ascertaining any inconsistency such as following:

Total Fixed Cost

4.41 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.

Asset Utilization Ratio

4.42 Asset utilization ratio is the ratio of total revenue to the total assets. It helps the internal auditor to assess the effectiveness of assets with respect to the revenue made by the entity. In general, the higher the asset tilization ratio, the higher is the operating efficiency of the entity. If the internal auditor is required to perform fixed asset verification procedures too as a part of the scope of his work, the auditor can refer to Guidance Note on Audit of Fixed Assets.

Cash and Bank

4.43 Cash and Bank plays a vital role for any business entrepreneur. The management of this liquid asset speaks about the ethics of an entity. With all kinds of vigilant measures implemented to safeguard these current assets, yet loop holes, will be there. Bank transactions can be more regularized than cash transactions, as the risks involved in cash is comparatively high. In case of construction entities cash transactions are relatively huge with amounts of transactions ranging from petty to large. The different types of transactions that get covered here include:

- Receipts of user fees
- Payment to vendors and sub-contractors
- Fund transfers
- Payment of petty expenses, cash withdrawals and imprest payments

4.44 In some cases, there might be a requirement to carry enormous sums of money in cash for payment of wages to the workers, meeting expense for purchase of materials, and alike. Illustration of how the procedure is normally followed in relation with a construction entity is mentioned here under. In the course of formulating the procedures other areas to be covered are:

- Persons Involved for every procedure.

- Key roles and responsibilities of such persons.
- Delegation of authority.

IOUs

4.45 In case of entities operating in this industry, IOUs (I Owe You) are advances commonly issued for purchase of materials, as also advance for short travelling and alike. On receipt of the bill from the concerned person and the balance cash, the expense is accounted for. It is important for the internal auditor to verify the IOUs during the period of performance of his internal audit procedures and ensure proper control over IOUs exists in the entity.

4.46 Internal auditor needs to review the following important aspects:

(i) Review the effectiveness of entity's policy of delegation of authority over cash and bank receipts and payments.

(ii) Ensure whether the entity's policy is strictly implemented and violations, if any, have been brought to the attention of senior management and got ratified.

(iii) Review maintenance of documentation with regard to:

 (a) Cash receipts

 (b) Cash payments

 (c) Bank receipts

 (d) Bank payments.

(iv) Ensure that Bank reconciliation statements were prepared regularly and all items have been properly reconciled.

(v) Ensure compliance with The Stamp Act, 1899 for stamping of receipts in excess of the prescribed limit.

4.47 Internal auditor can perform various analytical procedures such as following:

- Average Cash Utilization *vs* Average Cash Maintained

  The internal auditor may ascertain the average cash utilization project-wise and the average cash level maintained. In cases where there are significant huge cash level maintained, the need for such high cash requirement should be justified by the management. The internal auditor should consider the impact of high cash level with respect to risks of holding cash and interest cost.

- Cash Insurance *vs* Cash Balance

  Internal auditor can assess whether there has been any shortfall in obtaining cash insurance at the respective projects by comparing the cash limit at the project as against the cash insurance obtained.

4.48 These ratios should be compared to the previous periods and explanations for any significant fluctuations needs to be obtained. Also, explanations for high cash levels need to be obtained.

Model Checklist Related to Cash and Bank

S. No.	Particulars	Yes	No	N/A
1.	Audit of Cash and Bank			
1.1	Is there a monthly verification of cash and the same is reconciled with books?			
1.2	Are there surprise checks performed by the management/ internal auditors to ensure that cash is updated on a frequent basis?			
1.3	Are bank reconciliation statements prepared for all accounts on a periodic basis?			
1.4	Does the entity maintain both bank book and bank statement used for preparation of bank reconciliation statements (BRS)?			
1.5	Has the BRS been verified by appropriate level of authority?			
2.	Cash Receipts			
2.1	Is there a written process for receipt of cash at the site and the head office?			
2.2	Are there procedures to ensure that the cash is received by the appropriate authority at the site/ head office?			
2.3	Are there significant delays between cash receipt voucher given and the accounting of the receipt?			
2.4	Are there proper procedures to transfer the cash to head office/deposit at bank at frequent intervals?			

S. No.	Particulars	Yes	No	N/A
3.	Petty Cash Payments			
3.1	Is there a written process for receipt of cash at the site and the head office?			
3.2	Has proper approval been obtained in accordance with the policy before making payments by the entity?			
3.3	Is there a significant time lag between accounting for the petty expenses in the books?			
3.4	Is the cash being verified and reconciled on a daily basis?			
4.	Carrying of Huge Cash			
4.1	Does the entity have a proper procedure as regards carrying huge cash?			
4.2	Has the entity obtained Fidelity insurance and Transit insurance to ensure safety to the entity in case of loss of cash on account of theft or on account of loss in transit?			
4.3	Does the entity have a process of job rotation for carrying huge cash?			
5.	Verification of IOUs.			
5.1	Does the entity have a policy for IOUs?			
5.2	Does the policy provide for the limit in monetary terms that each level of employees can avail the facility, Number of times the facility can be availed during a particular period and the purposes for which the facility can be availed?			
5.3	Does the policy cover the period in which the IOUs should be settled?			
5.4	Is the accounting of IOUs with regard to the entity's policy and procedures? Does the entity accounts for the IOUs on a periodic basis?			

Revenue Recognition

4.49 The major source of revenue for the concessionaire service provider is the user fee collected from the users of the Infrastructural Services. This fee is generally determined and governed by the Grantor and the Operator has right to collect the fee. Such revenue is collected at the Infrastructural Facility itself and small but numerous numbers of transactions take place in this regard. And hence use of technology is inevitable. The revenues are collected and entries are punched in the computer software on real time basis.

4.50 The revenue for such services should be recognized as and when the user fee is collected.

However, in some of the cases the Operator may issue Smart Cards or periodical passes to the users of the Infrastructural Facility. The revenue of such passes or smart card should be recognized only when the services are provided. Till than the same should be classified as a liability in the Books of Accounts. However, since there are numerous transactions involving very small amounts, the management may adopt an accounting policy of accounting such revenue also on receipt basis. Internal Auditor needs to check the appropriateness of the accounting policy from the materiality angle.

4.51 In some of the cases the Software used by the entity for recording of the user fee may be different from the accounting software, in that case the auditor needs to verify the revenue appearing in the Books of Accounts from the Software used by the entity for recording of the revenue. Also, the Internal Auditor needs to cross check the Bank deposits from the revenue collection figure as per the software.

4.52 One more major issue emerges before the Internal Auditor is of the Revenue Leakage. The Internal Auditor should go through the reports generated by the software and analyse the Revenue Leakage Ratio. The same should be compared with the Industry standards or the tolerable limit set by the management. Any negative deviations should be reported to the management.

4.53 In some cases the operator gets only a provisional permission of colleting user fee due to non fulfillment of certain conditions imposed in the Agreement or by the Grantor. In such case the final permission is subject to certain conditions and if the conditions are not fulfilled then the revenue collected during that time is to be paid to the Grantor. In such cases the Internal Auditor needs to verify whether proper provisioning has been done for the amount or not? Also, the Internal Auditor must report the revenue recovered by the Grantor to the Management.

4.54 Generally, the Grantor commits a specified level of ROI (Return on Investment) to the Operator on the project. And the ROI is based on various factors like inflation index, Rate of Taxes etc. whenever, there is a change in Law and thus the ROI is changed than the Operator has a right to claim the loss from the Grantor. Internal Auditor needs to check whether the claims made by the Operator are as per the terms of the agreement.

Payroll

4.55 Payroll process involves selection and appointment of personnel, computation of monthly salary and reimbursements, monthly disbursements of salary, monthly deductions, payments on settlement, computation of tax deducted at source on salaries, salary advance, etc. The process of payroll is similar to any other industry. 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.

4.56 Internal auditor shall review the following aspects of payroll process:

(i) Review the HR manual to check the HR policies with regard to following:

- (a) Joining bonus
- (b) Availability of leave
- (c) Leave encashment
- (d) Gratuity
- (e) Leave travel allowance
- (f) Availability of perquisites
- (g) Reimbursements
- (h) Salary advances

(ii) Employment agreement including non-disclosure agreement.

(iii) Whether proper documentation has been maintained for employee's personal information, joining information along with compensation details.

(iv) Whether the registrations with PF, ESI, professional tax and other statutory authorities have been done and properly renewed.

(v) Whether the reimbursements payments are made as per approved policy.

(vi) Whether recovery and remittance of PF, ESI and Profession Tax from employees is made regularly.

(vii) Check the calculation, collecting and remitting of income tax from employees, calculation of settlement claims, and perquisites and payments.

(viii) Whether the procedure adopted and documentation maintained for employees attendance and leave claims is adequate.

(ix) Ensure that the leave encashment and leave travel allowance payment is as per the approved policy.

(x) Check that the provision for gratuity is done correctly.

(xi) Check the computations and approvals for incentives for employees.

4.57 The internal auditor may also perform additional analytical procedures over a period of time and compare them for ascertaining any inconsistency such as following:

- Productive Hours Ratio

  Productive hours estimation is a measure of the efficiency of the workforce during a particular period. In other words, it is the ratio between hours an employee works effectively to the total hours he works. By analysing this ratio, the internal auditor can understand the motivation level of employees, steps taken by the management towards maintaining efficiency and to some extent the trend of attrition.

- Average Employee Cost per Head per Project

  Average cost incurred for an employee 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.

- 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 needs to obtain explanations for the reason for such high turnover ratio.

- **Total Employees to Outsourced Workers Ratio**

  The total employees to outsourced workers ratio help the internal auditor to assess the reliance on outsourced workers and contractors for the entity's operations. The risk of employing high level of contract workers too must be assessed.

- **Reconciliation with Respect to Changes in the Number of Employees due to Additions, Terminations, Retirements, etc., Between Various Months**

  The internal auditor can assess the movement in employees for a month in comparison with another through tracing the additions and deletions in month based on each grade and obtain an insight on the plans of the management.

Model Checklist Related to Payroll Process

S. No.	Particulars	Yes	No	N/A
1.	**Specific Areas of Payroll Processing**			
1.1	Does the entity have a payroll process as approved by appropriate level of authority?			
1.2	Is the payroll process complete in all aspects, as applicable to the entity?			
1.3	Is there sufficient attendance register maintained by the entity for all workers (both employees and contractors)?			
1.4	Have all statutorily prescribed registers maintained by the entity with regards to both employees and contractors?			
1.5	Does the entity maintain a check-list of statutory remittances to be made on account of PF, ESI, Labour Welfare Fund and alike?			
1.6	Are cheques prepared and signed by two different employees?			
1.7	If the entity opts for bank transfer, is there appropriate level of authority prescribed to issue a bank transfer instruction to the bank?			
1.8	Is the payroll processing cross checked before payment is made?			

S. No.	Particulars	Yes	No	N/A
1.9	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?			
1.10	Have the incentive schemes been verified by the internal auditor on a test basis?			
1.11	Have these controls been tested for effectiveness?			
1.12	Is the attrition rate exceedingly high? Have justifications for such a high rate, if any been obtained?			
1.13	Have the reasons and explanations for any failures and control weakness observed on review of these complaints?			
1.14	Does the entity comply with the accounting requirements for ESOP, ESPP schemes and maintains proper record of the shares opted by the employees?			
1.15	Does the entity have 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?			

Operating Costs

4.58 The significant operating costs for any entity operating in infrastructure sector include the following:

(i) Hiring Expenses

The hiring expense could be for hiring of carriers, equipments and accommodation. The entity relies on transport vehicles for moving equipment, material from one location to another. It also depends on hired accommodation at remote location for its workers and employees.

Certain specialized equipment might not be cost effective for the entity to acquire them. In such cases, the other option available to the management is to hire the equipment for the specific construction period. In general, hiring expenses are a significant part of the cost of the entity. The management should have appropriate policy with regards to hiring of equipment.

(ii) Repairs and Maintenance

Another major expense incurred by the entity is in the nature of repairs and maintenance. This is absolutely important to ensure proper functioning of machines. In general, repairs and maintenance can be (i) Preventive Maintenance – to ensure machines do not break down; or (ii) Breakdown Maintenance – where the machine breaks down and unless repairs are carried out it will not run.

(iii) Logistics

Considering the labour intensive nature of the infrastructure industry and remote location, 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 logistics service providers in order to limit their liability and manage them professionally. The entity must maintain sufficient controls for proper usage of vehicles.

The internal auditor needs to verify the systems, processes, controls; procedures built within the system so as enable smooth, proper and orderly movement of 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.

The internal auditor may also perform following additional analytical procedures over a period of time and compare them for ascertaining any inconsistency.

Model Internal Audit Procedures for Operating Expenses

S. No.	Particulars	Yes	No	N/A
1.	Repairs and Maintenance			
1.1	Does the entity have a procedure for maintenance of equipment?			
1.2	Is maintenance done on a frequent basis?			
1.3	Are there sufficient records maintained to ensure that maintenance has been performed by the entity?			

S. No.	Particulars	Yes	No	N/A
1.4	Does the entity enter into Annual Maintenance Contracts (AMC) for specialised equipment?			
1.5	Does the entity have a proper log/register to ensure that maintenance has been provided for all equipments?			
1.6	In case of unforeseen breakdown of equipment, have explanations for such breakdown obtained?			
1.7	In case of frequent repairs required for the equipment, has a cost trade-off analysis performed to verify whether it is better to purchase an asset against maintenance.			
2.	Hiring and Logistics			
2.1	Does the entity have approved policy for hiring of transport vehicles, carriers, accommodations and equipments?			
2.2	Does hiring expenses lead to cost savings?			
2.3	Has the entity analysed the benefits of hiring against purchase of equipments/vehicles?			
2.4	In cases where certain equipments are hired very frequently, is it better to purchase it than hiring it?			
2.5	Has the entity received quotations of prices from different vendors to ensure cost effectiveness and good services before deciding on the vendor?			
2.6	Are there sufficient procedures to transfer from one segment to another and are there proper controls for allocation of costs between these departments?			

Agreement with Collaborators

4.59 Two or more organisations may join hands for the execution of a project. Agreements regarding sharing of income and expenditure, profits, co-operation in execution of contract and similar other aspects form part of such collaboration agreements. An internal auditor needs to familiarize himself with the essential features of such agreements to ensure compliance of the clauses mentioned in the agreement.

In case of agreements with foreign collaborators, the significance considering its financial, technical and legal implications is more. Clauses such as royalties, scope of work, repatriation, drawings and designs, amongst others are extremely important to be complied with.

Model Internal Audit Procedures for Agreement with Collaborators

S. No.	Particulars	Yes	No	N/A
1.	Agreement with Collaborators			
1.1	Does the entity keep a track of all the major clauses that are to be complied with respect to the collaboration agreement?			
1.2	Does the entity performs reconciliation of funds remitted, taxes deducted apart from other procedures performed?			
1.3	Does the entity value all gifts in the nature of tools, machinery at a proper valuation, if they are useful?			

Disputed Claims

4.60 Claims in case of civil construction could be claims against the carriers for losses in transit, claims against the EPC contractor for non-fulfillment of contractual obligations by them, claims against suppliers, insurance companies, claim by users and customs authorities for any loss or destruction of materials, equipments and duty refunds, etc. Such claims may or may not be accounted for.

4.61 The internal audit procedures that the internal auditor performs with respect to disputed claims are given below.

Model Internal Audit Procedures for Disputed Claims

S. No.	Particulars	Yes	No	N/A
1.	Disputed Claims			
1.1	Does the entity have an approved policy for ascertaining losses giving rise to claims from contingent asset complete in all aspects?			
1.2	Are the claims properly lodged and registered?			
1.3	Does the entity have a proper method of valuation of claims and is it supported with the corroborative evidence?			
1.4	Have proper follow up action been taken for the realisation of overdue claims and have the claims that are irrecoverable been systematically written off?			

Measurement Sheets

4.62 Measurement sheet is a record maintained by the EPC contractor for the work performed by them based upon which the work is certified. In general, a copy of the measurement sheet is provided by the EPC contractor to the entity.

The internal auditor needs to ensure that the bill process is in line with the measurement sheet provided by the EPC Contractor.

Risks Faced by an Entity Operating in the Infrastructure Industry

4.63 The internal auditor should make a risk assessment of the entity under audit. This is extremely important in order to ensure prevention of any non-compliance or undesirable event.

4.64 The risks of the entity are different at different stages. The stages can be broadly divided into following:

- Project Definition
- Planning Stage
- Execution Stage

- Completion of the Project.
- Maintenance and collection of user fees.

4.65 The risks faced by an entity operating in the infrastructure industry can be broadly classified as following:

- Industry Risk – Growth and demand is dependent on general economic conditions and a deceleration can adversely affect the entity's business and its earnings.
- Strategy Risk – The risk that skewed business strategy may result in lost opportunities.
- Competition Risk – Increased Competition from domestic and international entities affects market share and profitability.
- Liquidity Risk – To a large extent the cash flow is dependent on the user fees collected by the entity. Leakage in the recovery of user fees has a direct impact on the liquidity position which will affect the operations and earning of the entity.
- Government Policy Risk – Uncertainties with government policies can significantly affect the operations of the entities operating in infrastructure industry.
- Assets and Inventory Risk – Risk of accidents, fire, theft, etc., to entity's properties and stocks will affect the entity's operations affecting profitability. Similarly the breakdowns to the entity's machinery will affect operations and profitability.
- Operational Risk - Risks in operating the entity such as, competence gaps, equipment breakdowns, health and safety risks, etc.
- Price Inflation Risk – It includes following types of risks:
    - Volatility in prices of inputs and/or changes in assumptions may cause cost overruns affecting the profitability.
    - Delay in completion of project could result in liquidated damages and / or additional costs affecting profitability.
- Systemic Risk – Risk of change in regulations and the legal environment where the entity operates.
- Brand/Reputational Risk – Non compliance of terms of the agreement / non-delivery of the project during the scheduled period of time might lead to loss of reputation.

- **Accessibility Risk, Business Continuity, Security Risks –** Risks of accessibility of other service providers, infringement of Intellectual property rights and continuity of business to ensure completion of contracts.

4.66 The internal auditor needs to assess risk at each stage to ensure sufficiency of controls and procedures in built within the entity. The internal auditor needs to verify whether sufficient controls are available in the entity to detect such risks and prevent its occurrence by inducing the management to take appropriate steps in the light of overall business environment.

Reduction of Risks

4.67 The entity may reduce its risks by obtaining a Certificate of Insurance (COI) which demonstrates that a contractor has obtained liability insurance, generally for a specific time period. The COI provides some measure of protection to the entity in the event that an accident or damage occurs as a result of actions by a contractor's employee.

4.68 The entity should have a formal written policy concerning the requirement of a COI, as well as a file of COIs for every contractor. The COIs should be obtained before the contractors are on site performing work and should be retained for a specified period of time after project completion. A sample of the COIs should be selected and reviewed for compliance with minimum coverage contained in the bid or contract documents.

4.69 Contractors can often be on the job site long after the insured period has expired or the certificate has become outdated, especially since delays and scope changes may extend the duration of the project. The management also needs to ensure that all areas are covered under Certificate of Insurance. Another way to reduce the risk of future legalities from EPC Contractor is through obtaining a "Release of Lien" at the time of making the final payment. This document protects the entity if an EPC contractor or materials supplier sues the primary contractor for non-payment.

4.70 The entity should have a defined policy concerning these releases. Many entities establish guidelines that involve contract amounts, and they further reduce the risk by obtaining partial releases. Internal auditor needs to verify that the final, executed release of lien is obtained at the time of making the final payment. In addition, the internal auditor should confirm that any amendments a contractor may have written on the release before signing it are appropriate, and that the guidelines established for partial release of lien are followed. The internal auditor may also refer to various Technical Guides on risk management issued by the ICAI.

Maintenance of Books of Accounts and Documents

4.71 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 whether the controls for allocation of costs between different projects, are adequate and reliable in the light of the business operations.

S. No.	Particulars	Yes	No	N/A
1.	Books of Accounts and Documents			
1.1	Does the entity have proper accounting system commensurate with the regulatory requirements?			
1.2	Does the entity have specific books of accounts for work performed in SEZ?			
1.3	Are the control systems in place for estimating the revenue generated location-wise sufficient to ensure that proper books are maintained for the location?			
1.4	Does the entity have proper and reasonable system to allocate various costs incurred to the respective SEZ undertaking and non-SEZ undertaking as applicable?			
1.5	Does the entity have location-wise employee details to ensure proper allocation of payroll cost to the location?			
1.6	Are the books of accounts closed every month?			
1.7	Are the controls for re-opening of books proper to ensure prevention of manipulation?			
1.8	Does the entity maintain a project-wise profitability statement for ensuring proper recording of revenue based on the state of completion of the project in accordance with its accounting policy or accounting standard?			
1.9	Are there controls in place to ensure that all costs have been allocated to all projects in an appropriate manner?			

Compliance with Standards and Regulations

4.72 As explained earlier regarding the various statutory requirements applicable to infrastructure industry, the internal auditor is required to verify the compliance to these statutes and report thereon as a part of his internal audit. Also, the internal auditor needs to verify registration with various statutory authorities and renewal of the same as a part of his audit procedures.

4.73 Apart from the above regulations, the entity may have obtained certifications under various international and Indian organisations for a process or for the entity as a whole. e.g.

4.74 ISO 9001 (International Organization for Standardization) certification for various operation processes of an entity, OSHO 2236 (*Occupational Safety and Health Administration),* an US Department of Labour standard for material handling and storing of material and safety measures for worker.

4.75 ISO 9001:2000 specifies requirements for a quality management system where an organization:

- Needs to demonstrate its ability to consistently provide product that meets customer and applicable regulatory requirements, and
- Aims to enhance customer satisfaction through the effective application of the system, including processes for continual improvement of the system and the assurance of conformity to customer and applicable regulatory requirements.

4.76 All requirements of this International Standard are generic and are intended to be applicable to all organizations, regardless of type, size and product provided. The requirements for the certification include the following:

- A set of procedures that cover all key processes in the business;
- Monitoring processes to ensure they are effective;
- Keeping adequate records;
- Checking output for defects, with appropriate and corrective action where necessary;
- Regularly reviewing individual processes and the quality system itself for effectiveness; and
- Facilitating continual improvement.

4.77 An organization that has been independently audited and certified to be in conformance with ISO 9001 may publicly state that it is "ISO 9001 certified" or "ISO 9001 registered". Certification to an ISO 9001 standard does not guarantee any quality of end products and services; rather, it certifies that formalized business processes are being applied.

Two types of auditing are required to become registered to the standard: auditing by an external certification body (external audit) and audits by internal staff trained for this process (internal audits). The aim is a continual process of review and assessment, to verify that the system is working as it's supposed to, find out where it can improve and to correct or prevent problems identified.

There are other factors such as, choosing a vendor by an entity who has obtained ISO Certification. It is preferred to choose a vendor who is also ISO certified. The internal auditor is required to verify the scope of performance of audit procedures so as to include compliance with these standards also. The internal auditor is required to perform such audit procedures so as to ensure compliance of these standards and effectiveness of the controls prescribed.